Report of the Special Examination of Fannie Mae

May 2006

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.

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I. EXECUTIVE SUMMARY

In the late 1980s and 1990s, Fannie Mae grew rapidly into the largest firm in the U.S. housing finance system and a major global financial institution. The Enterprise achieved double-digit growth in earnings per common share (EPS) for 15 straight years and leveraged its extraordinary financial success into enormous political influence. That financial and political success gave rise to a corporate culture at Fannie Mae in which senior management promoted 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.

Fannie Mae management expected to write the rules that applied to the Enterprise and to impede efforts at effective safety and soundness regulation. Those rules included managerial latitude in deciding when to comply with Generally Accepted Accounting Principles (GAAP) and engaging in and concealing improper earnings management for the purpose of achieving announced earnings targets.

When Franklin Raines became Chairman and Chief Executive Officer (CEO) of Fannie Mae in 1999, he sought to lead the Enterprise into a new era of growth in business volumes and profits by challenging senior management and employees to double EPS in five years. Mr. Raines also made changes in Fannie Mae's compensation programs that enhanced incentives to achieve that goal.

A combination of factors led Fannie Mae senior management, through their actions and inactions, to commit or tolerate a wide variety of unsafe and unsound practices and conditions. 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.

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 senior management, and by failing to exercise the requisite oversight over the Enterprise's operations.

That misconduct ultimately led to the Securities and Exchange Commission (SEC) directing Fannie Mae to restate its financial results for 2002 through mid-2004, the departure of Mr. Raines and the Enterprise's Chief Financial Officer (CFO), Timothy Howard, 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.

Improper earnings management at Fannie Mae increased the annual bonuses and other compensation linked to EPS that senior management received. Compensation for senior executives that was driven by or linked to EPS dwarfed basic salary and benefits. For CEO Franklin Raines, for example, two compensation components directly tied to meeting EPS goals accounted for more than $20 million for the six years from 1998 through 2003. Three-year EPS goals also played a crucial role in determining the size of the approximately $32 million awarded to Mr. Raines during that six-year period under a long-term executive compensation program. In total, over $52 million of Mr. Raines' compensation of $90 million during the period was directly tied to achieving EPS targets.

This report describes the development and extent of 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 and the actions to remedy that situation that the Office of Federal Housing Enterprise Oversight (OFHEO) has directed the Enterprise to take to date. The report also recommends that actions be taken to enhance the goal of maintaining the safety and soundness of Fannie Mae.

Corporate Culture and Tone at the Top

During the period covered by this report, the corporate culture of Fannie Mae encouraged a perception of the Enterprise as a low-risk financial institution that was so well managed that it could hit announced profit targets on the nose every year, regardless of the state of the economy, and that compensated its senior executives appropriately for its extraordinary performance. The highest levels of senior management wanted Fannie Mae to be viewed as "one of the lowest risk financial institutions in the world" and as "best in class" in terms of risk management, financial reporting, corporate governance, and internal control. Chairman and CEO Franklin Raines, CFO Timothy Howard, and other members of the inner circle of senior Enterprise executives sought to convey that image to the public, employees, the Board of Directors, and investors.

The image of Fannie Mae communicated by Mr. Raines and his inner circle and promoted by the Enterprise's corporate culture was false. In the words of one current member of Fannie Mae's Board of Directors, the picture of the Enterprise as a "best-in-class" financial institution was a "façade." To maintain that façade, senior executives worked strenuously to hide Fannie Mae's operational deficiencies and significant risk exposures from outside observers—the Board of Directors, its external auditor, OFHEO, the Congress, and the public. 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.

Fannie Mae's corporate culture emerged in the late 1980s and early 1990s, when the Enterprise enjoyed extraordinary financial and political success that lasted until 2004. Over the years Fannie Mae compiled a remarkable track record of achieving its political objectives. As then Chief Operating Officer Daniel Mudd remarked in a memorandum to CEO Franklin Raines in November 2004, "[t]he old political reality was that we always won, we took no prisoners, and we faced little organized political opposition."

Senior management expected to be able to write the rules that applied to Fannie Mae and to thwart efforts to regulate the Enterprise. As Mr. Mudd remarked in the memorandum to Mr. Raines mentioned above, "We used to, by virtue of our peculiarity, be able to write, or have written, rules that worked for us." Writing their own rules included deciding when to comply with GAAP, engaging in and concealing earnings management, and failing to cooperate with and trying to interfere with OFHEO's special examination.

Fannie Mae senior management also skillfully promoted an image of the Enterprise as a private firm whose corporate objectives were essentially identical to the federal government's public policy objectives. The message was: what is good for Fannie Mae is good for housing and the nation. Senior executives used that image and their political influence to try to ensure that Fannie Mae operated under rules that differed from those that applied to other corporations.

The existence of a federal agency with the ability to regulate the Enterprise represented a direct challenge to senior management. To deal with that challenge, Fannie Mae took the extreme position that OFHEO simply had little authority over the Enterprise, while Fannie Mae's lobbyists worked to insure that the agency was poorly funded and its budget remained subject to approval in the annual appropriations process. The goal of senior management was straightforward: to force OFHEO to rely on the Enterprise for information and expertise to such a degree that Fannie Mae would essentially be regulated only by itself.

Fannie Mae's resistance to OFHEO's regulatory efforts intensified after the agency initiated its special examination of the Enterprise in 2003. Senior management made efforts to interfere with the examination by directing Fannie Mae'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 Director Armando Falcon, who had initiated that examination, was replaced.

Fannie Mae's corporate culture was intensively focused on attaining EPS goals. Decisions by Mr. Raines shortly after he became CEO in 1999 set an inappropriate tone at the top that permeated the Enterprise throughout his chairmanship. For the prior year, and forecast for 1998's as yet unreported financials as well, Fannie Mae had not hit the upper end of its EPS target range, a failure that had a direct effect on the compensation of its most senior officials. Those circumstances caused Lawrence Small, an Executive Vice President, to write Mr. Raines during the summer to inform him of Mr. Small's concern that Fannie Mae's "piggy bank" and various "magic bullets" could not make up the shortfall and that there would be much discontent among senior management if they were shortchanged again.

The message from Mr. Raines was clear: EPS results mattered, not how they were achieved. In the following years, time and time again, Fannie Mae employed last-minute adjustments that enabled it to meet its EPS target, whether on a quarterly basis to meet analysts' expectations, or on an annual basis to meet compensation targets.

In 1999, Mr. Raines set a goal to double Fannie Mae's EPS within five years, from $3.23 in 1998 to $6.46 in 2003. Mr. Raines' goal and the related EPS Challenge Option Grants intensified the focus at Fannie Mae on the achievement of EPS targets and reduced attention to other objectives. Most inappropriately, Mr. Rajappa, Senior Vice President for Operations Risk and head of Fannie Mae's Office of Auditing, the corporate financial watch-dog, gave a speech to his internal auditors which encapsulated the tone at the top and corporate culture of Fannie Mae under Mr. Raines' stewardship:

> By now every one of you must have 6.46 branded in your brains. You must be able to say it in your sleep, you must be able to recite it forwards and backwards, you must have a raging fire in your belly that burns away all doubts, you must live, breath and dream 6.46, you must be obsessed on 6.46. . . After all, thanks to Frank, we all have a lot of money riding on it. . . .We must do this with a fiery determination, not on some days, not on most days but day in and day out, give it your best, not 50%, not 75%, not 100%, but 150%. **Remember, Frank has given us an opportunity to earn not just our salaries, benefits, raises, ESPP, but substantially over and above if we make 6.46.** So it is our moral obligation to give well above our 100% and if we do this, we would have made tangible contributions to Frank's goals." [Bold emphasis added, underscore in the original]

Another reason to focus so intently on EPS targets was to preserve the illusion of low risk. Yet Fannie Mae consistently took a significant amount of interest rate risk and, when interest rates fell in recent years, incurred billions of dollars in economic losses. The Enterprise was also exposed to large operational and reputational risks.

The actions and inactions of the Board of Directors inappropriately reinforced rather than checked the tone and culture set by Mr. Raines and other senior managers. The Board failed to be sufficiently informed and independent of its chairman, Mr. Raines, and senior management, and failed to exercise the requisite oversight to ensure that the Enterprise was fully compliant with applicable law and safety and soundness standards. Those failures signaled to management and other employees that the Board did not in fact place a high value on strict compliance with laws, rules, and regulations. That message contributed to the Enterprise's many failures to comply with safety and soundness standards and the many unsafe and unsound practices documented in this report.

The conduct of Mr. Raines, CFO Timothy Howard, and other members of the inner circle of senior executives at Fannie Mae was inconsistent with the values of responsibility, accountability, and integrity. Those individuals engaged in improper earnings management in order to generate unjustified levels of compensation for themselves and other executives. They promoted a false image of the Enterprise as a "best in class" financial institution while neglecting to manage Fannie Mae properly and participating in or permitting a wide variety of unsafe and unsound practices. Those actions set a highly inappropriate tone at the top that was itself an unsafe and unsound practice.

The Executive Compensation Program

The executive compensation program of Fannie Mae provided strong incentives for senior management to engage in improper earnings management and other unsafe and unsound practices. As a direct result, senior management knowingly and purposefully used accounting maneuvers to achieve earnings goals to increase their own compensation. Meeting specific earnings goals took precedence over proper accounting, risk management, internal controls and complete and accurate financial reporting.

Under the executive compensation program, senior management reaped financial rewards when Fannie Mae met EPS growth targets established, measured, and set by senior management itself. Beyond the basic package of salary and benefits, three components of compensation depended directly on reaching EPS targets: 1) the Annual Incentive Plan, under which by 2003 more than 700 employees were eligible for bonuses; 2) the Performance Share Plan, which granted stock to the 40-50 senior executives based on 3-year performance cycles; and 3) the EPS Challenge Grant, a company-wide program championed by Franklin Raines that tied the award of a substantial amount of stock options to the doubling of core business EPS from 1998 to 2003. The AIP bonus pool grew from $8.5 million in 1993 to $65.1 million in 2003. Bonus awards for senior executives often totaled more than annual salary. For senior executives, EPS-driven compensation dwarfed basic salary and benefits.

While companies typically link the compensation of their executives to firm performance, relying heavily on one accounting-based measure such as earnings per share is problematic. Academic literature and practical experience suggests that when such a linkage exists executives can and do act aggressively to maximize their compensation by making accounting adjustments.

For the top senior executives at Fannie Mae, the entire Annual Incentive Plan bonus payout depended on annual EPS performance, increasing the incentive for senior executives to manipulate both EPS and EPS targets. Furthermore, the Annual Incentive Plan provided no incentive for management to add to earnings once the EPS number for a maximum bonus payout was achieved. That encouraged the shifting of income forward in years of plentiful core business earnings to meet EPS targets in future years as well.

Fannie Mae's executive compensation program gave senior executives the message to focus on increasing earnings rather than controlling risk. Senior executives, including the CFO, the Controller, and the head of the Office of Internal Auditing consistently reminded managers and other employees of their personal stake in meeting EPS targets. The effectiveness of senior management in both setting and hitting EPS targets to attain maximum bonus payouts is demonstrated by its track record. From 1996 through 2003, the final EPS number was always at or near the number required for a maximum Annual Incentive Plan bonus payout.

Fannie Mae senior management achieved those earnings targets by regularly manipulating earnings. They did so by, among other things, manipulating accounts and accounting rules, calibrating repurchases of shares and debt to achieve EPS targets, entering into questionable transactions, and misallocating resources. Management routinely shifted earnings to future years when the EPS target for the maximum bonus payout for the current year appeared likely. In addition, Enterprise executives purposely obscured their official disclosures of executive compensation and failed to provide complete information on the post-employment compensation awarded to former CEOs. Those actions were made possible by the failure of members of the Board of Directors to exercise oversight, the failure by senior management to ensure adequate internal controls, and failures of senior management and the members of the Board of Directors to require adequate external and internal audits.

Misapplications of GAAP, Weak Internal Controls, and Inappropriate Earnings Management

The extreme predictability of the financial results reported by Fannie Mae from 1998 through 2003, and the ability to hit EPS targets precisely each quarter, were illusions deliberately and systematically created by senior management. Senior executives exploited the weaknesses of the Enterprise's accounting and internal control system and misapplied GAAP to accomplish improper earnings management. In addition to measures and policies that primarily dampened overall earnings volatility, they used a variety of transactions and accounting manipulations to fine-tune the Enterprise's annual earnings results. The actions and inactions of senior Fannie Mae management constituted unsafe and unsound practices and failed to comply with a number of statutory and other requirements.

Senior management of Fannie Mae took pains to preserve the public perception of the Enterprise as a company that could be relied upon to produce steadily increasing earnings with a minimum of risk. The use of the "core business EPS" measure served as a foundation for implementing inappropriate earnings management techniques that conveyed to investors a false impression of Fannie Mae's financial performance and the inherent risks of its operations. Moreover, because core business earnings formed the basis for determining the amounts paid under Fannie Mae's Annual Incentive Plan, Performance Share Plan, and the EPS Challenge Grant, manipulation of reported earnings also enriched senior managers.

Senior management of Fannie Mae contravened accounting standards and regulatory requirements in a number of ways to manipulate its financial results to achieve earning objectives between the fall of 1998 and 2004. By using a variety of improper accounting techniques and financial transactions, senior executives eliminated or deferred, as needed, current period expenses and income. As a result, they simultaneously created the appearance of stable double-digit earnings growth and generally met, but only once substantially exceeded, the EPS goals that would yield the highest bonus payments.

When faced with new accounting standards that might increase earnings volatility as reported under GAAP, senior management neither initiated the development of a formal, written GAAP-compliant accounting policy nor invested in the new accounting systems needed to implement them properly. Instead, they patched existing systems and ways of doing business to accommodate their preferred interpretations of the new standards. The most significant examples discussed in the report are Fannie Mae's implementation of FAS 115, *Accounting for Certain Investments in Debt and Equity Securities*, in a manner that allowed for controlling earnings volatility and minimized investment in accounting infrastructure over GAAP compliance, and the improper implementation of derivative accounting under FAS 133, *Accounting for Derivative Instruments and Hedging Activities*. Management's disregard for GAAP compliance when GAAP numbers were likely to be volatile and their reliance on obsolete systems were not limited to those two areas. Those priorities characterized the implementation of many accounting policies and practices at the Enterprise, including FIN 46, accounting for dollar roll transactions, and accounting for real estate owned.

In order to reduce volatility in reported earnings, Fannie Mae went to extraordinary lengths to avoid recording GAAP-required write-downs of asset values known as other-than-temporary impairment losses. Frequently, when faced with a situation or new accounting standard that could necessitate recording impairment expense, management chose accounting practices that did not conform with GAAP. The Enterprise's efforts to avoid impairment losses focused on manufactured-housing- and aircraft-lease-backed securities, interest-only securities, and buy-ups. With respect to buy-ups, Fannie Mae's incorrect accounting spared it approximately $500 million in impairment losses in 1998. The 1998 earnings impact with respect to interest-only securities may have been of a magnitude similar to that for buy-ups. The amount of avoided impairments related to manufactured-housing- and aircraft-lease-backed securities amounted to approximately $265 million but authoritative amounts and timing of those impairments will not be determined until Fannie Mae completes its restatement of financial results. As with other issues, senior management's preferences for avoiding the expense and effort of developing new systems and for maintaining smooth and steady earnings growth took precedence over GAAP compliance and strong internal control.

Finally, by utilizing the strategies described above as a foundation, Fannie Mae management was in a position to employ several techniques to manipulate and manage earnings more directly. Those strategies included the use of cookie-jar reserves, certain Real Estate Mortgage Investment Conduit (REMIC) transactions to delay federal taxes or defer earnings recognition, debt repurchases, and certain insurance transactions. Those reserves and transactions were utilized and maintained to provide management with the opportunity to make last minute quarter-end adjustments to hit specific earnings targets. The transactions and strategies constituted additional instances of inappropriate earnings management undertaken to achieve annual EPS targets and maximize bonus payouts to senior management, violating safety and soundness standards.

