

The ***GSE*** REPORT™

Special Supplement

The Rudman Report: Findings and Analysis

May 2006

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On February 23, 2006, Fannie Mae released a report by former-Senator Warren Rudman and the law firm of Paul, Weiss, Rifkind, Wharton & Garrison LLP. The Rudman Report (“Report”) was commissioned by Fannie Mae’s Board of Directors and is remarkable. In one area after another the report concludes that management, outside advisors, and outside firms provided incomplete, misleading, or false information about critical accounting issues to the Board of Directors, and the relevant board committees.

The Report, which runs 616 pages plus another 2000 pages of appended documents, directs its criticisms primarily at Fannie Mae’s former Vice Chairman/Executive Vice President/Chief Financial Officer, the company’s former Controller, and other officials who are no longer at Fannie Mae. As one financial columnist concluded, however, this is not the whole story.¹

The Report is candid about its limitations. It focuses expressly on matters of accounting, financial reporting, internal controls, and governance. In these respects, the Report is responsive to the company’s agreement with OFHEO to examine and correct those issues. On the other hand, the Report does not address other critical matters, such as the extent that the company’s mortgage operations, hedging operations, or other activities are carried out effectively and with proper controls. Those critical issues must now be addressed by other examinations, and preferably by OFHEO’s special examination that is scheduled to be released on May 23, 2006.

The Report explicitly notes that Paul, Weiss was not charged with determining whether any of the conduct it reviewed would constitute a violation of law or breach of professional standards. The firm did not have the power to compel testimony or the production of documents and did not obtain cooperation, in whole or in part, from some of Fannie Mae’s former officials who possess important relevant information.

This review of the Report presents some of the Report’s major findings, and then reviews some of the larger issues that the Report raises. These larger issues are helpful in understanding the question that many are asking: *why would a GSE, with its government-subsidized access to market power and high returns, reach for yet greater returns that could be achieved only on the basis of improper and probably illegal conduct?* This review concludes with recommendations for addressing the larger issues to try to prevent a recurrence of similar problems in the future.

¹ Steven Pearlstein, “Fannie Mae Report Is Long, but It’s Not the Whole Story,” *Washington Post*, March 3, 2006, p. D01.

I. Findings of the Rudman Report

A. Accounting and Reporting

The bulk of the Report deals with accounting and reporting issues, followed by an examination of governance, compensation and similar matters. With respect to accounting and reporting, the Report found the following:

1. FAS 91

Financial Accounting Standard No. 91 (FAS 91) addresses the accounting treatment of nonrefundable fees and costs associated with originations and purchases of loans. The Report finds that Fannie Mae failed to comply with FAS 91 for 11 years after 1987. In 1998, Fannie Mae came into partial compliance by booking only \$240 million of the \$439 million in expenses that should have been booked to bring the company into compliance with GAAP.

The Report found that the company booked as much of the catch-up expense as it could while still meeting Wall Street's earnings-per-share (EPS) expectations.

The Report found that Fannie Mae also engaged in two much smaller questionable accounting changes that appeared to have been motivated by intent to hit bonus targets in the company's incentive plan. By hitting the highest-level target, management received bonuses totaling \$27.1 million in 1998 alone.

2. FAS 133

FAS 133 governs accounting for derivative instruments and hedge transactions. The Report concedes that FAS 133 has been subject to much criticism. Fannie Mae's approach, however, differed from FAS 133 requirements in "numerous and important respects." The Report continues, "Indeed, the record of our review shows that the Company's method of hedge accounting conflicted with clear and specific provisions of FAS 133."²

The Report further found that Fannie Mae's approach to FAS 133 was dictated not merely by a desire to avoid the perception of earnings volatility, but also by a desire to avoid "the substantial changes to the Company's business methods, and/or the development of new and complex accounting systems" needed to comply with FAS 133.³

In the view of the Report, the Fannie Mae Board of Directors was entitled to rely on the representations that it received from management, and reports from the company's outside accounting firm (KPMG), OFHEO, and Fannie Mae's Internal Audit, all confirming that view. This practice ended with OFHEO's Special Examination Report

² Rudman report, p. 102.

