

The ***GSE*** REPORT™

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*Special Supplement*

**Report of the Special Examination of Fannie Mae:**

*The Company Unmasked*

May 2006

## **Fannie Mae Accepts Civil Penalties, SEC Injunction, and OFHEO Consent Agreement**

On May 23, 2006, the Office of Federal Housing Oversight (OFHEO) released its Report of the Special Examination of Fannie Mae (the “Report”). That same day OFHEO and the SEC announced that Fannie Mae would pay \$400 million in civil penalties and agreed, without admitting guilt, to imposition of an injunction proscribing violations of the SEC antifraud laws. Investigations by the SEC and Justice Department are continuing.

Fannie Mae also signed a consent agreement with OFHEO under which the company will undertake remedial actions to address all the recommendations contained in the OFHEO Report, including accounting practices, internal controls, governance, capital plans, corporate culture, disclosure, personnel oversight and compensation, and oversight of certain corporate activities.

As part of the consent agreement, the company committed not to increase its mortgage portfolio assets beyond the level of December 31, 2005, except as provided in a plan to be submitted to OFHEO within 60 days and subject to its approval. Such plan can include a moderate annual increase for reasons of liquidity, housing goals, portfolio flexibility and competitive considerations.<sup>1</sup>

Fannie Mae also agreed to have its Board of Directors implement, within 120 days, a review of all individuals, including board members, mentioned in the report as participating in misconduct, to determine whether they are suitable to remain in their positions, and what disciplinary actions, including termination, may be necessary. Also, the company will assist OFHEO in pursuing actions against other individuals identified in the report and will review whether any past terminations should be deemed “for cause,” and, if so, is required to seek restitution and other redress from those individuals.

### **Scope of the Report**

The OFHEO Report is both extensive and limited. It is extensive in its analysis of the culpability of members of Fannie Mae’s Board and senior management, as well as numerous other officials of the company. In this respect it is far reaching as compared to the Rudman Report to Fannie Mae’s Board of Directors, which appeared to attribute most of the misconduct to the office of Vice Chairman and Chief Financial Officer, the Controller, and the Office of Audit. The OFHEO Report’s list of inappropriate corporate activities is much longer than those in earlier reports. The flavor of the Report may be obtained from OFHEO’s one-page summary, which is attached to this analysis as an appendix.

On the other hand, the OFHEO Report is expressly limited to “...the problems with Fannie Mae’s accounting policies, internal controls, financial reporting, and corporate governance that led to the restatement of the Enterprise’s financial reports...” (p. 2). Other matters, such as the quality of Fannie

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<sup>1</sup> Since the release of the OFHEO Report, Freddie Mac has indicated that OFHEO may seek similar limits for that company, but the details are not yet clear. Presumably, OFHEO could argue that the problems at both companies are an indication that portfolio limits are required because of the GSEs’ propensity to outgrow their operational and internal controls, even after they correct the particular problems that OFHEO identified at this particular time. Legislation to deal with portfolio limits more directly would be extremely valuable in limiting the potential risk to the financial system.

Mae's operational controls, compliance with new program approval requirements in the charter, or the company's political activities, are touched upon only in passing, if at all. Given the finding of the Report (p. 34) that, "Senior management expected to be able to write the rules that applied to Fannie Mae and to thwart efforts to regulate the Enterprise," it would be reasonable to check for misconduct in other areas of the company's operations as well.

The OFHEO Report will help to define the regulatory relationship with Fannie Mae and Freddie Mac in the future. Chapter 3 of the Report offers a legal analysis of OFHEO's authorities and standards of review. Among other parts of the analysis, the Report asserts (p. 21) that, "OFHEO possesses supervisory responsibilities and powers 'essentially similar to those of the Federal bank regulatory agencies.'" (Footnote omitted). While this assertion will need to be tested in court with respect to particular powers that OFHEO possesses, the findings of the Report provide the best possible context for such tests. Throughout the Report, OFHEO points to specific misconduct as either an unsafe and unsound condition or an unsafe and unsound practice. Since Fannie Mae signed the consent agreement with OFHEO, these points have not yet been subjected to judicial review.