The Role of the Office of Auditing and the External Auditor

Serious failures existed in both the internal and external audit functions of Fannie Mae, creating an environment conducive to inappropriate earnings management and serious accounting failures during the period covered by this report. Fannie Mae's internal audit unit, the Office of Auditing, failed to meet OFHEO safety and soundness standards with respect to (1) the reliability and integrity of financial and operational information, (2) the effectiveness and efficiency of operations, and (3) meeting its stated audit report objectives. The Office also failed to adhere to standards established by both the Institute of Internal Auditors and the Committee of Sponsoring Organizations, including those pertaining to auditor proficiency and the exercise of due professional care. As a result, the Office also failed to meet the responsibilities assigned to it by Fannie Mae's Board of Directors.

The failures of the Office of Auditing manifested themselves in a variety of ways. The Office's audit program 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. 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. In addition, the Office had insufficient staff and insufficient expertise at a time when demands on it were increasing due to the increased size and complexity of Fannie Mae's business, major information technology (IT) projects, and new assignments.

The Office of Auditing failed to perform its primary tasks and issued misleading reports about its work. Internal audits, although they indicated otherwise, failed to assure the compliance with GAAP of numerous accounting policies and practices. Internal auditors also failed to exercise due professional care in audits of critical accounting policies, practices, and estimates. That failure included improper testing of accounting procedures and practices and of internal controls, resulting in improper assurances of compliance with GAAP and improper assurances to the Audit Committee of the Board of Directors regarding internal controls. In addition, the Office of Auditing failed to exercise due professional care in investigating allegations of accounting improprieties raised by Roger Barnes, an employee of the Office of the Controller.

When shortcomings were found, they were not adequately addressed or communicated. Rather, the Office of Auditing misstated the extent of their assessments, especially with respect to GAAP. The Office's communications to the Audit Committee of the Board of Directors were frequently incomplete and inadequate, thereby violating its own Board-approved Charter and best practices. Perhaps the most serious communication failure concerned the Office's scope of its duties with regard to testing for GAAP compliance.

Similarly, external audits performed by KPMG failed to include an adequate review of Fannie Mae's significant accounting policies for GAAP compliance. KPMG also improperly provided unqualified opinions on financial statements even though they contained significant departures from GAAP. Both the failure to review adequately significant accounting policies and procedures for GAAP compliance and the representations regarding GAAP compliance indicate that Fannie Mae's external audits contravened requirements established by OFHEO. 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.

Both the internal investigation of Mr. Barnes' allegations and KPMG's external review of that investigation contravened safety and soundness standards that require an Enterprise both to maintain and implement internal controls that among other things provide for compliance with laws, regulations and policies, and to establish and maintain an effective risk management framework, to monitor its effectiveness, and to take appropriate action to correct any weaknesses. The internal investigation was tainted by an incomplete review of the accounting issues. The external review 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. The external review team had insufficient independent understanding of the accounting issues involved, failed to review Fannie Mae's internal accounting policy for compliance with GAAP, and relied on the auditors that had already expressed an opinion on the questioned accounting practices.

The Role of Senior Management

Fannie Mae senior executives engaged in a number of 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. Those practices 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 Enterprise'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.

Those failures allowed Fannie Mae senior management, for a time, to avoid questions or criticism about the Enterprise's improper accounting policies and transactions or the accuracy and integrity of its financial statements. Avoiding those topics benefited those same senior executives by helping to obscure the inappropriate executive compensation they received, which was triggered by the inaccurate EPS reported in Fannie Mae's financial statements.

Fannie Mae's internal control system contravened OFHEO's supervisory standards. Senior management failed to ensure appropriate segregation of duties, invest adequate resources in accounting and financial reporting, avoid key person dependencies, implement sound accounting policy development and oversight, and prevent conflicts of interest. Those and other deficiencies in Fannie Mae's internal control system resulted from decisions, actions, or inactions of Enterprise senior management that failed to meet OFHEO standards and constituted unsafe and unsound practices.

Senior management systematically undercut the independence of Fannie Mae's Office of Internal Auditing in three important ways: they required the Office to report to the CFO and barred unfettered communications with the Audit Committee of the Board of Directors; they tied the compensation of senior management of the Office of Auditing to earnings per share, a metric based on financial statements that the Office audited; and they appointed the Enterprise's Controller to head the internal audit unit, effectively allowing him to audit his own work for a year. In addition, Fannie Mae did not devote sufficient and appropriate resources to the Office of Auditing, resulting in serious weaknesses, including insufficient staff and insufficient expertise. By undercutting the independence and objectivity of the Enterprise's internal controls and internal auditors, senior management made it much less likely that they would be challenged to address Fannie Mae's control deficiencies.

Senior management systematically withheld information about the Enterprise's operations and financial condition from the Board of Directors, its committees, its external auditors, OFHEO, the Congress, and the public—or disclosed information that was incomplete, inaccurate, or misleading. Systematically withholding information prevented others from becoming aware of Fannie Mae's earnings management strategies, the fact that the Enterprise's accounting policies did not comply with GAAP, the pervasive weaknesses of its internal control system, and related safety and soundness issues.

When problems were brought to the attention of senior management, executives failed to conduct appropriate internal investigations and to follow up on the results of those investigations. In 2003, three Fannie Mae employees expressed serious concerns about the Enterprise's accounting. Roger Barnes, then a manager in the Office of the Controller, made allegations about Fannie Mae's accounting for deferred price adjustments under FAS 91 to Sampath Rajappa, Senior Vice President for Operations Risk, who then reported those concerns promptly to Ann Kappler, Senior Vice President and General Counsel. Another employee in Securities Accounting also expressed concerns about amortization accounting to Chief Operating Officer Daniel Mudd, and a third employee echoed those concerns. Ms. Kappler and Mr. Mudd initiated flawed investigations into those allegations and concerns. When those investigations were completed, Ms. Kappler made statements about the issues raised and their disposition—in one case, to the Audit Committee of the Board of Directors—that were false and misleading.

Senior executives in the Office of the Chairman at Fannie Mae prevented members of the Board of Directors from having unrestricted access to members of Enterprise management, including preventing Mr. Rajappa from having unfettered communication with the Audit Committee of the Board, despite the fact that Mr. Rajappa ostensibly reported to the chairman of that committee. Imposing restrictions on the access to Fannie Mae management by members of the Enterprise's Board of Directors violated OFHEO's regulatory requirements and impaired the ability of the Board to discharge its fiduciary duties.

The Role of the Board of Directors

The Board of Directors and its committees failed to meet the safety and soundness obligations set forth in OFHEO corporate governance regulations and other applicable standards for corporate governance. The members of the Board were all knowledgeable and qualified individuals, fully capable of understanding the business and corporate governance duties with which they were charged. The sophisticated and prestigious members of the Board 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.

The responsibilities of the Fannie Mae Board of Directors are clearly articulated in OFHEO's corporate governance regulation, which requires the Board to further the safety and soundness of the Enterprise and sets forth affirmative duties of the Board in carrying out those responsibilities. The corporate governance regulation also points the Boards of Directors of Fannie Mae and Freddie Mac to other applicable laws, such as those of the State in which an Enterprise chooses to incorporate, and to publications and other pronouncements of OFHEO for additional guidance on the conduct and responsibilities of the Board. The Fannie Mae Charter Act also sets forth the duties of the Board. Each of those authoritative sources delineates clear and consistent instructions for the Board to fulfill its oversight responsibilities.

The Board of Directors of Fannie Mae delegated important safety and soundness responsibilities to, and relied on reports from, its Audit and Compensation Committees. Those committees failed to meet regulatory and corporate standards in discharging their responsibilities. The failures of the Audit Committee had the most far-reaching safety and soundness implications, both because of the required independence of its directors and the scope of its responsibilities. The Audit Committee failed to safeguard Fannie Mae safety and soundness by providing inadequate oversight of the internal audit function and the performance of the head of the Office of Auditing, including issues of independence and objectivity. The Audit Committee failed to address the conflict of interest created by an inappropriate compensation system that tied auditors' compensation to the Enterprise-wide drive to double EPS. The Audit Committee failed to oversee the preparation of financial statements, to monitor the development and implementation of critical accounting policies, and to develop in-depth or specialized knowledge necessary to its oversight responsibilities. Finally, the Audit Committee failed to initiate a thorough investigation of whistle-blower claims of accounting irregularities when they arose.

The failure of the Audit Committee was compounded by failures of the Compensation Committee. The primary role of the Compensation Committee is to assure that senior management is properly compensated for its role in directing the affairs of the Enterprise. Nevertheless, the Compensation Committee approved a compensation structure that focused on a single measure—EPS—that was easily manipulated by management. The Compensation Committee failed to monitor that compensation system for abuse by senior management. The Compensation Committee also did not align the compensation of Fannie Mae's internal auditors with appropriate objectives. Finally, the Compensation Committee was too passive in allowing management to script its meetings and influence its choice of an independent compensation consultant.

In addition to the failures of the Audit and Compensation Committees, Fannie Mae's full Board of Directors failed in a number of ways that put the safety and soundness of the Enterprise at risk. The Board failed to stay informed of Fannie Mae corporate strategy, major plans of action, and risk policy. Having approved an executive compensation system that created incentives to manipulate earnings, members of the Board failed to monitor against such manipulations. The Board failed to provide delegations of authority to management that reflected the current size and complexity of the Enterprise. The Board failed to assure the effective operation of its own Audit and Compensation Committees. The Board failed to act as a check on the authority of Chairman and CEO Franklin Raines, and allowed him to concentrate considerable power in the hands of one person, CFO Timothy Howard. The Board failed to initiate an independent inquiry into Fannie Mae's accounting following the announcement of Freddie Mac's restatement and subsequent investigations, or the allegations by Roger Barnes, both of which involved earnings management. The Board failed to assure itself that the Enterprise's regulators were properly informed of Mr. Barnes' allegations. The Board also failed to ensure timely and accurate reports to Federal regulators.

The bedrock principle of OFHEO's regulation of Fannie Mae is that the entity must operate safely and soundly. The Board, in turn, must take reasonable steps to be sure that senior management is operating the Enterprise in accordance with that principle. Judging by the actions and inactions of the Fannie Mae Board, standards of prudent operation clearly were not met. Rather than an active, concerned Board that effectively supervised senior management, 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.

Remedial Actions

During the period of the special examination, OFHEO has directed Fannie Mae to take a number of actions, both as a result of the special examination and as part of OFHEO's continuous supervisory program. To prevent the recurrence of improper conduct, those steps have sought to remedy deficiencies and to enhance the safe and sound operation of the Enterprise going forward.

In an agreement with the Board of Directors reached in September 2004, OFHEO directed Fannie Mae to maintain an additional 30 percent of capital above the minimum capital requirement to compensate for the additional risk and challenges facing the Enterprise. Furthermore, OFHEO directed that Fannie Mae submit for approval the Enterprise's strategy to preserve and maintain capital levels at the required level and contingency plans in case those primary methods prove insufficient. OFHEO also directed Fannie Mae to obtain prior written permission from OFHEO before undertaking certain specified corporate actions and to inform OFHEO of any other significant action likely to impair the ability of the Enterprise to maintain capital sufficient to meet the required capital surplus levels.

As a result of those directives, Fannie Mae has taken significant actions to improve its capital position. Those actions included the issuance of $5 billion in preferred stock, a reduction in the Enterprise's common stock dividend, and a reduction in its on-balance sheet assets. The Enterprise will keep the enhanced capital position until the Director of OFHEO releases or modifies the requirement based upon satisfactory resolution of accounting and internal control issues that are the subject of OFHEO examination.

In addition to the capital requirements, OFHEO directed the Board of Directors of Fannie Mae to make significant changes to its corporate governance structure. Those changes include, but are not limited to, separating the Chairman of the Board and Chief Executive Officer positions, creating a new independent Office of Compliance and Ethics to conduct internal investigations, creating a Compliance Committee of the Board of Directors to monitor and coordinate compliance with the Enterprise's agreements with OFHEO, establishing a program for no less than annual briefings to the Board and senior management on legal and regulatory compliance requirements applicable to Fannie Mae, and creating a procedure for the General Counsel of Fannie Mae to report information on actual or possible misconduct directly to the Board, which will in turn notify OFHEO.

In order to address organizational failures at Fannie Mae, OFHEO required a number of changes to the risk management, internal control, internal and external audit, and accounting functions of the Enterprise. Those changes seek to address significant weaknesses, including lack of appropriate separation of duties and insufficient technical expertise. Additionally, OFHEO directed that the Board cause an independent review of organizational, structural, staffing, and control issues, focusing on but not limited to the Chief Financial Officer, Controller, accounting, audit, financial reporting, business planning and forecasting, modeling, and financial standards functions. As a result of that review, management has effected significant changes in the organizational structure of the Enterprise.

To address accounting problems, OFHEO directed Fannie Mae to restate inappropriate past financial statements, meeting all applicable legal and regulatory requirements, including having the new financial statements reaudited by the Enterprise's new external auditor, and to cease engaging in inappropriate hedge accounting. OFHEO also directed that the Enterprise implement an appropriate policy for FAS 91 accounting, develop and implement appropriate written policies and procedures for journal entries, and develop and implement a plan to address the deficiencies in the accounting systems for Fannie Mae's portfolio. OFHEO directed the Board to conduct reviews of certain control issues, including accounting policies and practices and procedures for journal entries. OFHEO also directed the Enterprise to conduct a complete review of staff skills, past performance, and roles in the revised corporate structure in accounting. Significant personnel changes have been made.

Recommendations

Based on the special examination of Fannie Mae, OFHEO's staff recommends to the Director that the following actions be taken to enhance the goal of maintaining the safety and soundness of the Enterprise.

1. Fannie Mae should be subject to penalties and fines consistent with the findings of this report.

2. Fannie Mae must meet all of its commitments for remediation and do so with an emphasis on implementation—with dates certain—of plans already presented to OFHEO.

3. Fannie Mae must maintain a capital surplus until the Director determines a change in the surplus amount is warranted.

4. Fannie Mae must continue to use independent consultants acceptable to the Director to validate and assure compliance with requirements. Cyclical targeted exams by independent consultants, at least every two years, are needed to assure systems and practices are being implemented properly.

5. Fannie Mae must develop new structures and operational plans for its Board of Directors related to Board reporting, maintenance of minutes, and other changes that will enhance Board oversight of the Enterprise's management.

6. Fannie Mae must review OFHEO's report to determine additional steps to take to improve its controls, accounting systems, risk management practices and systems, external relations program, data quality, and corporate culture. Once OFHEO has

approved the Enterprise’s plans, an emphasis must be placed on implementation of those plans.

7. Fannie Mae must undertake a review of individuals currently with the Enterprise that are mentioned in this report and provide OFHEO a report as to conclusions regarding terminations, transfers, or other remedial steps (such as disgorgement, restitution, or alteration of benefits) in cases of misconduct.

8. Fannie Mae must assure that departments are fully and appropriately staffed with skilled professionals who have available regular training opportunities in financial services industry standards.

9. Due to Fannie Mae’s current operational and internal control deficiencies and other risks, the Enterprise’s growth should be limited.

10. OFHEO should continue to develop its program of regulatory infrastructure to add additional rules and regulations that enhance the transparency of its supervision of the Enterprises. With the end of the special examination, OFHEO staff should be directed to address additional items raised during the preparation of this report as part of the regular examination program.

11. OFHEO should continue to support legislation to provide the powers essential to meeting its mission of assuring safe and sound operations at the Enterprises.

12. Matters identified in this report should be referred to OFHEO’s Office of the General Counsel for determination of enforcement actions that the Director may wish to consider.

13. Matters identified for remediation by Fannie Mae should be considered by the Director for application to both Enterprises.

IX. THE ROLE OF THE BOARD OF DIRECTORS

The duties and responsibilities of the Board of Directors of Fannie Mae, which are embodied in the Charter Act[1] and applicable law, are more particularly set forth in the OFHEO corporate governance regulation.[2] The corporate governance regulation charges the Board of Directors (including its appropriate committees) with furthering the safety and soundness of the Enterprise and sets forth affirmative duties that must be undertaken by the Board to meet its safety and soundness obligations.