³ Ibid.

that was presented to the Board in September 2004. As late as July 2004 the Board seems to have believed that no restatement would be necessary.

3. Other Accounting Practices

The Report documents numerous other areas where Fannie Mae's accounting practices violated accounting standards:

“[M]anagement'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.”⁴

B. Governance, Management, and Culture

1. Corporate Governance

Concentrated Authority at the Top

The Report finds that authority over Fannie Mae's management was highly concentrated. Fannie Mae's then-CEO Franklin Raines commented in 2003 on the company's significant history of “CEO-centered” decision-making.⁵ The Report states that, although Mr. Raines did try to broaden decision-making authority in 2000, senior officers subsequently expressed “ongoing concern” about the extent to which Mr. Raines delegated authority and his “level of involvement in the details of decision-making.”⁶

The Report points to the centralization of authority in the position held by former Vice Chairman/Executive Vice President/CFO Timothy Howard. When Mr. Raines became CEO in 1999, the Senior Vice Presidents for Financial and Structured Transactions, Financial Information, Portfolio Management, Portfolio Strategy and Investor Relations all reported directly to Mr. Howard, as well as the Treasurer and the Controller. In 2002, the company also shifted direct reporting by the Chief Credit Officer and the head of Internal Audit to Mr. Howard.⁷

In summary, one person, the Vice Chairman/Executive Vice President/CFO, had responsibility for planning transactions, carrying them out, accounting for them, reporting on them, and auditing them. The Report does not indicate that the CEO or other board members expressed concern, or even recognized the substantial conflict of interest that this created among these functions.⁸

⁴ Rudman report, Executive Summary, p. 4.

⁵ Rudman report, p. 426.

⁶ Ibid.

⁷ Rudman report, p. 429.

⁸ In 2004, was Fannie Mae Board Member Stephen Ashley told Daniel Mudd that, in failing to replace Chief Credit Officer Marzol in 2004, the company was “replacing accountability with succotash.” Mudd sent an e-mail to Raines, August 10, 2004, reporting this conversation. Rudman Report, p. 447, fn. 1710. However, the larger issue of consolidation of functions under one person does not seem to have been addressed.

Lack of Cross-Enterprise Teamwork

Despite the concentration of authority, the Report found, there was a lack of teamwork at the senior management level. The Report quotes Daniel Mudd, now Fannie Mae's CEO and then the company's Chief Operating Officer, as stating in 2000 that there was "a horizontal problem of silos and a lack of cooperation and flow of information across Fannie Mae." The Report singles out relations within Mr. Howard's finance organization as well as between finance and other parts of the company.⁹ In particular, there was "the absence of an effective cross-enterprise approach to operational risk management."¹⁰

Failure of Management to Provide Full and Truthful Information to the Board of Directors on Critical Issues

The Report states that, "The Board endeavored to operate in a manner consistent with its fiduciary obligations and evolving corporate governance standards....The Board did respond appropriately when it did receive indications that there were significant issues at the Company."¹¹

In one area after another, however, the Report concludes that the Board of Directors, and key board committees, received incomplete, misleading, or false information.

"Our investigation found that management's reports to the Board sometimes omitted critical adverse information and thereby left directors with a false sense of reassurance concerning the Company's policies and practices, the level and nature of internal resources, and the degree to which the Company genuinely met "best practices."¹²

The investigators found no evidence that the Board, including board committees, was briefed in any meaningful fashion on critical issues. "As a consequence, the Board lacked the information necessary to assess the claims of senior management that the Company possessed a first-rate accounting operation and robust internal control and compliance functions."¹³

The Report documents changes in governance since the departure of Mr. Raines. These include separation of the position of CEO from the Board Chairmanship, changes to the board committee structure, and changes in the leadership structure of the company.

⁹ Rudman report, pp. 442-443.

