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REVIEW OF THE RUDMAN REPORT ON FANNIE MAE

HEARING

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

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TUESDAY, MARCH 14, 2006

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REVIEW OF THE RUDMAN REPORT ON FANNIE MAE

Tuesday, March 14, 2006

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The committee met, pursuant to notice, at 2:00 p.m., in room 2128, Rayburn House Building, Hon. Michael G. Oxley [chairman of the committee] presiding.

Present: Representatives Oxley, Baker, Castle, Royce, Kelly, Feeney, Hensarling, Garrett, Pearce, Neugebauer, Price, McHenry, Campbell, Frank, Kanjorski, Waters, Maloney, Watt, Sherman, Moore of Kansas, Baca, Matheson, Davis of Alabama, and Cleaver.

The CHAIRMAN. In early 2003, we were led to believe that the GSE's were running smoothly with only a routine accounting restatement in progress at Freddie Mac. What we have learned since then is that Freddie Mac and Fannie Mae were involved in large scale misapplication of accounting standards and irresponsible corporate governance. OFHEO, Congress, and the American people were misled by the former leadership of these enterprises. The Federal Home Loan Bank system has had its own share of accounting and management problems.

In 2004, Fannie Mae's board turned for help to Senator Warren Rudman who, with his team of legal and accounting experts, has given us a report of both great quantity and quality. He has verified much of what OFHEO eventually uncovered, and the SEC subsequently confirmed, providing an in-depth understanding of the intent and motive behind the transactions reviewed.

This voluminous report details widespread departures by senior management from GAAP accounting, largely to minimize earnings volatility and meet forecasts and, in 1998, to trigger maximum executive bonuses. Accounting systems were grossly inadequate and employees were unqualified.

Senator Rudman found that management, "paid lip service to a culture of openness, intellectual honesty and transparency and discouraged dissenting views, criticism and bad news." Arrogance is a descriptive term used more than once. There was clear disdain for OFHEO.

Fannie Mae claimed to be in line with state-of-the-art corporate governance when in reality such standards were not being practiced. Failure to comply with Sarbanes-Oxley requirements of internal control over financial reporting is not an insignificant matter.

This report is costing between $60- and $70 million on top of the $500 million Fannie Mae spent last year on its financial restate-

ment work, a job that is far from done. Fannie Mae must also pay the legal expenses of its former Chairman/CEO and CFO.

The encouraging news, according to the Rudman report, is that Fannie Mae has undergone an extensive transformation in personnel and structure. There has been a dramatic shift in the "tone at the top." The company has not waited until issuance of this report to begin making necessary changes.

I welcome the effort that Chairman Steve Ashley and CEO Dan Mudd are making in this regard. What Senator Rudman and others have shown us occurred at the GSE's over several years. While those responsible have left, it's taking the GSE's years to make corrections. We look forward to OFHEO's final report on their special exam of Fannie Mae. We must learn from this experience.

The Rudman report underscores that it's time for a new combined regulator for the GSE's, with the tools and funding needed to prevent abuses from developing and permit swift enforcement action if they do. H.R. 1461 provides strong bank regulatory-like powers in the vital areas of capital, portfolios, product approval, and receivership commensurate with the task of overseeing these large and complicated companies. H.R. 1461 passed the House overwhelmingly last October. I urge the Senate to act so that Congress can pass overdue GSE regulatory reform this year.

Senator Rudman, we appreciate your work on this report and your appearance here today. I will be giving you a more formal introduction after the opening statements.

I now yield to our friend from Massachusetts, the Ranking Member, Mr. Frank.

Mr. FRANK. Thank you, Mr. Chairman. As a Member of the House who worked very closely with Senator Rudman, when he was in the Senate, on a wide range of issues from legal services to many others, I was very pleased when the Fannie Mae board had the good sense to engage him and give him carte blanche.

And I would just say that those of us know him, and that's pretty widespread in Washington, have such confidence in his integrity that we benefit from having a report that's not being challenged. The merits of the issues can be discussed and we are very appreciative for that.

I think we should make very clear what we are talking about here and that is a betrayal by some of those at Fannie Mae of their mission. And I think it's important to make a distinction. High ranking individuals at Fannie Mae betrayed the trust. I am hopeful that appropriate action will be taken based on this report and elsewhere for recouping money and for other efforts.

It is important, however, that we not let the housing mission of this entity suffer. This is a case where individuals misbehaved, some actively, some by not doing their jobs. But this is not something that ought to be used to undo the housing mission.

In fact, I join the chairman in his call for the Senate to act on legislation. And I want to address one particular error that I keep reading about, frankly, in some of the press, and that is the assertion that the bill that came out of the Senate Committee is, in its regulatory structure, tougher in some ways and more comprehensive than the House bill.

There is a difference between the bills with regard to an affordable housing fund. We have one, they don't. There's a difference between the bills concerning mandating a portfolio reduction. But in those parts of the two bills which deal with the regulatory structure, which replace OFHEO with a better armed, better equipped, better funded, and more comprehensive regulator, there is no difference.

And some of what happens here is a double counting. We read stories that say, well, the Senate bill is tougher because it calls for the portfolio reduction and it's got a tougher regulatory scheme. No, that's only half true. It does call for the portfolio reduction but we should be very clear that, with regard to the regulatory structure, we have a very tough bill, one that indeed included everything that I was told people thought ought to be in there.

I would commend to people the excellent letter from the chairman of the subcommittee who has been a longtime critic of the organization and whose criticisms of some of the leadership people has been vindicated by this report and other events. The letter he wrote to The Wall Street Journal—on today's Wall Street Journal, and it makes it very clear that the regulatory structure is a good one.

Which leads me now to join in the chairman's plea. To the extent that we have had problems in the past, as this report shows here and to some extent, Freddie Mac, the best way to prevent the recurrence is to act on legislation.

The two bills, the House bill and the Senate Committee bill, since the Senate hasn't voted on it, are essentially the same with regard to enhancing the regulatory structure and those who would kill the bill this year because of their opposition to the affordable housing fund and because they have, I think, an ideologically based view that says we shouldn't be giving housing an advantage in the capital allocation function and we ought to mandate a portfolio reduction, if they kill this bill they will leave in place a regulatory structure that hasn't been adequate, not because of failings of the individuals.

Everybody agrees that the problem has been the way it was structured. So that's what's at issue here. Will the Congress act on what would appear to be an agreement to enhance the regulatory structure or will ideological differences over Fannie Mae and insistence on cutting back on its housing goal lead to the demise of the bill, in which case we'll be left with this inadequate situation.

Last thing I want to say, there were two other issues here that deal with general corporate governance. Once again—and Fannie Mae certainly is not unique in this, nor Freddie Mac—incentive pay for the top executives, the CEO and the CFO, seems to me bad for two reasons.

First of all, I have to ask them a question. If they're making several million dollars a year, why in the world do we have to bribe them to do their jobs? None of us here get bonuses for doing our jobs. Giving top executives of major corporations extra money for doing their jobs makes no sense. These are very highly compensated people to start with and they shouldn't have to be bribed to do the job right.

It's especially a problem when, because of the inherent ambiguities of some of these issues, these bonuses, based on hitting targets, become incentives to play games with the accounting. So this whole question of executive compensation demands attention.

And finally, I am once again persuaded, as I read about the nonrole of the board of directors, that in too many American corporations the board of directors play the role that Murray Kempton, the great journalist, once ascribed to editorial writers, namely that they come down from the hills after the battle is over and shoot the wounded.

There does not appear to be here, as there was not in many other cases, any reasonable assertion of authority by boards of directors. If I had been on the board of directors when this was happening, I would be examining very closely my failures to step in. Now, the board did step in later on. They did shoot the wounded and they hired Rudman to come and cart them away, and that was a good decision. But both with regard to the abuses inherent in incentive pay for top executives and the passivity of the board of directors, there are lessons here not just about Fannie Mae, but about corporate America.

The CHAIRMAN. The gentleman's time has expired. The gentleman from Louisiana, Chairman of the Capital Markets Subcommittee.

Mr. BAKER. Mr. Chairman, I thank you for calling this hearing and your longstanding good work. I'm glad we have arrived at this point today. I certainly want to express my appreciation to the Senator and his colleagues for their longsuffering, detailed good work and I think it has been helpful in attempting to bring closure to a difficult chapter in American business history.

I think it is also important to recognize that, among the 2,600 pages of documents, it's easy to get side-tracked into minutiae and detail and arguing about when this or that occurred and forget for the moment that the larger obligation is to ensure that the American taxpayer is not held accountable for the missteps of the administration of a GSE or two.

If someone had 5 or 6 years ago predicted that both Freddie Mac and Fannie Mae would have large-scale dislocations of executives as the result of accounting missteps, no one would have thought it possible. In fact, the rating agencies, prior to and during the course of these discoveries, all claimed that both enterprises were at the highest pinnacle of their corporate governance activities. Indeed, this is a disappointing chapter to now conclude that all was not what it appeared.

As we go forward, it's my intention at the appropriate time to ask more detailed questions about the events of late 1998 and early 1999 and who was engaged in making important decisions but for the moment I'm merely pleased to be part of this hearing, Mr. Chairman, and I appreciate your good work.

I look forward to hearing the testimony of the witnesses we have today and know that, working together, we can get through this year possibly with the adoption of a new regulatory structure in place which gives not only the necessary professional skills but the financial resources to the regulator to be confident and to make as-

sessments and judgments about the professional conduct of these enterprises.

It is the only way, in my opinion, that we can assure taxpayers and homeowners that they will continue to be well-served by these enterprises.

I yield back, Mr. Chairman.

The CHAIRMAN. The gentleman yields back. The gentleman from Pennsylvania, Mr. Kanjorski.

Mr. KANJORSKI. Mr. Chairman, we meet this afternoon to review the recently-released report prepared by former Senator Warren Rudman at the request of the special review committee established by the Fannie Mae board of directors. This report examines the company's problems related to accounting standards, internal auditing controls and corporate governance, among other things.

As I have regularly noted at our past hearings in this area, it is important for our panel to conduct comprehensive and regular oversight over our housing government-sponsored enterprises to ensure that they fulfill their missions and operate safely and soundly. Today's hearing is, therefore, not only timely but also appropriate.

In compiling this report, Senator Rudman and his team of investigators left no stone unturned. As I understand, these experts reviewed more than 4 million pages of documents over a period of 17 months. They also conducted in excess of 240 interviews. As we begin today, I want to thank Senator Rudman and his team. I greatly appreciate their diligence in these important matters.

Their comprehensive report has helped me to understand what went wrong with Fannie Mae. In one of its most significant conclusions, this report identifies no new major accounting violations not already disclosed by Fannie Mae and the Office of Federal Housing Enterprise Oversight. In addition, while the report details many of the major corrective actions that Fannie Mae has taken to address these matters, it makes no significant recommendations about further actions needed to address the firm's past shortcomings.

Importantly, the report also observes that Fannie Mae has "undergone an extensive transformation both in personnel and structure" during the last year-and-a-half. It further finds that no member of the current management team knowingly participated in improper conduct.

While this report provides some assurances to Congress, the American public, and investors that Fannie Mae is turning the corner by directly and forthrightly addressing its accounting, auditing, and governance problems, we still must complete legislative action to improve the oversight of all government-sponsored enterprises. It is in the public's interest that we address these regulatory issues promptly and properly.

As I said in March 2000 at our very first meeting in this long series of hearings 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 independent regulation for Fannie Mae and Freddie Mac. Such regulation will protect the continued viability of our capital markets and promote confidence in Fannie Mae and Freddie Mac.

By and large, the bill that passed the House last fall by a vote of 330 to 91 would accomplish these objectives. Before the 109th Congress completes its work, I hope that our colleagues in the Senate will consider their bill and that we can finally reach a resolution on these matters.

Before yielding back the remainder of my time, I would be remiss if I did not note that, while Fannie Mae has cleared one hurdle with the release of the Rudman report in its ongoing efforts to restore accountability within the firm, other investigations by the Office of Federal Housing Enterprise Oversight, the Securities and Exchange Commission, the Public Company Accounting Oversight Board, and the Justice Department remain ongoing.

The determinations of these experts will likely play an important role in influencing how we will ultimately proceed on any legislation during the remainder of the 109th Congress. If and when these entities complete their examinations, I also suspect that we will meet again to study their conclusions. In other words, and to paraphrase the work of Robert Frost, we have promises to keep, and may have miles to go before we sleep.

In closing, Mr. Chairman, I commend you on your continued perseverance on these matters and I look forward to hearing from our distinguished witnesses.

The CHAIRMAN. The gentleman's time has expired. We now turn to our distinguished witness. Senator Rudman, welcome.

Senator Rudman is a partner in the law firm of Paul, Weiss, Rifkind, Wharton & Garrison here in Washington, and served two terms in the United States Senate representing the great State of New Hampshire. Prior to being elected to the Senate, he served 6 years as attorney general of that State. In recent years, Senator Rudman has been appointed to chair the Foreign Intelligence Advisory Board and the U.S. Committee on National Security 21st Century.

Senator Rudman, again, welcome to the committee and congratulations on a comprehensive report. We appreciate your willingness to come before the committee and testify. I know you brought your expert team with you and I'll let you introduce them.

STATEMENT OF WARREN B. RUDMAN, PARTNER, PAUL, WEISS, RIFKIND, WHARTON & GARRISON, LLP; ACCOMPANIED BY DANIEL J. KRAMER, ROBERT P. PARKER, AND ALEX YOUNG K. OH, PARTNERS; GEORGE MASSARO, VICE CHAIRMAN, HURON CONSULTING GROUP; AND JEFF ELLIS, MANAGING DIRECTOR, HURON CONSULTING GROUP

Sen. RUDMAN. Chairman Oxley, Congressman Frank, and members of the committee, first let me thank you for your gracious comments on the work that we've done.

On behalf of this entire Paul, Weiss and Huron team that was involved in our engagement on behalf of the Special Review Committee of the Fannie Mae Board of Directors, we want to thank you for inviting us to participate in this hearing and sharing our results with you.

Let me introduce you to the members of the team. We have Dan Kramer, Bob Parker, and Alex Oh from Paul, Weiss and George Massaro and Jeff Ellis from Huron. They are here because, as you

will see as we develop your questions, we organized this into a series of discrete investigations. There were so many complex issues involved, so each of these people ran a number of teams, I coordinated the entire effort, and so as you ask your questions, I may well turn to some of them to be able to give you the full texture of the answers that you're looking for, such as the one that Congressman Baker has indicated that he would ask later on.

It's unusual for attorneys to come before a Congressional committee to speak about a professional representation. In this instance, Fannie Mae's board of directors, through its Special Review Committee, instructed us at the outset of our engagement to be open and transparent to governmental authorities.

Since October 2004, we have provided weekly or bi-weekly briefings to the government agencies that have an interest in this matter, including OFHEO, the SEC, the United States Attorney's Office for the District of Columbia and, of course, the Public Company Accounting Oversight Board.

Under the instruction of the Special Review Committee and the board, the company has made the final report of this investigation public. In that spirit, we were encouraged by our client to accept your invitation to appear here today and assist the committee in any way that we can.

I will divide my opening statement into four parts. First, I will describe our engagement on behalf of the Special Review Committee of Fannie Mae's board, including the nature and the scope of this investigation. Second, I will describe our key findings, with some emphasis on the two most important accounting issues we considered: Fannie Mae's implementation of FAS 91 and FAS 133.

Third, I will summarize our findings regarding Fannie Mae's corporate governance and internal controls with regard both to our findings concerning the company's historical practices and to the significant changes that are underway at Fannie Mae today. I will conclude my statement with brief remarks on what our investigation did not cover.

Our engagement on behalf of the Special Review Committee began in September of 2004. At that time, OFHEO was in the midst of a Special Examination of Fannie Mae's accounting that began in the wake of the problems revealed at Freddie Mac in 2003.

In mid-September 2004, OFHEO issued a report of its findings to date that was critical of Fannie Mae's accounting, principally in two areas: the accounting for premium and discounts on the company's mortgage loan and mortgage-backed securities and the accounting for the derivatives Fannie Mae used to hedge the interest rate risk associated with its debt. The report also raised concerns about Fannie Mae's systems and practices in the accounting standards, financial reporting, and internal control areas.

Soon after OFHEO released its report, OFHEO and Fannie Mae's board of directors entered into an agreement. Certain aspects of that agreement were unusual and also vital to an understanding of this report. In the agreement, the board agreed to undertake an internal investigation of the matters raised in the OFHEO report. The board also agreed to study and address the organizational,

structural, internal controls, and governance issues that OFHEO had identified.

In other words, the board undertook a dual track approach in which it tasked Paul, Weiss and Huron to conduct an internal investigation to determine what happened and, at the same time, the board commissioned an analysis of what remedial measures should be made promptly to address OFHEO's criticisms.

As a consequence of this dual track process, the recommendations that we would have made regarding Fannie Mae's governance, internal controls, internal organization and the like either have been implemented already or are well underway.

The agreement between OFHEO and the board provided the focus of our investigation but did not limit the scope of this inquiry. From the outset, Fannie Mae's board and OFHEO encouraged us to conduct a broad review of the company's accounting, financial reporting, governance, and internal controls policies and systems, and to follow the facts wherever they might lead.

In February of 2005, OFHEO identified additional accounting and internal control issues at Fannie Mae and those issues were added to the scope of this investigation. Finally, the company identified new issues in a November 2005 Form 12b-25 filing with the SEC, and we considered those matters as well. The board placed no restrictions on our work and we received complete cooperation from the board and from the company's current management.

Early in our engagement, Paul, Weiss retained Huron Consulting Group, with the approval of OFHEO, as our forensic accounting experts. The accounting judgments in our report are Huron's and we concur in those judgments. We appreciate and admire Huron's important contributions to this investigation.

The investigation took about 16 months. Our team, including Huron, reviewed over 4 million pages of documents and conducted over 240 interviews of 148 Fannie Mae employees or former employees. Unfortunately, Fannie Mae's former chief financial officer, J. Timothy Howard, refused to cooperate in our investigation.

We interviewed the company's former controller, Leanne Spencer, on several occasions, but she declined to cooperate further after the company found that she had not produced certain documents from her files that were relevant to our investigation.

Our key findings:

Our report to the Special Review Committee is 616 pages long, and our executive summary, 31 pages. The three-volume appendix, which includes samples of documents that we discuss in our report, as well as submissions made by various executives, including Mr. Raines and Mr. Howard, add about 2,000 additional pages. In my view, anyone who wants a complete picture of our findings and analysis must review all of these documents carefully. With that caveat in mind, however, I believe that our principal findings can be summarized as follows.

One. The accounting, financial reporting, and internal audit operations of the second largest financial services company in the country were inadequate both qualitatively and quantitatively. The resources dedicated to these functions were insufficient. Senior managers in critical accounting, financial reporting, and internal

audit roles either were unqualified for their positions, did not understand their roles, or failed to carry out their roles properly.

Two. Management's interpretation of FAS 133, dealing with hedge accounting, departed from generally accepted accounting principles in a number of important respects. These departures from GAAP were not mere innocuous practical interpretations or modest deviations from a strict reading of the standard. In our view, the company's hedge accounting conflicted with clear and specific provisions of the authoritative accounting literature.

Moreover, the record shows that the company's implementation of FAS 133 was motivated by a desire to remove volatility from reported earnings while avoiding both the substantial changes to the company's business methods and the development of the complex accounting systems that otherwise would have been necessary to implement that standard properly.

Finally, and most importantly, we found that the company's significant hedge accounting practices were known to, and accepted by, the company's outside auditor.

Three. Management's application of FAS 91, which concerns the accounting for premium and discounts on mortgages and mortgage-backed securities, also violated GAAP. Our most significant finding in this area concerned the circumstances surrounding the company's decision to record $240 million of premium/discount amortization expense in 1998 when the company's calculations showed that the expense was actually $439 million.

We believe that there was no justification or rationale to support the recognition of only $240 million. Moreover, given other accounting entries and adjustments that the company made during this period, the evidence overall supports the conclusion that the company's accounting decisions at that time were motivated by a desire to meet earnings-per-share targets and to achieve maximum bonus awards under Fannie Mae's Annual Incentive Plan.

Once again, it is important to note that Fannie Mae's outside auditors were aware of these adjustments, although not necessarily of their motivation.

Four. In our report, we address 16 separate accounting issues. In virtually every instance we examined, Fannie Mae's accounting was inconsistent with GAAP. As we summarize in the executive summary of our report, management often justified departures from GAAP based on materiality assessments that were not comprehensive, on the need to accommodate systems inadequacies, on the unique nature of Fannie Mae's business or on "substance over form" arguments.

We found substantial evidence in a number of specific instances and overall that the company's accounting and financial reporting policies and procedures were motivated by a desire to show stable earnings growth, achieve forecasted earnings, and avoid income statement volatility.

However, with the exception of the one instance in 1998 that I referred to earlier, we believe that the evidence does not support the conclusion that these departures from GAAP were motivated by management's desire to maximize bonuses in a given period other than the one that I have spoken of.

Five. As an organizational matter, too much authority at Fannie Mae was concentrated in the former CFO. He had responsibility for management of the company's portfolio, for its treasury operations, its accounting and financial reporting functions. The CFO also functioned as the company's chief risk officer and had administrative responsibility for the internal audit function as well.

The CFO and other senior managers operated within silos that had little interaction with each other and which therefore lacked a complete appreciation and understanding of the others' roles and functions. In these circumstances, the checks and balances that would ordinarily exist in an organization of Fannie Mae's size and complexity were largely non-existent.

Six. Although Fannie Mae's top management professed a desire to hear the view of subordinates and to value intellectual honesty, openness, and transparency, the culture at Fannie Mae discouraged criticism, dissenting views, and bad news. This applied to the areas of accounting and financial reporting, among others.

One area in which senior management in the financial area was particularly sensitive was in achieving forecasted results. Even minor differences between forecasted and actual results appear to have caused great concern.

Seven. Management tightly controlled the flow of information to the company's board. In many instances, the information the board received in critical areas involving accounting, financial reporting, and internal controls was incomplete or misleading.

In particular, we noted many instances in which management assured the board, often in the presence of its outside auditor, that the company's critical accounting policies were consistent with GAAP. Management also assured the board that the company's accounting and financial reporting systems were adequate and that the accounting and financial reporting functions had adequate resources, even when senior managers, according to testimony, were aware that such was not the case.

Eight. The board relied heavily on senior management as well as the views of the company's outside auditor. Until OFHEO began its Special Exam in 2003, and even in the wake of earlier announcements of substantial accounting problems at Freddie Mac, the board received assurances that Fannie Mae's accounting was proper.

Moreover, through 2002, OFHEO's own reports to Congress on Fannie Mae gave the company high ratings, including high marks in such areas as corporate governance and the company's implementation of FAS 133.

Corporate Governance and Internal Controls.

As I noted earlier, our investigation was part of a dual track process in which Fannie Mae's board and management undertook significant reforms of the company's governance, organization, and internal controls while our work was underway.

We participated in these efforts at the board's direction by sharing information, commenting on various proposals and making suggestions. In our report, we made findings regarding the company's most significant governance, accounting, and internal control functions as they existed prior to 2004, and we also noted the significant changes that have taken place in each of these areas.

I will briefly summarize our findings.

Number one, the board. Fannie Mae's board of directors endeavored to operate in a manner consistent with its fiduciary obligations and evolving corporate governance standards. The board was open to examination by third parties, including OFHEO, and it generally received high marks.

The board, and particularly the audit committee, was sensitive to matters relating to accounting and financial reporting. The audit committee received regular assurances that the company's accounting complied with relevant accounting standards. And I would parenthetically say that a reference to the full report will give you a full texture of some of the events that took place.

The board has taken several significant steps since the release of the OFHEO report in September of 2004, including the separation of the chairman and the CEO positions, the establishment of a Risk Policy and Capital Committee to oversee financial and operational risk management, and the transformation of its Compliance Committee into a permanent committee with broad oversight in regulatory and compliance matters.

Office of the Chair. Fannie Mae's Office of the Chair, comprising the four most senior officers in a given time, suffered from functional and organizational problems. As noted above, a great deal of the authority and responsibilities for the company's risk management, financial reporting, accounting, and internal control functions, as well as a substantial portion of the company's business operations, was concentrated in the CFO. Senior management also exhibited and cultivated a culture of arrogance both internally and externally and perhaps, most of all, towards its regulator, OFHEO.

There have been substantial changes in the past year at the senior management levels. Structurally, the Office of the Chair no longer exists. In particular, the functions previously overseen by the CFO are now divided among a number of different officers, including the chief financial officer, whose duties are more consistent with a CFO's typical functions, a chief risk officer and a chief audit officer.

We have received numerous reports from inside and outside the company that its attitude has changed materially towards a more open and cooperative approach to its regulators, to the Congress, and to the companies with which Fannie Mae deals.

Office of Internal Audit or Auditing. We found that, prior to September 2004, the head of Internal Audit at Fannie Mae lacked the requisite expertise and experience to lead the internal audit operation at a company as large and as complex as Fannie Mae.

Moreover, on more than one occasion, the head of internal audit took steps that suggested he did not fully appreciate his organization's role within the company or his proper relationship with senior management. I would note parenthetically, the advent of Section 404 of Sarbanes-Oxley, which imposed a whole new layer of requirements on Internal Audit.

In addition, the internal audit group at Fannie Mae lacked adequate resources, particularly in recent years as the company grew in size and complexity and as the demands placed on internal auditors increased commensurately.

The company has a new chief audit officer who reports to the audit committee, with a separate reporting line to the new CEO only for administrative purposes. The internal audit function has been separated from risk management, which is to be overseen by a chief risk officer, and the structure and resources of the internal audit group have been enhanced significantly.

Office of the Controller. Prior to September of 2004, the controller's office at Fannie Mae suffered from some of the same weaknesses as the internal audit function. Leadership at the top lacked the accounting and financial reporting expertise and experience one would have expected at a company like Fannie Mae, and the office as a whole lacked the resources necessary to handle many of the complex accounting and reporting issues that the company faced, particularly in recent years.

The company's systems in these areas were grossly inadequate. As I noted earlier in my remarks, the company historically has justified deviations from GAAP on the ground that it did not have the systems necessary for strict compliance.

There have been significant changes in recent months. There is new leadership in the accounting and financial reporting areas, including individuals with substantial experience in public accounting or at large financial institutions.

Certain functions, such as accounting policy and business forecasting, have been moved outside of the controller's office. We understand that the company is increasing the resources dedicated to these areas, including both staffing resources and systems development resources.

Ethics and Compliance. Fannie Mae's compliance organization dates back at least 10 years. It has maintained a Code of Business Conduct and has supported an internal investigative unit, called the Office of Corporate Justice, to address employee complaints.

In 2003, the company established an Office of Corporate Compliance to develop and monitor compliance plans for the company's business units and provide training to employees. Our principal concern in this area was that the company's chief compliance officer, a deputy general counsel, reported directly to the general counsel and worked on matters involving employee claims against the company.

The compliance program thus suffered from at least the appearance of a conflict of interest. In addition, we believe that the program overall would have been better served by a chief compliance officer who had no other assigned duties.

In 2005, Fannie Mae established an Office of Compliance, Ethics and Investigations, OCEI, to oversee the preexisting ethics and compliance functions as well as a new ethics unit. The new chief compliance officer who heads OCEI has a direct reporting line to the CEO and to the compliance committee of the board.

Finally, I would like to conclude my statement with two observations on what our investigation did not cover.

I know this committee and your counterpart in the Senate, as well as the Administration, are concerned about the size and composition of the Fannie Mae portfolio. This issue, which of course relates ultimately to safety and soundness matters, was well beyond the scope of our inquiry. Those who wish to draw conclusions as to

that issue from the contents of our report are obviously free to do so, but that policy issue is well beyond the scope of our assignment. We have drawn no conclusions on that issue, nor do we have the expertise to address that issue.

Moreover, as you well know, in the report and its appendices, we have laid out the facts that this 16-month investigation has produced. Where appropriate, we have been critical of Fannie Mae and we have assigned general and specific accountability where we believe that was warranted. The question of liability and culpability for the conduct we described is a matter for various government departments and agencies to decide, as well as eventually the courts. It would have been decidedly inappropriate for us to reach conclusions in those areas.

Finally, Mr. Chairman, as you develop your questions, to the extent that there are documents that your committee is interested in that appear in the footnotes but are not in our current appendices, we will be happy to make those available for the record when requested.

Thank you very much, Mr. Chairman.

[The prepared statement of Senator Rudman can be found on page 54 of the appendix.]

The CHAIRMAN. Thank you, Senator Rudman. We're looking forward to a good series of inquiries from the committee. Let me begin.

I have somewhat of a personal interest in Sarbanes-Oxley and I want to raise a couple of issues with you. Of course, Fannie Mae is a publicly traded company, subject to the requirements of the Act. In October 2004, I asked former Chairman & CEO, Frank Raines, whether, in his view, any of the law's provisions or subsequent regulations had been violated or ignored, and he answered no.

He talked about, "an entire process around certification so that we know exactly at the highest levels of the company what decisions were being made and by whom." He went on to add that, "as a result of Sarbanes-Oxley, I have made a campaign in our company to go around and tell people, 'if you think there is something wrong, raise your hand. Raise your hand and it will be looked at'."

What did you find in terms of application by Fannie Mae of the Sarbanes-Oxley Act? Was the corporate environment conducive to its application and what role did Mr. Raines and former CFO Howard play in that regard?

Sen. RUDMAN. Let me say that Mr. Raines may have believed what he said. I have no way of knowing his state of knowledge. I can tell you—I'm going to ask Mr. Massaro and Mr. Ellis to comment—but I would tell you from my own experience and observations, both in practice and otherwise, that the implementation of Sarbanes-Oxley, Section 404, and all of the internal audit issues that raises, which lead ultimately to certification by CEO's and CFO's was grossly inadequate as were the systems.

So that would be my simple answer. And if George or Jeff would like to fill in on that, they are experts on Sarbanes-Oxley. They're actually our experts today on Sarbanes-Oxley.

Mr. ELLIS. In terms of internal control environment, I think the report speaks for itself. The control environment was extremely

weak. The application of accounting principles, we detected a number of items that is ongoing today. So I think that whatever the tone was set, it wasn't sufficient to implement the change that would have been expected.

The CHAIRMAN. In your testimony, Senator Rudman, you talked about the communication or lack thereof between the executives and the board. It does appear a lot of that was kind of a one-way street, that the board lacked sufficient quality information in their decision-making process.

Was that because of this culture of arrogance or did it go beyond that?

Sen. RUDMAN. This was a company that, in my view—and we say so in this report—was not terribly transparent outside of the tightly controlled area of the top executives of this company. We have example after example of the board not being given information that it should have been given, particularly—and I'm sure this will come out in questions that are posed here, particularly from what Mr. Baker said in his opening statement—as it relates to the 1998 and 1999 issues and what the board was told and what they were not told.

In addition to that, I think one of the most striking examples to me, having looked at all of the evidence that we produced and done some of the interviews and read all of them, the attitude towards the board was one of giving them what they thought they needed to and not much more.

And a good example of that, which we cite in our report, is when the Freddie Mac issue broke. There is documentary evidence that the board attempted to look closely at Fannie Mae's accounting to get some feel as to whether or not these same issues existed within the company, both in the audit committee, and at the full board level.

The board was given assurances, in some cases with the outside auditors present, that in fact those problems were not shared by Fannie Mae, when subsequent investigation by OFHEO and eventually by us indicates that that was not accurate. Did they believe that? There is no way, Mr. Chairman, for me to get inside of people's minds but it certainly is apparent to me that this board was not even given a hint of the severity of the problems, even when the Freddie Mac issue erupted.

And any board member worth his or her salt would have been very concerned about it, as they were. But they were not given information that would have raised the kind of red flags—and I heard Congressman Frank's opening statement and I respect his opinion but, you know, unless you have certain information at least given to you that gives you some indication that all may not be well, it's very difficult for board members to plumb the depths of the complexities of accounting systems, and that's what happened here.