## **Findings of the Report**

### ***Accounting Manipulations involving misapplication of GAAP***

The OFHEO Report finds that Fannie Mae engaged in numerous acts of misconduct, involving well over a dozen different forms of accounting manipulation involving violations of Generally Accepted Accounting Principles (GAAP). The headings of the Report's chapter (pp. 103-186) on "Misapplication of GAAP, Weak Internal Controls, and Improper Earnings Management" provide a good summary of the areas in which the Report finds improprieties:

- Improper Accounting Policies and Weak Internal Controls:
  - Derivative and Hedge Accounting,
  - Investment Accounting,
  - Securitization Accounting,
  - Dollar Roll Accounting,
  - Foreclosed Property Accounting (Real Estate Owned), and
  - Lack of Journal Entry Controls
  
- Misapplications of GAAP to Avoid Impairment Losses
  - Investment Securities
  - Interest-Only Securities
  - Misapplications Relating to Buy-ups
  
- Improper Transactions and Accounting to Fine-Tune Results
  - Short-Term Investment Securities
  - Income-Shifting REMICs
  - Debt Repurchases
  - Insurance Transactions
  - Inappropriate Use of Cookie Jar Reserves

### ***Management's Incentive to Meet EPS Targets and Increase Compensation***

OFHEO reported that management engaged in the improper activities listed above in order to meet the company's demanding earnings-per-share (EPS) goals which then resulted in management being awarded millions of dollars of compensation that those individuals would not have otherwise received without the improper manipulation of earnings. Fannie Mae's CEO Franklin Raines received compensation of \$90 million over the six years 1998-2003 that are a subject of the Report. Of that amount, over \$52 million was directly linked to achieving EPS targets (Report, pp. 1-2).

Fannie Mae tied major portions of executive compensation to EPS, and this metric was "easily manipulated by management." (p. 55). The incentives in the EPS-based compensation system "drove the misconduct in part because the Enterprise lacked policies, procedures, and internal controls that should have provided checks and constraints. Because the program, as designed and in that context, created strong incentives for unsafe and unsound practices and led to unsafe and unsound conditions, it was itself an unsafe and unsound practice." (pp. 56-7).

Fannie Mae's senior management used accounting maneuvers to increase their own compensation.

"...senior executives consistently managed to hit, but rarely exceed by much, the annual EPS goals that ensured a maximum bonus payout. [F]rom 1996 through 2002, the EPS number at the end of a given year was typically very close to the EPS maximum bonus payout target set at or near the beginning of each year, sometimes within fractions of a cent." (p. 86).

### ***Costs of the Misconduct to the Company and Shareholders***

The misconduct that led the SEC to require Fannie Mae to restate its financial results for 2002 through mid-2004 was extremely costly. It resulted (p. 1) in "losses of tens of billions of dollars in market capitalization for Fannie Mae shareholders, and expenses for the restatement process, regulatory examinations, investigations, and litigation that the Enterprise has recently estimated will exceed \$1.3 billion in 2005 and 2006 alone."

### ***A False Image of Being Low-Risk and World-Class***

The Report sets out (p. 2) how Fannie Mae stressed an image of being world-class and low risk. That image, however, was "false" and a "facade."

"The illusory nature of the Enterprise's public image and senior management's efforts at concealment were the two essential features of the Enterprise's corporate culture. Those features, which were both supported by repeated improper manipulation of earnings, are a major theme of the report."

The smoothing of reported earnings by the company allowed Fannie Mae to obscure the substantial interest rate risk that it was taking:

“Fannie Mae’s strategy for managing the retained mortgage portfolio involved taking a significant amount of interest rate risk, as members of the Board should have been aware.... At least some members of the Board should have been aware of the degree of options mismatching practiced by Fannie Mae, and that the associated interest rate risk is a source of earnings volatility that, if reflected properly in the financial reports, would make it difficult for the Enterprise to maintain very stable EPS growth.” (p. 46).

### ***Failures of the Internal and External Audit Functions***

The Report looks closely at Fannie Mae’s Office of Auditing and at its external auditor at the time, KPMG. It finds (p. 190) that the Office of Auditing had “insufficient staff and insufficient expertise” to do its job. Fannie Mae failed to invest sufficient resources into the essential functions performed by the office. (p. 195). The Senior Vice President who headed the Office of Auditing was not a CPA and had had no prior auditing experience. (p. 194).

“The Office...failed to properly confirm compliance with GAAP as specified in its audit objectives or to consistently audit critical accounting policies, practices, and estimates in a timely way. When shortcomings were found they were not adequately addressed or communicated. Internal audit reports prepared by the Office consistently understated problems and overstated work accomplished. *Rather than undertaking independent work to confirm compliance with policies and procedures, the Office often relied on the managers of units under audit to confirm compliance.*” (p. 190, emphasis added).