¹⁰ Rudman report, p. 424.

¹¹ Rudman report, p. 401.

¹² Rudman report, p. 437.

¹³ Rudman report, p. 438.

2. Management

Emphasis on EPS-Driven Business Goals

Under the leadership of Mr. Raines, Fannie Mae announced a goal of doubling the company's earnings-per-share (EPS) within five years, 1998-2003. The Report found that achievement of these EPS-driven goals was "inextricably linked" to achieving management's maximum bonus pools. Starting in 2000 the company set its highest EPS targets at the percentage growth (14.9 percent per year) that, if sustained, would allow for doubling of EPS in five years.¹⁴

Even the Internal Audit staff was driven by these goals. The company's compensation plan treated Internal Audit as it did any other business unit, with bonuses linked to EPS goals. As the Report states, "...this compensation package was not conducive to maintaining the appearance and fact of Internal Audit's independence and objectivity," although the investigation found no evidence that this result was intended.¹⁵

Inadequate Staffing of Critical Functions

The Report documents that there was a lack of adequate staff, and especially of staff and more senior officials with the requisite expertise and experience, in key parts of the company. The Report found "significant resource deficiencies" in Internal Audit, the Controller's Office, and the Office of Corporate Compliance, for example.¹⁶ The head of Internal Audit and the Controller both lacked the needed experience and expertise to carry out their responsibilities with respect to a company of the size and complexity of Fannie Mae. Thus, the head of Internal Audit had had no experience or formal training as an auditor; the Controller was not a certified public accountant.

Internal audit lacked both an adequate number of employees and also lacked employees with the needed skill sets: "Due to the limited number of employees with public accounting background or equivalent experience at other financial institutions, Internal Audit did not have the necessary resources to audit effectively aspects of Fannie Mae's business operations that were heavily affected by accounting principles and policies..."¹⁷ And, "A significant majority of the auditors had no prior audit experience before joining Internal Audit."¹⁸

The head of Internal Audit repeatedly reported to top management on the need to increase the office's resources, but did not convey this message to the Audit Committee of the Board of Directors. Indeed, the Report found that the head of Internal Audit was assuring

¹⁴ Rudman report, p. 533.

¹⁵ Rudman report, p. 466.

¹⁶ Rudman report, p. 438.

¹⁷ Rudman report, p. 470.

¹⁸ Rudman report, p. 471.

the Audit Committee that the office had sufficient resources even while he was urging management to address the office's staffing shortages.¹⁹

With respect to the Controller's Office, the Report found that:

“[T]he Controller's Office was hindered by significant understaffing, a lack of personnel with the requisite experience and expertise to handle the complex accounting tasks required of Fannie Mae's Controller's Office, and poorly integrated computer systems that required significant human intervention.”²⁰

Although the responsibilities of the office increased substantially, both through the acquisition of new functions and because of new reporting requirements arising from the company's registration with the SEC, the office increased by only 13 employees between 2000 and 2003. While the headcount of the office was 230 employees in September 2004, the company now estimates that it will hire another 150 employees in 2006, with a long-term goal of an office staff of 450 people. The company also is working to improve the functionality and capability of the office's computer systems, but the effort to overhaul and fully integrate the various systems within the Finance group is now only in the planning stages.

3. Culture

The Report devotes considerable attention to the corporate culture at Fannie Mae. It states that, “Management created an environment that was not conducive to open discussion and exchange of views.”²¹ The culture discouraged dissenting views, criticism, and bad news. It was, in the words of the Report, “a culture of arrogance.”²²

Internally, employees felt that they could not be comfortable telling senior management what it did not want to hear. Externally, the company soured its relationship with OFHEO, its regulator. Mr. Mudd stated that, “many members of senior management had no right to question Fannie Mae's policies in light of the Company's years of sustained success.”²³

The perceived arrogance of Fannie Mae affected the perceptions of its business partners, outside commentators, and policymakers. Commenting on the company's aggressive legislative tactics, the report states that, “Although such tactics often proved effective in protecting the Company against perceived legislative threats in the short run, the view has been expressed inside the Company and elsewhere that they did long-term harm to important Fannie Mae relationships on Capitol Hill.”²⁴ The Report states that the new

¹⁹ Rudman report, pp. 472-3.