I'm sure had they all to do it over, they might do things somewhat differently. But based on the record and the evidence we have, we found that they were not dealt with transparently, in some cases they were misled, whether intentionally or negligently is impossible for me to determine.

The CHAIRMAN. So in that case, basically, the alarm bells were heard—alarm bells in terms of Freddie Mac. Was it the board or a particular committee of the board?

Sen. RUDMAN. It was the audit committee and the entire board. Not only were they given loud alarm bells, some of which they sounded themselves—you couldn't help but do so if you read all the press that was coming up at that time—but in particular, it's interesting—and we'll get into this in subsequent questions—what happened with the writeoff I spoke of, which should have been $400-some-odd million, was only $200-some-odd million and how the board was dealt with on that issue and why it was dealt with that way.

So my best answer I can give you—after all, we only have evidence we can look at. We can have speculation but I can't speculate. I have to say that this board was not given the kind of information that would have led to the kind of vigorous inquiry that one might expect from an audit committee or a full board.

The CHAIRMAN. Thank you. My time has expired. The gentleman from Massachusetts.

Mr. FRANK. I appreciate that and I should make clear that, based on what you said, I should have rephrased what I said about the board, if it gave the impression that I was talking about personal shortcomings on those board members. What I'm really more concerned about is the structural weakness of the board of directors in this situation. This is part of the problem.

When we are told that we should not intervene too directly, either through the SEC or, you know, there are people who want Sarbanes-Oxley repealed, there are people who want it cut back substantially. And the argument has been that we should rely on the internal control mechanisms.

And what I should have said—and I appreciate the corrective, that it's not a criticism of the individual board members, but it does speak to the structural weakness of the board as an entity in corporate America. And here we had a case where they even had an outside regulator. Most corporations don't have an OFHEO. And even with all of that, the board was rather easily put off.

And so the question then, is, as a broader issue, should we be—I mean, we're going to—if the Senate will do something, we could pass a bill and we will have a very good regulator here. But in general, this is kind of an object—how easily a board of directors can be frustrated, even when it's been alerted by something else.

Do you have any ideas about what we should be doing going forward?

Sen. RUDMAN. Well, I certainly do and I think they're evolving. I think one of the results of Sarbanes-Oxley, which in my view is a positive impact, is that boards of directors in general and audit committees specifically are meeting a great deal more with outside auditors and internal auditors than they ever did before.

I mean, it was not unusual for major company boards to meet four, five times a year, audit committees to meet about that time. Today, in most major corporations, audit committees meet at least every month or two, have a number of teleconferences with their auditors and their internal auditors. So the whole atmosphere has changed and people, because of Section 404 of Sarbanes-Oxley,

have become far more inquisitive about what's going on in the accounting of a company. Had that existed at the time, I think you might have had a different result.

Mr. FRANK. Although even there we had a problem because you said they were inquisitive and they are, after all—many of them, sort of accountants. Should there be as a general rule, be some kind of staff allotment for the boards? In this case, they asked the right questions, they were alerted, they got stiffed, and they didn't really have—including by the outside auditor, which is a disturbing fact.

But should we try to institutionalize a little more help for them?

Sen. RUDMAN. Well, I think you have. As you know, Sarbanes-Oxley now makes it the job of the audit committee and the board to hire the outside auditors, rather than the company. So the audit committee has a far different relationship with outside auditors. That's number one.

Number two, most boards believe—and I think correctly so—that they have the right, and in fact do, hire special advisors to advise them on special subjects—

Mr. FRANK. As you were, in fact, hired by the board here.

Sen. RUDMAN. Exactly.

Mr. FRANK. Question—two more. One—and obviously this is very disturbing what happened at Fannie Mae and it also happened at Freddie Mac. But I, again, want to separate the misdeeds of individuals, the misjudgments of individuals from the important public policy functions. As you review this, was there at ever any time an—what we're told is, look, these are entities that some people think have a claim on the Treasury; they could implicate serious problems for the Federal Government.

Was there at any time any threat to the safety and soundness of the entity? Was there a fiscal crisis, potentially, because of these abuses?

Sen. RUDMAN. Well, I don't think I can answer that other than this way. Obviously OFHEO thought there was a problem because, as you know, they made adjustments to the required capital of Fannie Mae soon after their—in fact, that was part of their September intervention, if you will, that resulted in our being hired.

So shortly thereafter, Fannie Mae in fact changed its capital structure which leads me to the conclusion that OFHEO was uncomfortable because of the size of the changing in—or the write-down of the eleven billion in derivatives. They were uncomfortable with that so I assume they had a reason to—

Mr. FRANK. But even in the inadequate state of the regulatory structure at the time, they did have the power to order corrective action.

Sen. RUDMAN. Absolutely.

Mr. FRANK. Last point, and this does not in any way exonerate or mitigate what Fannie Mae did, but there had been some question about the relative ease of following the accounting standards in question, particularly dealing with derivatives.

Is there—again, we're talking about preventing this from happening going forward. We've got some special rules and restrictions at Fannie Mae. Did you or any of your team come to any opinion

about the accounting standards, particularly the one dealing with derivatives?

Sen. RUDMAN. Are you talking about the 133 standard?

Mr. FRANK. If I knew which number—

Sen. RUDMAN. The one on hedge accounting and derivatives?

Mr. FRANK. If I—yes. That one. If I knew the number, I would have told you.

Sen. RUDMAN. I don't know quite what you're asking me about that particular—

Mr. FRANK. Some people have said that part of the problem is that it's a very difficult standard to apply, that it's opaque, that it's—and that part of—again, this doesn't justify what they did because all their mistakes were in one direction. If it was simply a problem of being confused, the mistakes would have been more random. So with all the mistakes going one direction, the complexity isn't the problem, but that this may have contributed to the ease with which they could cover it up.

Sen. RUDMAN. Well, Congressman Frank, I don't know about the ease of covering up. I want to answer your question very directly because, in preparing for this hearing today, that very question that you have asked was raised and I answered it this way, that there must be a better way to write accounting standards than the way they are written. It reminds me a lot of the Internal Revenue Code. It requires a battery of experts to even figure out what some of the things mean.

Having said that, although that was a very complex standard, it was clear to us early on in this investigation that the strict requirements of FAS 133 were not met—

Mr. FRANK. I agree. This is not a justification—

Sen. RUDMAN. Now, are you asking was it easier to evade them or avoid them? I would say this, that any time documents like that can be written with greater clarity—and I believe the SEC and FASB are attempting to do that and have ongoing programs to do that—that would be in everyone's interest because I can tell you that this is a very complex standard, although, to understand what happened here was not that difficult.

The CHAIRMAN. The gentleman's time has expired. The gentleman from Louisiana, Mr. Baker.

Mr. BAKER. Thank you, Mr. Chairman.

Senator, again, I appreciate your work. It's really an incredible thing to try to read through. I wish I could say that I made it through all 2,600 pages, but I've gotten through the first 600, which, even that has been a challenge.

I'm targeting specifically—and there are a lot of areas I really would like to talk about. Although the lack of information flow to board members was obvious from the report, it would seem to me from the environment in which the corporation found itself with Freddie Mac having difficulty with the regulator and Congressional criticism, it would have been a time that board members should have exercised the highest standard of fiduciary conduct only for their own self-interest much less for the corporation and taxpayer, but I don't have enough time to do all that today.

In looking—and I'm not asking you to review this; I'm reciting it for the record—on page 46 of the report relative to a memo from

Ms. Spencer addressed to Mr. Raines on August 10, 1998, it states in part, priority one, the goal of making $3.21 per share the managed earnings target which just establishing as a corporate principle they were engaged in trying to manage that EPS figure at that time to meet street expectations.

On page 49, there is referenced by Ms. Spencer an 8:00 a.m. meeting on Friday morning, January 8th, which for the record Mr. Raines does not remember participating in; however, Mr. Howard and Mr. Spencer discussed with Mr. Raines in that meeting from their view the amount of rollover which should occur and ultimately, according to their view, Mr. Raines then became comfortable with the recommendation to record only a $240 million catchup.

In the hearing memo, which you had not had, I do not believe, on October 6, 2004, Mr. Raines stated that the report—and at that time he was alleging the OFHEO report, not your report—that the company willfully violated GAAP in order to maximize executive bonuses. He says, going on, upon reading of this allegation, I reviewed the relevant facts. We have no facts, no materials, nothing to support the allegations. Based on the facts as I understand them, the $240 million was arrived at as part of analysis conducted by accounting.

Then in response to my question which was, was there any discussion in which you participated relative to the determination of the catchup amount, Mr. Raines stated on the record, no, I did not participate in determining the amount of catchup. That was done, as I mentioned, within our financial function.

My first question, in light of your review and the facts you've accumulated, is it possible that the precision with which the 3.2309 was achieved was a mathematical business miracle or do you have reason to believe it was a result of some accounting manipulation?

Sen. RUDMAN. There's no question in our mind, Congressman Baker, it was the subject of some manipulation. And to give you the full texture of that, Alex Oh did that whole section for me and I think you'd find her response most interesting because it wasn't just the amount that was not written down. The amount that was written down then left them with an additional problem. There were a number of accounting—

Mr. BAKER. There's a couple of more steps I'd like to get to because in—unfortunately we're not like the Senate—

Sen. RUDMAN. Right. I would think she could answer that question briefly.

Mr. BAKER. But let me do this, because I'm going on a train and I think it comes right to your station. When you—did you have reason to believe that audit differences with KPMG, although not discussed by management to the board, were usual and customary or would that have been characterized as an aberrant act where—I can understand an auditor having a dispute, you sit down, you try to work through it, ultimately you don't have a formal audit difference recorded. The time of this happening, management knew, it was not translated to the board. And I'm building a reason for making these statements.

Since they did not disclose the audit difference, and the audit difference now is not material simply because the actions were not

GAAP-compliant, it's not material because the amount in the overall business environment was so small, it is material and important merely because it enabled ultimately the ultimate bonus targets to be hit.

As I understand it, the $200 million figure got you within the bonus subdivision at 3.22 but you weren't home yet. The second income adjustment got you to 3.2285; your next-door neighbors, but you're still not home. The third was 3.2309, which then triggered the $27 million payout in bonuses to the executives responsible for making these determinations.

My question, and you may be the best person to respond, is, given this relevant set of facts that it wasn't one unilateral act where you were having a technical dispute with your accountant, where you made adjustments still not resulting in the maximum target not being hit, where you had subsequent, although minor, intended acts resulting in executives being rewarded for earnings they did not achieve, is it clear that this was a manipulation of financials for personal remuneration?

Sen. RUDMAN. In that instance the answer is yes, and I say that because when you look at each of these transactions that were accumulated, non-GAAP compliant, to reach this number, that's the conclusion we reach as to 1998, 1999.

Mr. BAKER. And at the level that the executives of Fannie were held from a corporate governance perspective—and by the way, Mr. Chairman, I just want to stick this Standard & Poors corporate governance rating, January 30, 2000—let me get my glasses quick—3, as part of the record for another purpose at a later time—

The CHAIRMAN. No objection.

Mr. BAKER. Thank you, Mr. Chairman. My point is that if it is pretty much acknowledged that these activities occurred, the next question that came to me is what do we do about it. On one hand, we have the regulatory necessity to build a corporate governance box going forward, but with regard to these specific actions, these fall into a different category. A new regulator won't necessarily have the historical view we have.

I believe it to be within the board's authority to request or demand a repayment of bonuses earned when they in fact are not legitimately earned. I further believe that it's the right of the regulator at OFHEO to disgorge such earnings if he has a finding that it was fraudulently obtained. Not asking you to discuss whether this constitutes fraud. I'm merely asking, are either of those courses open to consideration by the board or have you—and you may not be able to disclose if you've had those discussions with the regulator.

Sen. RUDMAN. I'm glad to discuss it with you, Congressman Baker. We, number one, have not had those discussions with the board but I can tell you that obviously those options are open to the company. They are always open to the company. There's much precedent for that. Whether the company decides, based on this report, to do that is obviously beyond our scope.

I want to just say one other thing to you that's important, and that is that I believe—and I'm going to have Mr. Massaro and Mr. Ellis correct me if I'm wrong—that there are now new standards

about materiality and audit differences that are required to be reported to boards of directors.

Will you comment on that, George, as to what I am referring to?

Mr. ELLIS. Yeah. Subsequently, there are required communications with—

The CHAIRMAN. Can you pull that microphone a little closer?

Mr. ELLIS. I'm sorry. There are now subsequent communications with the audit committee that require the audit committee be provided with a list of unadjusted differences, so this would find its way to the audit committee in detail and that it's been a requirement for several years.

Mr. BAKER. I've exhausted my time. That's the reason—

Mr. FRANK. Will the gentleman just yield for 10 more seconds just so I could—

Mr. BAKER. I want to jump to one more thing and then I'd be happy to yield.

Mr. FRANK. Because I just want to express my agreement with him that they should get the money back, that there should be a request for that—

Sen. RUDMAN. Congressman Baker, I just want to tell you that had that been in place, had that type of disclosure been mandatory at the time of this 1998, 1999 incident that you have very accurately described, then my sense is that there would have been a different outcome.

Mr. BAKER. Well, all other corporate executives are now subject to rules of conduct which reward professionalism and penalize those things which are not within the rails. This is not within the rails and whatever action that needs to be taken to make compensation back to the shareholders, I think clearly it ought to be requested of the board and at appropriate time we will communicate with them and ask for your support of that recommendation.

The CHAIRMAN. The gentleman's time has expired. The gentleman from Pennsylvania.

Mr. KANJORSKI. I don't know whether to call you Mr. Chairman or Senator or the Honorable.

In listening to your analysis, particularly of the regulator's activities up until 2002, it seems to me you had the CFO, you had the internal auditing, you had the external auditor, and then you had the regulator in place. So you had four checks.

How in the world did they miss what was happening that the regulator could complement them on good governance and complying with GAAP?

Sen. RUDMAN. Well, Congressman, let me respond in this way. As far as the outside auditors were concerned, we of course were not tasked to investigate KPMG, although we did interview them and look at work papers and so forth, and my frank answer is that I don't know how they reached the conclusion they reached, particularly in the area of FAS 133. That's number one.

As far as OFHEO was concerned—and I don't think anyone presently at OFHEO would disagree with this, nor would former director Falcone—former director Falcone appeared before the Senate Banking Committee, in I believe it was 2004 or 2003—it was 2003—and testified at that time that the adequacy of resources and competence at OFHEO during that period was less than what it

should have been, and pretty much said to the Senate Banking Committee that our capacity to do our job at that time was not what it should have been. And I think that, to a large extent, overhangs all of the efforts of this committee and your counterpart on the other side of the Capitol to try to have a stronger regulator.

There is no question that OFHEO blessed not only the accounting generally but, in 2002, blessed the FAS 133 accounting as well as the governance of the corporation generally. Mr. Falcone's answer, which I take at face value, was that they did not have the capacity to do what they should have been doing at the time. I agree with that.

Mr. KANJORSKI. And I understand that. That's testimony in 2003. But by affirmative action, they complemented Fannie Mae in 2002 and for 4 or 5 years prior to that, that they complied and they had excellent governance. If he didn't have adequacy to make that judgment, why did he make that judgment?

Sen. RUDMAN. Well, I can only say, Congressman, that it is up to this committee and the Congress as a whole to end up with a regulator that's adequately funded and strong and competent. There is no question in the years leading up—and these problems at Fannie Mae didn't start in 1998 or 1999. Some of them were more historic than that.

The bottom line is that they, evidently, did not have the capacity to do the kind of in-depth examination that was required. As a matter of fact, as I'm sure you're aware, it was only when they were allowed to hire an outside major accounting firm to help them with their special examination of Fannie Mae that they came to the conclusion which they have come to, which we essentially have confirmed in this report.

Mr. KANJORSKI. Well, you've had an opportunity to look over the legislation this committee has passed through the House and the legislation that the Senate is putting together in regard to a new, stronger, world-class regulator. Do you think that we have now taken the appropriate action to create the type of regulatory body necessary so that this won't happen in the future?

Sen. RUDMAN. I believe you have and I think a wonderful model for the Congress is what has always been a highly respected government office, the Comptroller of the Currency. And when you look at what they do and how they do it and also certain parts of the Fed, that's the model, it seems, and I think that's the model you've tried to follow.

Mr. KANJORSKI. Very good. I yield back the balance of my time.

The CHAIRMAN. The gentleman yields back. The gentleman from California, Mr. Royce.

Mr. ROYCE. Thank you, Mr. Chairman. I think the lesson today is that things can go wrong at the GSE's and just as accounting can go wrong, so can other areas within the firm such as risk management. In the future, I think we have to recognize that it is possible Fannie Mae could make a mistake in managing its interest rate risk and could intentionally take more interest rate risk to meet their profit targets.

And with these possibilities in mind and in light of the systemic risk that mortgage portfolios pose, I do not think the enormous interest rate risk consolidated in the hands of two GSE's is worth

any benefit that may or may not result. And I think that interest rate risk will continue to loom large until something is done about the size of these mortgage portfolios.

As you noted on page 101 of your report, Fannie Mae's outstanding debt grew dramatically during the 1990s commensurate with the growth in its portfolio. The ability to hedge that debt against interest rate risk was a substantial component of Fannie Mae's risk management. Fannie Mae used derivatives to hedge the interest rate risk associated with its debt and the notional amount of its derivative portfolio also grew tremendously during the 1990's and into the 2000's.

Now, given that Fannie Mae's portfolio investment business was the central driver of earnings growth throughout the last decade, it appears that this became a prime area for manipulated earnings or for presenting more favorable GAAP financial results.

If the retained portfolio was significantly smaller, do you think Fannie Mae would have had problems of similar scale? That would be my first question. And the second question would be, during the period covered by your report, a number of key accounting changes took place, most prominently FAS 133. In your view, did the size of Fannie Mae's retained portfolio and its hedging strategy make it arguably too difficult or possibly too costly to implement these accounting changes properly?

Sen. RUDMAN. Well, to take your questions in order, Congressman, number one, obviously, if you had a smaller portfolio you would have a smaller hedge portfolio, you would have less risk. So that's obvious.

The second question, I'm not sure from what I've looked at that the accounting policies developed would have been a great deal different unless the portfolio was so small that every match could be done on an individual basis.

Mr. ROYCE. During the period covered by your report, is it fair to say that a central part of the company's culture was focused on steadily increasing earnings, would you think it likely that operational decisions during this period, such as the decision on growing the retained portfolio were driven by the same considerations?

Sen. RUDMAN. Well, I really don't know if I can answer that. My sense is that the accounting policies in place, the systems in place, and the level of competence in place would not have been any different, although I suppose the scale of the issue they were facing would have been smaller.

Mr. ROYCE. It seems to me that when Fannie Mae made the decision to dramatically grow the outstanding debt and then to hedge against that with the interest rate risk, with the derivatives, the reality was that that gave a certain opportunity for managed earnings.

And one of the points that I have been making for some time is that to allow that type of interest rate risk on the books is—and I think my Senate colleagues have come to that same conclusion—is to tempt people with an awful lot of opportunity to manage earnings.

Sen. RUDMAN. The only comment I would make, Congressman, is that I would agree with you totally that the Fannie Mae financial management structure we found in place in 2004 certainly was not

adequate to do what it was supposed to do. That is apparent with now, what, 18 departures from GAAP found in this report.

Whether it is competent to do that today is something this committee will have to decide.

Mr. ROYCE. Senator, thank you very much. I appreciate it.

Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman's time has expired. The gentlelady from California, Ms. Waters.

Ms. WATERS. Thank you very much, Mr. Chairman. Thank you for this hearing. This is very important and I would like to thank the Honorable Senator Rudman for the work that he's done with all of those who have contributed to getting this report so that we can begin to really, really, really understand what the problems are.

Senator, I have this belief that following the problems with Freddie Mac, that Fannie Mae tried to do everything possible to avoid falling into the same trap. Certainly, an organization as big as Fannie Mae, with the resources that they have, with as many bright people as they had, would have wanted to clean it up and to get it right after Freddie Mac. It's very difficult for me to believe that there would be any attempts to manipulate, to hide, to do something in the name of getting bonuses after the great exposure of the problem of Freddie Mac. So I want to know what has gone wrong.

Now, I remember very vividly when Mr. Raines was before this committee, he said he had sought outside advice on FAS 133 and he had gotten that advice and they had used that advice. However, it seems that there are some questions about how to do it and it continues even until today.

As I understand it, Freddie Mac still has accounting problems that they have to delay their 2005 reports; Fannie Mae does, too. What's wrong that these big agencies can't seem to get it right? I can't simply believe that they don't want to, that somehow, given all of this, they're trying to trick somebody or fool someone. What's wrong with FAS 133, the interpretation of how it works? Did you get into that in this report?

Sen. RUDMAN. We certainly did and it's covered in detail and I can only tell you that it's our opinion, and certainly Huron's opinion, mainly, that as the SEC decided in December of 2004, that they got it wrong, completely wrong. And the reason for this massive restatement that you referred to in your comments is because they have a new outside auditor involved in what will be a year or maybe a two-year dive into the accounting and financials to be able to furnish certified financial statements to the—

Ms. WATERS. Did they have an outside auditor that gave them counsel and advice on FAS 133 before?

Sen. RUDMAN. Indeed.

Ms. WATERS. And given that counsel and that advice, did they follow it? Did they use it as it was given to them, as it was advised to them?

Sen. RUDMAN. Well, Madam Congressman, I would say this to you, that there is some question in our minds as to whether KPMG really understood how the FAS 133 accounting was being applied. They certainly were aware of what was being done but if they un-

derstood the detail, it's not clear to me. And frankly, I don't know how they approved it because it was fairly obvious to us and to the SEC that it was incorrect.

Ms. WATERS. Well, my question is this. If you're getting advice from an outside auditor—I don't care whether you're Fannie Mae, Bank of America, whomever you are, and you're following that advice, and it appears that everybody is having the same problem with FAS 133, what then do you do?

Sen. RUDMAN. Well, I know that since the SEC made its ruling, a number of major American companies have decided to restate their FASB 133 application—

Ms. WATERS. How many other companies fall within this category?

Sen. RUDMAN. I don't know how many. I know several major companies. I have not followed—

Ms. WATERS. Bank of America? I mean, who else?

Sen. RUDMAN. I know General Electric made a public announcement—

Ms. WATERS. General Electric?

Sen. RUDMAN.—that they were doing some restatement. There is no question that FAS 133 was misapplied by a lot of people. The question you ask, however, goes to really another issue and that was what did the auditors know and to what depth did they understand the application. I don't know. I cannot answer that question.

Ms. WATERS. All right. Given the SEC's evaluation and their conclusion about FAS 133, is it clear now that any firm or all firms can now follow the direction, the instructions of SEC and do a better job with this?

Sen. RUDMAN. I believe so, Congresswoman, because it's been very clear and there's been other literature since that time as to how this should be applied. But I want to just come back earlier to something you said. There is no question that if you had Mr. Raines here today—and we interviewed him at length, for 8 hours or so—he would tell you that he relied on the outside auditors and his own financial people. That is his contention.

Ms. WATERS. Did the outside auditors agree with Mr. Raines that they had given him the advice and information that he said they had?

Sen. RUDMAN. Well, the outside auditors did in fact approve the financials for those years that this restatement is now being—covering the restatement, so I expect they must have.

Ms. WATERS. All right. Well, I think that's important for us to know. And I appreciate several things about the work that you have done. Number one, as my cursory review of it, it appears to be very, very detailed and a lot of work has gone into it. I also appreciate the fact that you made it very clear that you're not here to answer the question about whether or not Fannie Mae is too big. You did not get caught up in whatever the confrontation is between FM Watch and Fannie Mae. You're not in that mess.

You're here to talk about whether or not these accounting practices and some other things are followed; who was responsible; and the way that the accounting was done and other issues. So I thank you for clarifying that and I also thank you for not concluding that

some people should go to jail, some people should have to repay. That's up for others to determine.

Your work is as objective and as well done as you could possibly do it, and I thank you for not letting people put words in your mouth.

The CHAIRMAN. The gentlelady's time has expired.

Ms. WATERS. Thank you. I yield back the balance of my time.

The CHAIRMAN. Mr. Garrett.

Mr. GARRETT. Thank you, Mr. Chairman, and thank you Senator Rudman for being with us today to discuss your report. And after reviewing your report, I think it's only increased my resolve that something has to be done on a number of fronts as far as regulation and also changes in other laws as well.

Your report goes into quite a bit of detail as to how management pressed for specific earning levels to basically meet Wall Street's expectations, in all of the so-called accounting areas either tried to hide financial losses or smooth over the system. I sit up here and I'm amazed, though, that to this day Fannie Mae does not still have current financial statements and they will not have them, as I understand, until the end of the year.

If any other company in this country engaged in any of these practices and didn't have those results, the investors in those companies would be trying to sell that stock as quickly as they possibly can. But because this entity has the backing or the implied backing of the U.S. Government, when this report came out people weren't selling the stock; the stock actually rose and there, I think, is part of the problem.

I think we could get three points out of this. First of all, after Enron and Worldcom, as we stated before, Sarbanes-Oxley was passed to try to prevent situations such as those but it was 3 years later that we found with Fannie Mae the exact same thing was allowed to occur.

Your report seems to indicate that the board of directors, the auditing committee, the chairman, and independent auditors all met the current Sarbanes-Oxley's requirements but they were still able to mislead everyone to a tune of $11 billion, or maybe more, since we don't have their financials to this point. I think that should give everyone on this committee and this Congress pause, and give us an opportunity to go back and take a look at Sarbanes-Oxley as well to see how that has been implemented and whether other changes are made—necessary there as well.

In addition, I find it amazing that had there not been a problem with Freddie Mac, that OFHEO would never have known anything was going on, would never have begun to look into Fannie Mae, and we might not be having this hearing today whatsoever.

And finally, I find it interesting to note that, for all the expense of this report—and it was an expensive $65- or $70 million inquiry—that while we did spend a lot of time and discussion now on the accounting/mismanagement equation, there seems to be a lack or dearth of information with also operational problems. It's my hope that those aspects will come out with further inquiry into the matter.

Let me raise a couple of questions to you, then. Your report seems to go at great length but deals with—comes back with, in

my mind at least, an ambiguity as to their accounting practices, as to why they occurred. At times the report suggests that it was incompetence or insufficient personnel or at other times it was intentional. I refer to your report, page 399, where it says, "with the exception of the 1998 accounting changes which is previously discussed, we see little evidence that any individual policy or the policies in the aggregate were designed or implemented to manipulate Fannie Mae's financial statements".

Everything that I've heard so far and everything that I've seen in the report seems on the face of it—that cannot be believed that this was just an incident—one incident that you can say that was intentional and the other cases it was just purely by incompetence or mismanagement.

I don't believe that if you looked only at those areas that you can just say it applied to that one case. I would ask you to look also and comment on the company's handling of accounting derivatives as you do in the report. It would appear that if you look at the derivatives and the way that they were handled, it was intended—it was an intentional action there as well to have a smooth rate of flow on the cash reports and resulted in the false application of FAS 133. This is exactly what occurred with Freddie Mac; they just did it in a slightly different way.

So to come and say that it's only the one instance where it's intentional is—troubles me. It's not—certainly suggests that this was the only instance where it was manipulated for a particular purpose.

So I guess I would like to move it—the question to you, then, is were there other instances of that and were the operational deficiencies affecting the management decisions as to the earnings? For example, did the company, in other words, engage in unnecessary exposures in other areas that would smooth their exposures and smooth their earnings and what-have-you? And that would go to the question also as the portfolio—

Sen. RUDMAN. I will let Mr. Parker answer one of the parts of your question. Let me say that I think what we've said in this report is that in terms of manipulating accounting for bonus targets, we did not find any evidence of that other than in 1998 and 1999. We have said consistently that meeting EPS targets was an obsession with this company and much of the accounting that was done was for that purpose, which is, I think, a little different from what you've said.

I'd like Mr. Parker to address—

Mr. GARRETT. So the purposes was purely a managerial style, we're putting a target on the wall, we're going to aim it, not for the fact that we're going to get more pay at the end of the year, it's just that this is what we're going to aim for for the good of whatever else, we're just going to aim for that target?

Sen. RUDMAN. Congressman, if you want to believe that, that's fine. All we can do—we have strong evidence for 1998 and 1999 and that may be—you may be right. But we can only deal with evidence that we found. The evidence for 1998 and 1999 is clear, and we would not want to make assumptions or speculations. Others are free to draw different conclusions from the same facts.

I want Mr. Parker to address one part of your statement, which I think is important.

Mr. BAKER. And if I may, Mr. Garrett, your time has expired but the gentleman certainly can respond.

Sen. RUDMAN. Brief response, Bob.

Mr. PARKER. Yes, thank you. Congressman, you pointed out—

Mr. BAKER. [presiding] You need to pull your microphone a little closer. We're still not hearing you well.

Mr. PARKER. Thank you. Congressman, you pointed out a sentence on page 399 and let me just clarify what now appears to be an ambiguity.

The sentence that you read is from a chapter involving the accounting for certain affordable housing partnerships. What we were addressing in that sentence were the general policies—the general accounting policies regarding the affordable housing partnerships.

In 1998, one of the accounting changes that was made coincidentally with the recognition of the $240 million in premium discount amortization adjustments was a change in accounting in a related area involving these affordable housing partnerships. So what we were trying to do in this sentence was make clear that our 1998 conclusion stands but with respect to the accounting for the affordable housing partnerships generally, this was our finding.

And of course, I concur with Senator Rudman's remarks regarding the findings with respect to other accounting policies, some of which we do say that there were accounting decisions made to ensure stable earnings growth or other kinds of policies in that regard.

Mr. BAKER. Thank you. The gentleman's time has expired.

Mr. Watt.

Mr. WATT. Thank you, Mr. Chairman. Senator Rudman, obviously I haven't read 1,700 pages of your report, but every report I've seen on it, and certainly the testimony that you've given today, indicates that you all have done a fantastic job of getting down in the trenches and figuring out what was going on, and you've certainly done a great job today in your testimony of laying it out for this committee. And my colleagues have asked some exceptionally good questions.

I just have one question, really, and I don't think it will take 5 minutes, and maybe it will take somebody on your team to answer it. It's an accounting question. On page 5, in number 3 of your prepared testimony, you talk about this $240 million of premium discount amortization expense in 1998 when it should have been $439 million. That's $199 million difference.

I'm just interested in knowing what happens to that $199 million. Did it—as an accounting principle, does it get rolled to the next year or does it get forgotten about? What happens to that?

Sen. RUDMAN. I will have Ms. Oh answer that for you, Congressman.

Ms. OH. Under FAS 91, that $199 million was required to be recognized in 1998, so the entire $439 million should have been recognized—

Mr. WATT. I understand that. I'm talking about when it wasn't recognized, what happens to it.

Ms. OH. What in fact happened here is Fannie Mae deferred it into 1999, and reduced the $199 million through periodic on top adjustments of regular $8 million entries per month.

Sen. RUDMAN. All of which was not compliant with GAAP.

Mr. WATT. Tell me what that means when you say on top adjustments because I—I mean, when I first heard about this, it seemed to me that if you got $199 million worth of difference in expense one year, you don't recognize it one year, it just gets rolled to the next year. So it might benefit you one year but the next year it's going to catch up with you. And if it doesn't catch up with you that year, it's going to catch up with you at some point unless something happens.

So what I'm trying to figure out is what is this $8 million adjustment? Did that make it go away or did that just defer it into some subsequent year? Is it going to catch up at some point regardless of what you do? That's what I'm trying to figure out.

Ms. OH. I understand, Congressman. What happened here—you're right in your assumption that it eventually will catch up with you because you have to write off the $199 million in expense at some point. What happened here is under FAS 91, as interest rates change, you're supposed to renew your calculations periodically.