Specifically, OFHEO requires the Board to

> direct the conduct and affairs of the Enterprise in furtherance of the safe and sound operation of the Enterprise and … remain reasonably informed of the condition, activities, and operations of the Enterprise. The responsibilities of the Board include having in place adequate policies and procedures to assure its oversight of, among other matters, the following:
>
> (1) Corporate strategy, major plans of action, risk policy, programs for legal and regulatory compliance and corporate performance …;
>
> (2) Hiring and retention of qualified senior executive officers and succession planned for such senior executive officers;
>
> (3) Compensation programs of the enterprise;
>
> (4) Integrity of accounting and financial reporting systems of the Enterprise, including independent audits and systems of internal control;
>
> (5) Process and adequacy of reporting disclosures, and communications to shareholders, investors, and potential investors; [and]
>
> (6) Responsiveness of executive officers in providing accurate and timely reports to Federal regulators and in addressing the supervisory concerns of Federal regulators in a timely and appropriate manner."[3]

OFHEO's corporate governance regulation also points Boards of Directors to the body of law elected under 12 CFR 1710.10 and to publications and other pronouncements of OFHEO for additional guidance on conduct and responsibilities for the Board of Directors.[4] Thus, additional duties of the Fannie Mae Board arise from Fannie Mae's election to be governed by Delaware

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[1] In fact, its Charter Act requires Fannie Mae to make a formal assessment of its compliance with the applicable safety and soundness laws. *See* e.g. 12 U.S.C. § 1723a(k)(2).

[2] See 12 C.F.R. Part 1710 (2005). OFHEO requires that the "corporate governance practices and procedures of the [the] Enterprise ... shall comply with [its] chartering act ... and other Federal law, rules and regulations, and shall be consistent with the safe and sound operation of the Enterprise...." 12 C.F.R. § 1710.10(a).

[3] Title 12, C.F.R., Part 1710.15 (2004).

[4] 12 C.F.R Corporate Governance § 1710.15, and § 1710.10.

General Corporation Law, Del. Code Ann. tit. 8, as amended.[5] Delaware statutory and case law, however, is supplemental to OFHEO's corporate governance and safety and soundness standards that OFHEO has imposed since OFHEO's inception.[6]

Well-settled principles of good corporate governance hold that, to be observant of the best interests of the corporation, an independent director must "'exercise a healthy skepticism,'" and an alertness to possible wrongdoing on the part of corporate insiders."[7] In fact, a director's independence should be her "most distinguishing characteristic."[8] That said, in order to be effective, a director must do more than simply monitor management's performance. Applicable standards require that a director must actively undertake vigorous scrutiny of the corporation's affairs, and must be unfailingly vigilant in requiring that management continuously provide an adequate and frequent flow of information concerning the goals, objectives, operations, and financial condition of the corporation. For efficiency, a board will delegate its oversight work to various committees. For example, the audit committee, whose members should be independent and free of management influence,[9] is charged with, among other matters, reviewing the internal and external audit functions. It does not follow, however, that by delegating certain duties a board is absolved of responsibility to ensure that a committee does its work and reports adequately on that work. To the contrary, OFHEO's corporate governance regulation[10] specifically provides that "no committee shall operate to relieve the board of directors or any board member of a responsibility imposed by applicable law, rule, or regulation."[11] In the case of Fannie Mae, the Board of Directors imprudently failed to perform those important duties and responsibilities, in contravention of myriad applicable safety and soundness standards.

This chapter chronicles the oversight lapses of Fannie Mae's Board of Directors and, in particular, its Audit and Compensation Committees. In short, the Board of Directors failed to be sufficiently informed and to act independently of its Chairman, Franklin Raines, and senior management. The Board failed to exert the requisite oversight over the Enterprise's operations and to assure that the Enterprise was fully compliant with applicable law and safety and soundness standards. Among the Board's duties was the responsibility to ensure that Fannie Mae's financial reporting and disclosures were in accordance with generally accepted accounting principles (GAAP).[12] In the absence of policies and procedures adequate to safeguard the integrity of the accounting and financial reporting systems, Fannie Mae issued reports of condition containing materially false annual and quarterly financial statements, requiring the

[5] Fannie Mae complied with the election requirement in 12 C.F.R. § 1710.10(b) by electing to be subject to Delaware law for corporate governance purposes.

[6] 12 C.F.R. § 1710.10 (b) makes clear that federal law supersedes state law where there is any inconsistency. The Federal Housing Enterprises Financial Safety and Soundness Act of 1992, makes clear that OFHEO is primarily in charge of assuring the safety and soundness of Fannie Mae.

[7] *See* Knepper, W. *Liability of Corporate Officers and Directors,* 1.11, p. 27 (3rd Ed. 1978) (internal citations omitted).

[8] *Id*., p. 26.

[9] The New York Stock Exchange instituted the requirement that all listed public companies have an independent audit committee effective June 30, 1978. Id., p. 29.

[10] As discussed in Chapter III, the corporate governance and safety and soundness regulations promulgated by OFHEO capture these essential tenets and provide the analytical framework for assessing the Board's conduct.

[11] 12 C.F.R. § 1710.12(a).

[12] *See* 12 U.S.C. § 1723a(l), (k)(1) and (2).

restatement of results in prior financial reporting periods in an amount currently estimated at $10.6 billion. On the basis of those falsified financial statements, over a period of several years, the Chairman, the Chief Financial Officer, and various officers realized sizeable bonuses to which they were not entitled.

Senior management attributed Fannie Mae's unerring ability to hit pre-set earnings per share targets, and Wall Street analysts' projections, to its supposedly unique business model. That questionable construct went unchallenged by the Board for years. As discussed below, had the Board inquired into management's practices with appropriate vigor, many of the problems discussed in this report might have been avoided or addressed earlier.

The Board refrained from demanding accountability from the Chairman and other senior executives in numerous ways. Specifically, the Board abandoned its checks-and-balances oversight responsibilities; acquiesced in allowing management unbridled authority over its agenda, materials, and minutes; did not adopt and impose policies requiring that all critical accounting policies and major transactions be vetted before it or its designated committee; and acquiesced in allowing the Chairman to concentrate power in the Chief Financial Officer and then to seat him on the Board, which enhanced the power and influence of executive Board members. In fact, the Board allowed management to determine with little opposition the information it received and missed many opportunities for meaningful oversight.

Among those missed opportunities was the failure on the part of the Board, and the Audit Committee in particular, to challenge the Chairman and senior management at several critical points during 2003 when the Board should have required a thorough, independent investigation into Fannie Mae financial accounting and reporting practices. Those critical points included the January 2003 announcement by Freddie Mac, whose business model closely paralleled that of Fannie Mae's, that it was restating its financial statements due to misapplications of GAAP and initiating an internal investigation; the certification of Fannie Mae's financial statements in connection with the registration of its stock effective on March 31, 2003; the management shakeup at Freddie Mac in June 2003; the initiation by OFHEO of the special examination in July 2003; and the August 2003 allegation by an employee turned whistleblower, that certain accounting functions had significantly compromised the validity of the Enterprise's financial reporting just prior to the certification of its financial results in connection with its quarterly financial report (10Q) for the third quarter of 2003. The Board did not question the fast-tracked settlement of the employee's whistleblower claims after management had represented the allegations to be unsubstantiated. During the entire period under review, the Board repeatedly failed to discharge its responsibilities properly, engaged in conduct contrary to standards of prudent operation, and failed to ensure the safe and sound operation of the Enterprise.

The Board delegated important safety and soundness responsibilities to its committees. Of particular importance are the Audit and Compensation Committees. The members of the Fannie Mae Board of Directors were all knowledgeable and qualified individuals, fully capable of understanding the business and corporate governance issues with which they were charged. The chapter proceeds by documenting the responsibilities delegated to the Audit and Compensation Committees and the specific safety and soundness failures of those committees. The failures of those committees reflect failures of the entire Board of Directors. The following section focuses on failures of the full Board to discharge its oversight responsibilities as enumerated in statute, regulation, regulatory guidance, and industry best practice. The members of the Fannie Mae Board of Directors failed to stay appropriately informed of corporate strategy; review major business decisions; ensure appropriate delegations of authority; ensure that Board committees functioned effectively; provide an appropriate check on Chairman and Chief Executive Officer (CEO) Franklin Raines; and adequately oversee the risk policies, programs for legal and regulatory compliance, hiring and retention of qualified senior executive officers, compensation programs, and integrity of accounting and financial reporting systems, including independent audits and system of internal control.

Board Structure and Composition

To some extent the OFHEO corporate governance regulation allows the Board to rely, in directing the Enterprise, on reports from committees.[13] However as detailed later in this chapter, that reliance does not relieve Board members of their responsibility to oversee the functioning of those committees or of numerous other duties of the full Board. The Board approves Committee assignments, including the designation of committee chairs on an annual basis.[14] In 1998, the Board had six standing committees: Executive, Assets and Liabilities Policy, Audit, Compensation, Nominating and Corporate Governance, and Technology. In December 2003, the Technology Committee dissolved and its responsibilities shifted to the Audit Committee. Fannie Mae established three new Board committees in 2004: Housing and Community Development, Compliance, and Special Review. In 2005, the Assets and Liabilities Policy Committee dissolved and the Risk Policy and Capital Committee was established as its replacement.

Membership on the Fannie Mae Board of Directors was prestigious and provided members a high degree of visibility. Mr. Raines was recognized as a top CEO and served as the co-chairman of Business Roundtable, a prestigious business group of top executives of nationally renowned companies. The Board was comprised of highly knowledgeable and qualified individuals with extensive experience on corporate boards of directors, fully capable of understanding the business and corporate governance issues with which they were charged. Key current members of the Board who served during the period covered by this report include current Board Chairman Board Stephen Ashley, who is also Chief Executive Officer of the Ashley Group and a former president of the Mortgage Bankers Association. Audit Committee Chair Thomas Gerrity is a former Dean of the Wharton School at the University of Pennsylvania. Compensation Committee Chair Joe Pickett is the former Chief Executive Officer of Homeside International, Inc., and a former president of the Mortgage Bankers Association. Howard University President H. Patrick Swygert chairs the Compliance Committee. Housing and Community Development Committee Chair Kenneth Duberstein served as White House Chief of Staff in the Reagan administration. Former Secretary of Labor Ann McLaughlin Korologos chaired Fannie Mae's Nominating and Corporate Governance Committee from 2001 to 2004, and currently serves as Chairman of the Board of Trustees of the RAND Corporation.

13 12 C.F.R. § 1710.11.

14 Fannie Mae Corporate Governance by-laws: Article 4 at http://fanniemae.com/governance/bylaws/article4.jhtml?p=Corporate+Governance&s=Bylaws&t=Artlice=4:+The+Board-.

Other key members of the Board that served during the relevant period included Anne Mulcahy, Chairman and Chief Executive Officer of Xerox Corporation, and Vincent Mai, Chairman and Chief Executive Officer of the private equity firm AEA Investors, LLC, and a former managing partner at Lehman Brothers. Both chaired the Compensation Committee during their tenure at Fannie Mae. Appendix A provides more detail concerning the composition of the Board.

Between 1998 and 2004, management members of the Fannie Mae Board of Directors included James A. Johnson, who served as Chairman and Chief Executive Officer until December 1998, and who served as Chair of the Executive Committee until December 1999; Lawrence Small, who served as President and Chief Operating Officer until January 2000; Franklin Raines, who served as Chairman and Chief Executive Officer-designate from May 1998 to January 1999, and as Chairman and Chief Executive Officer from January 1999 until December 2004; Jamie Gorelick, who served as Vice Chair from May 1997 to May 2003; Daniel Mudd, who served as President and Chief Operating Officer from February 2000 until December 2004, and as President and Chief Executive Officer from December 2004 to the present; and Timothy Howard, who served as Vice Chairman and Chief Financial Officer from May 2003 to December 2004. Due to his material relationship with Fannie Mae as a consultant for the Enterprise, Board member Kenneth Duberstein is considered a non-independent non-management director.

Failures of the Committees of the Board

The Audit and Compensation Committees, two of the standing committees of the Board of Directors, failed to meet regulatory and corporate standards in discharging their responsibilities. Of those two, the one with the most far-reaching significance for safety and soundness, both because of the required independence of its members and the scope of its responsibilities, was the Audit Committee. The failures of the Audit Committee were compounded by failures of the Compensation Committee.

<u>Audit Committee</u>

As the standards governing the roles, responsibilities and conduct of audit committees have evolved over the past two decades,[15] one constant has remained: an audit committee acts under the imprimatur of the board of directors pursuant to the delegations of authority and responsibilities in its enabling charter and applicable law. Importantly, a board of directors, having conferred certain duties upon the audit committee by charter, cannot absolve itself of those responsibilities. It follows that any failure by the Audit Committee of the Board of Directors of Fannie Mae to adhere to the requisite standards constituted a failure of the Board.

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[15] Historically, the standards governing the roles and responsibilities of audit committees evolved in response to a rash of well-publicized cases of fraudulent financial reporting. For example, in 1987, the National Commission on Fraudulent Financial Reporting (the Treadway Commission) recommended that the boards of directors of all public companies be required by Securities Exchange Commission (SEC) rule to establish audit committees composed solely of independent directors, and outlined key recommendations for audit committees to follow in carrying out their responsibilities. *See* Louis Braiotta, Jr., *The Audit Committee Handbook, Third Edition*, 353-354 (1999).

Chief among the Board's duties was the responsibility to ensure that Fannie Mae's financial reporting and disclosures were in accordance with GAAP, in accordance with the Charter Act.[16] Of all the Audit Committee's responsibilities—including, for example, the oversight of internal and external auditing and internal controls—its principal obligation was to ensure the fidelity of Fannie Mae's financial reporting and disclosures.[17]

The Audit Committee failed to protect Fannie Mae's safety and soundness by not discharging its duties responsibly and effectively. This section reviews those duties and the Committee's failures.

Applicable Standards

Audit committees are subject to myriad legal and industry standards, which were published throughout the relevant time period, including the 1987 Treadway Commission Report, and two studies released in 1999 that called for strengthening an audit committee's role: the so-called Blue Ribbon Report[18] and the study commissioned by the Committee of Sponsoring Organizations of the Treadway Commission (COSO Report).[19]

Among other matters, the Blue Ribbon Report and the COSO Report called for new audit committee disclosure rules and enhanced auditor independence requirements. In response, the stock exchanges promulgated revised rules.[20] As an exchange-listed company, Fannie Mae is subject to the New York Stock Exchange (NYSE) Listing Standards. Thus, Fannie Mae was required to comply with the NYSE rule changes that required audit committees to consist of at least three independent directors, each of whom should be able to read and understand fundamental financial statements, and one of whom should have accounting or financial expertise.[21] The NYSE also outlined requirements of independence and required the adoption of a formal written charter.[22]

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[16] *See* 12 U.S.C. § 1723a(l), (k)(1) and (2).

[17] "Audit committees also help the Board [of Directors] by overseeing the conduct and performance of management with respect to the preparation of the company's financial statements and financial disclosures." *See* Fenwick & West LLP, "Audit Committee Duties and Best Practices" (March 21, 2002). p. 2.

[18] In 1999, the role of audit committees was revitalized and strengthened by the "Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees," February 8, 1999, (Blue Ribbon Report). The Blue Ribbon Report outlined ten specific regulatory changes regarding audit committees and five guiding principles for audit committees to follow when developing their own policies.

[19] *See* "The COSO Report, Fraudulent Financial Reporting: 1987-1997, An analysis of U.S. Public Companies, Commissioned by the Committee of Sponsoring Organizations of the Treadway Commission," March 1999. The COSO Report identified and analyzed instances of alleged fraudulent financial reporting by companies investigated by the commission in the ten-year period following the 1987 Treadway Commission Report and highlighted the need for independent and effective audit committee oversight.

[20] *See* NYSE, Nasdaq and AMEX, Audit Committee Rule Requirements, September 20, 1999. Those proposed rule changes were approved by the SEC on December 14, 1999. Securities Exchange Act Release Nos. 34-41, 980-982, October 6 and 13, 1999.

[21] *See* NYSE Audit Committee Rule 303.01(B)(2), September 20, 1999. The rule was approved by the SEC on Dec. 14, 1999.

[22] *See* NYSE Audit Committee Rule 303.01(B)(1), September 20, 1999. The rule was approved by the SEC on Dec. 14, 1999.