²⁰ Rudman report, p. 510.

²¹ Rudman report, p. 438.

²² Rudman report, p. 443.

²³ Rudman report, p. 445.

²⁴ Rudman report, p. 446.

CEO, Daniel Mudd, has taken steps actively to change the “tone at the top” to be more “open, collaborative, and humble.”²⁵

II. Larger Issues Raised by the Report

The Report contains many lessons. One of these can be seen in the reaction of the Board, and especially its Audit Committee, to the events at Freddie Mac that led to the ouster of its CEO and other top management. Another emerges from a review of the defense offered by Mr. Raines, the Fannie Mae CEO who was forced to retire in 2004. A third major lesson is seen in a closer look at the staffing and resource deprivations that vitiated the capacity of major Fannie Mae units such as Internal Auditing and the Controller’s Office. Finally, the issues associated with the company’s portfolio deserve a closer look.

A. The Freddie Mac Experience

One particularly instructive issue concerns the Board’s reactions to the 2003 announcement by Freddie Mac that it was dismissing senior officials and restating its financial statements. The Report states:

“The Board reacted quickly to the release of the announcement concerning accounting issues at Freddie Mac, and requested and received updates and assurances from management and KPMG on those issues, as well as to whether there might be similar issues at Fannie Mae. In response, management provided the Audit Committee with a report identifying only minor and immaterial issues at Fannie Mae.”²⁶

This finding is interesting in two respects. First, as the Report documents, Fannie Mae’s management gave the Audit Committee incomplete and misleading information in response to the committee’s inquiry. Second, a major lesson of the Freddie Mac situation, that seems to have escaped the Audit Committee, and the Board itself, was that Freddie Mac’s senior management had proved to be untrustworthy. Instead of pursuing the implications of that fact to their logical conclusion, the Audit Committee and Board instead turned to Fannie Mae’s senior management for assurance, and acquiesced upon receiving that assurance, at least until OFHEO presented the results of its special examination of Fannie Mae to the Board many months later.

It turns out that the failure of internal controls at Fannie Mae is parallel in many respects to the failure at Freddie Mac. At both institutions the internal control functions were deprived of needed resources and lacked the capacity to carry out their responsibilities. Key officials lacked the requisite skill sets. And key managers sought to avoid GAAP accounting out of a variety of motivations, at times apparently including personal self-interest in achieving bonus targets.²⁷

²⁵ Rudman report, p. 449.

²⁶ Rudman report, p. 401.

²⁷ Conditions at Freddie Mac are summarized in Office of Federal Housing Enterprise Oversight, *Report of the Special Examination of Freddie Mac*, December 2003.

B. The Franklin Raines Defense: An Environment of “Yes-Men”

The Report includes a lengthy letter from the law firm that is representing Mr. Raines. A key part of this response is that he was misinformed about events at his company:

“[T]his matter involves allegations that accounting professionals misapplied accounting standards and that Fannie Mae’s management and Board of Directors relied upon these erroneous judgments in connection with financial disclosure, after the judgments were, or appeared to have been, endorsed by internal auditors, outside auditors, and regulators.”²⁸

Moreover,

“[A]lthough the record does not support an inference that Mr. Raines should be judged legally culpable for the events at Fannie Mae, his departure as Chairman and Chief Executive Officer 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.”²⁹

This defense rests on the assumption that Fannie Mae’s CEO was entitled to rely on favorable reports of internal auditors, the company’s external accounting firms, and OFHEO, among others. In fact, each of these actors was affected by resource constraints, distorted incentives, and limited capacity to render the judgments on which the CEO relied.