And what happened in 1999 is that the interest rates went back up and there was no further need to recognize an expense position on the catch-up. Nevertheless, the company continued to recognize the $8 million on top entries, which is equivalent to just writing off $8 million as expense every month because they were trying to create a reserve for future interest rate volatility that would generate additional catch-up.

Mr. WATT. So within that 2-year period or within maybe a 5-year period, would you come out essentially the same place?

Ms. OH. Well, that would all depend on the interest rates and mortgage holders prepayment—

Mr. WATT. But if you were taking it as an expense, even if interest rates went up or down, you're offsetting it against something that it wouldn't otherwise have been offset against; isn't that right?

Ms. OH. Well, if you were to do a periodic assessment of the catch-up based on current interest rates, it may be that the expense position flips into an income position entirely so there's nothing to offset against.

Mr. WATT. Yes. Okay. All right. That's the—I've been wondering about that $199 million. I could use it, so it kept me awake at night.

Ms. OH. Glad I can help.

Mr. WATT. Ever since I first heard about it, I've been worrying about it.

Mr. FRANK. I don't think the question has kept anybody awake this afternoon.

Sen. RUDMAN. I think the important part, Congressman, is that it was not handled the way it should have been handled under—

Mr. WATT. In that year.

Sen. RUDMAN.—in that year—

Mr. WATT. Are you saying that in subsequent years it wasn't handled the way it should have been handled, either?

Ms. OH. That's correct.

Sen. RUDMAN. That's correct.

Mr. WATT. Okay. All right. I'm not trying to finesse anything here. I'm just trying to figure out whether—

Mr. BAKER. Would the gentleman yield on that point, just to make sure I'm getting—I don't want to get confused here. The on top $8 million going forward was a reserve account against future volatility which was not GAAP compliant.

Ms. OH. Right.

Mr. BAKER. So even not rolling the $200 million was not GAAP compliant, but the on top calculation going forward is akin to a bank which cannot expand its loan loss reserve account for future volatility. That's prohibited by the FDIC. So this is a customary understood business practice which they did not comply with. Is that fair?

Ms. OH. That's correct.

Mr. BAKER. Is that okay?

Mr. WATT. I appreciate the gentleman's edification of that. It will help me to sleep better tonight. Thank you.

Mr. BAKER. I got more where that came from.

Mr. Hensarling.

Mr. HENSARLING. Thank you, Mr. Chairman. And Senator, welcome to the committee. As a former aide to a certain former senator from Texas with whom you're well acquainted, I recall fondly the days when half of America thought your first name was Graham. And even though this is the Financial Services Committee, and not the Budget Committee, I certainly want to thank you for your work as being one of the few successful Members of Congress to actually restrain the growth of the Federal budget at the expense of the family budget.

Getting down to Financial Services business, obviously there's been a lot of testimony and focus upon trying to level out the earnings volatility that Fannie Mae had and you speak of their kind of corporate culture. And I believe on page 6 of your testimony—let's see—we found substantial evidence in a number of specific instances and overall that the company's accounting and financial reporting policies and procedures were motivated by a desire to show stable earnings growth, avoid income statement volatility.

As a former officer of an investment management firm that ran a hedged equity fund, I know through experience that the market does place quite a high premium on the smoothness of earnings, the lack of volatility. Was it within the scope of your investigation or do you have an opinion as far as Fannie Mae's activities in artificially smoothing out their earnings, what did this mean to Fannie Mae? What did it do to their market cap? How was it valuable to them to engage in this activity?

Sen. RUDMAN. Obviously when earnings are managed within the rules, they're allowed to be managed. Many American corporations manage earnings through perfectly legitimate applications of GAAP. What we found was the way Fannie had in fact established reserves, managed earnings, was beyond GAAP.

I think one of the interesting things about the work that we've done is that the company going forward has a whole new approach to accounting policy and I think I could probably predict with some

certainty it will be a long time before Fannie Mae does any accounting acrobats to hit a particular target. I think they'd rather face the music in the year that it happened. And I think that is probably the good result of all that's happened in the last few years.

But earnings management in this country is not necessarily a bad word, as long as it's done within legitimate bounds of GAAP accounting. We found 16 or 17 examples of non-GAAP accounting, particularly one we've just discussed with the Congressman who just left and with the chairman of the subcommittee.

Mr. HENSARLING. In looking at your testimony, I read in virtually every instance we examined, Fannie Mae's accounting was inconsistent with GAAP. In virtually every instance we examined. Harken to my colleague from New Jersey's earlier questioning, but for the implicit guarantee of the Federal taxpayer given this type of accounting and given the quantity of the accounting misstatement, which appears to rival that of Enron and Worldcom—I'm expressing no opinion on any malevolent intent at this point—but, but for that implied taxpayer guarantee, do you have an opinion of what would have happened to Fannie Mae's market cap or how they would have been punished in the marketplace when this discovery was made?

Sen. RUDMAN. Well, I can't answer that in any authoritative way. I think it's fairly obvious that if a company is supposed to earn a certain amount according to the financial markets and it doesn't meet the targets, that generally is not healthy for the stock of the company and the capitalization normally goes down.

One of the reasons that companies try to maintain stable earnings is to try to maintain a stable stock price with some growth. Obviously that is one of the things that we found happened here.

Mr. HENSARLING. Senator, like many other members of this committee, I have yet to wade through the roughly 700-page report and 2,000-page addendum and in the interest of candor I'm unlikely to do that.

My last question, since I'm running out of time here, is we've had representatives previously, I believe, of Fannie Mae who've testified that they are capable of hedging their interest rate and prepayment risk of their mortgage-backed securities, which I believe is now roughly an $800 billion portfolio.

Is it a fair reading of your report that there were many instances when that often was not true?

Sen. RUDMAN. George, do you want to take that?

Mr. HENSARLING. Have I finally stumped the man?

Sen. RUDMAN. I'm going to let Mr. Ellis take that because he looked at that particular issue.

Mr. ELLIS. I think what we found is we found issues with the accounting for their derivatives. We did not find anything that would indicate that economically they had entered into bad transactions, transactions that did not economically hedge their portfolio. But again, it was really looking just at the accounting issues and how they applied the accounting guidance in FAS 133.

Sen. RUDMAN. And I want to just follow up if I may, Mr. Chairman. You know, it's very important that the market understand what the true value is of these portfolios and that's the reason that

FAS 133 was adopted so that in fact there was an assessment of value each year. You know, people talk about the $11 billion restatement. That doesn't necessarily—that doesn't tell you how much will eventually be written off, if any. It has much more to do with the timing of when those—how those affected the income statements over the years that are covered by the restatement, which is why it's going to take a year-and-a-half or 2 years to figure it all out.

Mr. HENSARLING. Thank you, Senator. I see my time is up.

Mr. BAKER. Let me just—I hate to keep doing this but on clarifying that issue that the gentleman from Texas was just raising, there was at one time an issue relative to their duration gap. They had self-imposed bans of 90 days and they got out to 14 months. Just as a broad brush, you did not get into the issue of duration gap.

Sen. RUDMAN. We did not.

Mr. BAKER. Okay. Thank you very much. Mr. Davis.

Mr. DAVIS. Thank you, Mr. Chairman. Senator, in the same interest of full disclosure, I've got to make it through Doris Kearns and Taylor Branch until I get to your 700 pages, so it may take me a while, too.

Let me make an observation and get your reaction to it and let me frame it by saying that while I'm a 3-year youngster of this institution, I remember your work very well and you've had an enormously honorable career and you clearly continue that in the work that you do now and you make an interesting point that one can be in the U.S. Senate and simply decide to be a good, thoughtful, effective member and never get obsessed with running for President of the United States. So I thank you for the power of that example.

Let me tell you, I think, the one criticism that I think could be advanced frankly of this report, and I mean this as constructive criticism. Obviously, as you know, this report will carry an enormous amount of weight because of the power and the throw weight of your reputation and the power of your law firm and its reputation.

There's no question this was a thorough, incisive, and detailed report. There's every reason to believe that the SEC and the Justice Department will take this document seriously. Obviously the Justice Department and the SEC are in the process of making an evaluation as to liability, as to culpability and, in the real world, this is perhaps something that will inform their judgment.

Having said that, there's a little bit of a pattern that I can see in the opening statement that I suspect is contained in the report of being a little bit indiscriminate in the use of the word management. Obviously we have two players whose reputations are at stake: Mr. Raines and Mr. Howard. You make the observation that Mr. Raines was interviewed for 8 hours; you make the observation Mr. Howard declined to be interviewed.

Look at page 7, for example, of your opening statement. It says—

Sen. RUDMAN. Of today's statement—

Mr. DAVIS. Today's statement. Paragraph 6 says, "although Fannie Mae's top management professed a desire"—and you talk about the culture of suppressing dissenting viewpoint, it's a ref-

erence to top management. In the next paragraph, paragraph 7 says, "management tightly controlled the flow of information to the company's Board". Then, a few sentences later, "in particular, we noted many instances in which management assured the Board" of, in effect, falsities, frankly, regarding GAAP compliance.

Then paragraph 8, "the Board relied heavily on senior management". To a layman reading all of this, to a lawyer reading all of it, top management may imply Mr. Raines and Mr. Howard; management may imply them or someone else. It's very hard to read the report and necessarily follow that particular track and that's something that strikes me as a concern.

Someone reading this could make certain assumptions about Mr. Raines that could be erroneous, or could make certain assumptions about Mr. Raines and Mr. Howard together that could be erroneous. Do you take that concern as a valid criticism of this report?

Sen. RUDMAN. I think when you read the entire 616 pages, it becomes clear as to who we are talking about. We are talking about senior management of this company which covers, you know, the top four, five or six people who changed from time to time during this period, 1998 to today. We are certainly talking about the CEO who was also chairman at that time, and the CFO. We are talking about certain people who had major management roles, although not in the office of the chairman, in various control functions, audit functions. That's who we're talking about.

When we talk about senior management or top management, we're talking about probably about eight to ten people at the most, and if you read the report, as I'm sure you eventually hopefully will get a chance to do on a long flight somewhere, you will find that it is not hard to identify who we are talking about.

One of the things we tried to do, Congressman, in this report is we only could deal with evidence, both testimonial and documentary. And if we could not support with a footnote, with a document, what we have said, we didn't say it. We put a heavy burden on ourselves to make sure we were fair to everybody but we had no constraints on us and we said whatever we felt ought to be said, and I'll stand on that.

I would agree with you that maybe it would be clearer if each time you used the word management or top management you put out a string of names who we're talking about, but I think if you look at the report itself you'll find it's self-explanatory.

Mr. DAVIS. Let me ask a quick question because time is running out. The observation that there are instances in which management assured the board that the accounting policies were GAAP-compliant, did you come across any direct evidence that Mr. Raines participated in those assurances to the board?

Sen. RUDMAN. We have made an affirmative finding in this report that although we ultimately hold Mr. Raines responsible for a series of errors that are outlined in numbers one through eight of today's statement, we could find no evidence, testimonial or documentary, from anyone or any place that Mr. Raines knew that what was being suggested to him by his own accountants and his own internal people was non-GAAP compliant and he stated that repeatedly during his 8 hours of testimony. Now, that's all we have to go on.

Mr. DAVIS. And if the Chair would indulge me a little bit with just a couple of quick questions.

The first one is obviously you've testified very correctly about OFHEO's inadequacies, the lack of staffing and so on. Did you—and I'll ask you for quick answers because of time. Did you come across any direct evidence that anyone at Fannie Mae had affirmatively misled OFHEO regarding the accounting standards and GAAP-compliance?

Sen. RUDMAN. No, I don't believe we came through evidence of active misleading of OFHEO or anyone else.

Mr. DAVIS. And the last question, if the Chair would indulge—

Mr. BAKER. Yes, it's the last question.

Mr. DAVIS. Last question—

Sen. RUDMAN. Although I want to say that there is evidence you'll see in the report of not maybe going forward and getting further articulation on FAS 133, which maybe they should have done. There's also a question as to how much they revealed in certain instances to their outside auditors, and we say that as well.

Mr. DAVIS. Last question. Obviously one of the primary issues from a policy standpoint is what the Congress should do with respect to the capital requirements, portfolio limitations. You make it very clear in your report and in your testimony today that the only concern of your investigation had to do with issues that don't relate to safety and soundness and that implicitly suggests that—well, let me frame the question a slightly different way.

A lot of the momentum behind the portfolio changes and behind the changes in capital purport to be related to safety and soundness. The argument is that we need to do these things to create a stronger safety and soundness structure. I think it's important that your report seems to indicate that you wouldn't weigh into that, you wouldn't take a stand on the side of that position and argue that the portfolio and the capital changes need to be made for safety and soundness reasons.

Sen. RUDMAN. I think our report does bear on safety and soundness in terms of the financial structure because obviously without a good financial structure, you're not going to have safety and soundness; good numbers might not mean anything.

As far as the issue of the composition, the character, the size of the portfolio, I'll only say this: that there are people in this country who are economists and risk managers and risk experts that can give testimony to this committee or the Senate committee as to their assessment of what this risk is and I'm sure the Chairman of the subcommittee, now presiding this afternoon, knows who those people are.

We do not consider ourselves to have the expertise to offer any kind of a reasonable opinion. And I was in the Senate, Congressman. I offered a lot of opinions in which I had no expertise. I don't have that liberty anymore.

Mr. DAVIS. It's a requirement of being in the Congress, Senator.

Mr. BAKER. The gentleman's time has really now expired.

Mr. Campbell.

Mr. CAMPBELL. Thank you, Mr. Chairman, and thank you, Senator.

We talked a lot about reducing the earnings volatility and the objective of smoothing earnings. Sometimes when that's your intent, there is a motivation to understate earnings in addition to the motivation to overstate earnings. A lot of what we've heard about today is overstating earnings relative to GAAP.

Did you find examples of both overstatements and understatements?

Sen. RUDMAN. Yes, there was. And the report indicates there were years where there were certain holdbacks because they felt the following year might need more income. Yes. The answer is yes.

Mr. CAMPBELL. If, then, you take all the overstatements and understatements and offset one against the other, though, there's an overall general overstatement, I gather, of earnings and it's not simply just a smoothing exercise that involves misreporting the earnings in one period or another.

Sen. RUDMAN. Well, I think that's exactly what Deloitte & Touche is now engaged in. The reason, as the chairman referred to, that there is a restatement is nobody really knows the answer to that question. They have to go through the derivative portfolio and then through a whole number of accounting issues.

You may have noticed that yesterday Fannie Mae announced they had found other accounting issues; not major issues, but other issues. Not surprising. I expect there will be more of that and when that is all done and a statement is delivered to the SEC and certified, then that will answer your question. We have no way of knowing that answer.

Mr. CAMPBELL. At this point we just don't know if it's merely misstating within a period or if in fact the current balance sheet—

Sen. RUDMAN. And the SEC—

Mr. CAMPBELL.—is improperly stated.

Sen. RUDMAN. The SEC is very concerned about what you report in a period because that is what the market reacts to.

Mr. CAMPBELL. Obviously. No, I understand that. I'm just trying to understand whether there's a pattern of continuously overstating earnings or whether there's this smoothing pattern and you've indicated it appears to be more the smoothing pattern.

Sen. RUDMAN. I cannot say and we won't know that for another year.

Mr. CAMPBELL. But we don't know where we are. Okay. One other question relative to the earnings per share and the bonuses relative to earnings per share. Those earnings per share bonuses included the chief financial officer and the controller whose primary responsibility it is to determine the earnings per share number?

Sen. RUDMAN. There are a large number of people, 20 or 25, that were in that pool and it certainly included those people.

Mr. CAMPBELL. Including those people—

Sen. RUDMAN. Oh, yes.

Mr. CAMPBELL.—in accounting and finance—

Sen. RUDMAN. Right. Right.

Mr. CAMPBELL.—primary responsibility it was to determine that number.

Sen. RUDMAN. Exactly.

Mr. CAMPBELL. Did you in your analysis make a—well, is the company still paying on that basis—still paying earnings per share bonuses as they were?

Sen. RUDMAN. They have changed radically—

Mr. CAMPBELL. To?

Sen. RUDMAN.—to a system that blends a number of metrics. They did that with our help and with consultants that they hired to try to change the methodology for awarding incentive bonuses. And I will just take 30 seconds of your time, Congressman.

Mr. CAMPBELL. Please.

Sen. RUDMAN. It's very interesting to me the evolution of this whole subject. You all recall that during the 1990's there was a lot of upset in the Congress about executives being paid when their companies performed poorly, and that was a legitimate complaint. Now, they decided to change and they figured the best target was an EPS target because that was the purest expression of how the company was doing. We now find the problem with that is that there are all these accounting shams and ways to make adjustments from year to year that could make those targets more achievable.

So what Fannie, recognizing that, did was to bring in an entirely new compensation consultant. They worked with us to find out what we were developing from the past history, and developed a compensation system which has been fully disclosed to OFHEO and I'm sure available to this committee if it's interested.

Mr. CAMPBELL. One last question, if I may. I'm actually a CPA; I don't know how many there are on this committee but there aren't a lot, but this is very complicated stuff. And derivatives are very complicated and accounting for derivatives is even more complicated.

To what degree do you think that this is more incompetence or under-education—you alluded to that earlier, that there is at least some of that wherein people were not qualified to review and make these decisions—versus some kind of intentional act?

Sen. RUDMAN. That's always hard to determine based on the evidence you have, and of course we don't have the right of subpoena and so, you know, there are some people, one in particular, I would have liked to have talked to who we didn't. But my observation would be that, number one, it was a very difficult standard to interpret but the way they interpreted it was just flat out wrong and we say that in the report.

This was not some innocuous interpretation. It was very clear to the SEC several months after this inquiry started back in 2004 that they weren't on even the right page in their interpretation and it was our conclusion as well.

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

Mr. BAKER. The gentleman's time has expired. Mr. Cleaver.

Mr. CLEAVER. Thank you, Mr. Chairman. Senator Rudman, I am very impressed with your great and exhaustive investigation and I think everyone here has mentioned how much you are revered around this place. I think it is important for us to know what went wrong with Fannie Mae and of course we must make whatever changes we can or take some curative action.

But having said that, and now moving forward, this committee approved what I consider to be a major change in Fannie Mae's portfolio that would allow 5 percent of profits to provide for badly needed affordable housing and we, at this particular juncture in the history of our Nation, need that passed more than ever if you consider what's going on in the Gulf Coast area.

Do you think that these changes that we are proposing, which are still over in the Senate, are acceptable ways for Fannie Mae to deal in some areas that they have not previously touched?

Sen. RUDMAN. Congressman, you know, I would like to answer your question but I really—I'm not in a position to, not because I don't want to but because I don't have an opinion. The only part of the legislation I have looked at very closely, both the Senate and the House side, is the legislation in terms of strengthening the regulator, which I fully concur with.

As far as these policy issues as to how the investments ought to be made, what should be done with portable housing, with low income housing, how the portfolio ought to be adjusted, I really don't have an opinion because I truly don't know.

Mr. CLEAVER. That's the problem. We shouldn't have had a Senator—I could have probably tricked somebody else into answering the question. I really didn't think you were going to answer.

Sen. RUDMAN. Well, somebody at this table may have an answer but I don't.

Mr. CLEAVER. I'll go to them; it's probably too late, now. I was just very much interested in whether or not you thought that Fannie Mae could actually—that the legislation that came out of this committee was actually legislation that was helpful to Fannie Mae and would be beneficial to the country, and I understand your answer.

But going back, you—in the report you said that the information flow to the board was tightly controlled by management. Now, is that different than any Corporation, any eleemosynary institution, even the Congress? I mean, to some degree we are a board of directors and we don't get information—

Sen. RUDMAN. Well, that's a whole different—

Mr. CLEAVER.—tightly controlled—but, yeah, that's another—but, you know, I'm concerned—it seems to me that we have an issue here that is more related to character than systems and if that is the case, then there may be some people whose character flaws are spilling over on some others who don't deserve to be painted with this broad brush that I think many people in the country now have of the top people in Fannie Mae.

Sen. RUDMAN. Congressman, let me just refer to your question broadly. There is no question for a lot of years in this country boards of directors generally were not terribly active. They tended to be tightly controlled by the company, they were not independent. That's all changed.

It changed—actually, it started to change before Sarbanes-Oxley; it's changed in a major way since Sarbanes-Oxley. And today, the overwhelming number of companies are moving towards more transparency in terms of the board and boards have more responsibility and more accountability than they had before the events of

Sarbanes-Oxley and other civil litigation that has taken place since that time.

So I think that Fannie Mae certainly was not the only company that tightly managed information flow but I will say that there were certain aspects of disclosure to the board which were described in this report which I thought were rather egregious in the sense that they should have been more informed than they were.

Mr. CLEAVER. I yield back the balance of my time, Mr. Chairman.

Mr. BAKER. I thank the gentleman. Ms. Kelly.

Ms. KELLY. Thank you, Mr. Chairman.

Senator Rudman, were you aware of the First Beneficial case before you were hired by Fannie Mae?

Sen. RUDMAN. First Benef—

Ms. KELLY. The First Beneficial case. Were you aware of the First Beneficial case before you were hired by Fannie Mae?

Sen. RUDMAN. I was not personally aware of that case.

Ms. KELLY. Did you have the opportunity to review that case during your investigation?

Sen. RUDMAN. I seriously doubt it unless it had to do with something that we were looking at. Is this something up in the Philadelphia area?

Ms. KELLY. It was a major fraud case, sir, and it involved Fannie Mae, and I'm curious about how a major fraud case involving Fannie Mae would not be within your remit to examine how the internal controls and safety of soundness of the company.

Our review of the case in my committee found that Fannie Mae's behavior in this case was motivated by wanting to hit compensation targets for regional executives. It might be a good thing if there's somebody else at this desk who could answer that question.

Sen. RUDMAN. I don't think anyone here can. You can understand, Congresswoman, that we were given a scope to look into. We had a lot of information to look at. What year was that case decided?

Ms. KELLY. 1998 to 2002.

Sen. RUDMAN. Yes. We had no knowledge of that case, nor was there any information about that case produced to us. And I might say that we put out a major bit of notification to the company and anyone else who was interested to be in communication with us and many people were, but nobody informed us about that case. We're unaware of it.

Ms. KELLY. Senator Rudman, perhaps you could comment on the compensation culture at Fannie Mae during that time, 1998 to 2002.

Sen. RUDMAN. Well, what we have said in the report is that the events of 1998 and 1999, as I've testified before here previously, led to managing and earnings targets through improper accounting procedures which also one of the motivations was to maximize bonuses under the incentive plan for that year. We did not find that activity in terms of specifically bonus targets in the years thereafter.

Ms. KELLY. The vice president of Fannie Mae for the region at the time of this particular case I'm talking about was a man named Samuel Smith, III. He was promoted from regional vice president

for single family housing to national vice president of single family housing in spite of his having presided over Fannie Mae's relations with the First Beneficial case—with First Beneficial.

It seems—my question now is whether or not Fannie Mae has sufficient controls on officer promotion within the company to prevent that kind of behavior from being rewarded in the future.

Sen. RUDMAN. Congresswoman, I would say the answer to that is, frankly, I don't know but it certainly seems to me the sort of thing you ought to communicate to the company since you obviously have extensive knowledge of the issue. Understand, our investigation was based on a set of challenges referred to us by OFHEO from its September and February issuances to the company and thus to us and we looked at those issues.

Had someone brought that issue to our attention and had it had relevance to what we were doing, we certainly would have looked at it. Neither of those things happened.

Ms. KELLY. So if I understand you correctly, OFHEO did not ask you to take a look at any of these cases other—they gave you a straight portfolio and you did not look beyond that portfolio; is that correct?

Sen. RUDMAN. Only—well, they gave us a portfolio but we had full ability to look beyond the portfolio but it would have had to come within the portfolio of what we looked at. For instance, it certainly did not come in within any of the accounting issues. We had 16 accounting issues to look at. I doubt that what you're talking about is an accounting issue.

Ms. KELLY. Sir, I just wanted to ask you, because I clearly didn't understand—it sounded to me like it was they gave you a portfolio and you looked at the portfolio but you were able to look outside the portfolio but if it wasn't in the portfolio you couldn't look at it. I didn't quite understand what you were trying to tell me.

Sen. RUDMAN. Well, let me try to be clear, Congresswoman. I'm sorry for being obscure. If you look in the report and the supplements, you will find two communications from OFHEO, one in September, one in February. They define the scope of work they wish us to look at. Had any of that information related to the case you're talking about, we certainly would have looked at it. Evidently, it didn't.

Also, I might point out, there are a number of litigation matters Fannie Mae has been involved with over the years and unless they had some relevance to what we were doing, we certainly did not look at them.

Ms. KELLY. Well, in this instance, sir, the—what happened was Fannie Mae sold bad mortgages to the Federal Government. It would have been a good thing to take a look at. I've run out of time. Mr. Chairman, you may want to pick that up.

Sen. RUDMAN. Mr. Parker might have an additional response on that issue. Bob?

Mr. PARKER. Congresswoman, if I understand—I believe I now recognize the matter you're referring to. If I understand, I believe it was down in North Carolina. And the matter arose and was being investigated. If my recollection is correct, there were issues of that sort that were raised during the scope of our investigation. In other words, the matter was broached and was looked into dur-

ing our investigation and was being looked at, as I recall, by other government agencies. So that is not something we decided to duplicate or to bring within our scope at that time.

Ms. KELLY. But you did not mention it in your report.

Sen. RUDMAN. No.

Mr. PARKER. No, because we didn't do any activity with respect to it.

Sen. RUDMAN. If a governmental agency were actively involved in an investigation, we certainly would not refer to that in our report. That would not be appropriate for us to do.

Mr. BAKER. The gentlelady's time has expired. Mr. Price.

Mr. PRICE. Thank you, Mr. Chairman. Senator, I appreciate you coming today. I also want to lend my voice to those who have recognized your service, past and present, and I'm honored to have you before the committee and recognize your budgetary work that you've done in the past and I appreciate it so much. I also want to thank your colleagues for joining us today. This is a remarkable indictment, truly, I think, that we see before us. I appreciate your candor and it's very sobering information.

I have a couple of specific questions. The first relates to the information that you and your colleagues had available to you as it compared to the information available to the four levels of review that have already been talked about, the CFO, the internal auditor, the external auditor and the regulator.

On page 5 of your prepared remarks, item number two talks about FAS 133. The interpretation "departed from generally accepted accounting principles" or GAAP "in a number of important respects. These departures from GAAP were not mere innocuous practical interpretations or modest deviations from a strict reading of the standard". And then the final sentence there, "and importantly we found that the company's significant hedge accounting practices were known to, and accepted by, the company's outside auditor".

My question would be, do you believe that those four levels of review had the same information that you had available to you with which to determine whether or not the practices were appropriate?

Sen. RUDMAN. Well, I certainly know that OFHEO has had access to all of that because, not only have they had the right of course under their special examination to gather that documentation and that information and do a number of interviews, but we have on an ongoing basis been supplying them with information since October of 2004.

I have to believe, from the minutes we've looked at and from the emails we've looked at, that the manager of the company had consultations with its inside and outside auditors on these issues and I assume—since all of the documents that we've received are from their files, I assume they had access to those documents.

Mr. PRICE. And there's been some allusion earlier to a "ease of covering up" and I can't remember whether it came from the panel or whether it came from up here. Do you have an opinion as to whether or not there was an active covering up of what was going on or—

Sen. RUDMAN. On the contrary. I go back and I look at the testimony before Mr. Baker's committee by Mr. Raines and Mr. How-

ard, which Mr. Baker has referred to. They were quite open in their beliefs at that time and they had stated them rather clearly. I don't think that—if there was, we didn't find evidence of it. We found evidence of mismanagement, incompetence, incorrect interpretation of rules, but not anyone trying to hide that other than, in our opinion—and hiding wouldn't be the right word—not being at a level of transparency with the board of directors that I think is consistent with good governance.

Mr. PRICE. Right. That leads to my next question. You had a number of items throughout your prepared testimony. As an organizational matter, too much authority at Fannie Mae was concentrated in the former CFO. Checks and balances were non-existent. The information the board received in critical areas was either incomplete or misleading.

Would you offer an opinion as to whether or not you believe the changes that have been put in place at Fannie Mae currently are satisfactory to correct the problems that you—and the structural problems that you identified?

Sen. RUDMAN. I believe they are, for two reasons. Number one, because in my dealings with the management of the company since the new management took over, I have found them to be very open, very transparent and, frankly, a bit on the humble side compared to the prior management.

Secondly, and even more important, I've looked carefully at the backgrounds of each of the individuals hired in these new positions and they're all very high level people with great backgrounds. Now, does that say they can't make mistakes? I'm sure they can. But the probability of these kinds of mistakes with this team it seems to me is far less likely.

Mr. PRICE. So that would lend credibility to the comment that was made earlier that this was a character flaw and not a systems flaw. Is that—

Sen. RUDMAN. I think it was both. I'm not sure I'd use the word character. I think it was a competence flaw and a systems flaw.

Mr. PRICE. Okay. I've got very little time left but I did want to offer anybody the opportunity to make any recommendation regarding any other changes from a Congressional standpoint, a legislative standpoint that you all would recommend.

Sen. RUDMAN. I have said consistently when asked that when this finally goes to conference, it's vital that a strong regulator emerge. I think—

Mr. PRICE. Anything else besides that?

Sen. RUDMAN. No.

Mr. PRICE. Does anybody have any other opinion regarding that?

Sen. RUDMAN. Comments at all? No.

Mr. PRICE. Thank you ever so much. I appreciate your service.

Mr. BAKER. The gentleman's time has expired.

Mr. PRICE. Thank you.

Mr. BAKER. Mr. Pearce.

Mr. PEARCE. Thank you, Mr. Chairman. Thank you, Senator.

Whenever the bonuses were written out, $27 million more or less, what string of employees participated in the bonuses? In other words, how deep in the organization did those go?

Sen. RUDMAN. Alex Oh will answer that question.

Ms. OH. The bonuses were distributed from Office of the Chair personnel down to senior vice president levels.

Mr. PEARCE. And what was the largest bonus given?

Ms. OH. I believe it was slightly less than $2 million for 1998 and that's just the AIP component.

Mr. PEARCE. Was it within the scope of your study that you would look back through the history and see if there was a pattern of misstatements in order to achieve the bonus levels or are you just targeting this one experience?

Sen. RUDMAN. We started in 1998.

Mr. PEARCE. The line of questions that was coming from one of my colleagues is that if we somehow accounted for the stuff later, it might, really, no harm, no foul, with the exception that the company is $27 million lighter at the end of one process than it would be at the end of the other process. Is that more or less accurate?

Ms. OH. I don't believe we agreed with the questioner that—

Mr. PEARCE. I understand, but that's the drift. And even if we gave him the fact that the later sequence was not in accordance with GAAP principles—but even if we acknowledged that it might possibly have been, still you have defrauded the company out of $27 million up-front that is not recovered—

Ms. OH. That's correct.

Mr. PEARCE. Yeah. So there is a foul even though we eventually—even if we eventually accounted for it, so even the premise of his question was—

Mr. BAKER. Would the gentleman yield just for a moment?

Mr. PEARCE. I appreciate that. I would let the gentleman achieve his own time, if he would.

I would ask about the cooperation between the executives. How cooperative were they? In other words—

Sen. RUDMAN. During our investigation?

Mr. PEARCE. Uh-huh.

Sen. RUDMAN. We have had absolute, total cooperation from the Fannie Mae board, from all of the new management, people that were still there that had been under the prior management. None of our requests were—

Mr. PEARCE. Except Mr. Howard.

Sen. RUDMAN.—we received everything we needed and, as you see, we did about four-and-a-half million documents. We're still looking at documents to wind up our engagement but we've had as much cooperation as one could expect and it's been fine.