Both the SEC and the NYSE again proposed new standards to further strengthen audit committees[23] in response to the enactment of the Sarbanes-Oxley Act (SOX) in 2002,[24] which effectively federalized the role of the public company audit committee. SOX focused more attention on the need for independent oversight by increasing audit committee responsibilities and authority, and by raising committee membership requirements to include a greater number of independent directors.[25]

As discussed below, Fannie Mae's Board revised the Charter of the Audit Committee as new standards proliferated. For example, in early 2000, in response to the newly elucidated 1999 standards, the Board amended the 1996 Audit Committee Charter. The Board again revised the charter in 2003. That those charter revisions were undertaken is not in question; the issue, rather, is whether the Audit Committee complied with them.

In 1998, the responsibilities of the Audit Committee of the Board were set forth in the Audit Committee Charter adopted in 1996.[26] The 1996 Charter delineates the Audit Committee's oversight responsibilities with respect to regulatory compliance, accounting and financial reporting, the external auditor relationship, and internal auditing activities. Among other things, the 1996 Charter required the Audit Committee to:

- Meet with management, internal auditors, and the corporation's independent auditors, and to develop in-depth and specialized knowledge on matters relating to corporate accounting, financial reporting, internal control, auditing, and regulatory compliance activities;

- Review and make recommendations to the Board on the corporation's accounting and financial reporting practices and its annual financial report to shareholders;

- Assess the adequacy and effectiveness of internal controls, including compliance with established limits on derivatives risk;

- Receive periodic reports from management, internal audit, and the corporation's independent auditors on matters relating to corporate accounting, financial reporting, internal control, auditing, and regulatory compliance, and on the activities of management's Business Conduct Committee, including monitoring compliance with the Code of Business Conduct; and

- Recommend to the Board the appointment of the corporation's independent auditors and oversee the activities of the independent auditors.

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23 Securities Exchange Release No. 34-48,745, November 4, 2003.

24 Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 407, 116 Stat. 745, 790 (2002).

25 Annemarie K. Keinath and Judith C. Walo, "Audit Committee Responsibilities: Focusing on Oversight, Open Communication, and Best Practices," *The CPA Journal*, November 2004.

26 The Audit Committee Charter, November 19, 1996, was included in the Audit Committee Meeting Package, as part of the of the April 21, 1998, committee meeting minutes.

The Charter seemingly limited some of the Committee's authority by requiring the Audit Committee Chair to consult with executive management in overseeing and evaluating the activities and performance of the "Vice President for Auditing," and "the budgets and staffing of the internal audit department." Additionally, the Charter authorized the Audit Committee to "cause an investigation to be made" into any matter under its scope of responsibility that "is brought to its attention." The Charter later underwent wholesale revisions.

In 2000, the Audit Committee Charter revised the responsibilities of the Audit Committee members to include monitoring the integrity of the corporation's financial statements and the independence of internal and external audit functions.[27] The 2000 Charter further required the Audit Committee to review the corporation's financial reporting practices, including the significant issues and judgments made in connection with the preparation of the audited financial statements, and to receive periodic reports relating to the corporation's business environment, major risks, and risk management processes. Additionally, the importance of independent communication flow was emphasized. Again, the Charter provided authority for the Committee to "cause an investigation to be made into any matter within the scope of its responsibility that is brought to its attention." Here, the Committee's authority was expanded to permit it to "engage such independent resources to assist in its investigations, as it deems necessary." Thus, the Committee had full authority to initiate an investigation into any matter under its purview.

The Charter was again restructured in 2003[28] in conjunction with Fannie Mae's first proxy statement to shareholders upon SEC registration. At that time, the charter was amended to include the responsibilities of audit committees required by the Sarbanes-Oxley Act of 2002. The 2003 Charter clarified the Committee's responsibility to monitor independence of the internal audit function by requiring that the Committee ensure that no limitations or restrictions were placed on that function.

In addition to maintaining the pre-existing oversight responsibilities, the 2003 Charter also provided for heightened financial statement and disclosure responsibilities, including:

- A discussion and analysis of the outside auditor's judgment as to the quality of the corporation's accounting principles, significant financial reporting issues, and MD&A [Management Discussion and Analysis] disclosures;

- Review and discuss with the outside auditors all critical accounting policies, any alternative treatments under GAAP, and material communications with management; and

- Review and discuss with management and the outside auditor any correspondence with regulators or governmental agencies which raises material issues regarding Fannie Mae's financial statements, financial disclosures or accounting policies.

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[27] *See* Audit Committee Charter, July 18, 2000, at FMSE 014495-97.

[28] *See* 2003 Audit Committee Charter included in the Audit Committee Meeting minutes of January 21, 2003. FMSE 504223-228.

Failures of the Audit Committee

The Audit Committee of the Board of Directors failed to safeguard Fannie Mae's safety and soundness by not discharging its duties responsibly and effectively. Specifically, the Committee failed to evaluate the internal audit function and the performance of the head of the Office of Auditing, to oversee the production of financial statements, to monitor the development and implementation of critical accounting policies, to develop in-depth or specialized knowledge necessary to its oversight responsibilities, and to oversee adequately the work of the external auditor.

The Audit Committee was complacent in the oversight activities required by its Charter and applicable regulations, guidelines, and standards. Members of the Audit Committee exercised little, if any, meaningful or active oversight. They failed to perform disciplined and consistent evaluations of internal audit activities, to probe management of the Office of Auditing, or to discuss diligently or inquire adequately with respect to incomplete representations of management and the Office of Auditing regarding critical accounting issues. Those issues included whether critical accounting policies conformed with GAAP and the uncorroborated representations of management that the external auditor reviewed and approved those policies. The record fails to demonstrate adequate inquiry or thoughtful requests for additional information or explanation from Audit Committee members in their meetings with the external auditor.

The Audit Committee was required to develop in-depth and specialized knowledge on matters relating to corporate accounting and financial reporting in order to serve its oversight role effectively. That role encompassed oversight of both the internal and external auditor relationships as well as responsibility for monitoring the integrity of the Fannie Mae's financial statements. Further, standards during the relevant time period as developed by the Treadway Commission (1987), The Blue Ribbon Commission (1999) and the SEC (1999, 2000, and 2002) required audit committees to engage in vigilant and effective oversight of the Enterprise's financial reporting process and internal controls.

In February 2001, after the Blue Ribbon Report and resulting changes in SEC and NYSE standards, Sampath Rajappa, Senior Vice President for Operations Risk and head of the Office of Auditing, reported to Vice-Chairman Jamie Gorelick, Chairman and CEO Franklin Raines, CFO Timothy Howard, Controller Leanne Spencer, and others that he would address with KPMG how Fannie Mae would "meet all the foregoing requirements at the Audit Committee meeting."[29] Mr. Rajappa also claimed that "[i]n a nutshell, we are/will be in compliance with all the requirements." The requirements to which he referred included American Institute of Certified Public Accountants Statements of Auditing Standards SAS-89 and SAS-90, the NYSE's guidelines on audit committee governance standards, the SEC Final Rules on audit committee requirements, and the SEC independence rules as they pertained to the external auditor. At the

[29] E-mail chain from Sampath Rajappa to Jamie Gorelick with a copy to Franklin Raines, Timothy Howard, Leanne Spencer and others, "Re: Audit Committee Requirements," February 12, 2001, FMSE-KD 016986-88 (in which Mr. Rajappa reported that "KPMG and I will address how we meet all the requirements at the audit committee on Feb. 20.")

Audit Committee meeting on February 20, 2001, Mr. Rajappa and Ms. Theobald, of KPMG, reported that the Audit Committee either met or exceeded every requirement.[30,31]

In 2002, Fannie Mae Board policies and practices were reviewed with the goal of ensuring that Fannie Mae corporate governance was "best in class."[32] That review included an assessment of Fannie Mae's corporate governance policies and practices against the standards contained in SOX, NYSE listing requirements, OFHEO and SEC regulations, and best practices.[33] In early 2003, the Fannie Mae Board of Directors adopted a variety of enhancements to achieve "best in class" status.[34] Despite those representations and Fannie Mae's desire to be "best in class," both the Audit Committee and its chairman failed to comply with the Audit Committee Charter and professional standards.

<u>Failure to Oversee the Office of Auditing and the Head of the Office of Auditing.</u> The Audit Committee's responsibilities include oversight of both the internal and external audit functions independent of management. Effective execution of fiduciary duty and responsibility requires robust oversight and involvement, including candid discussions, diligent and knowledgeable committee membership, and the use of external consultants as authorized by the Audit Committee Charter. [35]

According to its charter, the Audit Committee has the express duty to oversee the internal audit function, which at Fannie Mae was conducted by the Office of Auditing. In that capacity, the Audit Committee is responsible for discussing Office of Auditing activities, including the appointment and replacement of its head, and its budget and staffing. The Audit Committee is also charged with determining the scope and performance of the internal audit function, reviewing the Audit Plan, and ascertaining whether there are any restrictions or limitations on the Office. In order to fulfill its duty, the Audit Committee also has the responsibility of obtaining periodic reports from the head of the Office regarding the findings of internal audits.

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30 *See* Audit Committee Meeting Minutes of February 20, 2001, FMSE 014870-014876 at 73.

31 While Mr. Rajappa, Senior Vice President for Operations Risk and head of the Office of Auditing, was reporting that Fannie Mae is or will be in compliance with all the requirements, including independent communication and information flow between audit committee and internal audit and external audit as well as candid discussions with management and external auditors, he also indicates that he " will meet with KPMG on Wednesday to go over their *exact* talking points. . ." and represents to already know "what they (KPMG) *intend* to say." *See* e-mail chain from Sampath Rajappa to Jamie Gorelick with a copy to Franklin Raines, Timothy Howard, Leanne Spencer, and others, "Re: Audit Committee Requirements," February 12, 2001, FMSE-KD 016986.

32 *See* Minutes of the Meeting of the Nominating and Corporate Governance Committee of the Board of Directors of Fannie Mae, July 16, 2002, FMSE 505365-66, at FMSE 505365.

33 *See* Minutes of the Meeting of the Nominating and Corporate Governance Committee of the Board of Directors of Fannie Mae, July 16, 2002, FMSE 505365-66, at FMSE 505365; Fannie Mae Corporate Governance Benchmarking Project: Issues for Consideration dated Aug. 6, 2002, FMSE 12859-87.

34 *See* Minutes of the Meeting of the Board of Directors of Fannie Mae, January 21, 2003, FMSE 504202-40, at FMSE 504220-21. *See also* Draft Working Scorecard for Benchmarking Project, January 16, 2003, FMSE 13512-16.

35 E-mail chain from Sampath Rajappa to Jamie Gorelick with copies to Franklin Raines, Timothy Howard, Leanne Spencer, et al, "Re: Audit Committee Requirements," February 12, 2001; Mr. Rajappa submits the five guiding principles for Audit Committee best practices from the SEC's chief accountant, including "robust oversight" of management and diligent and knowledgeable committee membership, FMSE-KD 016986-88, at 016987.

The Audit Committee failed to execute its oversight responsibilities adequately. Those failures primarily involved a lack of appropriate concern for safeguarding the independence of the internal audit function from financial reporting and business functions, and a lack of engagement in the planning and evaluation of internal audits.

The Appointment of Mr. Rajappa. While the Board has the overall responsibility for hiring qualified senior officers,[36] the Audit Committee Charter placed the responsibility for hiring and firing of the head of the Office of Auditing on the Audit Committee. In addition to conducting a thorough evaluation of the qualifications and credentials of a candidate, the Audit Committee was responsible for ensuring that the appointment in no way jeopardized the independence of the internal audit function.

As described in Chapter VIII, since Mr. Rajappa served as Fannie Mae Controller directly before his appointment to head the Office of Auditing, his appointment put him in the inappropriate position of auditing his own work. As Controller, Mr. Rajappa was involved in accounting analysis and decisions related to the entire financial operations of Fannie Mae, including Manufactured Housing, Loan Loss Reserves, REMICS, Purchase Premium and Discount Amortization, interest-only securities, impairment and mark-to-market rules, Synthetic MBS, and low-income housing tax credits. Many of those areas will be subject to restatement or have been identified as not in compliance with GAAP.

No discussion of Mr. Rajappa's new position as head of the Office of Auditing appears in the minutes of either the January 19, 1999, Board of Directors meeting or the minutes of the February 16, 1999 Audit Committee meeting. OFHEO found no other evidence of a critical evaluation of the sufficiency of Mr. Rajappa's education, training, experience (for example, the fact that he was not a certified public accountant), or his ability to oversee the internal audit function objectively, given his former position as Controller. Effective, diligent oversight in compliance with the Audit Committee Charter clearly required such a discussion.

When questioned during the OFHEO examination, Mr. Gerrity, the then newly-appointed Audit Committee Chairman, stated that he could not recall specifically whether Ms. Spencer had assumed the position of Controller by the January 1999 board meeting, nor did Mr. Gerrity know why Mr. Rajappa was selected to be the head of the Office of Auditing.[37] Mr. Gerrity also stated that he did not think it was awkward that Mr. Rajappa was formerly the Controller.[38] The Audit Committee clearly was aware of Mr. Rajappa's prior experience as Controller and had a responsibility to ensure there were no known independence violations or conflicts of interest. Instead, the Audit Committee stood silent as the Office of Auditing, under Mr. Rajappa's supervision, conducted audits of his former department.[39] The Audit Committee did not meet its responsibility to question, if not challenge, the appointment of Mr. Rajappa. At a minimum, the Audit Committee should have required Mr. Rajappa to recuse himself from any review function inconsistent with the Institute of Internal Auditors standards discussed in Chapter VII.

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[36] Title 12 C.F.R. 1710.15(b(2)

[37] Paul Weiss memorandum of interview with Thomas Gerrity, February 28, 2006, FM SRC OFHEO 00713198-218, at 00713203.

[38] OFHEO Interview, Thomas Gerrity, February 28, 2006, p. 87.

[39] OFHEO Interview, Sampath Rajappa, February 23, 2006, p. 13.

Inappropriate Compensation of Office of Auditing Staff. As discussed in Chapters VII and VIII, compensating senior internal auditors on an EPS-basis creates a problem at least as to the appearance of independence—a problem that was exacerbated by Mr. Rajappa's enthusiasm for EPS compensation. Although the Compensation Committee was directly responsible for setting bonuses, the Audit Committee was responsible for insuring the independence and objectivity of the internal audit function. That responsibility required the Committee to consider the independence and objectivity issues created by tying the compensation of the staff of the Office of Auditing to EPS, given the independent oversight role of that office. The Audit Committee's failure to address the inherent conflict of interest created by that compensation ultimately contributed to the inappropriate admonitions of Mr. Rajappa to his staff members to "live, breathe and dream 6.46" and that they should become "obsessed" with seeing to it that they did their part to help Fannie Mae achieve the EPS goal.[40] As evidenced by that communication and supported by a recommendation in Ernst and Young's report dated June 30, 2005 on Internal Audit Transformation-Recommendations,[41] the Audit Committee should have considered and recommended that an alternate method to determine incentive compensation be applied to Internal Audit.[42]

Other Issues Concerning the Independence of the Office of Auditing. Internal audit best practices require that "[t]he internal auditors' qualifications, staff, status within the company, reporting lines, [and] relationship with the audit committee of the board of directors must be adequate to ensure the internal audit function's effectiveness and objectivity...."[43] In order to fulfill its duty to oversee the internal audit function, the Audit Committee has a responsibility to ensure that the independence of the internal audit function is not jeopardized, either in appearance or fact. The Office of Auditing was supposed to be a direct report to the Audit Committee, with an administrative or "dotted-line" report to management. In practice those relationships appear to have been reversed.

In 2002, the "dotted line" reporting for the head of the Office of Auditing, Mr. Rajappa, moved from COO Mudd to CFO Howard.[44] According to Mr. Rajappa, CEO Raines made the decision that the reporting line should shift to the CFO. That reporting structure had the potential to jeopardize independence and should have been vetted through the appropriate channels, i.e., the Audit Committee. The minutes do not show that the Audit Committee addressed the issue. However, Mr. Rajappa recalled that Audit Committee Chair Gerrity approved of the change without discussing the issue with him. Thereafter, Mr. Rajappa recalls expressing his reservations regarding the reporting shift to Mr. Gerrity.