KPMG, the external auditor, also seemed to exhibit serious shortcomings. OFHEO conducted an assessment of KPMG’s work with respect to Fannie Mae’s adherence to FAS 91 (accounting for premiums and discounts relating to mortgage acquisition) and FAS 133 (accounting for derivatives and hedging) , two of the major areas where Fannie Mae’s accounting and disclosures departed significantly from GAAP. Among other shortcomings, OFHEO reports that, “KPMG did not have an adequate process for reviewing Fannie Mae’s accounting policies for compliance with GAAP.” (p. 208). KPMG also failed to investigate Fannie Mae’s 1998 failure to adjust earnings by \$199 million as was required by FAS 91. That failure allowed the company to meet earnings expectations of Wall Street. KPMG originally designated this amount as an audit difference, but then withdrew its objection on grounds that the amount was “immaterial.” As OFHEO notes, “the fact that the adjustment made the difference between Fannie Mae’s meeting and not meeting the predicted earnings target for 1998 rendered it material.” (p. 108).

With respect to FAS 133, KPMG identified many of the non-GAAP practices highlighted in the September 2004 OFHEO report on Fannie Mae. “KPMG regarded the practices as ‘practical applications’ of FAS 133 and determined that the improprieties would result in minimal financial statement impact. However, the SEC determined that the Enterprise’s ‘practical applications’ of FAS 133 represented material misrepresentations of GAAP.” (p. 219).

OFHEO concluded (p. 8) that, “The failure of KPMG to detect and disclose the serious weaknesses in policies, procedures, systems, and controls in Fannie Mae’s financial accounting and reporting, coupled with the failure of the Board of Directors to oversee KPMG properly, contributed to the unsafe and unsound conditions at the Enterprise.”

KPMG also failed to respond adequately to the allegations of fraud raised by a Fannie Mae employee in the Controller’s Office, Roger Barnes. A Fannie Mae Senior Vice President disparaged Mr. Barnes’ motivations and capabilities to KPMG (p. 226) and KPMG conducted an external review that “was not sufficient to make a determination regarding the propriety of the investigation performed by Fannie Mae or to evaluate the Enterprise’s conclusions regarding Mr. Barnes’ assertions.” (p. 8).

Finally, OFHEO points out (p. 300) that Fannie Mae paid KPMG substantially more in consulting fees than it did for KPMG’s services as external auditor. From 1998 to 2003, Fannie Mae paid KPMG a total of \$52.9 million in consulting fees, compared with only \$8.9 million in audit fees. “For KPMG, Fannie Mae, as one of the largest financial institutions in the country, was a prestigious client; however, the audit engagement was a minor part of the relationship.” (p. 301).

### ***Root Causes: A Harmful Culture and “Tone at the Top”***

As did the Rudman Report, the OFHEO Report points to a harmful corporate culture and “tone at the top” as lying at the root of Fannie Mae’s misconduct. While the OFHEO Report on Freddie Mac also pointed to corporate culture and “tone at the top” as producing corporate misconduct (OFHEO Report on Freddie Mac, pp. 4-17) the report on Fannie Mae finds more profound problems.

OFHEO finds (p. 34) that, “Fannie Mae’s financial success gave senior management steadily increasing amounts of money to use in efforts to influence the regulatory and legislative processes.” In particular, OFHEO documents (starting on p. 36, and at pp. 273-6) Fannie Mae’s implementation of a strategy of “opposing, circumscribing, and constraining OFHEO.”

“Senior management made efforts to interfere with the examination by encouraging and directing Fannie Mae’s lobbyists to use their ties to a key Congressional staff member to 1) generate a Congressional request for the Inspector General of the Department of Housing and Urban Development (HUD) to investigate OFHEO’s conduct of the special examination and 2) insert into an appropriations bill language that would reduce the agency’s appropriations until Director Armando Falcon, who had initiated that examination, was replaced.” (p. 38).

Following caselaw from the federal bank regulators, OFHEO finds interference with its supervisory investigation to be an unsafe and unsound practice (pp. 29 and 276).

### ***Responsibility of Senior Managers and the Board***

The Report summarizes (p. 9) the responsibility of senior Fannie Mae management for engaging in unsafe and unsound practices “to smooth reported earnings, hit the EPS targets that determined their compensation, achieve rapid growth while keeping administrative and other infrastructure-related expenses as low as possible, and limit internal and external criticism of the Enterprise.” The practices noted in the report include:

- failing to establish a sound internal control system;
- failing to maintain the independence and objectivity of Fannie Mae's internal auditor;
- failing to disclose to external parties accurate information about the company's financial condition and operations;
- failing to investigate employee allegations and concerns;
- failing to allow the Board of Directors unrestricted access to members of management; and
- making efforts to interfere with OFHEO's special examination.