Mr. PEARCE. And then—with the exception of Mr. Howard. Mr. Howard was non-responsive.

Sen. RUDMAN. Correct. I'm talking about the current management and I'm certainly talking about Mr. Raines and other employees of the company and former employees of the company.

Mr. PEARCE. Did the chairman have an observation?

Mr. BAKER. Yes, sir. I just wanted to give you some information. The 1998 to 2003 bonuses paid out was $245 million.

Mr. PEARCE. Thank you. How much was Mr. Raines's bonus?

Mr. BAKER. In one year, $1.9 million. I can give you more detail but I've got it up here.

Mr. PEARCE. Okay. That's fine. I would look to receive that.

Back on the gentlelady from New York, she was asking about First Beneficial. There was a pattern of $7.5 billion of loans that evidently were suspect that were sold into Fannie Mae and became a little bit messy, sold back and then maybe sold over to Ginnie Mae. In other words, they started making the rounds as bad loans have a tendency to do once no one can collect them.

Did any of your introspection—any of your looking at the background of Fannie Mae deal with this sort of a problem that might be inherent in their operation?

Sen. RUDMAN. We did not. It was not part of what we were doing.

Mr. PEARCE. Generally one can—

Sen. RUDMAN. I don't believe that's been settled yet, either. I believe that's still pending.

Mr. PEARCE. Generally one gets a feel for a corporation and its culture and for the practices. Would you think that you all studied enough about the culture at the company to realize if they would engage in practices that were a little bit suspect in the banking terms?

Sen. RUDMAN. I think what we say in the report is this company had a level of—a tone at the top, a level of arrogance that believed that it was pretty hard for Fannie Mae to be wrong about anything. Their whole experience with OFHEO and with the Congress historically as we did our investigation indicated to us that they believed that they were right and they would push very hard to prove they were right, either to the Congress or to OFHEO, depending on the circumstances.

Whether that led to accounting misstatements, I am in no position to say. What I can say is that the attitude of the company was not conducive to problem-solving. It was conducive to essentially defending its turf which it did rather successfully for a long time.

Mr. BAKER. The gentleman may have one more—his time is expired, but one more question if you'd like.

Mr. PEARCE. Well, that's fine. I see the time has expired. Thank you, Mr. Chairman.

Mr. BAKER. We're going to start with a second round because Mr. Frank and I both have another not lengthy set of questions and it follows on to Mr. Pearce's general observation. In looking at the significant volumes prepared by the counsel for Mr. Raines, there are the following sort of comments I want to get your reaction to, Senator.

We submit that it is not appropriate based on the record in front of you to rely on an amorphous criticism of tone or culture in analyzing Mr. Raines performance. A retrospective conclusion that there must have been cultural deficiencies because incorrect results were reached will not stand in the scrutiny of future adversarial proceedings.

Any attempt to portray Mr. Raines as having created an inappropriate tone or culture is unsupported. Although the record does not support an inference that Mr. Raines should be judged legally culpable for the events, his departure as chairman and CEO in the wake of the Office of the Chief Accountant's determination regarding accounting has exacted accountability for the performance of the company regardless of legal fault.

It seems to me that—I have a quote I believe it's yours and I'm not certain—that—or at least a statement of the report—that Mr. Raines was found to have contributed to the culture that improperly stressed stable earnings growth. Is that a correct assessment of the report's findings or to what extent was Mr. Raines truly the navigator of the ship in the culture that is troubling?

Sen. RUDMAN. Well, Chairman Baker, you know, I fully appreciate the position that counsel for various individuals take. That is their position. And the reason we published all of that is we thought that the committee was—and the Fannie Mae board and the world was entitled to see their position.

We obviously don't agree with that characterization that he did not contribute to that. As a matter of fact, when you look at page 5 of our executive summary, we find that he contributed to a culture that improperly stressed stable earnings growth and as chairman and CEO 1999 through 2004, he was ultimately responsible for the failures that occurred on his watch.

There's no question that he was a strong, driven, very competent presence and that he set the tone and there was no question in our mind that meeting these earnings targets was very important to Mr. Raines.

Mr. BAKER. And given your background inquiries, even though Mr. Howard is described as a very independent and powerful CFO, it is still not probable that in a world of accounting decisions at the level that has been discussed, that that would not—if not counseled, at least informed would be the customary business practice as to the actions being taken before they would be executed?

Sen. RUDMAN. Well, you know, Chairman Baker, I must say that that is one of the reasons we were very disappointed in being able to talk to Mr. Howard. We only have testimony from Mr. Raines and a lot of documents. And there is nothing in those documents that shows us Mr. Raines heavily involved in some of the financial decisions.

Your assumption may be correct, but we don't have a lot of evidence about that. I suspect that others may at some subsequent time. We don't have any.

Mr. BAKER. I thank you. Mr. Frank.

Mr. FRANK. Thank you, Mr. Chairman. I'm very much concerned about where we go from here. And you've made some comments which I appreciate about the strength of the regulator that we have in this bill and you did note that a contributing factor to the problems was that, as Mr. Falcone noted, OFHEO was underfunded and under-resourced.

Had the regulator of Fannie Mae and Freddie Mac at the time that this arose been the regulator that is contemplated in the bill that passed the House, does that in your judgment mean that what happened would have been less likely or at least caught earlier?

Sen. RUDMAN. Well, as I said, I don't like to speculate but, because we're both New Englanders, Congressman Frank, I will indulge this speculation.

It seems to me from the experiences I've had, both in private life and public life and serving corporate boards of various kinds and the work that I've done here at Paul, Weiss, that had this regulator had the depth of accounting expertise that it had when it engaged

Deloitte & Touche to do a deep dive, if you will, on Fannie Mae's accounting, that it is likely, in my view, that they would have uncovered some of the things that were uncovered in the 2004—

Mr. FRANK. And just to close the loop, the bill that we have passed out of the House, does that, in your judgment, provide those resources and the likelihood of that being available to the regulator?

Sen. RUDMAN. I think it probably does, but I would give you this caveat. I think any time a regulator like Fannie or the fed or the comptroller has an issue that could affect fundamentally large segments of the economy, it's always good they can come back to the Congress and ask for additional funds for special assistance.

Mr. FRANK. I appreciate it. But the structure would be appropriate.

Sen. RUDMAN. It is.

Mr. FRANK. There was some reference earlier—and I'm just interested in the magnitude of this—there was some reference comparing what you dealt with and examined to Enron and MCI. And in my judgment of both of those, we had just a woefully inadequate amount of revenue coming in. Was there that kind of problem at Fannie Mae? Is it comparable to Enron and MCI in the macro aspects?

Sen. RUDMAN. That was not the problem. I'm very familiar with those matters not only from having read about them but I've talked to people who were involved actively in and I don't think these are necessarily comparable. These are different kinds of issues.

Certainly, our report does not find people actively engaging—

Mr. FRANK. And not the order of magnitude of economic problem.

Sen. RUDMAN. No. No.

Mr. FRANK. One last question. It was rumored that there was an important Commission appointed and neither you nor Lee Hamilton was on it. Is that true?

Sen. RUDMAN. That's true.

Mr. FRANK. I'm surprised to hear that.

Mr. BAKER. The gentleman's time has expired. Mr. Pearce, did you want to take another round?

Mr. PEARCE. A couple more questions, pursuing just a little bit of the line of the questions that were just completed.

It did not in your mind rise to the level of magnitude of Enron and that particular problem. They put Martha Stewart in jail for 4,000 shares. Does it rise to that level?

Sen. RUDMAN. I'm sorry, Congressman. I didn't hear you.

Mr. PEARCE. I said Martha Stewart was put in jail—in other words, we're determining magnitude now. Enron was a larger magnitude, you said. Martha Stewart—I think there were 4,000 shares involved and she went to jail for obstruction and whether—and not telling whether or not she got some advance notice. So does this case rise to that magnitude?

Sen. RUDMAN. You know, I don't want to back into the question about culpability but I will just make the general observation that those cases involved the creation of entities that really didn't exist, created conspiracies to move funds around for a very—purposes that were deleterious to the markets.

We don't find that kind of evidence here. We find a lot of very serious financial mismanagement and we find some manipulation of earnings in order to reach bonus targets in a particular year and a real concern with meeting targets every year. That was an obsession. But I think that's a different level from what we're talking about.

Mr. PEARCE. Yes. Sure. Enron was the creation of other entities. But the HealthSouth, that was more of an accounting problem, WorldCom, again, was accounting fraud. So once you decide that you're going to—once a culture decides it's going to misstate, to manage the facts in order to get an outcome of $240 million bonus, and generally if you look at outcomes that accounting manipulation is designed for, usually there's some payoff for the individuals who are willing to get involved in that and I guess at the end of the day how can we say that one accounting fraud is different and more substantial, less substantial than another.

Because if you look, there seems to be a continuum at which the problem escalates. I can remember at one point Enron was a fairly straight oil and gas producer out in our particular area. But they then spun off the energy sector and got faster and faster players, saw more and more creases in the law, and then you could take a look at WorldCom, HealthSouth, Tyco, Commercial Financial Services.

Again, got a lot of players here moving numbers pretty fast and it appears that they benefitted personally, which appears to be the case here. How would those cases differ? How would my linking of those cases I think be inappropriate, I guess is my question.

Sen. RUDMAN. My answer would be that what someone in this government is going to have to decide, not me and not you, really, but someone in this government at the Department of Justice is going to have to decide whether or not any of these rise to the level of the kind of conduct you're talking about.

I truly don't know the answer to it, Congressman. I don't know.

Mr. PEARCE. And I appreciate the straightforwardness of the answer because many of these things are very difficult.

Mr. Chairman, I appreciate your indulgence.

Mr. BAKER. I thank the gentleman. I'll, for the record, bring us to closure today. I want to acknowledge that it is the board of Fannie Mae that engaged your firm and your team of experts to review and prepare an arms-length examination of a very troubled period of corporate performance. Thanks certainly on behalf of this committee and the chairman.

I want to make clear that we are very appreciative for the diligence exercised, the quality of the report generated and the findings which will be, I believe, of significant help to us going forward as we attempt to construct a new regulatory structure to assure homeowners of access to low cost housing and to assure taxpayers that they will not be placed in untoward risk.

You have performed a very valuable service and the committee is very appreciative, and we thank you for your time and participation here today.

Sen. RUDMAN. Mr. Chairman, I thank you for those words and I want to express my appreciation to your staff, Mr. Butler in par-

ticular, for being so helpful in getting us organized to appear here before you.

Let me also add I know there are a lot of footnotes in this report and some of your members may be interested in some of those footnotes, as you are. We will be happy to make them available.

Mr. BAKER. Oh, we have your mailing address and we're going to be good pen pals. Thank you.

Our meeting is adjourned.

[Whereupon, at 4:30 p.m., the committee was adjourned.]

A P P E N D I X

March 14, 2006

Opening Statement

Chairman Michael G. Oxley

Committee on Financial Services

Rudman Report on Fannie Mae
Tuesday, March 14, 2006

In early 2003, we were led to believe that the GSEs were running smoothly with only a routine accounting restatement in progress at Freddie Mac. What we have learned since then is that Freddie Mac and Fannie Mae were involved in large-scale misapplication of accounting standards and irresponsible corporate governance.

OFHEO, Congress, and the American people were misled by the former leadership of these enterprises. The Federal Home Loan Bank System has had its own share of accounting and management problems.

In 2004, Fannie Mae's board turned for help to Senator Warren Rudman, who, with his team of legal and accounting experts, has given us a report of both great quantity and quality. He has verified much of what OFHEO eventually uncovered and the SEC subsequently confirmed, providing an in-depth understanding of the intent and motive behind the transactions reviewed.

This voluminous report details widespread departures by senior management from GAAP accounting, largely to minimize earnings volatility and meet forecasts, and in 1998 to trigger maximum executive bonuses. Accounting systems were grossly inadequate and employees were unqualified.

Senator Rudman found that management "paid lip service to a culture of openness, intellectual honesty, and transparency...and discouraged dissenting views, criticism, and bad news." Arrogance is a descriptive term used more than once. There was clear disdain for OFHEO.

Fannie Mae claimed to be in line with state-of-the-art corporate governance, when in reality such standards were not being practiced. Failure to comply with Sarbanes-Oxley requirements of internal control over financial reporting is not an insignificant matter.

This report is costing between $60 and $70 million, on top of the $500 million Fannie Mae spent last year on its financial restatement work, a job that is far from done. Fannie Mae must also pay the legal expenses of its former Chairman/CEO and CFO.

The encouraging news, according to the Rudman report, is that Fannie Mae has undergone an extensive transformation in personnel and structure. There has been a dramatic shift in the tone at the top. The company has not waited until issuance of this report to begin making necessary changes. I welcome the effort that Chairman Steve Ashley and CEO Dan Mudd are making in this regard.

What Senator Rudman and others have shown us occurred at the GSEs over several years. While those responsible have left, it's taking the GSEs years to make corrections. We look forward to OFHEO's final report on their special exam of Fannie Mae. We must learn from this experience.

The Rudman report underscores that it's time for a new, combined regulator for the GSEs, with the tools and funding needed to prevent abuses from developing and permit swift enforcement action if they do. H.R. 1461 provides strong, bank regulator-like powers in the vital areas of capital, portfolios, product approval, and receivership, commensurate with the task of overseeing these large and complicated companies.

H.R. 1461 passed the House overwhelmingly last October. I urge the Senate to act, so that Congress can pass overdue GSE regulatory reform this year.

Senator Rudman, we appreciate your work on this report and your appearance here today.

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Statement of the Honorable Sue Kelly
Review of the Rudman Report on Fannie Mae
March 14, 2006

Thank you Chairman Oxley for holding this important hearing. Fannie Mae plays a vital role in our economy, purchasing mortgages from lenders and selling them to financial markets in order to generate liquidity for home purchases. This committee recognized the significance of Fannie Mae last year when it passed legislation to establish a strong new regulator for Fannie Mae and the other housing enterprises to allow them to carry out their missions while protecting taxpayers.

Last year the Subcommittee on Oversight and Investigations investigated a case where Fannie Mae had facilitated financial crimes against US taxpayers by First Beneficial of North Carolina. The owner of First Beneficial sold non existent mortgages to Fannie Mae. When Fannie Mae found out, instead of referring First Beneficial for fraud, it kept the few good mortgages for itself and allowed First Beneficial to reclaim the false mortgages and sell them to Ginnie Mae, a wholly owned government agency. At no time did Fannie Mae notify Ginnie Mae or the FBI of any illicit activity. Fannie's defense was that it didn't have to under the law.

The members of the Oversight Subcommittee did not buy that excuse, and I offered an amendment to HR 1461 that requires all federal housing enterprises to notify law enforcement whenever they think fraud has been committed, even if they are not themselves a direct victim. Hopefully the Senate will move on this legislation and allow it to become law.

Senator Rudman, in his report, fails to address this financial crime abetted by Fannie Mae, and the leadership culture that allowed the Fannie Mae official responsible for overseeing First Beneficial to be promoted to a Vice President of the Company. I look forward to questioning him about this case and others he may have reviewed.

OPENING REMARKS OF THE HONORABLE RUBEN HINOJOSA

Chairman Oxley and Ranking Member Frank,

I want to express my sincere appreciation for holding this important and timely hearing today to receive testimony from Senator Rudman on his comprehensive report detailing accounting irregularities at Fannie Mae.

Before I address the report itself, I want you to know that I appreciate all that Fannie Mae has done to improve the quality and quantity of homes in my district over the past decade. Prior to this, my district suffered from horrible housing conditions. Now, the housing supply in my district has increased significantly as has the quality of those homes. I will continue to support Fannie Mae, provided, and this is important, that they do not engage in any irresponsible corporate and reporting activity now, or in the future.

Although the size and composition of the Fannie Mae portfolio was beyond the scope of Senator Rudman's report, I continue to support the level of Fannie Mae's portfolio of loans. I disagreed one hundred percent with former Federal Reserve Chairman Alan Greenspan's recommended that Fannie Mae's portfolio be reduced from its current level to one hundred billion dollars worth of loans. Such a proposal would have negatively impacted Fannie Mae's ability to meet its mission and would have harmed my constituents. I strongly support for the Government Sponsored Enterprise legislation we passed in Committee and on the House floor this Congress, and I encourage our counterparts on the Senate side to adopt our proposal on portfolio size and on the affordable housing program.

Now that Senator Rudman has completed his report on Fannie Mae's financial irregularities, it is my understanding that reports from the Office of Federal Housing Enterprise, the SEC, and the Department of Justice are forthcoming. They will determine the liability and culpability for Fannie Mae's conduct.

Despite all the negative news reports and negative statements by opponents of Fannie Mae, I am pleased that the recommendations Senator Rudman's report makes regarding Fannie Mae's governance, internal controls, internal organization and the like either have been implemented or will be soon. I am also pleased to learn that Fannie Mae's Board and current management cooperated completely with Senator Rudman and his team of investigators. However, I plan to ensure that my staff keeps me informed of any additional irregularities in Fannie Mae or other Government Sponsored Enterprises. Congress and the public cannot and will not accept the financial accounting schemes outlined in the Rudman Report.

Thank you Mr. Chairman.

I yield back the remainder of my time.

OPENING STATEMENT OF
CONGRESSMAN PAUL E. KANJORSKI

COMMITTEE ON FINANCIAL SERVICES

HEARING TO REVIEW THE RUDMAN REPORT ON FANNIE MAE

TUESDAY, MARCH 14, 2006

Mr. Chairman, we meet this afternoon to review the recently released report prepared by former Senator Warren Rudman at the request the Special Review Committee established by the Fannie Mae's Board of Directors. This report examines the company's problems related to accounting standards, internal auditing controls, and corporate governance, among other matters.

As I have regularly noted at our past hearings in this area, it is important for our panel to conduct comprehensive and regular oversight over our housing government-sponsored enterprises to ensure that they fulfill their missions and operate safely and soundly. Today's hearing is therefore not only timely, but also appropriate.

In compiling this report, Senator Rudman and his team of investigators left no stone unturned. As I understand, these experts reviewed more than four million pages of documents over a period of 17 months. They also conducted in excess of 240 interviews.

As we begin today, I want thank Senator Rudman and his team. I greatly appreciate their diligence in these important matters. Their comprehensive report has helped me to understand what went wrong at Fannie Mae.

In one of its more significant conclusions, this report identified no new major accounting violations not already disclosed by Fannie Mae and the Office of Federal Housing Enterprise Oversight. In addition, while the report details many of the major corrective actions that Fannie Mae has taken to address these matters, it makes no significant recommendations about further actions needed to address the firm's past shortcomings.

Importantly, the report also observes that Fannie Mae has "undergone an extensive transformation both in personnel and structure" during the last year and a half. It further finds that no member of the current management team knowingly participated in improper conduct.

While this report provides some assurance to the Congress, the American public, and investors that Fannie Mae is turning the corner by directly and forthrightly addressing its accounting, auditing, and governance problems, we still must complete legislative action to improve the oversight of all government-sponsored enterprises. It is in the public's interest that we address these regulatory issues promptly and properly.

As I said in March 2000 at our very first meeting in this long series of hearings 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. Such regulation will protect the continued viability of our capital markets and promote confidence in Fannie Mae and Freddie Mac.

By in large, the bill that passed the House last fall by a vote of 330 to 91 would accomplish these objectives. Before the 109th Congress completes its work, I hope that our

colleagues in the Senate will consider their bill and that we can finally reach resolution on these matters.

Before yielding back the remainder of my time, I would be remiss if I did not note that while Fannie Mae has cleared one hurdle with the release of the Rudman report in its ongoing efforts to restore accountability within the firm, other investigations by the Office of Federal Housing Enterprise Oversight, the Securities and Exchange Commission, the Public Company Accounting Oversight Board, and the Justice Department remain ongoing.

The determinations of these experts will likely play an important role in influencing how we will ultimately proceed on any legislation during the remainder of the 109th Congress. If and when these entities complete their examinations, I also suspect that we will meet again to study their conclusions. In other words -- and to paraphrase the work of Robert Frost -- we have promises to keep and may have miles to go before we sleep.

In closing, Mr. Chairman, I commend you for your continued perseverance in these matters, and I look forward to hearing from our distinguished witness.

STATEMENT OF WARREN B. RUDMAN
Paul, Weiss, Rifkind, Wharton & Garrison LLP

BEFORE THE COMMITTEE ON FINANCIAL SERVICES
United States House of Representatives

March 14, 2006

Chairman Oxley, Congressman Frank, members of the Committee, on behalf of the entire Paul, Weiss and Huron team that was involved in our engagement on behalf of the Special Review Committee of the Board of Directors of Fannie Mae, we would like to thank you for inviting us to participate in this hearing today. Let me introduce to you those members of our team who are seated with me. My partners at Paul, Weiss are Robert Parker, Alex Oh and Daniel Kramer. Also with us today from Huron Consulting Group are George Massaro, Vice Chairman and Jeffrey Ellis, Managing Director.

It is unusual for attorneys to come before a congressional committee to speak about a professional representation. In this instance, Fannie Mae's Board of Directors, through its Special Review Committee, instructed us at the outset of our engagement to be open and transparent to governmental authorities. Since October 2004, we have provided weekly or biweekly briefings to the government agencies that have an interest in this matter, including the Office of Federal Housing Enterprise Oversight ("OFHEO"), the Securities and Exchange Commission ("SEC"), the United States Attorney's Office for the District of Columbia, and the Public Company Accounting Oversight Board. Under the instruction of the Special Review Committee and the Board of Fannie Mae, the company made the final report of our investigation concerning Fannie Mae available to the public. In that same spirit, Mr. Chairman, we were encouraged to

accept your invitation to appear here today and to assist the Committee in any way we can.

I will divide my opening statement today into four parts. First, I will describe our engagement on behalf of the Special Review Committee of Fannie Mae's Board, including the nature and scope of our internal investigation. Second, I will describe our key findings, with some emphasis on the two most important accounting issues we considered: Fannie Mae's implementation of FAS 91 and FAS 133. Third, I will summarize our findings regarding Fannie Mae's corporate governance and internal controls, with regard both to our findings concerning the company's historical practices and to the significant changes that are under way at Fannie Mae today. I will conclude my statement with brief remarks on what our investigation did *not* cover.

I. Our Engagement

Our engagement on behalf of the Special Review Committee began in September 2004. At that time, OFHEO was in the midst of a Special Examination of Fannie Mae's accounting that began in the wake of the problems revealed at Freddie Mac in 2003. In mid-September 2004, OFHEO issued a report of its findings to date that was critical of Fannie Mae's accounting, principally in two areas: the accounting for premiums and discounts on the company's mortgage loan and mortgage-backed securities portfolios, and the accounting for the derivatives Fannie Mae used to hedge the interest-rate risk associated with its debt. The report also raised concerns about Fannie Mae's systems and practices in the accounting standards, financial reporting and internal controls areas.

Soon after OFHEO released its report, OFHEO and Fannie Mae's Board of Directors entered into an agreement. Certain aspects of that agreement were unusual, and also vital to an understanding of our report. In the agreement, the Board agreed to undertake an internal investigation of the matters raised in OFHEO's report. The Board also agreed to study and address the organizational, structural, internal controls and governance issues that OFHEO had identified. In other words, the Board undertook a dual-track approach in which it tasked Paul, Weiss to conduct an internal investigation to determine what happened, and at the same time the Board commissioned an analysis of what remedial measures should be made promptly to address OFHEO's criticisms. As a consequence of this dual-track process, the recommendations that we would have made regarding Fannie Mae's governance, internal controls, internal organization and the like either have been implemented already or are under way.

The agreement between OFHEO and the Board provided the focus of our investigation, but it did not limit the scope of our inquiries. From the outset, Fannie Mae's Board and OFHEO encouraged us to conduct a broad review of the company's accounting, financial reporting, governance and internal controls policies and systems, and to follow the facts wherever they might lead. In February 2005, OFHEO identified additional accounting and internal controls issues at Fannie Mae, and those issues were added to the scope of our investigation. Finally, the company self-identified new issues in a November 2005 Form 12b-25 filing with the SEC, and we considered those matters as well. The Board placed no restrictions on our work and we received complete cooperation from the Board and from the company's current management.

Early in our engagement, Paul, Weiss retained Huron Consulting Group as our forensic accounting experts. The accounting judgments in our report are Huron's, and we concur in those judgments. We appreciate and admire Huron's important contributions in this engagement.

Our investigation took about 16 months. Our team, including Huron, reviewed over 4 million pages of documents and conducted over 240 interviews of 148 Fannie Mae employees or former employees. Unfortunately, Fannie Mae's former chief financial officer, J. Timothy Howard, refused to cooperate in our investigation. We interviewed the company's former controller, Leanne Spencer, on several occasions, but she declined to cooperate further after the company found that she had not produced certain documents from her files that were relevant to our investigation.

II. Our Key Findings

Our report to the Special Review Committee is 616 pages, and our executive summary is 31 pages. The three-volume appendix, which includes samples of documents that we discuss in our report, as well as submissions made by various executives, including Franklin D. Raines and Tim Howard, adds about 2000 additional pages. In my view, anyone who wants a complete picture of our findings and analysis must review all of these documents carefully. With that caveat in mind, however, I believe that our principal findings can be summarized as follows:

1. The accounting, financial reporting and internal audit operations of the second largest financial services company in the country were inadequate, both qualitatively and quantitatively. The resources dedicated to these functions were insufficient. Senior managers in critical accounting, financial reporting and internal

audit roles either were unqualified for their positions, did not understand their roles, or failed to carry out their roles properly.

2. Management's interpretation of FAS 133 (dealing with hedge accounting) departed from generally accepted accounting principles ("GAAP") in a number of important respects. These departures from GAAP were not mere innocuous practical interpretations, or modest deviations from a strict reading of the standard. In our view, the company's hedge accounting conflicted with clear and specific provisions of the authoritative accounting literature. Moreover, the record shows that the company's implementation of FAS 133 was motivated by a desire to remove volatility from reported earnings, while avoiding both the substantial changes to the company's business methods and the development of the complex accounting systems that otherwise would have been necessary to implement the standard properly. Finally, and importantly, we found that the company's significant hedge accounting practices were known to, and accepted by, the company's outside auditor.

3. Management's application of FAS 91, which concerns the accounting for premium and discounts on mortgages and mortgage-backed securities, also violated GAAP. Our most significant finding in this area concerned the circumstances surrounding the company's decision to record $240 million of premium/discount amortization expense in 1998 when the company's calculations showed that the expense was $439 million. We believe that there was no justification or rationale to support the recognition of only $240 million. Moreover, given other accounting entries and adjustments that the company made during this period, the evidence overall supports the conclusion that the company's accounting decisions at that time were

motivated by a desire to meet earnings-per-share targets and to achieve maximum bonus awards under Fannie Mae's Annual Incentive Plan. Once again, it is important to note that Fannie Mae's outside auditor was aware of these adjustments – although not necessarily their motivation.

4. In our report, we address sixteen separate accounting issues. In virtually every instance we examined, Fannie Mae's accounting was inconsistent with GAAP. As we summarize in the executive summary of our report, management often justified departures from GAAP based on materiality assessments that were not comprehensive, on the need to accommodate systems inadequacies, on the unique nature of Fannie Mae's business, or on "substance over form" arguments. We found substantial evidence in a number of specific instances and overall that the company's accounting and financial reporting policies and procedures were motivated by a desire to show stable earnings growth, achieve forecasted earnings, and avoid income statement volatility. However, with the exception of the one instance in 1998 that I referred to earlier, we believe that the evidence does *not* support the conclusion that these departures from GAAP were motivated by management's desire to maximize bonuses in a given period.

5. As an organizational matter, too much authority at Fannie Mae was concentrated in the former CFO. He had responsibility for management of the company's portfolio, for its treasury operations, and for its accounting and financial reporting functions. The CFO also functioned as the company's chief risk officer and had administrative responsibility for the internal audit function as well. The CFO and other senior managers operated within "silos" that had little interaction with each other

and which therefore lacked a complete appreciation and understanding of the others' roles and functions. In these circumstances, the checks and balances that would ordinarily exist in an organization of Fannie Mae's size and complexity were largely non-existent.

6. Although Fannie Mae's top management professed a desire to hear the views of subordinates, and to value intellectual honesty, openness and transparency, the culture at Fannie Mae discouraged criticism, dissenting views, and bad news. This applies to the areas of accounting and financial reporting, among others. One area in which senior management in the financial area was particularly sensitive was in achieving forecasted results; even minor differences between forecasted and actual results appear to have caused great concern.

7. Management tightly controlled the flow of information to the company's Board. In many instances, the information the Board received in critical areas involving accounting, financial reporting and internal controls was incomplete or misleading. In particular, we noted many instances in which management assured the Board, often in the presence of its outside auditor, that the company's critical accounting policies were consistent with GAAP. Management also assured the Board that the company's accounting and financial reporting systems were adequate, and that the accounting and financial reporting functions had adequate resources, even when senior managers were aware that such was not the case.

8. The Board relied heavily on senior management, as well as the views of the company's outside auditor. Until OFHEO began its Special Examination in 2003, and even in the wake of earlier announcements of substantial accounting problems at

Freddie Mac, the Board received assurances that Fannie Mae's accounting was proper. Moreover, through 2002, OFHEO's own reports on Fannie Mae gave the company high ratings, including high marks in such areas as corporate governance and the company's implementation of FAS 133.

III. Corporate Governance and Internal Controls

As I noted earlier, our investigation was part of a dual track process in which Fannie Mae's Board and management undertook significant reforms of the company's governance, organization, and internal controls while our work was under way. We participated in that effort by sharing information, commenting on various proposals, and making suggestions. In our report, we made findings regarding the Company's most significant governance, accounting and internal controls functions as they existed prior to September 2004, and we also noted the significant changes that have taken place in each of these areas. I will briefly summarize our findings.

1. The Board

Fannie Mae's Board of Directors endeavored to operate in a manner consistent with its fiduciary obligations and evolving corporate governance standards. The Board was open to examination by third parties, including OFHEO, and it generally received high marks. The Board, and particularly the Audit Committee, was sensitive to matters relating to accounting and financial reporting. The Audit Committee received regular assurances that the company's accounting complied with relevant accounting standards.

The Board has taken several significant steps since the release of the OFHEO report in September 2004, including the separation of the Chairman and CEO

positions, the establishment of a Risk Policy and Capital Committee to oversee financial and operational risk management, and the transformation of its Compliance Committee into a permanent committee with broad oversight in regulatory and compliance matters.

2. Office of the Chair (Senior Officers)

Fannie Mae's Office of the Chair – comprising the four most senior officers – suffered from functional and organizational problems. As noted above, a great deal of the authority and responsibility for the company's risk management, financial reporting, accounting and internal controls functions, as well as a substantial portion of the company's business operations, was concentrated in the CFO. Senior management also exhibited and cultivated a culture of arrogance both internally and externally, and perhaps most of all toward OFHEO.

There have been substantial changes in the past year at the senior management levels. Structurally, the Office of the Chair no longer exists. In particular, the functions previously overseen by the CFO are now divided among a number of different officers including a Chief Financial Officer, whose duties are more consistent with a CFO's typical functions, a Chief Risk Officer, and a Chief Audit Officer. We have received numerous reports from inside and outside the company that its attitude has changed materially toward a more open and cooperative approach to its regulators, to Congress, and to the companies with which Fannie Mae deals.

3. Office of Auditing (Internal Audit)

We found that, prior to September 2004, the head of Internal Audit at Fannie Mae lacked the requisite expertise and experience to lead the internal audit operation at a company as large and complex as Fannie Mae. Moreover, on more than

one occasion, the head of Internal Audit took steps that suggested he did not fully appreciate his organization's role within the Company or his proper relationship with senior management. In addition, the internal audit group at Fannie Mae lacked adequate resources, particularly in recent years as the company grew in size and complexity and as the demands placed on the internal auditors increased commensurately.