[40] *See* Sampath Rajappa's address to Audit Group on "what we can do to help achieve $6.46 EPS," FM SRC OFHEO 00142373-74.

[41] *See* Ernst and Young report, "Fannie Mae Office of Auditing, Internal Audit Transformation – Recommendations," June 30, 2005, FMSE 510811 - 510833.

[42] *Id.*, *Also see* "Report to the Board Compensation Committee on Appropriate Corporation Structure and Incentives for Fannie Mae Management," February 23, 2005, which recommended that bonus compensation for the head of Internal Audit should not be tied to earnings, FMSE-EC 008826 - 008992, at 909 and 947.

[43] Report of National Commission on Fraudulent Financial Reporting, (Treadway Commission), p.11.

[44] Paul Weiss memorandum of interview with Sampath Rajappa, January 19, 2005, FM SRC OFHEO 00227300-306 at 302. That page of that memorandum is the source for this and the following paragraph.

Mr. Rajappa questioned whether placing the head of the Office of Auditing under the CFO was appropriate from a best practices perspective. He raised those concerns with Mr. Howard who, according to Mr. Rajappa, claims to have unsuccessfully attempted to coordinate a discussion with Mr. Raines on the topic. As Controller, Mr. Rajappa had served as a direct report to Mr. Howard. Review of the integrity of financial information is among the core functions of the Office of Auditing, and Mr. Howard's direct reports (and, ultimately, Mr. Howard) were responsible for the development of accounting policy. Considering those facts, it is easy to understand why Mr. Rajappa was concerned with having the head of the Office of Auditing report to the CFO.

Mr. Gerrity's insensitivity to any perceived or actual breach of independence is evidenced by his failure to conduct any evaluation of the change in reporting or to discuss it with the Audit Committee as a whole. As a result of the inaction of the Audit Committee and the concomitant lack of clear guidelines, Mr. Howard was in a position to exert inappropriate influence on the Office of Auditing.[45] The Audit Committee's failure was further compounded during the annual review process. The Audit Committee Charter dictates that the Audit Committee is jointly responsible for the budget and staffing of the Office of Auditing. However, Mr. Rajappa's performance evaluations were written and presented by his supervisors—COO Small, COO Mudd, and ultimately, CFO Howard—with input from Mr. Gerrity.[46] Those evaluations were the basis for salary increases and bonuses. Mr. Gerrity's involvement in the process appears to have been a limited review of the evaluation prepared by Mr. Howard.[47]

The Scope of Internal Audits. The Audit Committee was directed by the Audit Committee Charter to establish the scope and evaluate the performance of the internal audit function. On an annual basis, the Office of Auditing developed its Audit Plan, which was vetted with the Audit Committee. That Audit Plan identified key risks and established audit priorities. Effective interaction between the Office and the Audit Committee regarding the Audit Plan was paramount to the development of an effective oversight mechanism. The Audit Committee expected the Office of Auditing to audit accounting and financial reporting areas for GAAP compliance because those internal audit reports indicated as much. However, as documented in Chapter VII, a communication gap existed between expectations of the Audit Committee and the practices of the Office of Auditing regarding the scope of the reviews. For example, Mr. Rajappa and others in the Office of Auditing have stated that testing for GAAP compliance was not within their mandate. Mr. Gerrity, on the other hand, indicated that the Office of Auditing was to serve as a "watchdog" for GAAP compliance in addition to the external auditor.[48] His understanding was based on his belief that the Office of Auditing understood GAAP and that noncompliance with GAAP would represent a material weakness.[49] That fundamental misunderstanding existed for

45 E-mail from Timothy Howard to Leanne Spencer, "FW: Fannie Scolded for Obsolete Accounting Systems," March 3, 2004, OFH-FNM00126929. In that e-mail, Mr. Howard informed Ms. Spencer that he had made it "blisteringly clear" to Mr. Rajappa that the latter was to run all Audit Committee issues by him before going to the Audit Committee Chair.

46 Paul Weiss memorandum of interview with Sampath Rajappa, January 19, 2005, FM SRC OFHEO 00227300-306 at 302.

47 OFHEO Interview, Thomas Gerrity, February 28, 2006, p. 46.

48 OFHEO Interview, Thomas Gerrity, February 28, 2006, p. 101.

49 OFHEO Interview, Thomas Gerrity, February 28, 2006 , p.101

five years, illustrating the lack of communication between the Audit Committee and the Office of Auditing as well as a lack of the robust oversight that applicable standards require.[50]

Lack of Timely Internal Audits of Critical Accounting Policies. In April of each year, the Audit Committee was responsible for approving the Audit Plan. That plan was developed as a roadmap for audit activities and was based on an assessment of critical policies and key control areas.[51] The process of establishing priorities was a function of both the inherent risk of the activity as well as the results of prior audit activities in the respective areas. As described later in this chapter, audit areas were color coded through that process. "Red" audits areas would be reviewed annually, whereas activities deemed "green" would only be examined every three years.[52] The Audit Committee was involved in the process and specifically requested that the Office of Auditing perform an annual review of the accounting for derivatives.[53] Despite audit differences in 1998 and 1999, and after being told by KPMG, in relation to the 1998 audit that a written policy was an absolute necessity, Fannie Mae waited until 2003 to conduct its first substantive review of the implementation of the FAS 91 policy formalized in December 2000.[54] Given that FAS 91 was a critical accounting estimate (as discussed in Chapter VII) and given the magnitude of the reporting errors that could—and did—result from an improper application of FAS 91, the Office of Auditing should have deemed the review of that policy a high audit priority. In the absence of initiative from the Office of Auditing, it was incumbent upon the Audit Committee to require an audit to be done on a more urgent basis prior to 2003.

<u>Failure to Make Adequate Inquiries.</u> Although the Board has the overall responsibility of assuring the integrity of Fannie Mae's accounting and financial reporting systems,[55] the Audit Committee is charged with the specific responsibility of overseeing "the accounting, reporting, and financial practices of the corporation and its subsidiaries, including the integrity of the corporation's financial statements. . . ." Gaining knowledge and making the appropriate inquiries are critical components of any oversight function. Early versions of the Charter even contained an explicit requirement that the Audit Committee "develop in depth and specialized knowledge on matters relating to the Committee's responsibilities . . ." Despite that directive, Mr. Gerrity was aware of neither how Fannie Mae formulated its accounting policies, nor who was responsible for them.[56] Also, as described in detail below, the Audit Committee failed to exhibit an appropriate level of knowledge about several of Fannie Mae's significant accounting policies, such as those related to FAS 91 and the allowance for losses. Furthermore, Mr. Gerrity stated that he "would count on management and/or Internal Audit and/or KPMG to raise [FAS 91, FAS 133, or other FAS issues with the committee]. That's the only way in which we would

[50] *See* Audit Committee Certification of FAS 133, FMSE 014893, FMSE 015316, FMSE 016125.
[51] OFHEO Interview, Sampath Rajappa, June 17, 2004, pp. 14-16.
[52] OFHEO Interview, Sampath Rajappa, June 17, 2004, pp. 14-16.
[53] OFHEO Interview, Sampath Rajappa, February 23, 2006, p. 85.
[54] Mr. Gerrity apparently never read Fannie Mae's "Purchase Premium and Discount Amortization Policy" as he had no recollection of seeing the written policy and only learned of the major provisions "in the last year or so." OFHEO Interview, Thomas Gerrity, March 14, 2006, p. 77.
[55] 12 C.F.R. 1710.15(b)(4).
[56] Paul Weiss memorandum of interview with Thomas Gerrity, February 21, 2005, FM SRC OFHEO 00713198-3218.

know."[57] This passive approach to gaining knowledge of critical accounting policies contravenes all applicable governance standards.

Low-Income Housing Tax Credits (LIHTC) Accounting. As detailed in Chapter VI, Fannie Mae realized a one-time earnings-per-share (EPS) benefit of $0.10 ($108.1 million)[58] as a result of a change in the method of accounting for the Enterprise's investments in low income housing tax credits (LIHTC) from a non-GAAP to a GAAP method. Without the LIHTC, Fannie Mae would not have met analysts' expectations or the EPS targets required for executives to receive the maximum AIP bonuses for 1998.

Considering that LIHTC represented a one-time benefit which resulted from a change made late in the fourth quarter that enabled Fannie Mae to pay out bonuses and meet Wall Street expectations, the Audit Committee members had an oversight-related duty to obtain additional information. Neither the Audit Committee nor the broader Board sought additional information regarding that accounting change, nor did they question the effect on reported EPS and thus AIP and long-term compensation payouts to executives. Considering that KPMG identified that issue as an area of disagreement in the Q4 1998 completion memo,[59] a reasonable inquiry to management and the external auditor would likely have yielded some clarity as to the components of the benefit. At a minimum, the Audit Committee would have received additional information regarding the magnitude of the EPS effect. As the change in LIHTC accounting materially affected reported EPS, the Audit Committee should have communicated the one-time nature of the change to the Compensation Committee to determine whether non-recurring or "poor quality" earnings should have had a negative impact on EPS bonus calculations. Mr. Mai, as a member of both the Audit Committee and Chair of the Compensation Committee, should have been particularly sensitive to the significance of EPS in terms of management compensation. By failing to make the appropriate inquiries regarding the nature of the change, the Audit Committee failed in its oversight role.

Allowance for Loan Loss Accounting. During the period covered by this report, Fannie Mae identified its treatment of the allowance for loan losses as a significant accounting policy.[60] The practice of over-reserving for the purpose of establishing an earnings "cookie jar" had been identified by Arthur Levitt and others as fertile ground for earnings management abuses. Therefore, the Audit Committee had a responsibility to gain sufficient knowledge of Fannie Mae's policy in order to evaluate the appropriateness of its application. Had the Committee members made the appropriate inquiries or conducted a review of the financial statements, they would have noticed that the level of the reserve stood essentially unchanged at approximately $800 million for the period 1997 through 2003.[61] In January 1999, CFO Howard presented the result of operations for 1998 to the Fannie Mae Board of Directors.[62] Mr. Howard told the

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[57] OFHEO Interview, Thomas Gerrity, March 14, 2006, p. 34.

[58] $108.1 million divided by 1,037 million shares outstanding resulted in an EPS impact of 10.5¢.

[59] *See* Fannie Mae Fourth Quarter Completion Memo, December 31, 1998, KPMG-OFHEO-063945.

[60] *See* Fannie Mae Annual Report 1998, p. 44.

[61] Mr. Gerrity stated that he did not even believe that loan loss reserves were considered "critical accounting policies" at Fannie Mae. OFHEO Interview, Thomas Gerrity, February 28, 2006, p. 75.

[62] *See* Notes for January 19, 1999, Board of Directors Meeting, FM SRC OFHEO 00310536-41 at FM SRC OFHEO 00310536-39.

Board that the swing from a credit loss position to net recoveries allowed the company to record a negative provision for losses of $50 million (another of the adjustments that allowed Fannie Mae to reach its maximum EPS target in 1998); however, outstanding allowance for future losses stayed the same. Mr. Howard even highlighted the size of the reserve to the investment community in a conference call related to 1998 earnings, stating that even though the amount seemed conservative, Fannie Mae intended to hold the level at $800 million dollars until the Enterprise got a better sense of where long-term trends settled out.[63] The Audit Committee failed to discharge its financial oversight responsibilities by not inquiring further regarding the amount of the reserve and not following up in subsequent years as the amount remained unchanged.

As detailed in Chapter VI, Fannie Mae methodology for recording adjustments to the reserve did not conform with GAAP. Controller Leanne Spencer explained to the Audit Committee at the February 20, 2001 meeting that the current methodology for recording charge-offs and recoveries was not the "preferable" accounting treatment. Additionally, she indicated that she would be investigating whether a change in accounting was appropriate.[64] The minutes of the Audit Committee do not reflect any inquiries regarding the appropriateness of the absolute level of the loss reserve despite a 27 percent decrease in the dollar value of credit losses in 2000 to the lowest level since 1984, when Fannie Mae's portfolio was one-tenth the current size. Neither does the record reflect any questions from members of the Committee regarding the possible accounting change. Ms. Spencer again addressed the issue in February 2002, informing the Audit Committee of an "alternative method" to reclassify recoveries.[65]

Fannie Mae did not elect to change its accounting treatment until 2003. Audit Committee meeting minutes do not reflect that the Committee sought more information regarding the necessity for a change or followed up to establish why the change was not implemented for fiscal year 2001. The Audit Committee appears not to have asked either management or the external auditor about the magnitude of the reserve.

"Yellow" Audit Reports. The Office of Auditing color-coded their audits according to importance, with "red" identifying audits with significant issues that required immediate attention. "Yellow" identified audits where controls needed strengthening and corrective action would be taken during the normal course of business, generally 18 to 24 months, according to Mr. Rajappa.[66] "Green" identified audits that were fairly clean, with issues that could be resolved quickly.[67] "Red" audits were reported to the Office of the Chairman and to the Audit Committee,[68] placed on the Audit Tracking List (ATL), and reviewed. That methodology was utilized in order to prioritize follow-up work and assist in the development of the audit plan.[69]

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63 *See* Notes for January 14, 1999, Conference Call, p.4, FM SRC OFHEO 034016 - 19.

64 There is significant similarity between Ms. Spencer's scheduled presentation, including a modified handwritten script, and the Audit Committee Minutes of February 20, 2001, concerning credit losses, charge-offs, and recoveries. See minutes at FMSE 014869-76 and Ms. Spencer's notes within The Year in Review Presentation, FMSE 367220-36, at FMSE 367227-28.

65 *See* Audit Committee Minutes, February 19, 2002, p. 3 FMSE 015292.

66 OFHEO Interview, Sampath Rajappa, June 17, 2004, p. 15.

67 *Id*.

68 OFHEO Interview, Thomas Gerrity, February 28, 2006, pp. 27-28.

69 *See* Fannie Mae Office of Auditing Audit Manual at FNM 00100541 at p.C-3.2-3.3.

According to Mr. Rajappa, "yellow" audits would go only to the Chairman of Fannie Mae and the Office of the Chairman but not to the Audit Committee.[70]

Several of the "yellow" issues were significant in and of themselves. In fact, with respect to the Amortization Audit dated July 9, 2003, Ann Eilers, Director for Accounting and Audit, indicated that the audit rating was "yellow" simply because management assured the Office of Auditing that they were working on the problem.[71] As a result, management was able to circumvent Audit Committee review.

In order to provide effective oversight of the control environment, the Audit Committee must have a reasonable understanding of the depth and breadth of internal control deficiencies. Simply reviewing the most egregious control failures did not provide the Audit Committee with that knowledge. For example, key-person dependencies and poor documentation might not raise a red flag in an isolated incident; however, a pattern of undocumented decisions (which existed) highlights a more significant breach of internal controls. The Audit Committee should have had a mechanism in place to understand the scope of internal control problems and management's efforts to address those problems. The significant lack of oversight by the Audit Committee enabled the Office of Auditing to conduct audits and issue findings with less than appropriate scrutiny.

<u>Failure to Oversee the Development and Implementation of Critical Accounting Policies.</u> Previous chapters have established that accounting policies and estimates that Fannie Mae designated as critical failed to comply with GAAP. In particular, those related to the amortization of purchase premiums and discounts (FAS 91) and accounting for derivatives and hedging activities (FAS 133). The Audit Committee failed in its responsibility to understand and ensure that appropriate application of critical accounting policies was occurring, as outlined by the Audit Committee charter as well as in standards previously discussed, despite the requirements that audit committees be informed, vigilant, and effective overseers of the financial reporting process and the company's internal controls.

FAS 91. The Fannie Mae Audit Committee did not actively monitor the critical policy of accounting for the amortization of discounts and premiums. The Audit Committee failed to address the implications of the 1998 FAS 91 audit adjustments, and systems control issues that were brought to the attention of Audit Committee Chair Gerrity in early 1999. Audit adjustments are proposed corrections identified through the external audit process. Prior to the issuance of Statement on Auditing Standards (SAS) 89 effective December 1999, there was no requirement that an external auditor inform the Audit Committee of those adjustments deemed immaterial. Following SAS 89, the external auditor was required to notify the Audit Committee of all audit differences, whether or not material.[72] As detailed in Chapter VI, KPMG identified

[70] OFHEO Interview, Sampath Rajappa, February 23, 2006, pp. 81-82; Mr. Gerrity confirmed that the Audit Committee did not review the yellow audits. OFHEO Interview, Thomas Gerrity, February 28, 2006, p. 33.