As the Report explains in great detail, Fannie Mae’s Internal Audit organization had been deprived of resources, was motivated, at least in part, by a desire to promote the corporate goal of increasing EPS, and operated in a corporate culture that discouraged the presentation of “bad news.” It is very possible that the capabilities of the company’s long-time external accountant were shaped by similar resource incapacity and susceptibility to the corporate culture in which it had worked for many years.

Then there is OFHEO, the regulator. From its inception, thanks to the lobbying power of Fannie Mae and Freddie Mac, OFHEO had been created as an institution that lacked the capacity needed to do its job.³⁰ OFHEO was limited by the appropriations process and had a budget that was much smaller, compared to the extent of its responsibilities, than the budget of the federal bank regulators. Whenever OFHEO tried to do its job well, as in the preparation of the *Special Examination Report on Fannie Mae*, it was subjected to considerable political pressure.

²⁸ Letter from Kevin M. Downey, Esq., Williams & Connolly, to the Honorable Warren B. Rudman, October 20, 2005, p. 4. Reproduced in Supplemental Appendix, volume 1, to the Rudman report.

²⁹ Kevin M. Downey, Esq., *Ibid.*, p. 7.

³⁰ See, e.g., Kenneth H. Bacon, “Privileged Position: Fannie Mae Expected to Escape Attempt at Tighter Regulation,” *Wall Street Journal*, June 19, 1992, p. A1.

In other words, Fannie Mae's CEO was relying on affirmations from organizations whose behavior had been shaped by the immense power of Fannie Mae itself, and its centralized leadership structure. As one financial commentator writes, "If, in the parlance of modern business, controlling one's environment is the name of the game, maybe Fannie controlled its environment too well, getting congenial answers until it was too late."³¹

C. Resource Deprivations Within Fannie Mae

The deprivations of adequate staff and systems in key organizations within Fannie Mae, presented in great detail in the Report, are striking, given the significant resources at the company's disposal. In 2003, the last year of Mr. Raines' program to double EPS in five years, net income of the company was \$7.9 billion and the return on equity for that year was 49.9 percent.³²

It appears that constraining spending on the company's administrative capabilities was a part of the company's drive, which existed well before Mr. Raines became CEO, to increase EPS. A memorandum from Fannie Mae President Larry Small to incoming Chairman and CEO Franklin Raines, dated August 10, 1998, is intriguing in this regard. Small states:

"[O]ur expense growth has predominantly taken place precisely where we have wanted it to increase, with a good bit of that growth funded by keeping other areas of the company fairly tight....Mortgage Operations, for example, is today handling approximately the same volume they processed in the refi boom of 1993 with half the staff."

It is interesting to note that the same parsimony existed at Freddie Mac in the same period. OFHEO reported that,

"...Freddie Mac actively managed the ratio between its administrative expenses and its average total mortgage portfolio (securitized plus retained mortgages).... That approach ignored the additional resources needed to develop the accounting, financial reporting, and internal controls necessary to support the growth of the burgeoning retained portfolio"³³

Not surprisingly, just as at Fannie Mae, resource constraints led to a similar problem of incapacity of the affected business units:

³¹ John Connor, "Capital Views: Usually 'The Smartest Person In The Room'"
Dow Jones Capital Markets Report, March 6, 2006

³² Office of Federal Housing Enterprise Oversight, *2005 Report to Congress*, Table 3 ("Fannie Mae Earnings") p. 30.

³³ Office of Federal Housing Enterprise Oversight, *Report of the Special Examination of Freddie Mac*, December 2003, p. 13.

“Simply stated, the quality and quantity of accounting expertise was too weak to assure proper accounting of the increasingly complicated transactions and strategies being pursued by Freddie Mac.”³⁴

This deprivation of administrative resources at both GSEs should be placed into context. Both Fannie Mae and Freddie Mac were growing rapidly, both in their portfolio businesses and in the outstanding mortgage-backed securities that they guaranteed. The combined outstanding debt plus mortgage-backed securities outstanding of the two firms increased from \$768 billion in 1990 to \$1.3 trillion in 1995 and \$2.4 trillion in 2000.³⁵ In other words the two firms were almost doubling in size every five years.