The Company has a new Chief Audit Officer who reports to the Audit Committee, with a separate reporting line to the new CEO for administrative purposes. The internal audit function has been separated from the risk management function (which is to be overseen by a Chief Risk Officer), and the structure and resources of the internal audit group have been enhanced significantly.

4. Office of the Controller

Prior to September 2004, the Controller's Office at Fannie Mae suffered from some of the same weaknesses as the internal audit function. Leadership at the top lacked the accounting and financial reporting expertise and experience one would have expected at a company like Fannie Mae, and the office as a whole lacked the resources necessary to handle many of the complex accounting and reporting issues that the company faced, particularly in recent years. The company's systems in these areas were grossly inadequate – as I noted earlier in my remarks, the company historically has justified deviations from GAAP on the ground that it did not have the systems necessary for strict compliance.

There have been significant changes in recent months. There is new leadership in the accounting and financial reporting areas, including individuals with substantial experience in public accounting or at large financial institutions. Certain

functions, such as accounting policy and business forecasting, have been moved outside of the Controller's Office. We understand that the company is increasing the resources dedicated to these areas, including both staffing resources and systems development resources.

5. Ethics and Compliance

Fannie Mae's compliance organization dates back at least ten years. It has maintained a Code of Business Conduct and has supported an internal investigative unit (the Office of Corporate Justice) to address employee complaints. In 2003, the company established an Office of Corporate Compliance to develop and monitor compliance plans for the company's business units, provide training to employees, *etc.* Our principal concern in this area was that the company's chief compliance officer, a deputy general counsel, reported directly to the General Counsel and worked on matters involving employees' claims against the company. The compliance program thus suffered from at least the appearance of a conflict of interest. In addition, we believe that the program overall would have been better served by a chief compliance officer who had no other assigned duties.

In 2005, Fannie Mae established an Office of Compliance, Ethics & Investigations ("OCEI") to oversee the pre-existing ethics and compliance functions, as well as a new ethics unit. The new Chief Compliance Officer, who heads OCEI, has a direct reporting line to the CEO and to the Compliance Committee of the Board.

IV. Other Matters

I would like to conclude my statement with two observations on what our investigation did *not* cover. I know this Committee and your counterpart in the Senate, as

well as the Administration, are concerned about the size and composition of the Fannie Mae portfolio. This issue – which, of course, relates to safety and soundness matters – was beyond the scope of our inquiry. Those who wish to draw conclusions as to that issue from the contents of our report are obviously free to do so, but that policy issue is well beyond the scope of our inquiry. We have drawn no conclusions on that issue.

Moreover, as you well know, in the report and its appendices we have laid out the facts that this sixteen month investigation has produced. Where appropriate, we have been critical of Fannie Mae and we have assigned general and specific accountability where we believe that was warranted. The question of liability and culpability for the conduct we describe is a matter for various government departments and agencies to decide. It would have been decidedly inappropriate for us to reach conclusions in those areas.

Thank you, Mr. Chairman.

A REPORT TO THE SPECIAL REVIEW COMMITTEE OF THE BOARD OF DIRECTORS OF FANNIE MAE

EXECUTIVE SUMMARY

PAUL, WEISS, RIFKIND, WHARTON & GARRISON LLP

WARREN B. RUDMAN
ROBERT P. PARKER
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HURON CONSULTING GROUP INC.

GEORGE E. MASSARO
JEFFREY H. ELLIS

February 23, 2006

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EXECUTIVE SUMMARY

I. INTRODUCTION

The Office of Federal Housing Enterprise Oversight ("OFHEO") began a special examination of Federal National Mortgage Association ("Fannie Mae" or the "Company") in November 2003 (the "Special Examination"). Almost one year later, OFHEO issued a report of its findings to date as of September 17, 2004 (the "OFHEO Report"). Among other things, the OFHEO Report found that the Company's accounting in various respects was not consistent with generally accepted accounting principles ("GAAP") and was motivated by management's desire to portray Fannie Mae "as a consistent generator of stable and growing earnings," and by an "executive compensation structure that rewarded management for meeting goals tied to earnings-per-share, a metric subject to manipulation by management."[1] OFHEO also concluded in its Report that the Company had "dysfunctional accounting policy development, key person dependencies, and poor segregation of duties" that contributed to accounting failures and safety and soundness problems.[2]

In September 2004, the Special Review Committee of the Board of Directors of Fannie Mae (the "SRC") engaged former Senator Warren B. Rudman and Paul, Weiss, Rifkind, Wharton & Garrison LLP (collectively, "Paul, Weiss") to conduct an independent investigation of, among other things, the issues that were raised in the OFHEO Report and to report our findings and conclusions to the SRC. This Executive Summary highlights the key findings and conclusions of the Paul, Weiss investigation. The full findings and conclusions are contained in a Report, which we also publish today.[3]

The scope of our investigation was initially defined by an agreement dated September 27, 2004 between the Board of Directors of Fannie Mae (the "Board") and OFHEO, which was supplemented by an agreement dated March 7, 2005, between OFHEO and the Board (collectively, "OFHEO Agreements"). The issues raised in the OFHEO Agreements primarily concerned the Company's accounting, internal controls, and corporate governance and structure. The scope of our investigation, however, was not limited to the issues in the OFHEO Agreements. In fact, the SRC did not place any

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[1] OFHEO Report of Findings to Date in the Special Examination of Fannie Mae, dated Sept. 17, 2004, *available at* http://www.ofheo.gov/media/pdf/FNMfindingstodate17sept04.pdf., Executive Summary at i.

[2] *Id.* at viii.

[3] *See* "A Report to the Special Review Committee of the Board of Directors of Fannie Mae" (the "PW Report" or the "Report"). The three-volume Appendix to the PW Report includes sample documents of interest that are discussed in the PW Report, and certain submissions that Paul, Weiss received from attorneys who represent former Company officers.

limitations on our inquiry and instructed us to follow whatever leads we discovered during the course of our investigation.[4] We received the full support of the SRC and the Board during the course of our review, and the SRC instructed the Company to cooperate fully with our investigation.

Pursuant to the OFHEO Agreements, and with the approval of both the SRC and OFHEO, we retained the forensic accounting services of Huron Consulting Group Inc. ("Huron") to assist in our investigation. During the course of the investigation, Paul, Weiss and Huron collectively reviewed more than four million pages of hardcopy and electronic documents and conducted more than 240 interviews.[5] The accounting opinions expressed in this Report are Huron's. Neither Paul, Weiss nor Huron, however, conducted an audit of the Company's financial statements. The task of preparing restated financial statements remains that of the Company, and the task of auditing those financial statements remains that of the Company's independent auditor, Deloitte & Touche LLP.

Our engagement was unusual in that the OFHEO Agreements required the Company, contemporaneously with our investigation, to undertake prompt remedial measures with respect to Fannie Mae's accounting processes and procedures and corporate governance. As we detail in the Chapter of our Report addressing Corporate Governance and Internal Controls, the Board and the Company, with our input, have diligently pursued their obligations under the OFHEO Agreements and many remedial measures are already underway. As a result, many recommendations that we would have made are already in the process of being implemented. Accordingly, while we document in the Report many of the significant corrective measures the Company has taken, we do not make significant additional recommendations.

Our factual findings and conclusions focus on management's intent and motive with respect to the transactions we reviewed. Paul, Weiss's mandate, however, did not include determining whether any of the conduct we reviewed constituted a violation of law or breach of professional standards or whether the Company may properly assert legal claims against any individuals or entities.[6] We leave to others the task of determining the consequences that should flow from our factual findings.

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[4] The SRC also specifically asked Paul, Weiss to review allegations made by a former-employee, Roger Barnes, including how the Company addressed Barnes's allegations, and any other matters raised anonymously by employees and former employees.

[5] As detailed further in Chapter II of the Report, our document review is ongoing. As recently as February 16, 2006, the Company brought to our attention the existence of new materials that could be relevant to our investigation. If necessary after reviewing all of the materials produced by the Company, we will supplement our findings and conclusions in this Report.

[6] For example, while the SRC was initially formed in January 2004 in response to a shareholder demand letter, we were not retained until September 2004 and were not

As with any private investigation, we relied on the voluntary cooperation of the Company, its employees (both current and former), and its agents. We did not have the power to compel testimony or production of documents. While we received good cooperation from the Company and its current employees, counsel and auditors, we were not able to interview certain former employees. Most significantly, Timothy Howard, a former Vice Chairman, Chief Financial Officer, and member of Fannie Mae's Board, declined our repeated requests for interviews. Similarly, Leanne G. Spencer, a former Senior Vice President and Controller, cooperated with our investigation during its early stages but declined further interviews after we became aware of a critical document in her files, which Spencer had failed to produce in response to Paul, Weiss's document requests to the Company.

Finally, under the SRC's direction, we cooperated fully with the United States Department of Justice ("DOJ"), the Securities and Exchange Commission ("SEC"), OFHEO, and the Public Company Accounting Oversight Board ("PCAOB"). Almost immediately after our retention, beginning in October 2004, we met with and regularly briefed the regulatory agencies on the progress of our investigation.

II. SUMMARY OF FINDINGS

The Company, under the Board's direction and with OFHEO's input, has undergone an extensive transformation both in personnel and structure since September 2004. Since that time, as we observe in the Chapter describing Corporate Governance and Internal Controls, there has been a dramatic shift in both the "tone at the top" and the Company's internal organization. During the course of our investigation, we communicated our findings to the SRC and the full Board, and the Company has not waited for the issuance of the PW Report before making necessary changes. As a result, (1) the Company has disclosed the principal problematic accounting issues that are the subject of this Report,[7] (2) no member of management who we found knowingly participated in improper conduct continues to be an employee of the Company, and (3) as noted above, our suggestions for changes in corporate governance either have been implemented or are underway.

We summarize below our principal conclusions about the Company's accounting practices, internal controls, and corporate governance and structure prior to 2005. We next summarize in detail each of the accounting issues and the related findings

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asked to address the demand letter. We understand that the SRC and the Board are ably represented by other counsel in connection with the demand letter and with respect to pending civil actions, and it was not our role to advise the SRC or the Board in such matters.

[7] As noted above, management and its current outside auditor are engaged in a restatement effort that involves a detailed review of all of the Company's accounting policies and practices. This process could result in additional matters being identified that are not addressed in this Report.

and conclusions contained in the Report. Due to the complexity of both the accounting and factual issues addressed in the PW Report, however, no summary can serve as an adequate substitute for reading the chapters that contain a full exposition of both the facts and our analyses.

Our principal conclusions with respect to Fannie Mae's historical accounting practices, internal controls, corporate governance, and structure prior to 2005, are as follows:

First, management's accounting practices in virtually all of the areas that we reviewed were not consistent with GAAP, and, in many instances, management was aware of the departures from GAAP. Management often justified departures from GAAP based upon materiality assessments that were not comprehensive, the need to accommodate systems inadequacies, the unique nature of Fannie Mae's business, or "substance over form" arguments. For example, management unjustifiably departed from GAAP with respect to: (1) its implementation of Statement of Financial Accounting Standards ("FAS") 133 in order to minimize earnings volatility and to avoid having to make investments in new systems to accommodate the standard; (2) its application of FAS 91, because compliance with FAS 91 would have resulted in greater earnings volatility than management had wanted; and (3) its approach to accounting for interest-only securities in combination with other securities to avoid impairment write-downs that would have been required under GAAP for the interest-only securities.

Second, except for one instance in connection with the 1998 financial statements, we did not find evidence supporting the conclusion that management's departures from GAAP were motivated by a desire to maximize bonuses in a given period. We did, however, find evidence amply supporting the conclusion that management's adoption of certain accounting policies and financial reporting procedures was motivated by a desire to show stable earnings growth, achieve forecasted earnings, and avoid income statement volatility. For example, management's strategic execution of debt buybacks, purchase of finite risk insurance products, and acceleration of certain expenses related to corporate-owned life insurance, among other strategies, helped the Company to show a trend of stable earnings growth from 2001 to 2004. Similarly, management did not alter its accounting practice for the allowance for loan losses, even though management was aware that the allowance was overstated, because the reduction of the allowance would have generated a "spike" in income.

Third, employees who occupied critical accounting, financial reporting, and audit functions at the Company were either unqualified for their positions, did not understand their roles, or failed to carry out their roles properly. This deficiency was most clearly manifested by employees who occupied senior positions in the Office of the Controller ("Controller's Office") and the Office of Auditing ("Internal Audit"). In addition, the resources devoted to accounting, financial reporting, and audit functions were not sufficient to address the needs of an institution as large and complex as Fannie Mae. This was apparent, for example, in our review of the Company's implementation of

FAS 149 (concerning the accounting for forward commitments), in which resource constraints led to a haphazard adoption of the standard.

Fourth, the information that management provided to the Board of Directors with respect to accounting, financial reporting, and internal audit issues generally was incomplete and, at times, misleading. Management tightly controlled the information flow to the Board generally, and Howard, in particular, filtered the accounting and financial information the Board received. For example, management provided incomplete or misleading information in connection with (1) presentations regarding the 1998 amortization expense calculation; (2) briefings requested by the Board concerning Freddie Mac's restatement announcement in 2003, and whether Fannie Mae had any similar accounting issues; and (3) a presentation regarding the Special Examination in 2004, where the Board was left with the incorrect impression that the Company's accounting under FAS 91 and FAS 133 was justifiable and defensible, and that no restatement would be required.

Fifth, the Company's accounting systems were grossly inadequate. This fact became apparent in our review of several areas – most notably our review of the Company's accounting for premium and discount amortization under FAS 91, but also in connection with the Company's accounting under FAS 133 and FAS 149. The accounting for the Company's investments in affordable housing partnerships also was affected by systems limitations.

Finally, we conclude that Howard, the former CFO, and Leanne Spencer, the former Controller, were primarily responsible for adopting or implementing accounting practices that departed from GAAP, and that they put undue emphasis on avoiding earnings volatility and meeting EPS targets and growth expectations. As for former Chairman and CEO Franklin D. Raines, we did not find that he knew that the Company's accounting practices departed from GAAP in significant ways. We did find, however, that Raines contributed to a culture that improperly stressed stable earnings growth and that, as the Chairman and CEO of the Company from 1999 through 2004, he was ultimately responsible for the failures that occurred on his watch.

* * * *

A. Fannie Mae's Application of FAS 91

We reviewed two primary issues with respect to management's application of FAS 91: first, we looked at management's support and motivation for its decision to record only $240 million in additional premium expense in the fourth quarter of 1998 when the Company's own analysis indicated it should have recorded $439 million in additional premium expense; second, we reviewed management's development and implementation of a purchase premium and discount amortization policy in 2000 (the "Amortization Policy" or "Policy") that included a "precision threshold" within which management retained substantial discretion not to make adjustments that were required under FAS 91.

1. 1998 FAS 91 Adjustment

The Company was required under FAS 91 to amortize premiums and discounts on its loans and mortgage-backed securities ("MBS") using the "level yield" method. The application of the level yield method resulted in periodic adjustments to increase or decrease interest income to reflect, among other things, the effect on the cumulative amortization of premium and discount of differences in actual and estimated prepayments as a result of interest rate movements (this adjustment is referred to at Fannie Mae as "catch-up"). The amount generated for this catch-up adjustment for the fourth quarter of 1998 was $439 million in expense, which, under FAS 91, the Company was required to recognize in the same period. Howard and Spencer, however, recommended to the Office of the Chairman that the Company recognize only $240 million out of $439 million in expense and defer $199 million in expense to future periods. The reduction would be accomplished through periodic "on-top" entries. Recognizing the full $439 million in expense would have caused the Company to miss then forecasted earnings per share ("EPS") for 1998 of $3.22 per share, and also would have resulted in falling below the EPS-based threshold for triggering employees' bonus payments. We conclude that deferral of the $199 million in catch-up expense violated GAAP.

Howard and Spencer also recommended and recorded other adjustments that had the effect of making up for the shortfall from forecasted EPS caused by recognizing the $240 million in catch-up expense for 1998. First, Howard and Spencer accelerated a planned change from a non-GAAP to GAAP method of accounting for the tax credits received in connection with the Company's investment in low income housing tax partnerships, which resulted in recognizing an extra year's worth of credits in 1998. The net after-tax effect of the change in accounting for investments in low income housing partnerships was $108 million in income. We conclude that the accounting method adopted by management was in accordance with GAAP, but that management's motive for accelerating the method change was to offset the EPS shortfall created by recording the $240 million in amortization expense.

The second adjustment made by management was the reversal of $3.9 million in "aged balances" from a suspense account. The adjustment, which had no support, was recorded as "miscellaneous income" and served to incrementally increase EPS to $3.2309, which triggered maximum employee bonuses for 1998. Because the Company had already exceeded published analyst expectations of $3.22 for 1998 through management's other 1998 actions – *i.e.*, recording only $240 million of catch-up expense and accelerating the recognition of tax credits – we infer that this unsupported $3.9 million entry can be explained only by a motive to increase EPS results from $3.22 to $3.2309, the minimum amount of EPS needed to trigger the maximum bonuses.

Howard and Spencer then made incomplete and misleading disclosures to the Board about these entries in their reports on the 1998 financial results. For example, at the January 19, 1999 meeting of the Board of Directors, Howard's presentation omitted the fact that the Company's systems indicated that $439 million in catch-up expense

should be recorded, and misleadingly suggested that the $240 million in catch-up expense was recorded at management's option because there was "room" created by the recording of two years' worth of tax credits. Similarly, Spencer failed to inform the Audit Committee in February 1999 that the full catch-up expense adjustment should have been $439 million, and that, in fact, the Company's auditor had noted an audit difference for the unrecorded $199 million expense. Further, Spencer misleadingly described the reason for the ability to record an extra year's tax credits as due to improvements in the Company's systems and controls, rather than management's correction of historical accounting methodology that had not been in accordance with GAAP.

Spencer did inform the Company's outside auditor of the decision to reduce interest and guaranty fee income by only $240 million in expense as opposed to the calculated $439 million in expense, and of the accounting change for the tax credits. The outside auditor noted an audit difference for the deferred catch-up expense amount of $199 million, and certified the Company's financial statements for 1998 without qualification. Also, the auditor's 1998 workpapers showed that the outside auditor reviewed the activity in the account from which the $3.9 million was reversed into income and noted an audit difference for the remaining balance in the suspense account.

2. Management's Development and Implementation of the Amortization Policy

After noting an audit difference for the $199 million unrecorded amortization adjustment for 1998, the Company's outside auditor asked management to develop and formalize a policy concerning its FAS 91 calculations. Management, under the direction of Howard, developed an Amortization Policy and implemented it in December 2000.

We conclude that the Policy was developed for the purpose of avoiding audit differences with the outside auditor, rather than for the purpose of complying with GAAP. For example, the Policy contained provisions that were inconsistent with GAAP, such as the provision creating a "precision threshold" within which management did not have to recognize adjustments that were otherwise required under FAS 91 on the grounds that all amounts within the threshold were the "functional equivalent of zero." Management, however, did review the significant terms of the Policy with the Company's auditor at the time of its adoption and we did not see any evidence that the auditor disagreed with its terms.

Significantly, management disregarded the terms of the Policy when it did not suit its purpose. The most obvious example of management's disregard for its own policy was the recognition of catch-up that fell within the calculated range, which was supposedly the "functional equivalent of zero."

Howard and Spencer also misled the Board about the purpose of the Policy and how it was implemented. Spencer made a presentation about the Amortization Policy to the Audit Committee in November 2003 in which she failed to disclose the fact that management's implementation of the Policy was not consistent with

the Policy's terms. Further, Spencer and Howard were both present at a July 19, 2004 joint meeting of the Audit and the Special Review Committees of the Board where one of the critical issues under discussion was OFHEO's potential allegation that management engaged in earnings management by inconsistently applying the Amortization Policy. Neither Spencer nor Howard disclosed at this meeting the fact that management had, in fact, applied the Policy inconsistently, and that OFHEO's allegations would find support in the facts.

B. Fannie Mae's Application of FAS 133

The Company's outstanding debt grew dramatically during the 1990s (commensurate with the growth in its portfolio). The ability to hedge that debt against interest-rate risk was a substantial component of the Company's risk management strategy. The Company used derivatives to hedge the interest-rate risk associated with its debt, and the notional amount of its derivative portfolio also grew tremendously during the 1990s and into the 2000s.

FAS 133, which was issued in 1998 and was adopted by the Company on January 1, 2001, required companies to recognize derivatives at fair value, with changes in fair value recognized in income. Companies could avoid the earnings volatility associated with FAS 133 by entering into transactions that qualified for hedge accounting. FAS 133 refers to this as "special accounting."

We recognize that there has been substantial criticism of FAS 133 and, in particular, that some hold the view that FAS 133 injects inappropriate volatility into earnings. We are also aware that, in the wake of the SEC's announcement concerning errors in Fannie Mae's accounting under FAS 133, a number of companies have announced that they would restate their FAS 133 accounting.

With respect to Fannie Mae's application of FAS 133, we conclude that management did not engage in mere innocuous practical interpretations or modest deviations from a strict reading of the standard. Rather, management's implementation of FAS 133 was motivated not only by a desire to avoid earnings volatility, but also by a desire to avoid substantial changes to the Company's business methods, and/or the need to develop the new and complex accounting systems that would be required to satisfy FAS 133 standards. These considerations led management, with Howard's support and with the knowledge of senior managers in the Controller's Office, to adopt an approach to hedge accounting that deviated from the standard's clear requirements in numerous and important respects.

For example, management adopted the so-called "shortcut" method of hedge accounting for many of its hedge transactions, even when the derivatives in those transactions did not have a fair value equal to zero and the terms of the derivatives and the hedged instrument were not "exactly the same," as FAS 133 requires. The Company also disregarded amendments to FAS 133 that the FASB adopted over a year before the standard took effect that foreclosed management's approach to the accounting for transactions the Company referred to as "term-outs," which were an important element of

the Company's hedge strategies. The Company's accounting policy regarding anticipated debt issuances also violated FAS 133 requirements by not specifying a single, proper methodology to assess a hedge's effectiveness, and by treating those transactions as perfectly effective based on a "duration matching" methodology that was inconsistent with FAS 133 requirements. Finally, the Company's hedge documentation was insufficient and in most cases incorrect; for example, the Company's documentation posited that the critical terms of the hedged instrument and the derivative were "identical," which was not the case.

It appears that senior accountants in the Controller's Office were of the view that any deviations from a "strict application" of FAS 133 were immaterial. However, management did not conduct a systematic or comprehensive test to support that proposition, and the tests that it did conduct provided inadequate support for that view.

The record also shows that management took steps throughout the FAS 133 implementation process to keep the Company's outside auditor informed of its decisions. Management engaged the auditor to review the Company's new hedge accounting policies (the "Derivatives Accounting Guidelines") prior to the effective date of FAS 133, to ensure that the principal features of the Company's implementation program complied with GAAP. The audit workpapers reveal that the auditor knew of, and accepted, Fannie Mae's major accounting policies concerning FAS 133 on the grounds that any deviations from GAAP reflected in Fannie Mae's policies were immaterial. In April 2000, moreover, the auditor described to the Board's Audit Committee its planned involvement in the FAS 133 implementation effort and prior to OFHEO's Special Examination, the auditor did not raise any concerns to the Audit Committee or the full Board regarding the Company's approach to hedge accounting.

In addition, the Company's Derivatives Accounting Guidelines were available to, and were reviewed by, OFHEO examination staff. As late as June 2002, when OFHEO issued its report on Fannie Mae's operations in 2001, OFHEO reported that the Company's implementation of FAS 133 had a sound basis.

Howard set the tone for the FAS 133 implementation effort and, from the outset and throughout the process, he focused the implementation team's efforts on avoiding the volatility associated with FAS 133 while not changing the Company's business practices to any significant degree. However, we did not find any evidence that Howard directed anyone to violate GAAP.

Raines's involvement in the implementation effort was minimal. While he was familiar with the Company's goal of avoiding income statement volatility and the complex systems development effort associated with complex hedge accounting under FAS 133, we saw no indication that he knew that the Company's application of FAS 133 contained substantial departures from GAAP.

Finally, the Board received assurances from management on several occasions (as well as from the Company's auditor and OFHEO) that the Company's implementation of FAS 133 was appropriate. Prior to the OFHEO Special Examination,

the Board did not have any indication that the Company's application of FAS 133 contained substantial departures from GAAP.

The SEC's Office of the Chief Accountant announced in December 2004 that the Company's historical application of FAS 133 did not comply with GAAP, and that the Company was disqualified from applying hedge accounting from FAS 133's effective date. The Company is restating its financial statements with respect to its hedge accounting.

C. Conclusions About Other Accounting Issues

In addition to management's application of FAS 91 and FAS 133, we reviewed management's application of numerous other accounting issues, most of which were identified by OFHEO in the February 11, 2005 Letter, and by the Company in a November 2005 SEC Form 12b-25 filing. We summarize below our findings with respect to those issues.

1. Accounting for the Allowance for Loan Losses

We reviewed the Company's accounting for the allowance for losses on loans in its mortgage portfolio and the liability for losses associated with its guaranty of mortgage-backed securities (collectively referred to as the "Allowance"). From 1997 through 2003, the Allowance was essentially unchanged at roughly $800 million despite improved credit quality and improved credit administration. For example, credit losses as a percentage of the average book of business declined from 0.027% in 1998 to 0.006% in 2003, which caused the number of years of losses covered by the reserve to increase from 3.3 years of losses in 1998 to 7.2 years of losses in 2003.

The methodology the Company used for setting the Allowance before 2004 (roughly from 1997 through 2003) did not comply with GAAP because it was not based upon a detailed and documented assessment of the loss exposure inherent in the portfolio as required by GAAP. Management, along with the Company's auditor, recognized its departure from GAAP as early as 1998, but did not make any changes to the methodology or the accounting until 2002. Management's methodology for setting the Allowance also did not incorporate its improved credit performance, which should have been a factor in the analysis for setting the level of the Allowance. For example, the Company's forecasted loan losses over the period were consistently in excess of actual loan losses incurred, yet the Allowance was never adjusted to reflect the actual results.

We did not find any evidence that management actually used the Allowance to manipulate earnings or to offset unrelated one-time expenses in a given period. We did find, however, that certain members of management – particularly, Spencer – viewed the Allowance as a "war chest" that could be drawn down to offset unrelated one-time events. While, there is no evidence that Spencer used the Allowance in this way, the evidence, at a minimum, reflected her awareness that the Allowance was overstated. In addition, the overstated Allowance made it easier for management to meet year over year earnings targets in subsequent years. Had the excess reserve been

reversed when management first became aware that the Allowance was overstated, this "non-recurring" income would have made the subsequent year's earnings growth goals that much more difficult to achieve.

2. Accounting for Dollar Rolls

A typical "dollar roll" transaction at Fannie Mae involved a transaction in which the Company borrowed funds from a counterparty for a specified period of time, using a security from the Company's portfolio as collateral. To effect a dollar roll transaction, Fannie Mae would "sell" to the counterparty a security from its portfolio as collateral and simultaneously enter into an agreement to "purchase" a similar security at a future date. Assuming that the relevant accounting standards currently set forth in FAS 140 were satisfied, the Company was required to account for the arrangement as a financing (*i.e.*, a short-term loan) rather than as a sale and a purchase.

Failure to comply with the relevant accounting standards had two potential consequences: (1) Fannie Mae would have to account for the transfer of collateral as a sale, with consequent recognition of gain or loss; and (2) as the collateral for dollar rolls were MBS held in the Company's "held-to-maturity" portfolio, the treatment of the transfer of the collateral as a sale would have resulted in the "tainting" of the portfolio (that is, the Company's held-to-maturity securities portfolio would be reclassified as available-for-sale, with significant accounting consequences).

Fannie Mae's accounting for dollar roll transactions did not comply with GAAP for a significant portion of the time period covered by this Report. Although FAS 140 became effective in 2000, and the accounting requirements for treating dollar rolls as financings were set forth in previous authoritative literature, the Company did not have an accounting policy that addressed all of the relevant requirements until 2003.

In addition, coordination among the offices responsible for dollar roll transactions – particularly between Financial Standards in the Controller's Office, the Securities Trading Operations group in the Treasurer's Office, and Portfolio – was weak. Consequently, there were significant gaps in the Company's processes for addressing the accounting requirements for dollar rolls. The processes failed to address the FAS 140 requirement that the collateral returned to Fannie Mae be "substantially the same" as the securities that Fannie Mae "rolled out." There also was no evidence that, prior to about 2002, and possibly thereafter, the Company satisfied the FAS 140 requirement that the value of the collateral be adequate to reacquire the security. Accordingly, we conclude that management lacked a basis for reaching the conclusion that any given dollar roll transaction properly should be accounted for as a financing.

Although we noted significant gaps in the Company's accounting for dollar rolls as financings, we conclude that the failure to follow GAAP in this instance was not intentional or motivated by an effort to achieve forecasted earnings. Rather, the failure stemmed from a lack of rigor in the Company's accounting. We understand that, as part of its restatement effort, the Company is reviewing its dollar roll transactions to determine whether individual transactions did, in fact, comply with the accounting

standards, and which transactions should properly have been accounted for as sales and purchases.

3. Accounting for Forward Commitments

FAS 149, which had an effective date of July 1, 2003, amended FAS 133 to clarify that firm commitments to purchase mortgage loans or purchase and sell certain MBS should be treated as derivatives. Accordingly, FAS 149 required that these firm commitments (like other derivatives covered by FAS 133) be recorded on the Company's balance sheet at fair value and subsequently marked to fair value at the end of each reporting period until the settlement date. Changes in the fair value of the commitments would be reflected in the Company's earnings unless the derivative qualified as part of a hedging relationship.

Fannie Mae designated many of its firm commitments as hedges of the risk resulting from changes in the price of the mortgage loans or MBS the Company would acquire or deliver when the commitment settled. Under FAS 149, hedge accounting would have been appropriate only if the provisions of FAS 133 – and specifically the provisions regarding hedges of forecasted or anticipated transactions – were met. Consequently, as FAS 133 specifies in these circumstances, the Company was required to document the hedged transaction with sufficient specificity so as to identify when that transaction occurred.

We reviewed the history of management's implementation of FAS 149 and the policies and procedures that were adopted with regard to hedged transactions involving firm commitments. We found that the effort to implement the standard stretched the Company's resources in both of the departments that were most immediately affected by the new standard: Financial Standards and Portfolio. The resources were strained by a lack of systems and staffing to the point that it became difficult, if not impossible, for the Company to implement the standard correctly and in a timely fashion. The Company did not adopt a final accounting policy regarding FAS 149 until October 2003, nearly four months after the standard's effective date. Likewise, the Company's procedures to address several of the important issues raised by FAS 149 were not complete until months after the standard took effect. The Company revised its hedge documentation several times after the standard's effective date, and, as late as mid-2004, the specifications for the systems necessary to account properly for the hedge transactions were still in the discussion stage.

The policies and procedures the Company adopted to implement FAS 149 did not comply with GAAP. For example, the Company's hedge documentation did not describe a hedged forecasted transaction with sufficient specificity such that one could identify whether a transaction that occurred was the hedged transaction.

These departures from GAAP resulted from three related factors: (1) the lack of advance preparation for the changes that FAS 149 required; (2) the incorrect assumption at the outset of the implementation that, with only minor exceptions, all commitments would be eligible for hedge accounting; and (3) the unexpected complexity

involved in the application of FAS 149 to the wide variety of Fannie Mae's commitments and forward trade transactions. We did not find that the failures in this area resulted from an effort to manipulate the Company's financial results.

Weakness in the Company's implementation of FAS 149 became apparent the first time the Company closed its books after FAS 149's effective date, which resulted in a $1 billion error on the Company's balance sheet. Although the error was immediately brought to the Board's attention, rather than explaining the problems associated with the implementation effort, Spencer informed the Board that the implementation process was well in hand. This omission was especially significant as the balance sheet error triggered an examination by OFHEO of Fannie Mae's FAS 149 implementation process and its "end-user" accounting systems. The Board thus lacked relevant information relating to an issue that the Company's principal regulator deemed particularly significant.