[71] OFHEO Interview, Ann Eilers, July 23, 2004, p. 242. Since the Audit Committee only received reports on 'red' audits, changing the color to "yellow" by promising timely resolution was an easy means to avoid Audit Committee scrutiny.

[72] Under SAS 89, the external auditor is ". . .required to inform the audit committee about uncorrected misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented

an audit difference of $200 million related to FAS 91, the amortization of premiums and discounts, in 1998. As part of the year-end audit work, KPMG met with Audit Committee Chairman Gerrity in early 1999 and advised him of that audit difference and how it arose and that the FAS 91 systems needed improvements.[73] For several reasons, Mr. Gerrity should have considered the audit difference material. First and foremost, the size of the difference should have been a red flag. Mr. Gerrity has stated that he now would consider a $200 million audit difference to be material.[74] The reduction in amortization expense also had an important effect on executive compensation. It boosted EPS by over 12¢ per share, and without that boost EPS would not have met the minimum needed for an AIP bonus for 1998.[75] That effect on executive compensation alone should have been sufficient to deem the difference material, irrespective of Fannie Mae's quantitative parameters for determining materiality.

Even after the FAS 91 audit differences were disclosed to the Audit Committee by Ms. Spencer in February 2000, the record fails to show that either Mr. Gerrity or the full Audit Committee followed up to confirm that a policy had been implemented or that Mr. Gerrity or the Committee questioned KPMG again. Given KPMG's position that Fannie Mae's practices were imprecise, reasonable inquiry by the Audit Committee would have exposed the lack of a formal policy. In fact, the record fails to show that the Audit Committee members made an effort to familiarize themselves with that critical accounting policy before Ms. Spencer made a presentation to the Audit Committee in November 2003.

The Audit Committee failed in its oversight role by not demanding that a formal policy for FAS 91 be put in place and that such a policy, when put into place, be endorsed by the Financial Standards group of the Enterprise and the external auditor. In doing so, the Committee failed to insure the integrity of financial results. The Audit Committee also failed to adequately oversee the development of the annual audit plan. Armed with the knowledge of KPMG's audit differences in 1998 and 1999 related to amortization of purchase premiums and discounts, the Audit Committee had a responsibility to ensure that the Office of Auditing conducted an internal audit of that area. Such an audit was not conducted until 2003.

FAS 133. The Audit Committee had opportunities to question management's implementation of FAS 133 but failed in its duty to do so.

In an Audit Committee update on the FAS 133 effort in April 2000, the minutes of the meeting reflect comments of KPMG partner Julie Theobold that KPMG intended to perform a significant amount of testing of financial reporting and planning during the year 2000. She stated that KPMG's test work would emphasize the system and accounting changes required to account for hedges under the new standard.[76] In his February 2001 report to the Board of

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that were determined by management to be immaterial, both individually and in the aggregate, to the financial statements taken as a whole. . ." Also See AICPA Practice Alert 94-1: Dealing With Audit Differences, February 1994.

73 OFHEO Interview, Julie Theobald, February 16, 2005, pp. 47-48.

74 Paul Weiss Memorandum of Interview with Thomas Gerrity, March 14, 2006, p. 29.

75 Mr. Gerrity was unaware that there was a "cliff" built into the AIP targets and, as a result, had no understanding of the significance of the audit difference. OFHEO Interview, Thomas Gerrity, March 14, 2006, p. 63.

76 Audit Committee Minutes, April 18, 2000, p. 5, FMSE 014459-65.

Directors, CFO Howard criticized the standard and focused on the effect the standard would have on Fannie Mae's financial statements.[77] Minutes of those meetings, however, do not reflect any discussion of the principles used to implement FAS 133 at Fannie Mae, the critical decisions that the Enterprise made regarding systems development or accounting, or the results of any KPMG testing that had preceded implementation. The Audit Committee should have inquired about that information in order to gain sufficient understanding to judge whether appropriate accounting decisions had been made and effective systems were in place.

Furthermore, management represented to the Financial Accounting Standards Board (FASB) and the financial community in 1999 that a delay in implementing FAS 133 was imperative because of the extensive accounting changes the Enterprise was facing when, in fact, one of the three major principles of the Enterprise's implementation of FAS 133 was to leverage off existing accounting systems. In Mr. Howard's letter to FASB Chairman Edmund Jenkins, Mr. Howard emphasized the need for more time to develop new accounting systems to address the complex changes that FAS 133 would require. He stated that those changes were further complicated because of requirements resulting from year 2000 system changes.[78] Mr. Boyles, then Director for Financial Standards, headed a letter-writing campaign with other companies and organizations to convince FASB of the need to delay implementation of FAS 133.[79] In addition, the Enterprise represented in its financial statements that the delay granted by FASB would give the Enterprise "adequate time to build the accounting and management systems needed to implement the new standard."[80] The inconsistency between the aggressive lobbying efforts to delay the standard and the ability of Fannie Mae to qualify virtually all of its derivatives for hedge accounting under the "short cut" method, as described in OFHEO's *Report of Findings to Date*, should have prompted the Audit Committee to explore more closely Fannie Mae's implementation of the standard.

Failure to Investigate Allegations Made by Roger Barnes**.** Section 301 of the Sarbanes-Oxley Act of 2002 (SOX) requires audit committees of companies that register their stock with the Securities and Exchange Commission (SEC) to establish procedures for the receipt, retention, and treatment of complaints regarding accounting, internal accounting controls, or auditing matters; and the confidential, anonymous submission by employees of concerns regarding questionable accounting or auditing matters. Further, SOX requires that each audit committee shall have the authority to engage independent counsel and other advisers, as it determines necessary to carry out its duties.[81]

As described in Chapter VIII, in October 2003 Roger Barnes, a manager in the Office of the Controller, approached Fannie Mae through his lawyer to pursue a settlement of claims of discrimination resulting from allegations he had previously raised regarding Fannie Mae's amortization policies and earnings management. Fannie Mae entered into a settlement agreement with Mr. Barnes on November 3, 2003. Given its responsibilities for regulatory

77 Board Meeting Minutes, February 20, 2001, pp. 9-10 FMSE 004788-800.
78 Letter from Timothy Howard to Edmund Jenkins, April 12, 1999, p. 2 FMSE-SP 074288-90.
79 See 1999 self-assessment by Jonathan Boyles, p. 2, FMSE 698829-33.
80 Quarterly report Q&A excerpt FMSE 417002.
81 The Sarbanes-Oxley Act, 107 Pub. L. No. 204, 116 Stat. 745, July 30, 2002.

compliance and investigation of complaints related to accounting, internal controls, and auditing matters, the Audit Committee was required to ensure a timely, thorough, and independent investigation into Mr. Barnes' allegations. The allegations, and the subsequent settlement agreement, should have raised the concern of every member of the Audit Committee, especially when considered against the background of the recently released Baker Botts report on Freddie Mac's internal investigation and the initiation of the OFHEO special examination.

The Audit Committee failed to make further inquiries or convene a special investigation after being informed at the November 17, 2003 Audit Committee meeting that Fannie Mae had reached a settlement with Mr. Barnes.[82] The news of the settlement was received by the Audit Committee just three days after the Committee had been convened in order to discuss certification of the third quarter financial statements. Fannie Mae settled the case without bringing the matter to the Audit Committee and elected to postpone discussion of the matter until after the financial statements had been certified. Given that OFHEO had just announced a special examination of Fannie Mae's accounting practices, the Audit Committee was on notice that such allegations warranted further investigation. At a minimum, the Audit Committee had an obligation to ensure that the matter be disclosed to OFHEO. Instead, the matter was ignored until February 2004, when it was reviewed as part of the special examination.

<u>Failure to Question the Assignment of Both Chief Financial Officer and Risk Policy Functions to Mr. Howard</u>. In 2000, Mr. Howard became a member of the Office of the Chairman. At that time, he also assumed responsibility for all credit and interest rate risk policy functions, becoming the equivalent of a chief risk officer for Fannie Mae. That consolidation gave Mr. Howard direct responsibility "of all people who either set risk policy or did risk analytics"[83] in addition to his core role of overseeing financial and accounting policy as CFO.

As discussed in Chapter VIII, the risk assessment function should be independent from the accounting and reporting functions to assure the fullest exchange of views. Consolidation removes an important control. It creates an environment in which mistakes and inappropriate manipulation may go unchecked as financial reporting results can easily be affected or manipulated by the views of the individual with accounting oversight. The assignment of responsibility for risk policy issues to Mr. Howard should not have been permitted by the Audit Committee or the Board. Fannie Mae's own research found no other peer company having a CFO also serving as CRO.[84]

With the reassignment of Adolfo Marzol, the Chief Credit Officer, in 2004, power was further consolidated as Mr. Howard assumed Mr. Marzol's duties as well. With that move, another source of internal control was removed. Upon the announcement of Mr. Howard increased duties, Board member Ashley voiced his displeasure with management, yet no steps were taken to remedy the situation.[85] The record shows no indication of Audit Committee

[82] The November 17, 2003, meeting is also the meeting that contained a presentation by Ms. Spencer regarding the critical accounting policy for FAS 91. See Audit Committee Meeting Minutes at FMSE 504796-805.

[83] OFHEO Interview, Timothy Howard, August 5, 2004, p. 7.

[84] E-mails between Jill Blickstein and Rebecca Senhauser, August 12, 2004, FM SRC OFHEO 00713573-74.

[85] E-mail from Daniel Mudd to Franklin Raines with copies to Timothy Howard, Thomas Donilon and Jill Blickstein, August 10, 2004, FMSE-E KD0048713.

involvement or inquiry. Oversight of the risk management function should have been performed by the Audit Committee by way of the Office of Auditing, according to Fannie Mae's internal audit charter. The record does not show that the Audit Committee reviewed and approved or had any of the required involvement in the consolidation of powers and responsibilities in Mr. Howard. Consequently, the Audit Committee failed in its oversight responsibilities and allowed an inappropriate consolidation of risk and financial accounting and reporting to occur.

Failure to Adequately Oversee Sarbanes-Oxley Section 404 Compliance Implementation. Chapter VII describes the decision of Fannie Mae management to assign responsibility for Sarbanes-Oxley (SOX) 404 compliance to the Office of Auditing and the inadequacy of the resources of that office relative to the task. Ultimately, the Office was diverted from performing its core functions and was unable to perform its new functions.[86]

The Audit Committee is responsible for the budget and staffing of the Office of Auditing, the establishment of the annual audit plan, and evaluation of any restrictions or limitations placed on that office.[87] Thus, the members should have been aware of the heavy workload placed upon the Office of Auditing and the inadequacy of its resources. In April 2004, the Audit Committee was presented with an opportunity to address the staffing limitations that resulted from SOX activities. In contrast to previous years, the Audit Plan for 2004 only scheduled 54 internal audits, compared with an average of 120 audits performed in past years[88] That reduction should have been a clear indication to the Committee that resources in the Office were stressed. While the Audit Committee inquired as to what more could be accomplished were the Office of Auditing to receive additional resources, the Committee fell short by approving an abbreviated Audit Plan and authorizing only temporary contract employees to assist in technical writing and flowcharting.[89]

Even assuming that the Audit Committee possessed a positive view of the Office of Auditing, the importance of ensuring Fannie Mae's SOX compliance required that it obtain sufficient information as to how those SOX responsibilities at Fannie Mae would be carried out. There is no indication of any discussion, let alone debate, in any of the Board Minutes or Audit Committee minutes that OFHEO reviewed. Rather, it appears that Fannie's Mae's management assigned those new responsibilities to the Office of Auditing without any meaningful Audit Committee participation.

Oversight of the Independent Auditor. As described in Chapter VII, KPMG improperly provided unqualified opinions on financial statements that contained significant departures from GAAP. The Audit Committee failed to oversee the independent audit function of the Enterprise as required by OFHEO guidance and regulation. In addition, the Audit Committee missed critical opportunities for meaningful inquiry into KPMG's audit activities associated with Fannie Mae's

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[86] Memorandum from Kathryn Rock to Robert Levin, "Management's 2004 Assessment of Internal Control over Financial Reporting," August 12, 2005, FMSE 519599-616, at 606, where PricewaterhouseCoopers (PWC) identified hundreds of potential control problems that the Office of Auditing had not identified in 2004.

[87] 2003 Fannie Mae Audit Committee Charter. FMSE 504223 – 228.

[88] *See* Head Count Request for 3 FTE in 2003, FMSE-IR 284780-781, and Office of Auditing and KPMG Joint Audit Plan 2004.

[89] *See* Audit Committee Meeting Minutes, April 19, 2004, pp. 2-3, FMSE-SP 082060 - 68.

implementation of critical accounting estimates and significant accounting policies that may have revealed deficiencies in the independent audit program. Instead, as confirmed by Mr. Gerrity, the Audit Committee passively waited for KPMG to raise issues to the Audit Committee.[90]

The Audit Committee also failed to inquire about the work KPMG performed, or failed to perform, to determine that Roger Barnes' allegations regarding Fannie Mae's amortization accounting were without merit. Had the Audit Committee questioned KPMG, they would have learned that KPMG had not performed sufficient review or test work to make a determination about the merits of Barnes accounting allegations and that KPMG audit partners had misrepresented their position to Fannie Mae staff, to Mr. Barnes, and to the Audit Committee.

As shown in Table IX-1, the fees that Fannie Mae paid its independent auditor for audit related work accounted for a small fraction of the total fees KPMG received annually from the Enterprise.

Table IX-1: Fees paid to KPMG by Fannie Mae, 2000-2003[91]

Year	Audit Fees	Other Fees	Total Fees	Audit as Percent of Total
1998[92]	$ 760,000	$8,000,000	$ 8,760,000	9
1999[93]	$ 810,000	$6,879,000	$ 7,689,000	11
2000	$1,199,000	$6,610,000	$7,809,000	15
2001	$1,402,200	$6,774,036	$8,176,236	17
2002	$1,978,955	$7,511,478	$9,490,433	21
2003	$2,721,300	$8,254,807	$10,976,107	25

The increase in audit fees from 9 percent of total fees in 1998 to 25 percent of total fees in 2003 reflects, at least in part, the sharp increase in the number and complexity of accounting policies and practices that the Enterprise had to adopt during that time-frame and dramatic growth in the Enterprise's portfolio business.[94] Furthermore, lower fees before 2002 reflect the fact that

90 OFHEO Interview, Thomas Gerrity, March 14, 2006, p. 34.

91 Fannie Mae *Notice of Annual Meeting of Shareholders*, 1998; Fannie Mae *Notice of Annual Meeting of Shareholders*, March 29, 1999; Fannie Mae *Notice of Annual Meeting of Shareholders*, March 27, 2000; Fannie Mae *Notice of Annual Meeting of Shareholders*, April 2, 2001; Fannie Mae *Notice of Annual Meeting of Shareholders*, April 2, 2002; Fannie Mae *Notice of Annual Meeting of Shareholders*, April 14, 2003; Fannie Mae *Notice of Annual Meeting of Shareholders*, April 14, 2003; Fannie Mae *Notice of Annual Meeting of Shareholders*, April 23, 2004. Other Fees include fees related to REMIC pricing, closing and validation services, due diligence on multifamily loans, assistance on regulatory matters, and tax services.

92 KPMG Peat Marwick Trend Analysis Economic Indicators and Audit Fees, KPMG-OFHEO-175801; Fannie Mae presentation, "Discussion of the 1998 Audit," February 16, 1999, p. 7, FMSE 014347-014356 at 353.

93 Letter from KPMG to the Audit Committee, February 9, 2000, FMSE 014701.

94 Between 1998 and 2004, the Enterprise implemented, among others, the following accounting statements, guidelines, and pronouncements: FAS 133 Accounting for Derivative Instruments and Hedging Activities; FAS 140 Accounting for Transfers and Services of Financial assets and Extinguishment of Liabilities-a Replacement of FASB Statement 125; FAS 148 Accounting for Stock-Based Compensation Transition and Disclosure – An Amendment to FASB Statement 123; FAS 149 Amendment of Statement 133; FAS 150 Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity; Emerging Issues Task Force Issue 99-20

Fannie Mae was not an SEC registrant. 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.