The Report also finds (pp. 10-11) the Board of Directors culpable:

“...the Fannie Mae Board of Directors was a passive and complacent entity, controlled by, rather than controlling, senior management. The Board and its committees missed a host of opportunities to uncover and correct the issues and events described in this report. Instead, Fannie Mae suffered an enormous loss in credibility and reputation, and its shareholders suffered large financial losses. An effective Board, operating in accord with generally accepted standards of prudent operation, would have prevented much of what occurred.”

Among the shortcoming of the Board (p. 10), its members failed to,

- stay appropriately informed of corporate strategy;
- assure appropriate delegations of authority;
- ensure that Board committees functioned effectively;
- provide an appropriate check on Chairman and CEO Raines;
- hire and retain a qualified senior executive officer to manage the internal audit function;
- initiate independent investigations of Fannie Mae; and
- ensure timely and accurate reports to federal regulators.

Former Senator Warren Rudman told the *Washington Post* that OFHEO's Report and the Rudman Report agree on the facts, but defended the Board. "[OFHEO's] comments on the tone at the top, the arrogance of the corporation, tracks with what we said," Rudman said. "The two reports don't disagree that the board was at times misled, either intentionally or unintentionally, and was given bad information." (*Washington Post*, May 24, 2006, "Study Finds 'Extensive' Fraud at Fannie Mae," p. A-1).

### **Next Steps**

The system that Congress designed for Fannie Mae and Freddie Mac provided these companies with special advantages and exceptions:

- They have lower capital requirements than other financial institutions, and therefore can maximize the use of leverage.
- They enjoy a lower cost of capital, either through direct access to the Treasury, or in the debt markets, where they are perceived to have implied government backing. The "implied federal guarantee" of their debt allows them to issue bonds whenever they find a need for funds,

regardless of market conditions, at interest rates lower than those granted to the best fully private companies.

- Federal support allows them to increase their financial flexibility by issuing callable long-term debt.
- They are exempt from state and local taxes.
- They are exempt from filing with the SEC,<sup>2</sup> saving both the expense of filing and the time needed to compile and write SEC disclosures. SEC exemption gives the GSEs the advantage of not having to properly disclose their financial data on a timely basis, and exempts them from laws such as the Foreign Corrupt Practices Act.
- With an “implied federal guarantee” of GSE debt, private investors do not judge them with the same risk standard, providing a benefit to both their debt and their stock.
- Their exclusive charters ensure their shared-monopoly status.

Together, these special advantages and exemptions work to prevent these GSEs from having any market discipline being imposed on them. In addition, it is clear from the OFHEO Report that Fannie Mae used its powerful political machine to prevent its regulator from doing its job so that it could not only engage in the nefarious practices revealed in the Report, but to also “excessively use” the benefits of its exclusive charter.

The fundamental reality revealed by the OFHEO reports on Fannie Mae and Freddie Mac is that the GSEs are so powerful that they create a sense of complacency in their managers who inevitably may become tempted to pursue financial goals without regard to the risks to the taxpayers, their shareholders, or even the law. Even new GSE management subject to the best regulatory oversight will not deal with the fundamental problem of two companies with unique subsidies and powers and the enticements and risks that this creates. That is a subtext of the summary presented in the OFHEO Report (p. 1) about the factors that led Fannie Mae senior management to commit or tolerate so many transgressions:

“Those factors included the Enterprise’s enormous financial resources and political influence, the expectation that senior management could write the rules that applied to Fannie Mae, financial rewards tied to a measure of profits that management could easily manipulate, and the relative disinterest of senior executives in adhering to standards of prudent business operations.”

### ***Reform is Needed***

The OFHEO Report makes a number of recommendations (pp. 13-14) for remedial action. Most of these are now included in the consent agreement that OFHEO signed with Fannie Mae. The Report

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<sup>2</sup> Both Fannie Mae and Freddie Mac voluntarily agreed to register with the SEC under the 1934 Act, but are not subject to registration of their securities under the 1933 Act. This special treatment means that the GSEs are not subject to the same kind of oversight that applies to other companies. Since its voluntary agreement was reached with the U.S. Government, Freddie Mac has not registered with the SEC under the 1934 Act because they have not filed financial statements since that agreement went into effect. Fannie Mae complied with the agreement once, but due to the fact that it has not filed financial statements since their initial filing with the SEC, Fannie Mae has not been able to continue to comply with the agreement.

makes three recommendations of particular interest:

- (1) OFHEO should continue to support legislation to provide the powers essential to meeting its mission of assuring safe and sound operations at the Enterprises;
- (2) Due to Fannie Mae's current operational and internal control deficiencies and other risks, the Enterprise's growth should be limited; and
- (3) Matters identified for remediation by Fannie Mae should be considered by the Director for application to both Enterprises.