4. Classification of Securities Held in Portfolio

Our investigation included an assessment of the Company's interpretation and application of FAS 115, which specifies the accounting for a security depending on its classification as either: (1) held to maturity ("HTM"), (2) available-for-sale ("AFS"), or (3) trading. Once a security is classified as HTM, the security may be reclassified only in narrow, specified circumstances.

FAS 115 states: "*At acquisition*, an enterprise shall classify debt and equity securities into one of three categories: held-to-maturity, available-for-sale, or trading." Management's accounting policy did not require the classification of a security to be determined on the date of acquisition, as required by FAS 115. Instead, management interpreted the phrase "at acquisition" to mean "at the end of the month of acquisition." We found no support or justification for such an interpretation.

In practice, the Company classified securities "at acquisition," but that classification was subject to change. When a Company trader executed a trade, he or she either would select a classification or the system would classify the security as HTM by default. Near the end of the month, management determined whether HTM securities should be reclassified to AFS. That practice violated GAAP.

The Company's approach violated an unambiguous accounting rule regarding the classification of securities as HTM, AFS, or trading. Although the Company's procedure for determining a security's final classification involved the consideration of factors such as "balance sheet effects" and "economic opportunities," we saw no evidence that management intentionally used this mechanism to manipulate its net income. Moreover, at least as of 2003, the Company's auditor was aware of management's practices in this area and did not raise an objection. We also found no evidence that management discussed this issue with the Board prior to the OFHEO Special Examination.

5. Recognition of Interest Expense and Income

Until early in 2003, the Company's liquid investment portfolio ("LIP") and debt accounting systems (known as ORION and STAR, respectively) calculated interest expense and income on certain investments and debt instruments as if there were 30.4 days in each month, even if the instrument's terms required interest payments on an "actual/365" or "actual/360" basis. As a result of this practice, management avoided the fluctuations in interest income and expense that would result from the fact that the twelve months of the year and the four calendar quarters do not have the same number of days. Management also periodically accrued additional interest expense through "on-top" entries, and these entries were then amortized over the remainder of the year.

Management should have accounted for these investments and borrowings by recognizing interest income and expense in accordance with the legal terms of those arrangements, regardless of the fact that such treatment would generate fluctuations in the recognition of income and expense from month to month and from quarter to quarter. Management discontinued these practices in the second quarter of 2003, at which time it began to recognize interest income and expense in accordance with the actual terms of the instruments.

Spencer and other officers in the Controller's Office knew or should have known that the Company's practices did not comply with GAAP. The audit workpapers indicated that the Company's outside auditor was aware of this practice at least as of July 2003. We saw no indication that this issue was ever brought to the attention of the Board.

6. Accounting for Other-Than-Temporary Impairment of Manufactured Housing Bonds and Aircraft Asset-Backed Securities

In April 2004, OFHEO raised concerns about the Company's accounting for other-than-temporary impairment ("OTTI") of investments in manufactured housing bonds ("MH bonds") and aircraft asset-backed securities ("Aircraft ABS"). We found that the Company did not have a formal process for monitoring investments for OTTI until mid-2003, when it formed an Impairment Committee, and also did not evaluate all of its HTM or AFS investments for OTTI, as required by GAAP, prior or subsequent to formation of the Impairment Committee. Management's failure to monitor all HTM and AFS investments for OTTI represents a control weakness, and suggests the possibility that the Company underreported OTTI on investments that it did not monitor.

In addition, prior to 2004, Fannie Mae relied primarily on internally developed discounted cash flow ("DCF") models to measure impairment on MH bonds and Aircraft ABS and, thus, to determine the OTTI amounts it recognized, even though bid/ask dealer pricing was available. While we did not find that management chose to rely on DCF modeling in order to achieve particular earnings goals, we note that the DCF model included assumptions that were subject to management discretion and data errors that impacted both the timing and the amount of OTTI the Company recorded.

After OFHEO raised its concerns regarding impairment on MH bonds and Aircraft ABS in 2004, Fannie Mae discussed its policies for measuring and recognizing OTTI with the SEC, and ultimately worked with OFHEO to implement a new policy in April 2004.

7. Accounting for Investments in Interest-Only Mortgage-Backed Securities ("IO MBS")

Beginning in 1995, management combined its IO MBS investments with other securities (specifically, MBS and REMIC securities) for accounting purposes, and treated the IO MBS as an increase in the premium or reduction in the discount on the other security.[8] Management initially consulted the Company's outside auditor for this accounting treatment for the IO MBS investments, and the auditor did not object to the Company's approach.

We believe that the Company's account for IO MBS investments violated GAAP. EITF 90-2, which addressed an analogous situation and should have been applied by management to the accounting for its IO MBS investments, required that an exchange transaction take place before the accounting for the individual interest-only and principal-only securities can change.

Furthermore, management's primary motive for engaging in this accounting treatment was to avoid recognizing impairment charges on the IO MBS. Management did not fully disclose its motivation or all of the material facts relating to its IO MBS accounting to the outside auditor. While management did consult with the auditor for its accounting treatment of IO MBS investments in 1995, by 1998, management intentionally withheld from the auditor its impairment analysis of the IO MBS. Management did so apparently fearing that the new audit team might disagree with the old audit team and require management to change its accounting for IO MBS, which could have resulted in the Company being required to recognize impairment losses.

Management failed to inform the Board of the issues relating to its accounting for the IO MBS investments until OFHEO raised questions about these practices in April 2004. In particular, Freddie Mac's restatement raised nearly identical issues, but management, in its presentation to the Board about the Freddie Mac restatement, failed to disclose the existence of its own problematic "synthetic" IO MBS combinations.

8. Securitization of Wholly-Owned MBS

In the normal course of its business, Fannie Mae issues guarantees to holders of securities backed by pools of mortgage loans. In a majority of these transactions, lenders transfer pools of mortgage loans meeting certain criteria to Fannie

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[8] These IO MBS are also referred to as "synthetic REMICS" in the PW Report.

Mae, which transfers those loans to trusts that Fannie Mae establishes, and for which it serves as trustee. The lenders usually receive a certificate (*i.e.*, MBS) evidencing the right to receive cash flows from the underlying loans (less a guaranty fee).

Fannie Mae acquires interests in the MBS it guarantees as an investment, and at times has acquired 100 percent of the MBS from a particular trust. With the adoption of FIN 46 in 2003, the Company was required to determine whether it needed to consolidate any of those trusts onto its balance sheet. However, under FIN 46 a party (other than the transferor) with a variable interest in a Qualifying Special Purpose Entity ("QSPE") is not required to consolidate that entity, as long as it does not have the unilateral right to dissolve the trust or change the entity so it no longer meets the definition of a QSPE. An entity is a QSPE if the transferor does not have the unilateral right to dissolve the trust, and either (1) third parties hold more than ten percent of the beneficial interests in the entity, or (2) the transaction is a guaranteed mortgage securitization ("GMS"). Management treats the securitization of pools of loans as GMSs and the trusts as QSPEs.

Under FIN 46, management was required to evaluate its trust portfolio to determine whether it should consolidate those trusts in which it owned 100 percent of the beneficial interests because it had the unilateral ability to dissolve the trust. To avoid the need to evaluate thousands of trusts and the requirement to consolidate those trusts (which would have required the Company to recognize the loans held in the trust rather than the MBS on its balance sheet), management developed a structure in which it would transfer wholly-owned MBS to a new trust, called a Mega, and sell one percent of the beneficial interest in each Mega to a third party. According to management's initial analysis of the relevant accounting standards in 2003, this approach would allow it to avoid consolidation of the trusts because the Company would no longer have the unilateral ability to dissolve them.

During a discussion between an accountant in Financial Standards and members of the FASB staff in 2004 regarding another transaction, the accountant raised the issue of whether structures like Megas – which are securitizations of securities, not securitizations of loans – qualified as a GMS. The FASB staff did not disagree with her conclusion that the answer was no. Accordingly, management reevaluated its accounting for Megas; essentially, management concluded that it should consolidate the Megas and account for the transfer of the one percent interest as a secured financing.

Management's initial accounting policy in this area was incorrect, but we conclude that this was the result of an inadvertent misinterpretation of the applicable accounting literature.[9] We have not found any evidence suggesting it was motivated by a

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[9] As we discuss in our Report, management also took an alternative approach to certain pools in which it acquired a 100 percent interest in the MBS. Rather than consolidate the loans or include the trust in a Mega, management reclassified the MBS from AFS to HTM. This approach also was inconsistent with relevant accounting standards. The policy that supported this approach was reversed in 2004 as well, and our

desire to manipulate the Company's financial statements. In fact, the Company reversed course after Financial Standards learned of its mistake and corrected the Company's accounting policy. Accountants in Securities Accounting then assessed the impact of the error on the financial statements and determined it to be immaterial.

We understand that management is reviewing these transactions, including the Company's approach to the consolidation of trusts under its new policy, as part of its restatement effort.

9. Accounting for Income Tax Reserves and Certain Tax-Advantaged Transactions

We reviewed the Company's process for establishing reserves related to tax credits the Company received as a result of its investments in synfuel partnerships and in connection with certain tax-advantaged transactions known at Fannie Mae as Short Term Interest Securities ("STIS"). We also considered management's reporting of the tax benefits from its synfuels investments and STIS transactions on its financial statements.

The process that management used to determine its tax reserves appears reasonable. However, we are not able to form any conclusions as to whether specific tax reserve levels were appropriate and represented known tax liabilities because the Company did not maintain documentation adequate to explain the rationale for its decisions with respect to the establishment and amount of individual tax reserves. Several documents, however, indicate that Spencer and others in Financial Reporting, in some instances, may have recorded amounts to the Company's tax reserve that were not connected to known tax liabilities, but instead were booked for inappropriate earnings management purposes.

With respect to the synfuels partnerships, management established a reserve percentage for the purpose of calculating the Company's tax reserve. However, it appears the Company also recorded an additional unsupported "excess" amount in the reserve at year-end 2002 that it did not release to earnings until the third quarter of 2003. The remainder of the reserve was released in the fourth quarter of 2003. Interviewees were unable to explain why the amounts were released over two quarters and we have seen no documents that offer a reason.

Management opted to obtain only a draft "should" level opinion from outside counsel for its STIS transactions, even though it expected the IRS to examine the transactions. Apparently, the Company sought to avoid the additional expense associated with issuance of a final opinion, and it believed that the draft opinion provided adequate support for the Company's position. Although certain documents from the Company's files may be read as questioning whether the STIS transactions had an adequate business

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conclusions regarding the bases for the error and management's intent apply to these circumstances as well.

justification, interviewees stated their belief that the STIS transactions had genuine economic benefits distinct from the tax benefits, and, based on evidence that the transactions were expected to (and did in fact) generate a profit, we have no reason to dispute that assessment.

10. Accounting for Insurance Products

Fannie Mae purchases mortgage insurance in order to mitigate its exposure to credit losses on loans, to comply with the Charter Act (*i.e.*, the Company is required to have credit enhancement for loans with a loan to value ("LTV") ratio equal to or greater than eighty percent), and as a broader risk mitigation strategy. Beginning in 2001, however, management, under Raines's direction, began considering finite risk insurance products as a method for accomplishing earnings-related goals in addition to mitigating the Company's exposure to losses. Several of these contemplated transactions were motivated either by a desire to shift income between periods (in particular from 2001 and 2002, into 2003 and 2004), or to offset the impact of other actions that were expected to result in a sharp increase in earnings.

In January 2002, management executed a policy with Radian that absorbed a portion of a deductible on an existing insurance policy covering certain high-risk loans, and which had a large premium in 2002 with predictable returns in future periods (the "Radian Transaction"). In November 2005, the Company announced that the Radian Transaction had not been accounted for in accordance with GAAP and that it had to be restated because the policy "did not transfer sufficient underlying risk of economic loss to the insurer" to qualify for the insurance accounting treatment it was given. We agree with this assessment, and also conclude that the Radian Transaction was entered into for the primary purpose of "shifting" income out of 2002 into 2003 and 2004, to demonstrate stable earnings growth.

11. Accounting for Out-of-Portfolio Securitization ("Portfolio Pooling System")

In its February 11, 2005 letter to Stephen B. Ashley, OFHEO reported that an error in Fannie Mae's Portfolio Pooling System ("PPS") had led to the misclassification of loans that the Company held in its portfolio. We determined that the error appeared in the interface between PPS, which the Company uses to securitize the loans that it acquires, and LASER, the Company's system of record for loans that it holds in its portfolio. The error resulted in loans destined for securitization at a future date being erroneously classified as held-for-investment ("HFI") rather than held-for-sale ("HFS").

Our inquiry focused on why the error had gone undetected since the program was implemented in the 1980s. We determined that the error in classification would have been relevant to the Controller's Office, as the accounting for loans in the Company's portfolio differs depending on whether they are classified as HFI or HFS. We concluded that the Controller's Office received information regarding the classification of the loans from the PPS system before the system error resulted in an

erroneous classification. Moreover, under the Company's accounting policy at the time, loans that were designated within a given month for securitization were accounted for as securities rather than as loans. Because most of the loans that flowed through the PPS system were accounted for as securities under this policy, the number of loans that the Company accounted for as HFS was relatively small. Thus, any discrepancies that resulted from the classification error would have been difficult to detect.

12. The Debt Repurchase ("Buyback") Program

We reviewed the Company's debt buybacks for the period from 2000 to 2004, including the motive, accounting, and disclosures for the buybacks. We conclude that buyback transactions were accounted for and reported in accordance with GAAP. Management disclosed the extent of the debt buybacks and the resulting losses in Fannie Mae's public disclosures.

We do not dispute that management had legitimate business purposes for executing debt buybacks during the period, including a desire to manage interest-rate risk. However, we conclude that management's execution of buybacks suffered from several deficiencies.

First, management's motivation for executing buybacks was primarily earnings driven. Management used debt buybacks to depress income in 2001 through 2003, in order to show stable earnings growth; and management also focused primarily on the present period EPS impact of the buybacks in determining the size of the buybacks. Management never discussed its motivation with the Board, including at a meeting of the Assets & Liabilities Policy Committee of the Board in 2004, where management presented an after-the-fact view of the buybacks conducted in prior years. As a result, the Board was not able to assess the impact of the buyback transactions for awarding bonuses, which were tied to achieving stable EPS growth.

Second, buybacks were executed with little or no formal contemporaneous documentation of the economic benefit to the Company, and no clear policy or procedures for the approvals required for the transactions. While Huron's analysis did not identify any clearly non-economic buyback transactions, the absence of any documentation supporting buyback decisions or procedures represents a control weakness.

13. Accounting for the Amortization of Callable Debt Expenses

Fannie Mae issued both callable and noncallable debt to finance its activities. When Fannie Mae issued debt, it incurred various expenses such as commissions, legal fees, and similar costs. In addition, any difference between the face amount of the debt and the proceeds from issuing the debt gave rise to a premium or discount on the debt issuance.

Relevant accounting literature requires that callable debt expense be amortized over the life of the debt, regardless of a possible call of the debt prior to

maturity. Any unamortized expense must be recorded in the accounting period in which the call occurs and the debt is extinguished. Management established a policy, however, of amortizing callable debt expense over the estimated life of the debt – that is, the period between issuance of the debt and the expected call date. In addition, the Controller's Office implemented "amortization end date changes" to reflect new expected call dates, resulting in a change in the amount of expense recorded in future periods. Neither the initial amortization of the expense over the estimated life of the debt, nor the implementation of amortization end date changes, was consistent with GAAP.

Moreover, the Company did not apply its approach to the accounting for callable debt expense – and particularly the amortization end date changes – in a consistent fashion. On at least one occasion, for the third quarter of 2002, Financial Reporting made a late on-top entry that was inconsistent with its past practices. The purpose of entry was to offset an unrelated entry by recognizing additional interest income, and thereby bringing net interest income back in line with the Company's expectations.

The Company's accounting policy regarding the amortization of callable debt expense appears to reflect Financial Standards' long-standing misinterpretation of the applicable accounting rules, rather than a deliberate disregard of them. However, the evidence concerning the periodic adjustments, and particularly the adjustment in the third quarter of 2002, leads to the conclusion that the Company used these adjustments to meet earnings expectations. Spencer and other Financial Reporting personnel played a key role in recording that adjustment.

The Company's outside auditor was aware of the Company's accounting policy regarding callable debt expense, and of the on-top adjustment in the third quarter of 2002, but may not have been fully informed of the nature of, or reasons for, this adjustment.

14. Minority Lending Initiative

Fannie Mae implemented a Minority Lending Initiative ("MLI") program in 2002 to increase the Company's financial support for mortgages to African-American homeowners. The initiative was considered an important component of the Company's overall mission and was viewed by some as a means of securing loans that would meet the guidelines set by the Department of Housing and Urban Development ("HUD").

A Company employee raised concerns regarding the initiative in response to an e-mail broadcast to all employees by the Chair of the SRC. The employee was concerned that the Company appeared to be paying an excessive price for loans that were underperforming and that the MLI program might have been devised to meet corporate targets.

We saw nothing to indicate that the MLI program had an improper purpose. We did identify one issue concerning the accounting for payments in 2003 that the Company made to Resource Bancshares Mortgage Group, Inc. ("RBMG"), the

mortgage lender that originated a majority of the loans acquired under the MLI program. Because direct acquisition of the loans from RBMG may have violated Fannie Mae's Charter, the Company arranged for RBMG to sell the loans to a third party, Self Help. Self Help then sold the loans to Fannie Mae on terms that management concluded were Charter-compliant. The payments at issue were intended to compensate RBMG for the difference between the price the Company had committed to pay RBMG, and the price paid to RBMG by Self Help. The Company capitalized these payments as part of the cost of the acquired loans when they should have been expensed. The aggregate amount of the payments we have been able to identify was approximately $35.5 million.

15. Accounting for Realignments and the Security Master Project

We reviewed management's accounting for differences generated in the process of identifying and correcting errors and mismatches between its amortization database and loan and securities databases. The process of adjusting the amortization database to match the loan and securities databases was known as "realignments."

Realignments were essentially corrections of errors, and as such, management should have analyzed and accounted for their impact in accordance with APB 20. Management failed to do so.

We found that management did not account for realignment impacts properly under GAAP. For the most part, management deferred the recognition of these differences by recording them to balance sheet accounts and amortizing them over multiple years. On other occasions, in addition to deferring the recognition of these differences and amortizing them over time, management included the cumulative deferred realignment amounts and estimates of future realignments in its calculation of catch-up; and on still other occasions, management recognized the realignment impacts into income in the period they were identified.

No one we interviewed could explain why management failed to apply APB 20 to realignment impacts or the basis for the inconsistent accounting treatment of such impacts. At a minimum, this demonstrates that the Company did not have adequate accounting policies or procedures to ensure that its personnel complied with GAAP in this area. Furthermore, the decision to capitalize and defer realignment impacts over time smoothed out the errors' impact on income in any one period. With respect to the inclusion of realignments and estimates of realignments in the catch-up calculation in 2003, we conclude that management was motivated, in part, to avoid recording or to reduce the amount of the catch-up adjustment required under the Company's amortization policy.

16. Accounting for Investments in Affordable Housing Partnerships

Our inquiry regarding affordable housing partnerships focused on three issues: (1) the Company's accounting for its capital contributions to the partnerships; (2) the methodology used to account for low income housing tax credits ("LIHTC") and net operating losses associated with the partnerships; and (3) the Company's policy and

practice regarding the accounting for possible impairment of these investments. In each of these areas, we conclude that the Company's accounting policy and its financial reporting was inconsistent with GAAP.

Fannie Mae's accounting for investments in affordable housing partnerships violated GAAP in several respects. This was particularly true in the first half of the 1990s when the Company used an inappropriate accounting methodology to calculate its portion of the net operating losses in the partnerships. In addition, the accounting for the partnerships' net operating losses was incorrect when the Company had obligations with respect to future capital contributions. Management also did not have a formal policy regarding the assessment of impairment in its partnership investments until 2000. The policy the Company developed at that time required that it recognize impairment of each investment only in the tenth year; prior to the tenth year, management did not assess individual investments for impairment as the accounting literature requires.

Excluding the events surrounding the accounting for net operating losses and tax credits in 1998 (discussed in Part A.1. above), we have not seen any evidence that the Company's accounting or reporting regarding affordable housing partnerships was done with the intent to affect earnings in any period. Rather, the problems associated with the Company's accounting in this area appear to stem from misinterpretations of relevant accounting standards, and a lack of resources, particularly in the systems area, prior to the late 1990s.

The Company is reviewing the accounting for these partnerships during the past several years as part of its restatement effort.

III. CORPORATE GOVERNANCE AND INTERNAL CONTROLS

Our conclusions with respect to the Company's corporate governance and structure prior to 2005 are organized into the following areas: the Board of Directors; the Office of the Chairman and other key elements of senior management; the Company's ethics and compliance functions; Internal Audit; and the Office of the Controller. In addition to our findings and conclusions, we also describe the substantial changes that have taken place since September 2004.

A. Board of Directors

With respect to the conduct of the Board prior to September 2004, we conclude that the Board endeavored to operate in a manner consistent with its fiduciary obligations and evolving corporate governance standards. The Board was open to examination by third parties and responsive to outside commentary, and it generally received high marks from outside observers. The Board sought, received, and relied on support and assurances from Company management, internal and external auditors, and regulators. Management shared its accounting policies and practices with its outside auditors and with OFHEO during the relevant period. As a result, both were generally aware of many of the accounting and financial reporting matters and related judgments

discussed in this Report. Prior to the release of the OFHEO Report, however, the Board was not notified of any substantial concerns, and received assurances from internal and external sources that the Company was complying with applicable rules and regulations, and with best practices in the industry.

The Board, and in particular the Audit Committee, was sensitive to matters relating to accounting and financial reporting. The Audit Committee requested and received briefings regarding the Company's critical accounting policies, and was regularly assured that Fannie Mae was acting in accordance with relevant standards. For example, the Board reacted quickly to the release of Freddie Mac's announcement in 2003 about its accounting issues. Fannie Mae's Board requested reports from management and the Company's outside auditors on whether Fannie Mae might have accounting problems similar to the ones discovered at Freddie Mac. In response, management provided the Audit Committee with a misleading report that identified only minor and immaterial issues at Fannie Mae.

The Board also responded appropriately when it received indications that there were significant issues at the Company. The Board has made considerable effort to examine and improve its structure, composition, policies, and practices. The separation of the Chairman and CEO positions, the creation of the Risk Policy and Capital Committee to oversee financial and operational risk management, and the transformation of the Compliance Committee into a permanent committee with broad oversight of compliance matters, are all positive developments.

B. Office of the Chairman

Through the end of 2004, management did not fully inform the Board of the Company's accounting issues, internal control deficiencies, or the inadequacies of its internal systems. Further, although management paid lip service to a culture of openness, intellectual honesty, and transparency, the actual corporate culture suffered from an attitude of arrogance (both internally and externally) and an absence of cross-enterprise teamwork (with a "siloing" of information), and discouraged dissenting views, criticism, and bad news. Finally, the Company lacked appropriate structure and personnel for adequate risk management across risk areas (with an extremely broad collection of functions and authorities residing in the CFO), and lacked a genuine cross-enterprise approach to operational risk management.

Since the end of 2004, the new management team led by CEO Daniel H. Mudd, with the active engagement of the Board, has made a concerted effort to reform the management structure and the "tone at the top." These changes include: (1) redefining management committees and lines of reporting with a view to improving internal controls, management of risks, and horizontal and vertical information flow; (2) adopting a management style that seeks to be more open, collaborative, and humble; (3) establishing a Chief Risk Officer position (with an independent Risk organization); (4) revamping the CFO position with a set of responsibilities more appropriate for the position; (5) eliminating the Law and Policy group, with the movement of core compliance functions to a new, independent Office of Compliance, Ethics &

Investigations; (6) integrating the Company's businesses (including the Mortgage Portfolio business, which historically reported to the CFO) under a new Chief Business Officer position; and (7) shifting the Company's external relations toward a more cooperative relationship with OFHEO, Congress, and customers (with a substantial reduction in the size and aggressiveness of Fannie Mae's lobbying and grass roots activities).

In sum, as of the date of this Report, the new senior management team is in the process of undertaking meaningful substantive and tonal changes. These changes have improved the functioning of the Company both internally and externally.

C. Internal Audit

Prior to release of the OFHEO Report in September 2004, the head of Internal Audit lacked the requisite expertise and experience to lead the internal audit operation at an organization as large and complex as Fannie Mae. Moreover, on more than one occasion, the head of Internal Audit took steps that suggested he did not fully appreciate his organization's role within the Company or his proper relationship with senior management.

Internal Audit also did not possess a sufficient number of auditors with the requisite mix of technical accounting expertise and auditing experience to carry out its responsibilities related to Fannie Mae's increasingly complex business. Although Internal Audit's workload increased substantially in the years prior to 2005, Internal Audit requested only modest increases in headcount. In addition, the department's training programs were inadequate to compensate for these deficiencies.

Internal Audit's communications with the Board and management were deficient and, at times, inaccurate. On a number of occasions, Internal Audit provided assurances to the Audit Committee that Internal Audit's staffing was adequate in terms of quantity and quality (when it had told management otherwise) and that it had audited Fannie Mae's accounting for compliance with GAAP (when it actually audited only for compliance with Fannie Mae policies interpreting GAAP). In addition, Internal Audit's reporting of its audit issues to the Audit Committee (and to members of senior management) lacked clarity and did not succinctly prioritize the findings or the subsequent remediation.

The Audit Committee and senior management have acted to address many of these deficiencies. They have taken steps to replace Internal Audit's leadership, restructure its organization, focus its responsibilities on its core audit mission, and reform its processes and procedures. Substantial progress is underway in each of these areas.

D. Ethics and Compliance Functions

For more than a decade, Fannie Mae has maintained a Code of Business Conduct, provided Code-related training to employees, and investigated violations of the Code and other corporate policies. The Company also has a longstanding and

experienced investigative unit to handle employee complaints. Moreover, at the beginning of 2003, Fannie Mae acted to enhance its ethics and compliance program, by (1) pulling together ethics and compliance functions within the Legal Department; (2) creating the Office of Corporate Compliance ("OCC") to develop and monitor business unit compliance plans, administer employee training, and otherwise provide central management of ethics and compliance matters; (3) appointing a Chief Compliance Officer to oversee the existing investigative unit (the Office of Corporate Justice ("OCJ")) and the OCC; and (4) replacing the old Business Conduct Committee (which had been chaired by the head of Human Resources) with a new management-level compliance committee chaired by the General Counsel.

Although these accomplishments are worthy of note, and the ethics and compliance functions contained many well-meaning and dedicated professionals, the Company's ethics and compliance program as of late 2004 continued to suffer from the following deficiencies:

- Management devoted too few resources to Fannie Mae's ethics and compliance functions (and especially the OCC).
- Management undermined the perceived independence and impartiality of the Company's ethics and compliance functions by housing them within a litigation section of the Legal Department, headed by a Chief Compliance Officer who also served as the head of the employment practices litigation group responsible for defending the Company against employee complaints.
- Management failed to invest appropriate responsibilities and stature in its Chief Compliance Officer, who did not hold a dedicated position; did not report to the Board of Directors; and had no discernable compliance responsibilities other than to supervise the activities of the OCC and the OCJ.
- Without an active management-level oversight committee, and with an under-resourced and relatively low-stature OCC, the Company lacked an effective mechanism for coordinating compliance matters across the enterprise.

Since September 2004, Fannie Mae has taken important steps to rectify deficiencies in its ethics and compliance functions. Most notably, it has created a new Office of Compliance, Ethics & Investigations ("OCEI"), which (1) is independent of the Legal Department, (2) reports directly to the CEO and the Compliance Committee, (3) is led by a new Chief Compliance Officer who is committed full-time to ethics and compliance functions, and (4) will not only absorb the functions and resources of the OCC and the OCJ, but will also have a dedicated ethics unit. Moreover, management now provides the Board with detailed written reports on ethics and compliance programs and activities.

E. The Controller's Office

Prior to September 2004, the Controller's Office suffered from significant resource deficiencies. The headcount of the Controller's Office increased only modestly in the years prior to 2005, even as that office experienced dramatic increases in workload stemming from the introduction of new and complex accounting standards, the Company's decision to become an SEC registrant, and the growth of Fannie Mae's business. The Controller's Office leadership lacked adequate staffing, sufficient accounting and financial reporting expertise, and experience for a financial services company as complex as Fannie Mae.

In addition, the Controller's Office relied to a substantial degree on inadequate systems that required considerable manual effort, further straining the already overburdened staff. For example, the closing process was manually intensive and unduly susceptible to human error. The relevant computer systems were not integrated and, consequently, the process of preparing the Company's monthly financial information required significant manual processes, including numerous manual journal entries to the general ledger. In addition, prior to the middle of 2004, the Controller's Office lacked formal written procedures regarding journal entries and account reconciliations, did not have standardized documentation to support journal entries, and permitted employees to sign off on journal entries for other employees.

Since the release of the OFHEO Report, Fannie Mae has made changes to the structure and personnel of the Controller's Office, and to the Company's approach to the development of accounting policy. The Controller's Office, with active support from senior management and considerable reliance on outside expertise, has made significant efforts to augment its resources and the procedures and systems used in the development and oversight of accounting policies and financial reporting.

IV. EXECUTIVE COMPENSATION

In the September 2004 Agreement, Fannie Mae agreed to report on the Company's "compensation regime and its relation to strategic plans and their impact on accounting and transaction decisions and any revisions to avoid inappropriate incentives." In accordance with this undertaking, the SRC initiated a two-part review: (1) a historical analysis of Fannie Mae's executive compensation structure and its relationship to efforts to meet financial goals (such as EPS targets); and (2) a prospective assessment of the Company's compensation structure and recommendations for revisions to that structure. The SRC asked Paul, Weiss to review Fannie Mae's compensation programs and to assess the role of EPS or other financial indicators as a compensation trigger. Paul, Weiss was not asked to review or analyze employment contract issues or any individual compensation issues.[10]

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[10] The SRC engaged Semler Brossy Consulting Group ("Semler Brossy") to evaluate the Company's current compensation structure and to make recommendations on

Historically, the Company's target compensation levels consistently lagged behind those of the Company's "comparator corporations." Therefore, to facilitate payment of market-competitive compensation for executives, Fannie Mae intentionally set its "maximum" EPS target at levels that the Company expected to achieve. Because the expected EPS number was not an aggressive goal, the Company regularly exceeded it and triggered maximum bonus, stock, and stock option awards. This resulted in executive compensation at (but not above) the target compensation level. Beginning in 2002, the Company attempted to correct this situation and to align EPS targets and target bonuses in accordance with Fannie Mae's written compensation philosophy (that is, executive compensation would have been consistent with the Company's philosophy if the Company met the "target" EPS, rather than the "maximum" EPS). However, due to unanticipated shifts in market compensation, even under its new program Fannie Mae's executive compensation continued to lag behind market levels, and Fannie Mae executives received total compensation at market levels only if the Company met maximum EPS bonus targets.

Non-financial corporate performance goals played a part in executives' long-term executive compensation through the Company's PSP. These goals were set, and performance against them was assessed, by the Compensation Committee of Fannie Mae's Board of Directors based on a report prepared by management. We found that management consistently tendered excessively positive reports to the Compensation Committee.

During the course of our review, OFHEO requested, and the SRC agreed, that we also review the role that the Legal Department played in compensation decisions. OFHEO's request stemmed from two anonymous letters that accused attorneys in Fannie Mae's Legal Department of excessive and inappropriate involvement in compensation decisions and, specifically, of improperly attempting to "cloak" compensation decisions with confidentiality under the guise of the attorney-client privilege. We found no evidence to support these allegations or that the Legal Department was inappropriately involved in executive compensation decisions.