One of the primary functions of the Audit Committee is to oversee the engagement of the outside auditors. Over the period covered by this report, that role required the Audit Committee to become increasingly engaged with the outside auditor so it could make knowledgeable, thoughtful, and probing inquiries. Such inquiries are necessary for the Audit Committee to understand the scope and quality of the independent audit work for which they have contracted and to assure the Board that the Enterprise's financial statements present fairly its financial condition and are prepared in accordance with GAAP. The Committee's failure to adequately perform this role contributed to the unsafe and unsound practices of the Enterprise.

<u>Compensation Committee</u>

The duties and responsibilities of the Compensation Committee of the Board of Directors of Fannie Mae (Compensation Committee) are set forth in the Compensation Committee Charter, and OFHEO regulations and guidance,[95] which incorporate the listing standards of the New York Stock Exchange (NYSE) and applicable safety and soundness standards.[96] The primary role of the Compensation Committee is to "discharge the responsibilities of the Board relating to compensation of Fannie Mae executives,"[97] which is achieved principally by overseeing and advising the Board on the adoption of policies governing Fannie Mae's annual compensation and stock ownership plans. The Committee is also responsible for producing the annual report on executive compensation that is included in the Enterprise's annual proxy statement. In accordance with both the Safety and Soundness Act and the Charter Act, Fannie Mae is only authorized to pay compensation that is reasonable and comparable with compensation for employment in similar businesses involving similar duties.[98] Section 309(d)(2) of the Charter Act also requires that a "significant portion of the compensation of all executive officers. . . shall

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Recognition of Interest Income and Impairment on Purchas and Retained Beneficial Interest in Securitized Financial Assets; Statement of Position 01-0 Accounting for certain Entities (including Entities with Trade Receivables) That Lend To or Finance the Activities of Others; FIN 45 Guarantor Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others – An Interpretation of FASB Statements N5, 57, and 107 and Rescission of FASB Interpretation No. 34; and Consolidation of Variable Interest Entities – An Interpretation of ARB No. 51.

[95] 12 CFR §§ 1710.12(c)(2), 1720 and Appendix A to Part 1720 – Policy Guidance-Minimum Safety and Soundness Requirements.

[96] *See also* Schwartz, B. and Goodman, A. L., "Corporate Governance: Law and Practice, Chapter 10: The Compensation Committee," § 10.01 (2005) (Corporate Governance Law & Practice). The 1992 adoption of federal securities regulations requiring proxy statement disclosures about executive compensation and the enactment in 1993 of section 162(m) of the Internal Revenue Code, which eliminated the corporate income tax deduction for compensation over $1million paid to the CEO and other four most highly compensated executive officers (the so-called "Named Executive Officers"), also have substantively affected the responsibilities of compensation committees.

[97] Compensation Committee Charter, set forth by resolution in the Meeting Minutes of the Nominating and Corporate Governance Committee, dated January 20, 2003. See FMSE 505379, 505390-392.

[98] *See* 12 U.S.C. § 4518 and 12 U.S.C. § 1723a(d)(2), respectively.

be based on the performance of the corporation."[99] As the Board members charged with oversight of compensation, the Compensation Committee members have particular responsibility to review the Enterprise's compliance with those statutory provisions.

OFHEO regulations require that the Compensation Committee shall be in compliance with the charter, independence, composition, expertise, duties, responsibilities, and other requirements under the NYSE rules.[100] The corporate governance NYSE listing standards were revised in 2003 to impose new requirements on the composition and proceedings of compensation committees.[101] The NYSE rule provides specific structural and procedural requirements for board compensation committees of listed companies.[102] There are two basic requirements: (1) a compensation committee must consist of independent directors, and (2) the board must adopt a written compensation committee charter.[103] Under the NYSE rule, the charter must include provisions that address the compensation committee's purpose and responsibilities and that provide for an annual performance evaluation of the committee. The committee's purposes and responsibilities, at a minimum, must include direct responsibility to:

> (A) review and approve corporate goals and objectives relevant to CEO compensation, evaluate the CEO's performance in light of those goals and objectives, and, either as a committee or together with the other independent directors (as directed by the board), determine and approve the CEO's compensation level based on this evaluation;
>
> (B) make recommendations to the board with respect to non-CEO compensation, incentive-compensation plans and equity-based plans;[104] and
>
> (C) produce a compensation committee report on executive compensation as required by the SEC to be included in the company's annual proxy statement or annual report on Form 10-K filed with the SEC. [105]

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[99] 12 U.S.C. § 1723a(d)(2). As discussed in prior chapters, for its performance metric, Fannie Mae elected to use an internally derived accounting target, EPS, which is highly subject to manipulation by executive management.

[100] 12 CFR § 1710.12(c)(2). As stated previously in this chapter, as a listed company, Fannie Mae is subject to the NYSE listing standards.

[101] *See* Corporate Governance Law & Practice, at §10.02. At the same time, new best practice guidelines were published by a number of influential organizations.

[102] *Id*. at §10.02.

[103] *Id*. at §10.04.

[104] *Id.* The NYSE rule mandates the compensation committee take direct responsibility ("either as a committee or directly with other independent directors") only for CEO compensation; there is no law, regulation or listing rule requiring a listed company's compensation committee be directly responsible for the compensation of anyone other than the CEO. But because compensation plans are designed around the application of IRC §162(m) to the Named Executive Officers, and because plans designed to comply with that provision's exception for performance-based compensation are normally administered by the compensation committee, it is the practice in many companies to have the compensation committee review and approve the overall compensation (i.e., base salary and performance-based incentive plan awards) for all Named Executive Officers.

[105] *Id.*

Additionally, as in the case of the other independent board committees, and the board as a whole, the charter for the compensation committee of a NYSE-listed company must provide for an annual performance evaluation. The NYSE listing requirements do not prescribe any particular format or procedure for the performance evaluation.[106]

Finally, the NYSE also suggested that the compensation committee have the sole authority to hire, set the compensation and other terms of engagement of, and fire any compensation consultant who assists in the evaluation of director, CEO, or senior executive compensation. While the direct retention and control of compensation consultants is not a legal requirement or even a mandatory listing standard, it has become the recognized best practice.[107]

The Compensation Committee charters reveal a significant bias in the committee's approach to its oversight role in several important respects. First, as described in the Fannie Mae Compensation Committee Charters of 1998, 2003 and 2005, the general role and purpose of the Compensation Committee was to "support" the Enterprise's "core compensation philosophy" of "pay for performance and comparability."[108] Throughout the 1998 to 2005 period, the justification for that core philosophy was to position the Enterprise to compete for available talent in the financial services industry. But while outwardly plausible, that argument belied its true purpose. As demonstrated in the 2003 charter, the pay for performance rationale in fact conditioned the Committee's authority to review and approve the CEO's compensation and its oversight of the Enterprise's compensation programs.[109]

Second, the charter mandates that "the corporation's use of stock-based compensation shall align the interests of employees and directors to those of Fannie Mae stockholders." As discussed in Chapter V, that mandate ultimately went unfulfilled. Third, the charter contemplates the Committee is to keep the Board informed and use independent sources and consultants, providing the Committee with authority to retain outside counsel, experts or other advisors it determined appropriate to assist it in performing its functions. Again, as discussed in Chapter V, the Committee ultimately lacked the independent counsel it required. Finally, the charter did not provide the Compensation Committee with sole authority to retain, supervise, pay, or fire any compensation expert who was to assist Fannie Mae in the evaluation of executive compensation. Had such authority been conferred and implemented, an independent expert could have provided a counterweight to management's control of the information the Committee received.

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[106] *Id*. In its commentary to the 2003 corporate governance rules, the NYSE suggested that the compensation committee charter also address committee member qualifications; committee member appointment and removal; committee structure and operations (including authority to delegate to subcommittees); and committee reporting to the board. The Compensation Committee charter does not specifically address these issues, other than to state the committee shall make regular reports to the Board on its activities.

[107] *Id*.

[108] *See*, Compensation Committee Charter 1998, 2003 and 2005, FMSE-EC 040020-040021, FMSE-EC 019639 and http://www.fanniemae.com/governance/committees/compensation/charter.jhtml?p=Corporate+Governance&s=Board+Committees&t=Compensation&q=Charter, respectively.

[109] *Id*.

In sum, the charter aligned the Compensation Committee with management's interests in the development of compensation policies and plans. In supervising the compensation programs, the Compensation Committee failed in three main ways:

- Having approved an EPS-based executive compensation program that provided strong incentives for earnings management, the Compensation Committee failed to monitor it or ensure that the proper checks and balances were in place to prevent manipulation of earning targets or results;

- Together with the Audit Committee, the Compensation Committee permitted executive management to compensate senior internal auditors under the same EPS-biased plans that created the perverse incentives to manipulate earnings and undermined their independence; and

- The Committee allowed management to script its meetings and rubber-stamped executive compensation proposals made by senior management.

Failure to Monitor the Compensation System

As established in Chapter V, the lion's share of the compensation of Fannie Mae's senior management was based on EPS performance. The focus on a single measure creates an incentive to manipulate earnings, particularly for the highest level of senior management, which stands to benefit the most. Once the singular focus on EPS was established, it was incumbent upon the Board of Directors and the Compensation Committee, in particular, to monitor and scrutinize the EPS results. Such actions would have led the Compensation Committee to question the extraordinary success of senior management in consistently and precisely meeting EPS targets associated with maximum AIP bonus payouts. That realization should have led to an Audit Committee inquiry as to how that extraordinary success was achieved. Compensation Committee minutes make no mention of any concern about the connection between the potential manipulation of EPS and executive compensation until 2004. The Compensation Committee's failure to monitor for abuse of the executive compensation system by Fannie Mae management is another example of failed corporate governance.

By the time Compensation Committee Chair Anne Mulcahy raised questions about the pattern of reported earnings relative to targets, it was too late to be a meaningful check on earnings management. A document entitled "Mulcahy Meeting Notes" dated January 13, 2004 provided from the files of Lorrie Rudin suggests some concern within the Compensation Committee about the well-established trend of "maxing out" on AIP bonus awards every year. Remarks attributed to Ms. Mulcahy were as follows:

> Ann- 'doesn't look good that maxing out every year.' Be ready to discuss maxing out issue. Want assurances that goals are stretch and that don't max out next year.[110]

[110] Lorrie Rudin, Director for Executive Compensation and Benefits, was the custodian of this document. FMSE-EC 015740 – 015745 at EC 015740.

Ms. Mulcahy's concern regarding "maxing out every year" in Annual Incentive Plan (AIP) bonuses was not timely. As documented in Chapter V, for the first time in many years, it was highly unlikely that Fannie Mae would come close to "maxing out" on AIP payouts. Senior management in 2004 was stretching to meet *minimum* payout targets.

Further, as discussed in Chapters V and VI, senior management, with full knowledge of the Board, used both stock buybacks and debt buybacks to achieve pre-set earnings-per-share targets. The Compensation Committee should have questioned closely the rationales for these well-publicized transactions due to their significant impact on annual EPS and the ease with which they could be undertaken by company management.

Insensitivity to Office of Auditing Compensation

As discussed earlier in this chapter, the Compensation Committee should have prevented the inappropriate compensation of Office of Auditing staff. Year after year, the Committee approved an EPS-based compensation structure for internal auditors without questioning its propriety or referring the question to the Audit Committee, which was responsible for supervising the Office of Auditing. Despite the sophistication of the Compensation Committee members and its chair, Mr. Mai, who was a former chairman of the Audit Committee, the Compensation Committee failed in its duty to align compensation with appropriate objectives for internal auditors.

The Committee's Passivity

From as early as 1998, as a memorandum from Fannie Mae General Counsel Stasia Kelly to Compensation Committee Chair Mai indicates, Fannie Mae senior management often scripted meetings of the Compensation Committee,[111] which influenced how meetings were conducted.[112] While the Compensation Committee report included in the annual proxy statement was signed by the independent, non-management Board Members who served on the Committee, in 2003 Mr. Raines, who was by far the largest beneficiary of Compensation Committee actions, edited the draft of that Committee's report to shareholders.[113] Nowhere in the minutes of

[111] *See* memorandum from Stasia Kelly to Vincent Mai, "The 'Script' for the July 17, 1998 Compensation Committee Meeting," July 15, 1998, FMSE EC 055725 – 055732. *See also* memorandum from Stasia Kelly and Thomas Nides to Vincent Mai, "'Script' for the Compensation Committee Meeting of November 16," November 12, 1998, FMSE EC 055749 – 055759; memorandum from Thomas Donilon and Tom Nides to Vincent Mai, "'Script' for Compensation Committee Meeting of January 18," January 14, 2000, FMSE-E EC0071086-0071095; memorandum from Thomas Nides to Vincent Mai, "The 'Script' for the May 18, 2000 Compensation Committee Meeting," May 16, 2000, FMSE-E EC0071134-0071135.

[112] A request by Joe Pickett to chair the January 2002 Committee Meeting resulted in a same day notice to senior Fannie Mae management. Thomas Donilon wrote in an e-mail to Franklin Raines, Timothy Howard and Daniel Mudd: "Joe Pickett called to day to say he is willing to act as acting chair of the comp committee at the January meeting. He said that he has both the time and the interest. Dan, if this is the way we want to go we'll have to get a briefing scheduled for Joe." E-mail from Thomas Donilon to Franklin Raines, Timothy Howard and Daniel Mudd, "Misc.," December 12, 2002, FMSE E EC0090803.

[113] Mr. Raines was a member of the Board of Directors but not of the Compensation Committee. "With FDR Edits-(March 28, 2003) Compensation Committee Report on Executive Compensation." Attachment to an e-mail from Jill

Committee meetings is there any suggestion that the Committee seriously vetted management's recommendations.

In 2003 the Compensation Committee sought to hire an executive compensation consultant who was to be accountable to the Committee rather than to management. Nonetheless, Mr. Raines played a key role.[114] In an undated letter from that year to Compensation Committee Chair Mulcahy, Kathy Gallo, Senior Vice President for Human Resources, wrote that the Fannie Mae management consultant on executive compensation, Alan Johnson Associates, recommended two firms that could serve as an independent Compensation Committee advisor: Fred Cook and Company and Brian Foley and Company. Ms. Gallo and Christine Wolf, Vice President for Compensation and Benefits, interviewed candidates from both firms.[115] A subsequent September 2, 2003 letter to Ms. Mulcahy from Ms. Gallo, however, reflected the key role Mr. Raines played in Board decisions, even when it came to the actions of a Board committee on which he did not sit:

> After our last conversation about an independent consultant to serve as the Committee's expert, I updated Frank on your readiness to explore the Brian Foley (of Fred Cook) option. Frank was very much opposed to that idea because he has some significant concerns about both Fred's executive compensation philosophies and the way he sometimes advances his agenda on the topic. Frank's concerns stem from observing Fred in a (distant) past interaction with the Fannie Mae board and more recently in the Business Roundtable meetings. Given that, Frank would strongly prefer that we not introduce anyone from Cook's organization into a compensation advisory role for Fannie Mae. I regret not spotting this issue before I proposed Brian to you.[116]

Cook Consultants had helped design Fannie Mae's first formal compensation philosophy in 1991.[117] Gallo recommended two additional candidates for consideration, one of whom (Semler Brossy) had been the runner-up to Alan Johnson Associates in the selection of management's compensation consultant.[118] Shortly after receiving the recommendation from

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Blickstein to Kathy Gallo, March 28, 2003, included in an e-mail chain from Iris Aberbach to Thomas Donilon, "[Fwd. Re: [Fwd. Compensation Committee Report on Executive," April 4, 2003. FMSE-E EC0013686-0013691.