Thus, despite OFHEO's statements that it already has the powers of the bank regulators with respect to safety and soundness, OFHEO would welcome enactment of legislation to strengthen its powers.

The need for a stronger OFHEO is incontrovertible. Recall that OFHEO's 2003 Annual Report (p. 34) stated that, "Fannie Mae's internal control framework and the management of that framework are effective. Management has an accurate and reliable process for identifying risks to business processes and implementing appropriate controls."

With the issuance of its current Report, OFHEO has overcome the resistance to effective oversight of the GSEs. It is time now for the Congress to overcome that same resistance and give the regulator the mandate and capacity to do its work effectively henceforth. The problems revealed at both GSEs show that mere gestures at reform are likely to lay the groundwork for the cycle of GSE hubris and misconduct to be repeated in future years.

What is needed is legislation that not only focuses both GSEs on their original mission, but also gives their regulator authority which tracks the authority available to bank regulators, including full enforcement powers, the ability to impose capital requirements that match those required of other regulated financial institutions, the ability to put a failed GSE into receivership, and more. In addition, Congress needs to examine the special exemptions and subsidies provided to both GSEs to determine whether it is appropriate to continue them, such as their SEC exemption and their exemption from state and local taxes.

Absent legislation, the SEC and Justice Department and attorneys for Fannie Mae's shareholders will continue their work. At the very least, their actions could well make a further contribution to changing Fannie Mae's corporate culture and "tone at the top," as the OFHEO Report recommends.

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## Appendix – OFHEO’s Summary of the Report

- Fannie Mae senior management promoted an image of the Enterprise as one of the lowest-risk financial institutions in the world and as “best in class” in terms of risk management, financial reporting, internal control, and corporate governance. The findings in this report show that risks at Fannie Mae were greatly understated and that the image was false.
- During the period covered by this report—1998 to mid-2004—Fannie Mae reported extremely smooth profit growth and hit announced targets for earnings per share precisely each quarter. Those achievements were illusions deliberately and systematically created by the Enterprise’s senior management with the aid of inappropriate accounting and improper earnings management.
- A large number of Fannie Mae’s accounting policies and practices did not comply with Generally Accepted Accounting Principles (GAAP). The Enterprise also had serious problems of internal control, financial reporting, and corporate governance. Those errors resulted in Fannie Mae overstating reported income and capital by a currently estimated \$10.6 billion.
- By deliberately and intentionally manipulating accounting to hit earnings targets, senior management maximized the bonuses and other executive compensation they received, at the expense of shareholders. Earnings management made a significant contribution to the compensation of Fannie Mae Chairman and CEO Franklin Raines, which totaled over \$90 million from 1998 through 2003. Of that total, over \$52 million was directly tied to achieving earnings per share targets.
- Fannie Mae consistently took a significant amount of interest rate risk and, when interest rates fell in 2002, incurred billions of dollars in economic losses. The Enterprise also had large operational and reputational risk exposures.
- Fannie Mae’s Board of Directors contributed to those problems by failing to be sufficiently informed and to act independently of its chairman, Franklin Raines, and other senior executives; by failing to exercise the requisite oversight over the Enterprise’s operations; and by failing to discover or ensure the correction of a wide variety of unsafe and unsound practices.
- The Board’s failures continued in the wake of revelations of accounting problems and improper earnings management at Freddie Mac and other high profile firms, the initiation of OFHEO’s special examination, and credible allegations of improper earnings management made by an employee of the Enterprise’s Office of the Controller.
- Senior management did not make investments in accounting systems, computer systems, other infrastructure, and staffing needed to support a sound internal control system, proper accounting, and GAAP-consistent financial reporting. Those failures came at a time when Fannie Mae faced many operational challenges related to its rapid growth and changing accounting and legal requirements.
- Fannie Mae senior management sought to interfere with OFHEO’s special examination by directing the Enterprise’s lobbyists to use their ties to Congressional staff to 1) generate a Congressional request for the Inspector General of the Department of Housing and Urban Development (HUD) to investigate OFHEO’s conduct of that examination and 2) insert into an appropriations bill language that would reduce the agency’s appropriations until the Director of OFHEO was replaced.
- OFHEO has directed and will continue to direct Fannie Mae to take remedial actions to enhance the safe and sound operation of the Enterprise going forward. OFHEO staff recommends actions to enhance the goal of maintaining the safety and soundness of Fannie Mae.