V. FANNIE MAE'S INVESTIGATION OF ROGER BARNES'S ALLEGATIONS

In August 2003, Roger Barnes, then a manager in the Controller's Office, raised allegations of accounting impropriety at Fannie Mae, including potential noncompliance with FAS 91. Barnes also alleged that Controller's Office management was not receptive to employee concerns regarding Fannie Mae's accounting, and, shortly thereafter, he alleged that he had been discriminated against on the basis of race and gender. Approximately three months later, after Internal Audit and the Legal Department had conducted three investigations into Barnes's allegations, and Barnes had threatened to bring a lawsuit against Fannie Mae, Barnes and Fannie Mae executed a settlement

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revisions. Semler Brossy presented its report and recommendations to OFHEO on February 24, 2005.

agreement. In the agreement, Barnes relinquished all legal claims against Fannie Mae in exchange for monetary consideration. The agreement also required Barnes to cooperate with investigations into matters relating to his allegations. Barnes subsequently submitted written testimony to Congress, and he participated in an interview by OFHEO. His testimony and interview raised additional accounting issues and included other allegations against Fannie Mae.

In light of these events, the SRC asked Paul, Weiss to determine: (1) whether the Company's investigations into Barnes's accounting allegations were conducted appropriately, and (2) whether the Company entered into the settlement agreement with Barnes for an improper purpose, such as to prevent him from pressing his allegations of accounting impropriety. As the substance of Barnes's allegations concerned the accounting for premium/discount amortization under FAS 91, we also inquired into the substance of those allegations.

We conclude that the Company's response to Barnes's allegations was flawed in several respects. The Controller's Office did not communicate appropriately with Barnes regarding either accounting or personnel matters. The remedial measures Fannie Mae directed the Controller's Office to undertake following the investigations into Barnes's allegations were not effective in improving the reporting environment within the Controller's Office. The Company's investigation into Barnes's allegations also suffered from conflicts-of-interest and inappropriate pressure to complete the investigations in an unreasonable time frame due to looming CEO/CFO certification deadlines. In addition, the Legal Department assigned to Internal Audit the task of assessing whether the accounting practices Barnes identified violated GAAP, but Internal Audit was not equipped to render such determinations.

As for Barnes's underlying allegations of accounting problems, we conclude that some of his allegations had merit. For example, we address his claims regarding FAS 91 in a separate section and we also conclude that management's practice of editing certain conditional prepayment rates ("CPRs") was inappropriate because, among other things, management could not identify a consistent rationale for changing the CPRs, the Controller's Office made the changes without consulting the economists who developed the CPRs, and the changes were not applied consistently to all areas of Fannie Mae.

As for the Company's decision to reach a settlement of threatened litigation with Barnes, we conclude that the decision was based on an appropriate analysis of the Company's litigation risk and was not motivated by a desire to conceal misconduct by Fannie Mae or its employees or officers or by a desire to silence Barnes.

VI. MANAGEMENT'S CONDUCT DURING OFHEO'S SPECIAL EXAMINATION

We reviewed management's conduct during the OFHEO Special Examination through the issuance of the OFHEO Report in September 2004. In particular, we focused on the adequacy of the Company's document production in

response to OFHEO's requests, and on the conduct of the Legal Department and its advisors during the examination, including the accuracy of the information they provided to the Board.

With respect to the Company's response to OFHEO's document requests, we found no evidence that anyone at the Company, or its counsel, intended to obstruct or impede OFHEO's Special Examination, or that anyone directed others to destroy evidence or not to cooperate fully with OFHEO. We do find, however, that the Company's Legal Department did not initially undertake a sufficiently comprehensive search for documents in response to OFHEO requests. Many of the documents that were responsive to OFHEO requests did not turn up until 2005, when the Company's lawyers abandoned their approach of allowing employees to search their own files and adopted a new approach of having attorneys review all files in employees' offices for responsive documents.

We also found that the Company's outside counsel, which was charged with the task of conducting responsiveness and privilege reviews of the documents collected by the Legal Department, construed OFHEO's requests very narrowly. While we believe that those decisions were made in good faith, it is clear to us that the Company would have been better served by a less restrictive approach by its lawyers to collect and produce documents in response to OFHEO's requests. First and foremost, a more expansive document collection approach would have provided the attorneys with documents that would have enabled them to have a more complete understanding of the facts and be in a better position to recognize the many problems with the Company's accounting practices. Second, a fuller document production may have staunched the increasingly hostile relationship between the Company and OFHEO during the Special Examination.

We also reviewed the information and advice that the Board received during the Special Examination, including from the Company's outside counsel and its accounting expert. OFHEO added this issue to our review after it raised questions about whether the Company's lawyers shielded certain documents from OFHEO through an overly aggressive use of privilege during the course of the Special Examination, and whether any lawyers "lied to" or "misled" the Board in connection with the Special Examination.

With respect to the Company's assertion of privilege during the Special Examination, while there were instances where documents that the Company had identified as privileged were later determined not to be privileged, we did not find any evidence that lawyers made aggressive privilege determinations in order to shield relevant information from OFHEO. We found that lawyers – both in-house and outside – sought to make good faith determinations of privilege in the fast-moving examination, and did not find any instance where critical documents were placed on privilege logs without any basis for a claim of privilege simply to prevent their production to OFHEO.

As for the advice the Board received, our interviews of Board members revealed that they mistakenly believed that the forensic accounting firm outside counsel

had retained to assist it in the Special Examination had been engaged to validate the Company's accounting practices, and had opined that those practices complied with GAAP. This misconception arose because outside counsel did not clearly explain to the Board the accountant's limited role throughout the course of the Special Examination. As a result, Board members took significant but unwarranted comfort in the belief that the Company's accounting practices were supported by two major accounting firms: the Company's outside auditors, and the forensic accounting firm hired by outside counsel for the Special Examination.

We saw no evidence that would call into question the good faith of the Company's lawyers, or their experts, who were undoubtedly taking directions directly from management about the overall strategy to take with respect to defending the Company in the Special Examination. However, neither management nor the Company's lawyers provided the Board with sufficient information about the issues raised in OFHEO's Special Examination to allow the Board to weigh the risks and make an informed decision about the best course for the Company. Management and the Company's counsel focused unduly on OFHEO's motives in conducting the Special Examination, and they incorrectly dismissed numerous accounting issues as "OFHEO's arguments" and "disagreements." On the one occasion when management and Company attorneys gave the Board a substantive presentation about the issues under review during the Special Examination, they understated the problems, telling the Board of possible "OFHEO arguments" or "disagreements" accompanied by ready assurances that such practices were reasonable and defensible, and did not give the Board a sufficient indication that OFHEO's "arguments" may be well founded. It turned out, of course, that management and the Company's lawyers were wrong about the accounting issues raised by OFHEO. The Company would have been better served if management and the Company's lawyers had informed the Board of all of the material facts and analyzed and discussed the risks arising from those facts in a more dispassionate fashion, and we recommend that the Company's lawyers make a concerted effort to give more balanced and comprehensive presentations to the Board in the future

VII. OTHER ALLEGATIONS

A. Issues Raised by Current and Former Fannie Mae Employees

The Chairperson of the SRC caused a "broadcast" message to be sent to all Fannie Mae employees on November 29, 2004, which encouraged Company employees to contact Paul, Weiss directly with any information or knowledge they might have about "any unusual or atypical transactions in the past five years." In response, a number of Fannie Mae employees contacted us. Several of the issues that were raised were incapable of further review due to the unavailability of the employee to provide specific factual information, and we referred one issue to the Company for further resolution. Some of the information we received related to topics already within our scope from the OFHEO Agreements and other issues. One contact led to our review of the Minority Lending Initiatives and another led to our investigation of the Company's consideration of certain insurance policies.

B. Fannie Mae's Equity Investments in Gulf Bank

Finally, we investigated the allegations raised by an anonymous former employee in a letter submitted to OFHEO and to the Chairman of the Board concerning the Company's investment in a bank in South Florida, Gulf Bank. The anonymous letter raised questions about the basis for, and the motive behind, an $800,000 equity investment in the minority-owned bank that the Company made as part of its Community Development Financial Institution ("CDFI") program. The author of the letter also made specific allegations that a senior Fannie Mae officer received inappropriate gifts from the Chairman of Gulf Bank, Salvador Bonilla-Mathe.

We concluded that the allegations against the officer were unfounded. He received two gifts from Bonilla of minimal value (a bag of coffee and a book about a charity with which Bonilla was associated). Bonilla also sent him a chess set which, following the advice of counsel, he returned to Bonilla. We have found no evidence of misconduct on his part in this respect, or in any other aspect of the Gulf Bank transaction.

We also did not find that the decision to invest in Gulf Bank was inappropriate at the time the investment in Gulf Bank closed, Fannie Mae was aware that the bank was under some scrutiny by the Federal Reserve Bank, but it does not appear that the extent of the scrutiny was known; moreover, the decision to proceed with the investment was made with the advice of outside counsel. Finally, although Fannie Mae's investment in Gulf Bank was not written off immediately, it was written off about eighteen months after the investment took place following an outside firm's valuation of all CDFI investments.

STANDARD
&POOR'S
Setting the Standard

Corporate Governance Score

30 January, 2003

FANNIE MAE

U.S.

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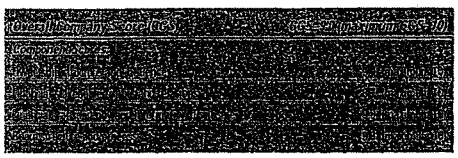


For important information on Corporate Governance Scores, please see the last page of this report.

Executive Summary

Standard & Poor's has assigned Fannie Mae a corporate governance score of 9.0 on a 10 point scale, reflecting governance practices that are consistently strong or very strong across each of our areas of analysis.

Fannie Mae's unique corporate status, its size and influence in the housing market, its connection with the government, its public interest mission and the scope of its activity in the fixed income capital markets are all distinctive features of its operating environment. These factors increase its public visibility and invite scrutiny from the private and public sectors and the media. In addition, they allow more scope for external stakeholder influence at Fannie Mae than would be the case for companies with lower public profiles.

Particular governance anomalies that come with Fannie Mae's special status include appointment by the President of the United States of five of its 17 board members (board size is set by statute at 18 members; the board size of 17 used throughout this report reflects a current vacancy); special corporate status as a Government-Sponsored Enterprise (GSE); regulatory status under the U.S. Department of Housing and Urban Development (HUD); and an historical exemption from both state and local taxes and from registering its securities with the U.S. Securities and Exchange Commission (SEC). While in certain respects the company's governmental dimension and its corporate status may challenge traditional views of investor rights, it is our view that Fannie Mae manages its governance process capably, and that external influences do not materially distort or negatively influence Fannie Mae's governance vis-à-vis its financial stakeholders.

Our conclusions in the individual categories of our analysis can be summarized as follows:

Ownership Structure and External Stakeholder Influence is assessed as very strong, as Fannie Mae discloses significant detail about who owns its shares and there is little possibility for conflicts of interest or undue influence among its widely dispersed shareholdings. The role of the government in its current operations is not considered a material governance issue at the moment, though given Fannie Mae's special status and strong political influences this is a factor that requires ongoing monitoring—particularly with regard to potential conflicts between the interests of financial stakeholders and Fannie Mae's public mission.

Investor Rights & Relations are assessed as strong, as the company has assured equal rights for all of its owners. Our assessment of ownership rights reflects the fact that Fannie Mae's shareholders do not have the right to elect a certain meaningful number (28%) of directors, given the five directors appointed by the President. Fannie Mae has no takeover defenses per se, but the market for corporate control for Fannie Mae is likely to be inhibited by its special status and market position.

Transparency & Disclosure at Fannie Mae is of a very strong standard. Fannie Mae's size, and the complexity of particular accounting practices, notably FAS 133, make its financial practices subject to high levels of external scrutiny. However, the company's web site and annual report provide a very strong basis of disclosure that meets or in some cases exceeds SEC requirements. While historically the company has been exempt from registering its securities with the SEC, it will voluntarily do so with respect to its common stock, and will be in line with the Securities Exchange Act of 1934 in early 2003. This should improve access to Fannie Mae's disclosure through the SEC's online EDGAR system, and will bring Fannie Mae into conformity with other U.S.-listed companies. It should not however, materially change the level of disclosure that Fannie Mae currently provides. We assess positively Fannie Mae's audit process and how its independence is maintained, but note a high level of non-audit fees paid to the company's auditor.

Board Structure & Process scores very high in our analysis. The company combines a good mix of new and longer-serving directors, directors of high caliber and with a diversity of skills and a strong voice of independence and engagement. From our meetings with a number of Fannie Mae directors and from access to board notes and meeting minutes, board effectiveness appears strong, particularly in the strength of its committees. The presence of presidentially appointed directors (Presidentials) on the board might on its face appear to be a negative factor, but we have seen no evidence to suggest that the Presidentials act in any way inconsistent with their fiduciary duties to the company's shareholders and on balance find their presence to be mildly positive to the board's effectiveness. In January 2003, the Fannie Mae board chose to establish a formal presiding director structure that Standard & Poor's believes could provide a counterbalance to the combined Chairman/CEO role. The structure has largely been in place in all but name for some time. We have seen evidence that this role is in practice similar to that of a lead director. Although the concentration of power in the combined Chairman/CEO position brings some positives as well, it warrants monitoring. However, it is our view that this has not proven to be a practical concern at Fannie Mae given its strong and independent board as well as the constraints and regulatory oversight that come from Fannie Mae's special corporate status.

Company Overview

Fannie Mae (formally The Federal National Mortgage Association) is the largest provider of low-cost financing for mortgages in the U.S. It is the second-largest company in the U.S. by assets and the largest non-bank financial services company in the world. Fannie Mae was established by Congress in 1938 as a federal agency to support home ownership and the economy at large and was fully privatized in 1968. The company received its listing on the New York Stock Exchange in 1970. Today, Fannie Mae is one of only a handful of companies in the U.S. (Freddie Mac, Farmer Mac, and Sallie Mae are others) that enjoy the status not of a typical corporation, but of a GSE, a type of federally chartered corporation. As such, Fannie Mae is not incorporated in any state, though it has chosen to follow the corporate governance laws of Delaware.

As a GSE, Fannie Mae has a congressional charter that gives it a public interest mission to increase the availability and affordability of housing to low, moderate, and middle-income households in the U.S. In addition, as a GSE Fannie Mae is exempt from SEC registration and enforcement actions from potential violations of most federal securities laws, although it is subject to antifraud securities laws. However, Fannie Mae's imminent voluntary registration

with the SEC will improve access to disclosure and assure regulatory oversight and its securities will remain exempt under the Securities Exchange Act (see below). Fannie Mae receives no financial backing from the U.S. government and its debt is not officially guaranteed by the government. However, there is an implied basis of financial support, in part based on the Secretary of the Treasury's "discretionary authority" to purchase up to $2.25 billion of Fannie Mae's securities at any one time (though this amount would cover far less than 1% of Fannie Mae's obligations) and the general belief that the government would step in if necessary to protect the stability of the secondary market. Implied governmental support also allows Fannie Mae to borrow at favorable interest rates. Fannie Mae is closely regulated by HUD and the Office of Federal Housing Enterprise Oversight (OFHEO), whose sole mission is to ensure the safety and soundness of both Fannie Mae and Freddie Mac.

In 2001 and 2002, criticism has been raised over Fannie Mae's corporate governance and regulatory environment from several quarters: In Congress, Richard Baker, Chairman of the Capital Markets, Insurance and Government Sponsored Enterprises Subcommittee of the House Financial Services Committee, and a long-time critic of Fannie Mae, has raised questions about the oversight role of OFHEO in regulating Fannie Mae and its sister company Freddie Mac. Such criticism has been seconded by a few media sources and by FM Watch, a micro-lobby backed by some of Fannie Mae's competitors, upset at what they view as unfair government support for the company and for Freddie Mac, another GSE, and critical of these companies' public interest role in directing additional money into the housing market (see Section 1.2).

In response to some of these criticisms and the market's increased focus on issues of corporate disclosure, Fannie Mae has decided to voluntarily register its common stock with the SEC, but not its unsecured debt and mortgage backed securities (MBS) that it uses to facilitate its main business of creating a secondary mortgage market (see Section 3.1 below). Fannie Mae's first SEC filings will occur in the first quarter of 2003. These filings will end the anomaly that gives Fannie Mae more discretion than other listed companies regarding its disclosure obligations.

SEC oversight aside, Fannie Mae is among the most tightly regulated financial companies in the world. OFHEO, for example, completed a risk-based stress test for capital adequacy in 2001 that ties capital requirements directly to the risk profile of its assets, hedging strategies, and off-balance sheet exposures, a measure that is not even contemplated by the New Basel Capital Accord. According to published statements, the stress test is said to require a level of capital to allow Fannie Mae to remain solvent throughout a 10-year span of "depression-level" economic conditions plus, "for good measure", an additional 30% to account for operations risk.

The company chairman and CEO is Franklin Raines, who has served in these roles since 1998.

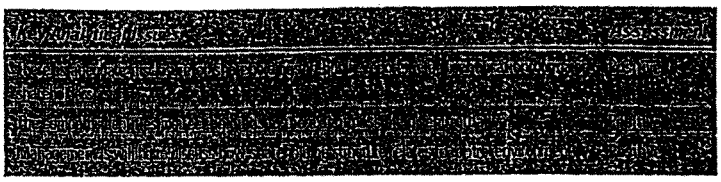
Standard & Poor's Rating Services has assigned a 'AAA' credit rating to Fannie Mae, reflecting both its own operating and financial strength as well as the implicit governmental support that comes from its unique corporate status. ***This corporate governance score is conducted separately and independently from Standard & Poor's credit rating operations.***

Component 1: Ownership Structure and Influence

Component Score—9.0

1.1 Transparency of Ownership

Fannie Mae has a transparent ownership structure. The company discloses all major shareholders above 5% of shares outstanding.

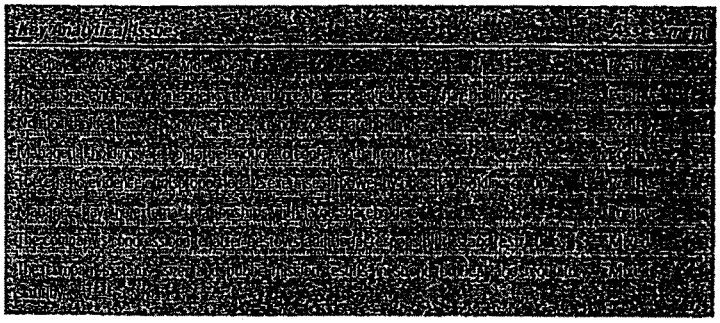


Fannie Mae is a widely held company and its shareholding structure is broadly transparent. The company discloses in its annual proxy statement all beneficial owners of its common stock above 5% in line with, but not subject to, SEC regulation. With a holding of 10.4%, FMR Corp., the parent of Fidelity Management & Research, is the only holder with more than 5% of shares outstanding. The company does not disclose smaller stakes. Fannie Mae also does not disclose breakdowns of its shareholders by type.

Shareholdings of directors and senior executives in the company are adequately disclosed, as are shares held under option by directors and executives.

1.2 Influence of Ownership and Other External Stakeholders

Fannie Mae shares are widely held. There is no evidence of large block shareholders with disproportionate influence on company management. Fannie Mae's public mission, enforced by its congressional charter, gives it both more responsibilities and restrictions than a typical corporation.



Fannie Mae's shares are widely held and the largest shareholder, Fidelity, is a nominee representing the interests of thousands of smaller shareholders. As such, there is little reason to suspect that any one shareholder or group of shareholders has a disproportionate influence on the management of the company and there is little potential for conflicts of interest between owners and managers. Directors and officers themselves hold far less than 1% of outstanding shares. Minority interests are protected by a strong combination of legislation, listing rules, and independent board oversight.

While not owners themselves, Congress and the federal government are major stakeholders in Fannie Mae. Their interest is clearly to use the financial flexibility of a private company to pursue societal goals of increased home ownership. The government, through congressional oversight, the congressional charter, and regulation by OFHEO and HUD, restricts the business of Fannie Mae to supporting the housing market, which it does by buying and securitizing mortgages. Fannie Mae may not expand into other, potentially more profitable areas of business, and may not pursue business outside the U.S. Moreover, there are more direct interventions in the day-to-day business of Fannie Mae: all debt and MBS issued by the company must receive approval from the U.S. Secretary of the Treasury. Whether these can be considered negative influences is

questionable; investors have long known that Fannie Mae is a product of the federal government and has a narrowly defined social mission.

The potential for conflict between the company's social mission and the interests of its shareholders is mitigated to the extent that directors' fiduciary duties—including the Presidential directors—are to the shareholders, not to the furtherance of the company's social mission. Indeed, except for the role of the Treasury and the company's congressionally defined business, Fannie Mae's chartered restrictions might not be considered materially different from regulatory restrictions on banks and other financial institutions.

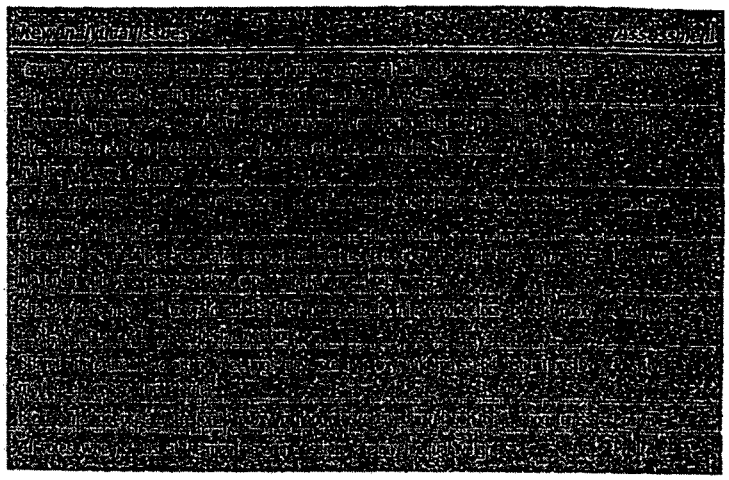
While the influence of its regulators and of Congress may not materially affect Fannie Mae's corporate governance at present, there is a possibility that this could change in the future. In 2001, for example, OFHEO proposed regulatory changes that would have, among other things, lowered the liability threshold for Fannie Mae's directors as well as introduced new legal duties of directors potentially in conflict with Delaware law and potentially making it more difficult for Fannie Mae to recruit new directors. Another example of political influence comes from Congress, where representative Richard Baker, Chairman of the Capital Markets, Insurance and Government Sponsored Enterprises Subcommittee of the House Financial Services Committee and a long-time critic of Fannie Mae, has been a proponent for a top to bottom, congressional-led review of Fannie Mae's corporate governance practices and for increased disclosure of its debt securities in addition to its common stock (criticism seconded by the editorial page of a prominent national newspaper and FM Watch). In both cases, Fannie Mae to this point has been able to use persuasion, its political connections and supportive legal opinion to maintain the status quo that it clearly believes serves the interests of its shareholders. In our interview with one of Fannie Mae's directors, it was observed that dealing with external political, regulatory, and legislative risk is something that the company is quite good at; a skill that has helped the company and its shareholders over the long term. Political attempts to challenge Fannie Mae's current role will doubtless continue, and it will remain an ongoing requirement for the company's managers and directors to govern the company in the context of these strong external influences.

Component 2: Financial Stakeholder Rights and Relations

Component Score—8.7

2.1 Shareholder Voting & Meeting Procedures, Including Regularity, Ease of Access and Information on Shareholder Meetings

Fannie Mae's commitment to shareholder democracy is strong. The company supplies comprehensive information to shareholders well in advance of company meetings. Voting procedures are fair and in line with typical procedures for a Delaware corporation.



Fannie Mae has well-established procedures for both conducting shareholder meetings and disseminating shareholder meeting information. Registered shareholders are mailed notices of meetings and proxy statements, together with the annual report, sufficiently in advance of meetings to make informed voting decisions, usually more than 30 days in advance. Proxy statements include detailed explanations of each voting item and good information on voting procedures, rules, instructions, and deadlines. All information is simultaneously posted on Fannie Mae's web site, although it is not as yet posted to the SEC's online reporting system, EDGAR.

Voting at shareholders meetings is by poll, and all votes, whether physically present at the meeting or represented by proxy, are counted equally. Beginning in 2002, shareholders wishing to vote by proxy may do so by mail, telephone, or the Internet. Shareholders vote on all major company decisions including the annual election and removal of directors (with the exception of presidentially appointed directors), appointment of auditors, remuneration plans, substantive bylaw amendments, and major mergers and acquisitions that qualify under New York Stock Exchange listing rules.

Fannie Mae does not count so-called "broker non-votes" in shareholder approval of voting items, even items classified as routine by the New York Stock Exchange. This makes Fannie Mae unusually progressive in its voting policies, especially in comparison with other U.S. companies we have reviewed. Broker non-votes occur when shareholders holding shares through their brokerage accounts do not provide voting instructions and brokers themselves vote in the assumed interests of the beneficiaries.

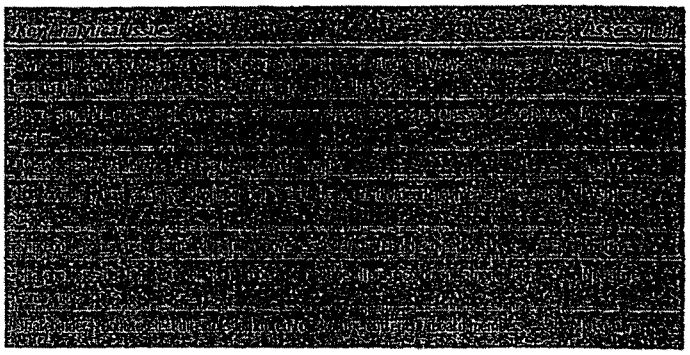
Fannie Mae has also quite positively ensured that shareholders have voted to approve each of its equity-linked compensation plans, including its ESOP, something that until recently few companies have undertaken to do.

Shareholders may also, with a very small amount of equity, put forward shareholder proposals at shareholder meetings, in line with current SEC rules (again, that Fannie Mae is not required to follow as an exempt issuer). Fannie Mae reports that it has entered into discussion with every shareholder resolution proponent in its history and has allowed virtually every shareholder proposal it has received onto its agenda, a decision that U.S. companies have

significant discretion over when proposals deal with "ordinary business" issues, as defined by the SEC. A proposal to restore cumulative voting to the company's bylaws has been on the agenda each year since 1988; it has never received majority approval from shareholders. Though cumulative voting for directors was once in Fannie Mae's articles, the company has argued that, as a widely held company, cumulative voting might result in the election of directors representing specific interests, rather than shareholders as a whole. Cumulative voting can be beneficial in cases, unlike at Fannie Mae, where the share structure includes a large block holder. Shareholders may also nominate directors to the Fannie Mae board in line with clear procedures set out in the company's bylaws.

2.2 Ownership Rights

Ownership rights are clearly stated and well-protected. The bylaws include a number of provisions that increase shareholder oversight beyond what is typical for a U.S. corporation, although shareholders do not have the opportunity to vote on all directors.



Rights attached to Fannie Mae shares are secure and fully transferable. All common shares have equal rights and there are no multiple classes of shares with variable rights. Owners of common shares have the right to vote, to receive dividend payments and, in the case of liquidation of the company, to receive proportional payment in turn.

Voting rights attached to Fannie Mae shares are laid out in the company's bylaws and the Delaware General Corporation Law (DGCL), the state corporate law that the company chose to follow in a number of respects in 2001 in response to an OFHEO requirement. Shareholders vote on all major company decisions including the annual election of 12 of the 17 directors (Fannie Mae has determined that an unclassified board is appropriate for its current circumstances), appointment of auditors, remuneration plans, substantive bylaw amendments, and major mergers and acquisitions that might qualify under New York Stock Exchange listing rules.

One-third of Fannie Mae shareholders may also petition the board to convene a special shareholder meeting, a shareholder right that a minority of U.S. corporations allow. Calling a special meeting allows shareholders to propose changes to a company's governance structure that would not be possible under the SEC's shareholder proposal guidelines, and that would perhaps be less expensive and disruptive than a proxy contest. Fannie Mae holders do not enjoy preemptive rights over new share issuances, another right that most U.S. companies removed by the 1980s, and shareholder class action securities suits are unlikely to be allowed at Fannie Mae because, as a GSE, the company is exempt from most federal securities laws.

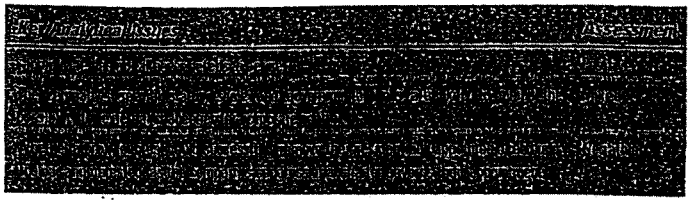
The company has a clearly articulated dividend policy, underpinned by an annual peer analysis against the dividend policies and payout ratios of the financial companies on the S&P 500 index and with an intention to remain at about the 65th percentile in payout. Recently, Fannie Mae has responded to its investors who wanted a more tax-friendly method of returning value to shareholders, and it has, until January 2003, been reducing its payout ratio and using the difference to repurchase stock.

Finally, we note that shareholders cannot vote for, or indeed, vote to remove if necessary, all directors on the Fannie Mae board, as five of the board's 17 members are appointed by the U.S. President (typically, this is five of 18; one director has recently left the board). The system is a fact of life at Fannie Mae, and there are broad positives as well as negatives that accrue to

the board by having these members (see Section 4.3 below), yet fundamentally, the owners of the company cannot pass judgment on all 17 board members each year. Fannie Mae shareholders also do not vote to approve dividends, to receive the financial statements, to approve technical bylaw changes, or to waive rights to new share issuances, as these rights of ownership are typically reserved for the board at U.S. companies.

2.3 Takeover Defenses

While Fannie Mae's bylaws contain no takeover defenses, its unique position in the markets and as a regulated, congressionally chartered company makes a potential change in control unlikely.



Fannie Mae's bylaws do not contain any takeover provisions as such. There is no classified board (Fannie Mae has determined that an unclassified board is appropriate for its current circumstances), no poison pill, no freeze out provisions on large share purchases or other devices that are normally used to frustrate takeover bids. Yet Standard & Poor's also recognizes that, as a highly regulated and congressionally chartered company, Fannie Mae is unlikely to be the target of a takeover. And even if this were to occur, there is a question of whether Congress would allow a change in control.

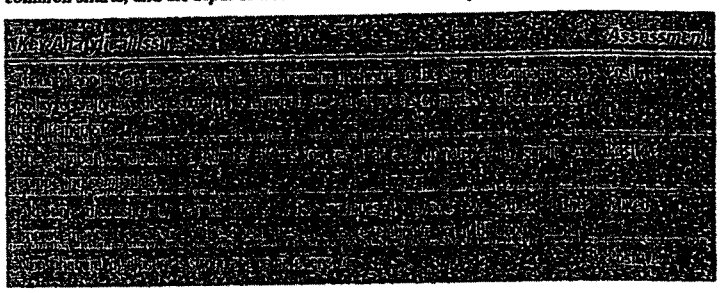
To some extent this might provide Fannie Mae management with fewer short-term performance pressures that can keep the company focused on its long-term strategy. However, it can also have the effect of limiting the channels that shareholders have to exercise change in corporate control. Moreover, it is unclear and untested whether a proxy contest for large changes to the board could remove the five Presidential appointees because their appointment is governed by the company's charter, which can only be amended by Congress.