Both the OFHEO *Special Examination Report on Freddie Mac* and the Report are filled with discussion how the units responsible for accounting and internal controls were expected to fulfill increasingly demanding and complex responsibilities with virtually static resources. The conclusion is clear: the companies failed to modernize their accounting and internal control functions to keep pace with their rapid growth; Fannie Mae and Freddie Mac simply outran their systems and controls.

D. The Special Problem of the GSE Portfolios

For the GSEs, their sizeable portfolios pose special control, systems, and risk management problems. Major accounting and reporting problems indicated in the Rudman Report, e.g., those relating to FAS 91 and FAS 133, relate to Fannie Mae’s portfolio holdings. This was similar to the findings of the Special Examination Report of Freddie Mac.

Senator Richard Shelby, Chairman of the Senate Banking Committee, sees a direct link between Fannie Mae’s problems and its large portfolio:

“Many of these issues arose because of the large retained portfolio held by Fannie Mae. While a portfolio of this size is not a critical component in achieving their housing mission, it did serve as a mechanism to allow Fannie Mae to ensure earnings growth....I remain committed to passing a strong GSE regulatory reform bill this year. While a report of this nature may soothe investors, the GSEs’ portfolios remain a systemic risk for the U.S. economy.”

III. Conclusion: Learning Lessons from the Rudman Report

The Report offers an opportunity to learn lessons and try to prevent a reoccurrence of the kinds of problems that occurred at both Fannie Mae and Freddie Mac.

A. The Need to Check all Systems

³⁴ Ibid., p. 14

³⁵ These figures are presented in Thomas H. Stanton, *Government-Sponsored Enterprises*, AEI Press 2002, p. 4.

A major cause of Fannie Mae's and Freddie Mac's difficulties was that the GSEs essentially outran their systems and management controls. The companies grew with great rapidity thanks to their access to government subsidies that are not available to other competitors. Taking its outstanding debt plus outstanding MBS as a measure of growth, Fannie Mae grew from \$411 billion in 1990 to \$812 billion in 1995, \$1.35 trillion in 2000, and \$2.26 trillion in 2003, the last year for which figures seem to be available.³⁶ The problem of growth was compounded by the increasing complexity of the company's operations, such as the need to use increasing volumes of derivatives and hedges.

It is well settled that, when a company manifests problems with its management and systems, this may be a sign that management and systems also could be troubled in other parts of the company. Dartmouth Professor Sydney Finkelstein, who has studied corporate failures, quotes with approval the comments of John Keogh, the president of a company that writes liability insurance policies for corporate directors and officers:

“[I]f you find a problem in one piece of the business, it's probably an early indicator of a bigger problem...It's the [problems] that take longer to come to the surface that tend to be the ones that destroy companies.”³⁷

For the sake of the GSEs, and not incidentally, the financial system, it would be important for OFHEO to undertake a thorough examination of the operating systems of Fannie Mae and Freddie Mac. Indeed, the letter from Fannie Mae's then-President Larry Small, cited above, seems to imply that not only the company's control systems, but also its mortgage operations, were subject to stringent resource constraints.

B. The Need for Effective Regulatory Oversight

This relates to a second lesson. Fannie Mae's and Freddie Mac's ability to control their environments included the creation of a regulator in 1992 that lacked the mandate, resources, and regulatory tools to do an effective job. Besides its indication of the potentially pernicious effects of Fannie Mae's policy of “growth at any price,” the Report also documents a basic precept: feedback is a gift. At least until oversight weaknesses were exposed with the failures at Freddie Mac, the GSEs lacked a regulator, much less other outside bodies such as rating companies or even the GSE's own accountants, with the capacity and/or fortitude to provide bad news to the companies' management and directors.

As Professor Finkelstein amply documents in his book, many company failures can be linked to the inability of top management to receive feedback that could signal the emergence of problems at an early enough stage to allow intervention to avert substantial damage.

³⁶ Office of Federal Housing Enterprise Oversight, 2005 Annual Report to Congress, 2005, p. 31.

³⁷ Quoted in Sydney Finkelstein, *Why Smart Executives Fail and What You Can Learn From Their Mistakes*, Portfolio Press, 2003, p. 250.

In summary, a major lesson of the Report is that effective regulatory oversight is desperately needed, particularly since the GSEs' Congressionally-provided benefits insulate these companies from any market discipline.

This relates to a second problem with oversight of the GSEs currently, which. Congress granted these privately-owned companies with a number of special advantages and exceptions:

1. Both GSEs have lower capital requirements than any other financial institution, and therefore can maximize the use of leverage.
2. They enjoy a lower cost of capital 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.
3. Federal support allows them to increase their financial flexibility by issuing callable long-term debt.
4. They are exempt from state and local taxes.
5. Both GSEs were completely exempt from filing with the SEC, until they voluntarily agreed a few years ago to register with the SEC under the 1934 Act only. The voluntary agreement did not require them to register their securities under the 1933 Act. Effectively, however, since the GSEs are not filing financial statements, despite the fact that they are publicly-traded companies, they are not currently subject to either the 1933 or the 1934 Act. The SEC exemption gives the GSEs the advantage of not having to properly disclose their financial data on a timely basis, and exempts them from such laws as the Foreign Corrupt Practices Act.
6. 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. The high leverage that they employ gives the GSEs exceptional returns on equity.
7. Their exclusive charters ensure their duopoly status, thereby preventing any private company from being able to compete against them in any market or product line the GSEs choose to dominate.

Combined, these Congressionally-granted special advantages and exemptions insulates these companies from normal market discipline that is imposed on all other private companies that are publicly traded. Without any market discipline, the need for an effective regulator with all of the necessary regulatory tools at its disposal, is even more critical.

C. The Need to Limit Excessive Growth

The Report, the OFHEO *Special Examination Report on Freddie Mac*, the experience of federal bank and thrift regulators, and Sydney Finkelstein's research into other company

failures all demonstrate the potentially destructive effects of both rapid growth that is questionable and market dominance. Finkelstein puts it well:

“Want to know one of the best generic warning signs you can look for? How about success, lots of it!....Fantastic success or overwhelming dominance doesn’t mean that bad things are happening or will happen. However, there are an extraordinary number of times when precisely these attributes are in place in companies that run up against failure.”³⁸

There is ample evidence of Fannie Mae and Freddie Mac simply outgrowing the capacities of their management and systems. Meanwhile, the companies’ leadership, enamored of spectacular returns on equity, year-in and year-out, allowed critical systems to fall increasingly behind the GSEs’ rapid rate of annual growth.

In summary, OFHEO needs to treat rapid growth as a safety-and-soundness concern. As the GSEs’ regulator, OFHEO should be examining and curtailing both the rate of GSE growth and the GSEs’ market dominance in any given area.

The framers of Fannie Mae’s Charter Act were cognizant of the dangers of excessive growth by a company whose success was fueled by government sponsorship. The Fannie Mae charter, at 12 U.S.C. § 1719(a)(1), contains an express provision requiring limitations on excessive growth:

“The volume of the corporation’s purchases and sales, and the establishment of the purchase prices, sale prices, and charges or fees, in its secondary market operations under this section, should be determined by the corporation from time to time, and such determinations should be consistent with the objectives that such purchases and sales should be effected only at such prices and on such terms as will reasonably prevent excessive use of the corporation’s facilities...”

While the Freddie Mac charter does not include this same language, OFHEO would seem to have authority under its safety-and-soundness responsibilities to achieve a similar result with respect to that GSE.