Component 3: Financial Transparency and Information Disclosure

Component Score—9.0

3.1 Quality & Content of Public Disclosure

While Fannie Mae has not been obliged to report to the SEC as an exempt issuer, the company has adopted a program of voluntary disclosures and publication on its web site that meets or exceeds SEC disclosure requirements. Less is disclosed about non-common stock than about common shares, and the depth of web-based disclosure has improved over the last year.



As an SEC-exempt issuer until early 2003, Fannie Mae has had few disclosure requirements other than its frequent reporting to its regulator, OFHEO, and before that, to HUD. Despite this, Fannie Mae has consistently undertaken to provide disclosure to its shareholders and stakeholders at a level that meets or in some cases exceeds that required by the SEC. In recent years, a combination of voluntary initiatives and specifics of OFHEO's oversight have resulted in disclosure about Fannie Mae's financial health that is unavailable from other, similar financial institutions.

Fannie Mae's financial reporting includes not just the typical financial statements and notes, but also a review of its derivative and hedging activities, its off-balance sheet risk, and an overview of its outstanding mortgage portfolio. Audited financial statements are included in an annual report sent to shareholders each year. In addition to these disclosures, the company adopted a series of voluntary initiatives in October 2000, designed to increase financial transparency in light of increasing market expectations and investor scrutiny. The company launched six voluntary initiatives in total (the seventh is voluntary SEC registration) that seek to provide investors with more information about its financial condition and risk management. The initiatives are as follows:

1. Fannie Mae periodically issues small amounts of publicly tradable subordinated debt, with the assumption that such debt is a useful gauge of market confidence in the company;
2. A commitment to maintain at least three months' worth of liquidity, assuming there is no access to public debt markets;
3. Implementation of Fannie Mae's own version of a risk-based capital stress test (since superseded by OFHEO's stress test);
4. Monthly interest rate risk disclosure that provides the financial impact of interest rate fluctuations on its business, including its duration gap, or the extent to which the duration of its assets and liabilities are matched;
5. Quarterly disclosure of credit loss sensitivity (the sensitivity of its future credit losses to an immediate 5% decline in home prices);
6. Obtaining an annual "risk to the government" or financial strength rating from a nationally recognized rating agency.

Taken together, the voluntary initiatives meet or exceed what is generally expected in terms of disclosure from other U.S. financial institutions, particularly the disclosure that is forward-looking. Fannie Mae intends to continue its monthly disclosures under its voluntary initiatives, even as these are not required by the Exchange or the SEC.

We also note the publication of an "operating EPS" figure, which strips out the effects of FAS 133, a measure that Fannie Mae undertook to provide increased clarity to investors in light of the new accounting rule that brought all of Fannie Mae's derivatives onto its balance sheet. The company quite positively provides substantial disclosure on its web site that helps investors

understand the new rule. Separately, but also positively, Fannie Mae was among the first 10 companies in the U.S. to announce that it would expense the full cost of stock options. It discloses insider trades of Fannie Mae stock on its web site within the current regulatory timeframe (though not, as yet, to the SEC), and provides strong disclosure of special purpose vehicles and risk management techniques that it employs, arguably among the most important disclosures the company makes given its business. It is also assessed positively that the company has defined and publicized a clear corporate mission, and has set clear and challenging financial goals that can be measured and tracked by investors (the 1999 goal to double the rate of operating EPS growth within five years, for example).

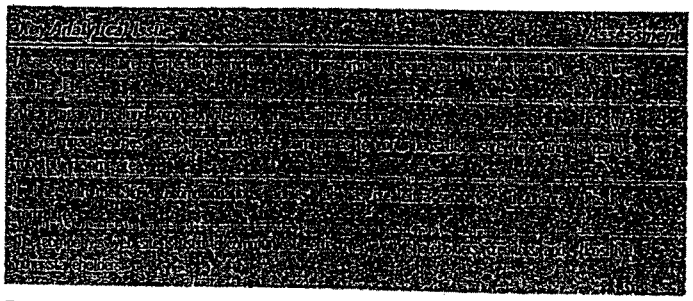
We note that Fannie Mae has come under some criticism during the past year for its disclosure relating to its debt and MBS. While Fannie Mae will voluntarily register its common stock with the SEC under the 1934 Act, its securities offerings, including offerings of debt securities, remain exempt; primarily because of the number of securities issued (Fannie Mae estimates that its issued securities represent between five and six times the total number of such securities of all other U.S. issuers combined). Were Fannie Mae forced to register each of these securities, a challenging administrative burden could arise for both Fannie Mae and the SEC, and the offsetting benefits might not match the cost. For example, more disclosure (like loan to value ratios of loans within particular MBS, or credit scores of the borrowers within MBS, as smaller, private-label issuers of MBS include) could have the impact of reducing the number of MBS that could be sold. This could contribute to increased disclosure at the expense of liquidity in the MBS market itself. Standard & Poor's believes that Fannie Mae, together with its regulators, the Treasury, and the SEC, has for the moment decided that the value of liquidity and efficient markets exceeds the benefits to be gained from increased disclosure.

This argument has not convinced everyone though, and Standard & Poor's believes it is possible that Fannie Mae will decide to disclose more about its MBS in the medium term. One argument, that more should be disclosed about Fannie Mae's derivative counterparties, is less convincing. While Fannie Mae discloses concentration of the total notional amount of derivative transactions outstanding among its counter parties, disclosing more details is unknown among commercial banks and has never been required by the SEC. Fannie Mae, for its part, has argued that all its derivative transactions are collateralized and that counterparties maintain strict controls and enjoy high credit ratings themselves.

Non-financial disclosure reaches a high standard and is assessed positively, reflecting substantial disclosed information about the board, compensation and corporate governance policies, and information and research about the American housing market that the company makes available on its web site. The company has recently improved disclosure about its own governance practices, and will post, as of January 31, 2003, committee and governance charters and its own definition of director independence on its web site.

Finally, Fannie Mae ranked among the 8th decile in Standard & Poor's 2001/02 Transparency & Disclosure study—a level that ranks favorably with its U.S. peers in the S&P 500 index and with other non-U.S. companies in a broader global context.

3.2 Timing of, and Access to, Public Disclosure



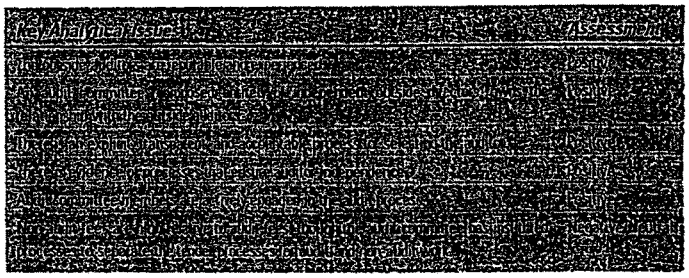
Timing and access to public disclosure is strong, though access will improve when the company begins reporting to the SEC in 2003 and its annual and quarterly filings are posted to EDGAR, the SEC's online searchable database.

Though the company has never been subject to Regulation Fair Disclosure (Reg FD), Fannie Mae has voluntarily complied with the rule since its introduction in 2000. Following Fannie Mae's registration with the SEC, it will be formally subject to the rule, although nothing of substance is expected to change. In a similar way, Fannie Mae's continuous disclosure policies follow those required by the SEC; all material changes to Fannie Mae's financial position are posted to its web site without delay. Moreover, its monthly financial reports come closer than any other U.S. company's, financially or otherwise, to continuous disclosure: monthly reports include operational EPS numbers, changes to its duration gap, and updates of many of the voluntary disclosure initiatives. Fannie Mae's web site also assists in creating a continuous disclosure regime: it includes speeches, presentations, testimony before Congress, as well as downloadable copies of all its public disclosure, including some historical disclosure as well.

Finally, we note that Fannie Mae has followed the SEC recommendation to form a high-level disclosure committee. The committee is designed to keep the board and management apprised of changes in disclosure expectations as well as to ensure that material issues are disclosed to the market on a timely and ongoing basis. Fannie Mae's disclosure committee includes its controller, general counsel, treasurer, senior credit officer, head of investor relations, head of internal audit, and chief of communications.

3.3 Auditor Independence and Audit Process

Fannie Mae's audit committee demonstrates a commitment to the independence of the audit process. Its members are actively engaged with both the internal audit team and the outside auditors.



Fannie Mae's auditors, KPMG, are appointed by shareholders on an annual basis, upon the recommendation of the independent audit committee and the board as a whole. The audit committee addresses the effectiveness of the auditor's service on an annual basis and is responsible for monitoring their independence. In line with the provisions of the New York Stock Exchange's recommendations concerning audit committees, and in line with the 2002 Sarbanes-Oxley Act, Fannie Mae's audit committee is composed entirely of independent, non-executive board members, at least one of whom meets the NYSE financial expertise requirements, and the auditor's reporting relationship with the company is through the audit committee of the board, rather than with the CFO's office or with management in general. In addition to its audit work for Fannie Mae, KPMG provides the company with other services and their fees for this work are shown below:

Fees	*2001 ($ Mil.)*	
Audit	1.05	12.84%
Non-audit	7.13	87.16%
Total	8.18	100%

While the non-audit fees are substantially higher than those for audit, 86.2% of all non-audit services provided to Fannie Mae by KPMG represent tax advice and comfort letters on the company's REMIC securities (Real Estate Mortgage Investment Conduit, a type of security representing ownership in a trust of multiple securities pegged to cash flows from different mortgages). The audit committee took the extra step to put this significant amount of business out to tender, though it did not decide to exclude KPMG from the tender itself, deciding that to do so would be to give in to the appearance of a conflict of interest when at the same time the committee agreed that the REMIC services did not affect the auditor's independence in fact. A statement testifying to the committee's confidence in the auditor's independence, despite the extra

fees, is included in Fannie Mae's latest annual report. While Standard & Poor's found no evidence that challenges the committee's assessment of auditor independence, outside confidence in the process may rely on both the perception of independence in appearance as well as in fact. KPMG has acted as Fannie Mae's auditors since the company was split off from the federal government in 1968.

Standard & Poor's met with members of Fannie Mae's audit committee, internal audit department, and the KPMG lead partner and saw evidence of a strong commitment to audit independence, to robust audit and internal control procedures, and to a strong policy to avoid conflicts of interest. The committee has put substantial time and effort into building a strong working relationship with the internal audit team and the outside auditors and meets frequently with both groups, often without management present.

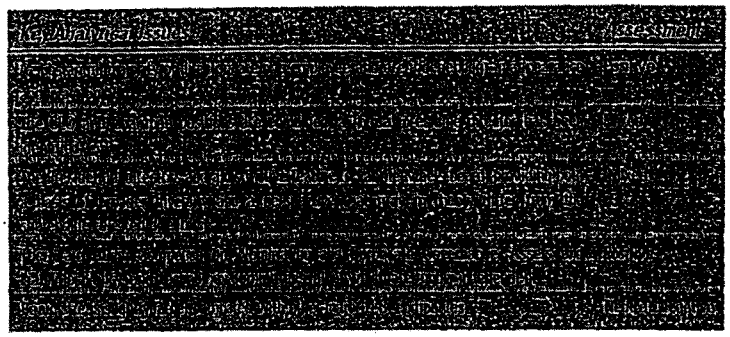
Linked to this is the company's serious focus on risk management, given the nature of its operating activities. Fannie Mae actively monitors and discloses key aspects of its risk management exposures relating to credit and interest rate risks. The company's internal auditor reports on a direct basis to the chair of the audit committee and works together with the financial management to ensure audit committee understanding of Fannie Mae's operating complexities and to provide timely information with regard to Fannie Mae's key financial exposures.

Component 4: Board Structure and Process

Component Score—9.3

4.1 Board Structure & Composition

Fannie Mae's board is well-structured, if somewhat large, as a result of the Presidential appointees. Solid committee framework.



Fannie Mae's board structure meets or exceeds the latest rules on board composition proposed by the New York Stock Exchange, and has for some time. Fannie Mae's board has a clear and substantial majority of independent, non-executive directors, a combined Chairman and CEO, (see Section 4.2), a presiding director that provides leadership for the non-executives, and independent board committees. At 17 members, the Fannie Mae board is somewhat larger than most corporate boards in the U.S.. An overview of the current board's structure is shown below:

	Executives	Shareholder-elected non-executives	Presidentially appointed non-executives	Total
Full Board*	3	9	5	17
Audit Committee	0	3	2	5
Compensation Committee	0	3	0	3
Nominating and Corporate Governance Committee	0	4	0	4
Assets and Liability Policy Committee	0	4	4	8
Technology Committee	0	3	4	7
Executive Committee**	1	5	0	6

*We note that Stephen Friedman, a shareholder-elected non-executive, left the board in December 2002 upon his appointment to head the President's National Economic Council and that Jamie Gorelick, a Vice Chair and executive of the company, has announced that she will leave the board in July to focus on her work with a federal commission investigating the September 11 attacks and to pursue other interests. The company has announced that it intends to propose CFO Tim Howard as her replacement on the board. The board has begun a search for a replacement for Mr. Friedman.

**The executive committee is authorized to transact business for the corporation in between board meetings. The committee did not meet in 2001.

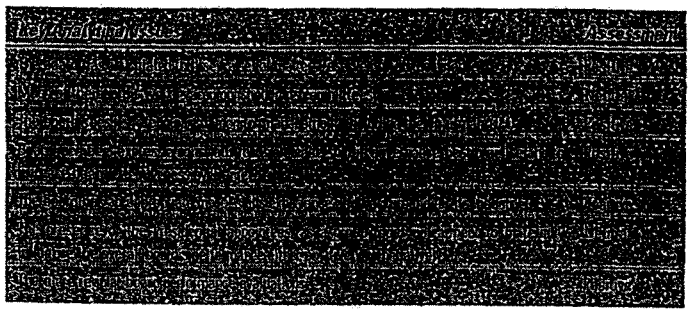
One feature of the board, the five Presidential appointees, can be viewed both positively and negatively. These members bring to board discussions a diversity of viewpoints and opinions that may not normally make it on to the board of a company Fannie Mae's size. Though turnover of the Presidentials has not been especially frequent, the constancy of change every several years has meant that the board has become very good at bringing new members on, familiarizing new members with its complex business, and integrating them into the larger group.

For all of its negatives in terms of shareholders' right to elect all directors, it is also true that, like the occasional rotation of audit firms, the presence of five directors over whose appointment management has no authority can be a check against behavior that might not be

in the best interests of shareholders. On the other hand, the tenure of presidentially appointed directors is typically shorter than that of their shareholder-elected colleagues, and many Fannie Mae directors recognize that the Presidentials make the size of the board quite a bit larger than it would be otherwise, with an inevitable effect on efficiency and formality. (Average board size among larger U.S. companies is not constant, but is generally between eight and 12 members) Its large size would appear to be another reason why so much of the board's decision-making is run through its committees. (For more about the role of the Presidentials, see Section 4.3 below.)

4.2 Role & Effectiveness of the Board

The board appears to be an effective monitor of management. Directors appear to be engaged and show a desire to demonstrate leadership in board effectiveness and governance.



Fannie Mae's board met eight times in 2001 and slightly more frequently in 2002. Attendance rates are reported in aggregate, and no board director attended less than 75% of official meetings. In common with many U.S. boards, much of the work at Fannie Mae is accomplished through its various committees, which meet before board meetings and throughout the year. While there is always a chance that heavy committee work will create divisions among, or different classes of directors, we note that every Fannie Mae director sits on at least one board committee and from our director interviews we detected little if any division of this kind. Committee chairmen are nominated by the Governance and Nominating Committee and approved by the board as a whole. Given the lead role of the committees, a potential concern worth monitoring is that several committee chairs serve on several other outside boards. There is no concern about conflicts of interest in this regard; the key area of focus is whether this could result in insufficient focus on Fannie Mae responsibilities. We have no evidence to suggest this is a practical problem to date. For most of Fannie Mae's directors, this is their primary board membership, or they have resources to help them with their duties that lessen risk of overload. Moreover, the company's corporate governance guidelines require non-executives to inform the Corporate Governance and Nominating Committee before accepting any new outside directorships. The committee will then form a judgment about how any new board seat may affect board service at Fannie Mae.

From our access to board minutes, committees themselves appear to be efficiently run and cover a large amount of ground in each meeting. For example, Standard & Poor's reviewed with audit committee members the process through which it decided to continue to use its auditor KPMG for important non-audit work relating to its REMICs. The committee decision to employ KPMG was justified ultimately on the basis of cost and the assertion that the nature of this work would not compromise the integrity of the audit process. On this basis the company appears to have consciously chosen what it viewed as the most cost effective provider of these services, in full awareness that this would not create positive optics with regard to the balance of audit versus non-audit fees. While in our view the absence of non-audit fees in this case would create fewer questions about the independence of the audit process, we assess positively from a procedural perspective the fact that this question was seriously and thoughtfully addressed by the audit committee.

The audit committee is chaired by Thomas Gerrity, a professor and former dean at The Wharton School of Business of the University of Pennsylvania, and is distinguished by the high amount of both formal and informal interaction among its members. Again it is notable that

Fannie Mae's chief internal auditor reports to the head of the independent audit committee on the board on a straight-line basis.

The Nominating and Corporate Governance Committee is chaired by Ann McLaughlin Korologos, a professional and experienced board member who sets high procedural standards for the board as a whole. For example, this committee has undertaken a comprehensive comparative review of the changing corporate governance landscape with a view to maintain Fannie Mae's leadership in this area. In this, the committee has been supported by a strong team out of the corporate secretary's office.

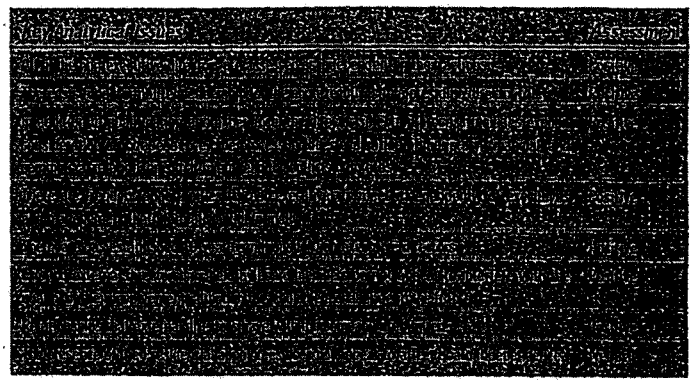
Like a majority of U.S. companies, Fannie Mae's board is led by a combined Chairman and CEO. Standard & Poor's is agnostic as to the relative merits of a split chairman and CEO, believing that there are potential risks to board effectiveness and oversight under both systems (split CEO/chairmen can themselves lead to competing power centers on the board and can also damage board effectiveness). In Fannie Mae's case, the combination does represent a significant concentration of power, but the board has taken the position that this concern is outweighed by the benefits of clear leadership and quick decision-making, particularly given the politics and competitiveness of its industry. Concerns are also lessened by the way that the CEO is monitored by a strongly independent board with strong, formalized leadership by a presiding director. (See Section 4.3 below.) In our analysis, we have no evidence to raise concerns about the concentration of power, but given this structure, the strong role played by the Chairman/CEO warrants ongoing monitoring in this context.

There is a thoughtfulness to the board's activities that is designed to increase effectiveness and cohesion as a group: there are frequent meetings of the non-executives separate from management, including unstructured meetings and day retreats to discuss strategy or other issues, and other meetings are organized where the non-executives can dine casually with the CEO; trips have been organized to neighborhoods where the effects of Fannie Mae's work can be seen by the directors; there is a robust orientation program for new directors that is both deep and broad, (developed for the Presidentials but of benefit to everyone), and there are regular evaluations of both board and CEO effectiveness that are completed with more than a pro forma approach.

Finally, the strength of the board is seen in a variety of areas, but two can be singled out here: the speed and effectiveness of the board's response to OFHEO's proposed changes in 2001 to its corporate governance (including the introduction of specific director responsibilities that may have been in conflict with most states' business judgment rules and lowered thresholds for director liability), and the way that the board has led a strong branding effort over the last several years that focuses equally on Fannie Mae's social mission and its leadership in technology and electronic commerce. Standard & Poor's has seen evidence, both in board of director meeting minutes and in meetings with directors themselves, that the board met these very different challenges with a seriousness of purpose and in partnership between management and the outside directors.

4.3 Role and Independence of Outside Directors

The quality of Fannie Mae's independent directors is very strong. Directors are highly independent and demonstrate a clear commitment to the strength and independence of the board as body. The presence of the Presidential appointees does not appear to impair the independence of the non-executives as a group.



In our interviews with non-executive directors, we have assessed them to be intellectually independent and independent in their actions and have no reason to believe this is not representative of the non-executive directors as a whole. Two potential conflicts have been disclosed in the company's public reports (one director has received consulting fees from the company and another is president of a local university whose neighborhood has received significant help from Fannie Mae and its foundation). While these reflect potential areas of outside concern, we have seen no evidence that these factors materially impair the independence in fact (as opposed to in appearance) of the individual directors in question. For its part, the company has disclosed a specific definition of independence for its board, and has identified the former director as not independent according to this criteria.

In all respects Fannie Mae's non-executive director selection criteria and processes are very strong, and Standard & Poor's saw evidence that great care is taken in selecting new members with appropriate skills, experience, and knowledge. Independence is a specific consideration in the selection process. Moreover, consideration of independence among the non-executives continues after appointment, and there are procedures in place to track material changes.

Leadership for the independent directors exists, and has recently been formalized in the position of the chairperson of the Nominating and Corporate Governance Committee (the current presiding director is Ms. Korologos). The chairperson of the Nominating and Corporate Governance Committee takes the lead when non-executives meet alone, an opportunity given at each board of directors meeting. Directors we spoke with report that they can equally approach Mr. Raines or Ms. Korologos with concerns. Fannie Mae's board committee chairmen tend to be more experienced and longer-serving directors, and we understand these directors play subtle leadership roles for other non-executives as well. We note that the company has decided to link its presiding director (as well as the chair of its audit committee) to shareholders by publishing an email and mailing address for these board members on its web site and will include these addresses in its next proxy statement. While this was a recommendation of the Sarbanes-Oxley legislation, Standard & Poor's positively assesses attempts to strengthen communication between non-executives and the shareholders they represent.

Worries that several directors sit on a large number of other boards are mitigated in practice: although there is always concern about the impact on a director's time should a crisis occur on another board, for most of Fannie Mae's directors, this is clearly their primary board membership or they have resources to help them with their duties that lessen risk of overload. In this way, Standard & Poor's does not find a one-size-fits-all rule governing board seats particularly helpful.

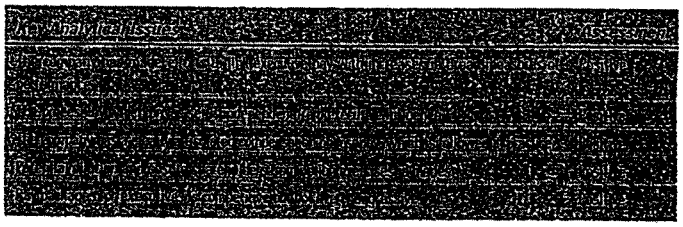
As mentioned above, five members of Fannie Mae's board are appointed by the President of the United States and do not stand for election by holders of the company's common stock. Five new directors may technically be appointed each year, but in practice, appointees tend to stay

through the majority of each administration. According to Fannie Mae's charter, one of the five appointees must come from the mortgage lending industry, one must come from the real estate industry, and according to the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (the 1992 Act that created OFHEO), one of the appointees must have represented community or consumer interests, or have committed themselves to provision of housing for low-income households. In practice, Fannie Mae has no influence or say in the presidential appointment process, and does not provide the White House with recommendations, though the White House will often share names of potential appointments to Fannie Mae before they are announced, but only to ensure they meet Fannie Mae's standards of independence and to preclude any conflict of interest. The appointments are acknowledged to be among the more sought-after at every change in administration, both because they offer directorships of one of America's largest companies and because they are considered to be well-paid.

Standard & Poor's meetings with Fannie Mae board members confirmed that, despite the appointment process, no instructions are given to appointees on how to vote or otherwise behave on the board and the five appointees do not meet together as a group. All directors, whether presidentially appointed or not, share the same fiduciary duties of care and loyalty to shareholders and there is little in appointees' appearance, voting patterns, level of board activity, or other behavior that distinguishes them from their stockholder elected colleagues. Moreover, Standard & Poor's has found no evidence that the presence of these directors has diluted the board's independence or that they have hurt the board's effectiveness in any way other than board size.

4.4 Board and Executive Compensation, Evaluation, and Succession Policies

Compensation policies at Fannie Mae are competitive and transparent. The company attempts to link a substantial majority of executive pay to the performance of the company, at levels that increase in seniority. Standard & Poor's has seen evidence that the Compensation Committee limits the influence that executives can have on their own pay.



Fannie Mae's congressional charter requires the company to pay its executives compensation that is comparable to other publicly traded financial institutions and also sets a broad rule that "a significant portion" of pay should be connected to Fannie Mae's own performance. Another over-arching compensation principle is the independence of the process by which executive pay it set.

The company has applied these principles to its compensation structure for its senior executives, which is composed of four main components: a base salary in cash, annual benefits, annual incentives and long-term incentives. Except for base salary, each of these components is linked to increases in annual and multi-year performance. Moreover, Standard & Poor's has seen evidence that the board has limited the influence of executives on their own pay levels.

Fannie Mae's compensation policies for its CEO and senior executives are benchmarked and reviewed each year against a peer group of financial and financial service companies under the supervision of the board's Compensation Committee, composed entirely of independent, outside directors. Moreover, the Committee uses an outside consultant to assist with the process and discloses its name in public reports. Fannie Mae aims to be at or slightly below the 65th percentile in each of the four main components of pay packages, except for cash compensation (salary and bonus), which it benchmarks to the 50th percentile.

Standard & Poor's assesses positively the Committee's efforts to connect pay with performance: annual bonuses are paid out entirely on growth in EPS (although the company does not disclose required growth levels or whether it uses its operating or GAAP EPS figures for this); longer term incentives like performance shares or restricted stock only payout over three- and four-year performance cycles, respectively, again linked to EPS measures and underpinned by participants' achievement of pre-established goals related to Fannie Mae's business, as assessed by the Committee (performance shares have a three-year performance cycle and payout to 50%

in the fourth and fifth year after grant; restricted stock pays out in tranches of 25% over a four-year period). Stock options, with the exception of an EPS-linked challenge grant in 2000, pay out simply upon increases in the company's share price and do not include performance-linked criteria for option exercise. In today's environment, investors increasingly expect earnings or other financial performance hurdles for all equity-linked awards.

Expected dilution to current shareholders' stakes when outstanding awards are exercised is, at less than 5% of outstanding shares, modest compared with Fannie Mae's U.S. peers (overhangs at financial service companies are often twice as large). Moreover, dilution fears are lessened by the company's current policy to cover restricted stock awards with repurchased shares and the company's lowered share price. CEO pay at Fannie Mae, while not especially modest, is well-disclosed and not out of line with its peers (it is also benchmarked to the 65th percentile of its U.S. peers). In 2001, base salary was set at just under US$1 million and annual bonuses and longer-term option and performance awards increase total pay to just over US$7 million, with approximately an additional US$3.2 million (current value) paid and deferred. In the most recent year, performance criteria attached to these longer-term awards were fully met and the full compensation awards were granted to the CEO.

We note that the board has established challenging stock-retention rules: the CEO must hold a minimum of five times his base salary in Fannie Mae stock, and is given three years to attain this level. For the Vice Chairman, the minimum is three times salary; for Executive Vice Presidents, it is two times salary. Standard & Poor's believes that stock retention can better align the interests of executives with shareholders than stock options alone.

Executive severance arrangements are modest and fully disclosed. Parties to these agreements may receive payments if they are not re-elected by shareholders, upon a change of control or a few other reasons, though payouts are comparatively modest and do not extend beyond one year. Moreover, there are no unusual retirement benefits to a leaving CEO or other executives and all termination benefits are submitted to OFHEO for approval.

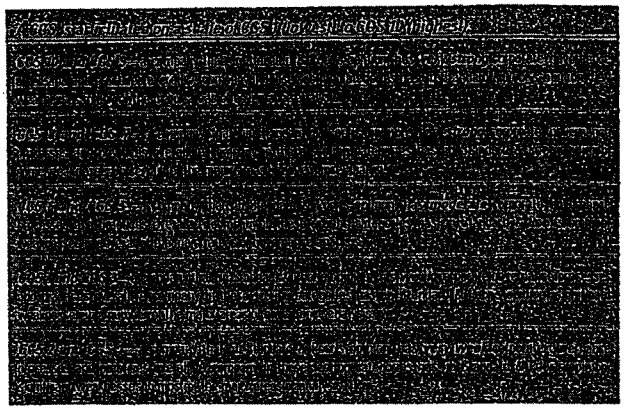
Board evaluation and succession policies are assessed as very strong: although the board has avoided individual director performance reviews because they are seen as too divisive, this does not detract from the serious CEO and board evaluations that are conducted each year. The process is managed through the company's strong corporate governance committee and the company secretary's office. Unlike many U.S. companies, executive succession at Fannie Mae is far from ad hoc. The board regularly reviews contingency plans and meets to agree on their approach to both expected and unexpected changes in leadership.

Each non-management director of Fannie Mae receives an annual cash retainer of US$35,000 in addition to payments of US$1,000 for each board or committee meeting they attend and US$10,000 if they chair a board committee. In addition, they participate in a restricted stock program and separate stock option program for directors that awards set amounts of stock at set dates, limiting discretion. The terms of these plans appear to be well-structured and are intended to align outside directors' interests with those of shareholders. Nonetheless, it would be positive if shares received under these plans could not be sold, or if awards did not fully vest, until directors leave the board.

Corporate Governance Scores

A Corporate Governance Score ('CGS') reflects Standard & Poor's assessment of a company's corporate governance practices and policies and the extent to which these serve the interests of the company's financial stakeholders, with an emphasis on shareholders' interests. These governance practices and policies are measured against Standard & Poor's corporate governance scoring methodology, which is based on a synthesis of international codes, governance best practices and guidelines of good governance practice.

Companies with the same score have, in the opinion of Standard & Poor's, similar company specific governance processes and practices overall, irrespective of the country of domicile. The scores do not address specific legal, regulatory and market environments, and the extent to which these support or hinder governance at the company level, a factor which may affect the overall assessment of the governance risks associated with an individual company (see below 'Country Factors').



GovernanceWatch

A 'GovernanceWatch' designation may be used to highlight the fact that identifiable governance events and short-term trends have caused a CGS to be placed on review. GovernanceWatch does not mean that a change to the CGS is inevitable. GovernanceWatch is not intended to include all CGSs under review, and changes to the CGS may occur without the CGS having first appeared on GovernanceWatch.

Country Factors

Although Standard & Poor's publishes country governance analyses from time to time, it is important to note that Standard & Poor's does not currently score individual countries. However, consideration of a country's legal, regulatory and market environment is an important element in the overall analysis of the risks associated with the governance practices of an individual company. For example two companies with the same Company Scores, but domiciled in countries with contrasting legal, regulatory and market standards, present different risk profiles should their governance practices deteriorate i.e. in the event of deterioration in a specific company's governance standards, investors and stakeholders are likely to receive better protection in a country with stronger and better enforced laws and regulations. However, in Standard & Poor's opinion, companies with high corporate governance scores have less governance related risk than companies with low scores, irrespective of the country of domicile.

For a full explanation of Standard & Poor's criteria for measuring corporate governance standards, please refer to the latest edition of "*Corporate Governance—Criteria & Methodology*".

Important Note

A CGS is based on current information provided to Standard & Poor's by the company, its officers and any other sources Standard & Poor's considers reliable. A CGS is neither an audit nor a forensic investigation of governance practices. Standard & Poor's may rely on audited information and other information provided by the company for the purpose of the governance analysis. A CGS is neither a credit rating nor a recommendation to purchase, sell or hold any interest in a company, as it does not comment on market price or suitability for a particular investor. Scores may also be changed, suspended or withdrawn as a result of changes in, or unavailability of such information.

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