One area of concern in excessive corporate growth relates to the GSEs’ portfolios. The interest rate risk of their portfolios, coupled with prepayment risk, means that the two GSEs are increasingly dominant users of derivative securities and hedging. Alan Greenspan, in a letter written as Chairman of the Federal Reserve Board articulated the problems caused by the GSEs’ burgeoning portfolios:

“As Fannie and Freddie increase in size relative to the counterparties for their hedging transactions, their ability to quickly respond to changing market conditions and correct the inevitable misjudgments inherent in their complex hedging strategies becomes more difficult, especially when

³⁸ Finkelstein, *Why Smart Executives Fail*, pp. 251, 253.

vast reversal transactions backed by their thin capital holdings are required to rebalance portfolio risks. Furthermore, the success of interest-rate-risk management, especially the exceptionally rapid timing necessitated by dynamic risk adjustments, requires that the ultimate counterparties to the GSEs' transactions provide sufficient liquidity to finance an interest-rate-risk transfer that counters the risk. Otherwise, large and rapid destabilizing adjustments will result in sharp changes in the interest rates required to rebalance and hedge the GSEs' mortgage portfolio.”³⁹

IV. The Rudman Report as a Warning

Since the Report became public, Fannie Mae has reported to the SEC that the company will need to restate its financial statements by approximately \$28.5 billion. This would, we believe, make the Fannie Mae restatement the largest in United States history, dwarfing the \$9 billion misstatement that was the basis for the Enron scandal.

According to Fannie Mae's Form 12b-25 (page 7) and in direct violation of GAAP, Fannie Mae did not properly account for \$28.5 billion of trusts (QSPE) used for MBS under FAS 140. Like Enron, Fannie Mae had previously reported these QSPEs as an investment in subsidiaries. Instead, Fannie will have to account for these assets under FIN 46R, which requires the company to record (“consolidate”) the assets and liabilities of the QSPEs on its financial statements at fair market value. According to the filing, “the net effect of the consolidation would be to increase the assets and liabilities recorded on our balance sheet for any portion of these trusts that we do not own.” The income related to these assets will also restated.

It seems obvious that the problems that have been revealed are not just the result of bad past management but, rather, it is the result of a Congressionally-designed system of a government-backed (implied and otherwise) shared-monopoly combined with a hamstrung regulator that allowed this to happen. Earlier in this report, the question was asked “why would a GSE, with its government-subsidized access to market power and high returns, reach for yet greater returns that could be achieved only on the basis of improper and probably illegal conduct?” The probable answer is because *it could*.

As a shared-monopoly, these two GSEs have little incentive to ensure that their business operations are “world class” or to impose restraints on the excessive use of the benefits granted by their charters because they have not needed to do so: the GSEs controlled the environment in which they operated, and the system that was supposed to keep them in check was designed to be ineffective.

While some of their control has dissipated with each new announcement of another misdeed or mistake, it has not been eliminated. As one example, the just-passed House ethics reform legislation included an exemption for Fannie Mae, Freddie Mac, and the Federal Home Loan Banks from the “earmark” reform provisions in that bill, presumably

³⁹ Letter from Alan Greenspan, Chairman Federal Reserve Board, to Senator John E. Sununu, January 3, 2006, p. 2.

further enhancing the value of their implied guarantee. As another example, even though these two GSEs have not been filing financial statements, the New York Stock Exchange (“NYSE”) made an unusual exception for them and decided not to de-list their stocks from the NYSE.

Fannie Mae and Freddie Mac are not large institutions, when compared with other publicly-traded companies, but they are probably the most highly leveraged financial institutions in the world, which makes the situation very dangerous because they have very little capital supporting their structures. It is long past due for policymakers and those concerned with making homeownership affordable to scrutinize these highly leveraged companies who want to continue to continue to exploit their subsidies, implied and otherwise.

In conclusion, the Freddie Mac *Special Examination Report* and the Rudman Report on Fannie Mae offer an important wake-up call. These reports document failures of governance, management, systems, and controls that inflicted damage especially on the GSEs’ accounting and reporting functions. It is time now to restrain these companies, cutting short an alarming trend that will harm consumers, taxpayers, and industry combined.

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