114 Johnson Associates was viewed as the management consultant for executive compensation purposes. FMSE-E EC0013760.

115 Letter from Anne Mulcahy to Kathy Gallo, FMSE EC 010102 – 101003.

116 Letter from Kathy Gallo to Anne Mulcahy, September 2, 2003. FMSE-EC 010106 – EC010108 at FMSE EC 010106. In her letter, Ms. Gallo incorrectly identifies Brian Foley of Foley and Company as an employee of Fred Cook and Company. In a previous undated letter to Ms. Mulcahy, Ms. Gallo indicated that she and Christine Wolf, Vice President for Compensation Benefits, had interviewed Jeffrey Kanter of Fred Cook and Company and Brian Foley of Brian Foley and Company and recommended that the Compensation Committee meet with Mr. Kanter, of Fred Cook and Company, but not Mr. Foley. FM SRC OFHEO 01027533-534.

117 "Briefing for Compensation Committee: The Role of the Compensation Committee in the OFHEO/Fannie Mae Agreement," October 19, 2004, p. 4, FMSE-KD 060250.

118 "When Tim Howard and I searched for our new comp expert, Roger was a close second to our choice of Alan Johnson." Letter from Kathy Gallo to Anne Mulcahy, September 2, 2003, FMSE-EC 010106 – EC010108 at FMSE EC 010106.

Ms. Gallo, the Compensation Committee chose Semler Brossy as its independent consultant.[119] Management thus appears to have orchestrated the selection process to ensure that a consultant CEO Raines opposed did not receive the contract.

Failures of the Full Board of Directors

In addition to the failures of the Audit and Compensation Committees, Fannie Mae's full Board of Directors failed in numerous ways that put the safety and soundness of the Enterprise at risk. The Board of Directors failed to stay informed about Fannie Mae corporate strategy, major plans of action, and risk policy. Having approved an executive compensation program that created incentives to manipulate earnings, members of the Board of Directors failed to monitor against such manipulations. The Board failed to provide delegations of authority to management that reflected the current size and complexity of the Enterprise. The Board failed to ensure the effective operation of its own Audit and Compensation Committees. The Board of Directors failed to act as a check on the authority of Chairman and CEO Franklin Raines. The Board failed to initiate an independent inquiry into Fannie Mae's accounting following the announcement of Freddie Mac's restatement and subsequent investigation or allegations of Roger Barnes, both of which involved earnings management. The Board failed to assure itself that Fannie Mae's regulators were properly informed of Mr. Barnes' allegations. Finally, the Board of Directors failed to ensure timely and accurate reports to Federal regulators.

<u>Failure to Stay Informed of the Corporate Strategy</u>

To carry out the oversight duties and responsibilities of the Board of Directors, OFHEO requires that members of the Board ensure they receive accurate, timely, and sufficient information about the operations and financial condition of Fannie Mae. The Board is also responsible for working with executive management to establish the Enterprise's strategies and goals in an informed manner.

The Board members should have been alerted to the accounting problems at Fannie Mae by the problems at Freddie Mac. By virtue of their status as government-sponsored enterprises, Fannie Mae and Freddie Mac enjoyed a unique position in the market that gave both Enterprises an advantage over other financial institutions. Their charter advantages did not, however, insulate the Enterprises from the interest rate and credit risks inherent in their businesses. It is incumbent on the Board of Directors to understand those risks, the strategies that were available to manage them, and the choices that management made with respect to the trade-off between risks and returns, and the implications and effects of key accounting rules. Fannie Mae and Freddie Mac chose different approaches to managing interest rate risk. Freddie Mac hedged more of its risk than Fannie Mae, as reflected in the differences in the risk-based capital requirements of the two Enterprises. In every quarter that OFHEO has calculated risk-based capital requirements, Fannie Mae's requirement has consistently exceeded Freddie Mac's on both a dollar and percent-of-assets basis. Nonetheless, Fannie Mae consistently reported earnings that were less volatile than Freddie Mac's. In 2003, Freddie Mac admitted

[119] E-mail from Monica Medina to Thomas Donilon, "Re: Comp Call," September 23, 2003, FMSE E EC0013670.

manipulating its accounting to report artificially lower earnings volatility. Yet, the Board failed at the time to initiate an independent inquiry even as OFHEO began its own examination.

Over time, Mr. Howard communicated to the Board and to the investor community the consistent message that Fannie Mae was a low-risk, high-return, "best-in-class" company. The Enterprise consistently met or slightly exceeded analyst estimates for earnings per share. Fannie Mae also constantly reinforced the public image of a low-risk, high-return company that provided stable, predictable earnings growth. In its annual reports, Fannie Mae told investors that the company had "been able to deliver double-digit growth in operating EPS, year after year, through all types of economic and financial market environments. . . ."[120] The Enterprise asserted that this performance resulted from its disciplined approach to risk management.

While compelling, that message was not consistent with the real-world relationship between risk and return, and the realities of accounting. First, the most, and perhaps only, comparable firm to Fannie Mae is Freddie Mac. Fannie Mae was taking more interest rate risk than Freddie Mac, yet reporting less earnings volatility. To achieve higher returns, a company normally must take on more risk and expect to experience greater fluctuations in earnings—that is, higher earnings volatility. Taking on more risk does not imply a less disciplined approach to risk management. Discipline in risk management relates to the willingness of a company to define clearly the level of risk it wishes to accept, and the skill with which it subsequently monitors and measures that risk, and limits it within established bounds. Ignoring that reality, and failing to question Fannie Mae's dubious earnings trend, evidences a clear safety and soundness failure on the part of the Board.

As described in Chapter VI, accounting rules have also introduced new sources of earnings volatility that may or may not be related to actual business risk or financial performance. The most significant of those new rules, FAS 133, requires that a company mark certain of its derivatives to market, but not necessarily the assets whose value is hedged with those derivatives if the company intends to hold them for investment. To the extent Fannie Mae used derivatives to hedge the interest rate risk of its retained mortgage portfolio (much of which is classified as held-for-investment), the asymmetrical accounting produced by FAS 133 affected reported earnings in ways that did not accurately reflect its actual earnings or its financial risk. Members of the Board of Directors should have questioned the continued minimal reported earnings volatility after the implementation of FAS 133. Had they done so, they might have identified management's earnings manipulations. Not doing so constitutes a failure to discharge the Board's responsibility to oversee the safety and soundness of Fannie Mae.

Even after well publicized media coverage about earnings management concerns of the SEC, which the Board had heard as early as 1998, there is little evidence that the Board showed any concern over the consistent good news earnings reports of management, never questioning

[120] *2001 Fannie Mae Annual Report*, p. 7.

management as to how Fannie Mae was able to meet EPS targets with precision and with little earnings volatility.[121]

The Board accepted the representations of senior executives that Fannie Mae was the best at doing what it did and that extraordinary financial success was to be expected. The Board failed to question whether the pattern of reported earnings could be an indication of improper earnings management, failed to probe management, and failed in its responsibility to oversee the safe and sound operation of the Enterprise.

At the Board of Directors annual Strategic Review meetings held each July, Fannie Mae executives consistently reported meeting or exceeding planned earnings targets. For example, in 2000, the Board was told:

> Fannie Mae achieved EPS of $2.08 [year to date] June, our 50th quarter of double digit operating EPS growth. EPS is $.01 above plan at $2.08, expected to meet or exceed the target for the year of $4.27, keeping the company on a path to achieve the goal of doubling EPS between 1998 and 2003.[122]

In July 2002, Mr. Howard made a presentation to the Board entitled, "Corporate Risk Appetite."[123] The presentation included a slide of Fannie Mae's EPS growth and showed the reported earnings per share growth pattern against the trend from December 1990 through projections for December 2002. The chart indicates very little earnings volatility over the twelve-year period. For comparison, Mr. Howard also presented EPS growth charts for three other companies: Alcoa, Fifth Third Bank, and Citigroup. Unlike the Fannie Mae EPS growth, these three charts showed significant volatility in the EPS growth.

There are no indications from the minutes of those meetings that Board members questioned Fannie Mae's ability to meet EPS targets so consistently and often to the penny. Nor do the minutes indicate that Board members questioned Fannie Mae's ability to show smooth and rapid earnings when other financial companies subject to the same interest rate environment as Fannie Mae showed significant earnings volatility. When asked about that lack of inquiry, Audit Committee Chairman Thomas Gerrity stated that he believed "it had become a general presumption that the nature of [Fannie Mae's] business allowed for fairly steady earnings per share growth, at least on a core adjusted internal management perspective,"[124] and that if the comparable companies depicted in the presentation "were in the business that Fannie Mae was in, that they could probably achieve similar results."[125]

The oversight responsibilities vested in the Board of Directors should preclude such presumptions. As noted previously, the most comparable firm to Fannie Mae is Freddie Mac,

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[121] As described in Chapter VII, in October 1998 KPMG met with the Audit Committee Chairman, Vincent Mai, to discuss, among other things, a recent public speech made the Chairman of SEC and how the SEC had been focusing on earnings management issues.

[122] Mid-Year Corporate Performance Assessment, dated July 2000 and distributed to Board members by Thomas Donilon on July 13, 2000, in preparation for the July 2000 Board of Directors Strategic Review. FMSE 003813.

[123] Fannie Mae Board of Directors Strategic Review, New York, July 16, 2002. FMSE 017408-017426.

[124] OFHEO Interview, Thomas Gerrity, March 14, 2006, p. 93.

[125] OFHEO Interview, Thomas Gerrity, March 14, 2006, p. 99.

which is in exactly the same business. Fannie Mae management was claiming smoother earnings than Freddie Mac, despite Freddie Mac's more conservative approach to risk management.[126] Further, by January 2003 the Board knew or should have known that Freddie Mac's steady earnings stream was being questioned in a restatement because of issues related to earnings management. Thus, there was no excuse for any such presumption after that date.

At the July 2003 Strategic Board Retreat, Mr. Howard again presented slides that depicted Fannie Mae's low earnings volatility and remarkable EPS growth. In addition, the presentation included a discussion of Fannie Mae's "earnings variability objective," the strategic objective to minimize earnings volatility. According to Mr. Ashley, at the request of the Board, management discussed the sustainability of its business strategy at the strategic retreat. Based on those discussions, management and the Board concluded that the strategy was sustainable.[127] That conclusion failed to consider, however, the conflict between minimizing earnings variability and Fannie Mae's other financial objective of double-digit earnings growth.[128] In order to meet the latter objective, Fannie Mae hedged only part of its prepayment risk. As a result, some earnings volatility should have been expected. Such volatility could (and did) lead management to accounting manipulations to minimize reported earnings variability. Committee minutes for the Strategic Retreat do not reflect candid consideration of or deliberation about the implications of Fannie Mae's strategic objectives.

Given the information available to various committees of the Board, the full Board should have been increasingly aware of the risks of earnings management practices at Fannie Mae. Throughout the year, the Audit Committee routinely received reports on EPS targets and achievements by Mr. Howard and Ms. Spencer, and the Compensation Committee received reports detailing the links between management bonuses and EPS targets. Every year from 1998 through 2004, there was at least one Board member who was assigned to both committees. In fact, in 2003 three Board members (Anne Mulcahy, Taylor Segue, and Joe Pickett) sat on both Committees.[129] Minutes of the meetings of those committees do not reflect that those Directors questioned the compensation structure at Fannie Mae or determined that such a structure could lead to improper earnings management.

Safety and soundness standards require that Board members ensure that they are provided with timely, accurate information about the operations and financial condition of the Enterprise that is sufficient to enable the Board to perform its oversight duties and responsibilities. The Board of Directors is also responsible for working in an informed manner with executive management to establish the Enterprise's strategies and goals. As established in Chapter V, Fannie Mae had an uncanny history of hitting its maximum bonus EPS targets and analyst

[126] Presentation by Timothy Howard to Fannie Mae Board of Directors Strategic Retreat, "Corporate Risk Management Objectives," July 14 & 15, 2003, FMSE 017263-74 at 71;
[127] OFHEO Interview, Stephen Ashley, April 20, 2006, at p. 96-98.
[128] 2003 Corporate Objectives Progress Report.
[129] Fannie Mae *Notice of Annual Meeting of Shareholders*, 1998; Fannie Mae *Notice of Annual Meeting of Shareholders*, March 29, 1999; Fannie Mae *Notice of Annual Meeting of Shareholders*, March 27, 2000; Fannie Mae *Notice of Annual Meeting of Shareholders*, April 2, 2001; Fannie Mae *Notice of Annual Meeting of Shareholders*, April 2, 2002; Fannie Mae *Notice of Annual Meeting of Shareholders*, April 14, 2003; Fannie Mae *Notice of Annual Meeting of Shareholders*, April 14, 2003; Fannie Mae *Notice of Annual Meeting of Shareholders*, April 23, 2004.

expectations with precision. That remarkable achievement should have led a reasonably diligent Board to inquire as to how that record was achieved. Despite indications from management and in the wider financial community of the uniqueness of that record, the Board failed to challenge the strategic direction of Fannie Mae (including the risk management strategy) and failed to draw conclusions that the focus on earnings targets could lead to deliberate manipulations by management to circumvent GAAP and enter into dubious transactions to achieve those targets. Until 2004, the minutes lack any indication that the Board addressed such questions.

Failure to Review Major Business Decisions and Ensure Appropriate Delegation of Authority

Fannie Mae operates under a corporate governance model that includes broad delegation of authority to management that was adopted in 1981 under Chairman and CEO David Maxwell. The bylaws grant broad powers to the Chairman of the Board to make virtually all business decisions, with periodic reporting to the Board on major business decisions:

> Chairman of the Board shall have such powers and perform such duties as the Board may prescribe. Except as otherwise provided by law, the corporate charter, these Bylaws, or the Board, the Chairman shall have plenary authority to perform all duties as may be assigned to him from time to time by the Board.[130]

In practice, management does not generally bring issues relating to business operations or major transaction to the Board for deliberation or approval but reports to the Board on initiatives already underway. Management's own review of Board minutes and resolutions resulted in the following conclusion by Senior Vice President and Deputy General Counsel Anthony Marra in a November 2003 memorandum:

> [M]anagement initiates and implements policies, procedures, and programs and then reports back to the Board on its actions. This has permitted management to have substantial flexibility on how it has carried out the company's business strategy. As long as the Chairman consents, management can undertake a wide range of business activities.[131]

In fact, as late as June 2004, Monica Medina, Vice President and Deputy General Counsel for Corporate Governance, recounted Fannie Mae's lack of formal policy for the Board to approve large transactions and management's discretion on whether or not to inform the Board of such transactions.

> In other areas, such as approval of large transactions, there are no firm guidelines or standards, and the board and management have until now made the decision of whether to notify the Board or seek its approval on a case by case basis.[132]

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[130] Fannie Mae Bylaws Article 4, Section 4.08.

[131] Memorandum from Anthony Marra to Thomas Donilon, Ann Kappler, Monica Medina, and Iris Aberbach, "Corporate Governance," November, 2003, FMSE-KD 035147-155 at 148. Minutes of the Nominating and Corporate Governance Committee, July 14, 2004, FMSE 505442-43.

[132] Email from Monica Medina to Michael Useem of the Wharton School of Business, University of Pennsylvania, "draft project description," June 11, 2004, FMSE-KD 035146.

That such broad discretion was accorded to management contravenes corporate governance standards, and despite recommendations from outside advisors in 2001, the Board did not address the delegation issue until 2004, when it was identified as an area to be reviewed as part of continuing efforts of the Nominating and Corporate Governance Committee to benchmark Fannie Mae's corporate governance policies to industry best practices, efforts initiated in 2002.[133] The Board could delegate authority to management; however, delegation that was overly broad, and the failure to revisit and review delegations of authority as the Enterprise's business changed and grew, contravened applicable safety and soundness standards.

During the period covered by this report, the Board was aware of the broad delegation at Fannie Mae. For example, in an interview during the course of the special examination, Board member Donald Marron challenged Fannie Mae's debt buyback program on the basis that there were no boundaries to the repurchases and that management had complete authority to make decisions with respect to buybacks. During an interview, Mr. Marron noted that

> all of [Tim] Howard's presentations regarding debt buybacks had been historical—meaning Howard would present to the Board what the Company did the quarter before, not on its plans for buying back debt in the future. Marron could not recall there being any boundaries on the Company's practice of buying back debt or management looking to the Board for consent as to the size or parameters of the purchases.

When asked about whether Mr. Marron "challenged" management on that issue:

> Marron agreed, and said that he had asked why the company was buying back debt, what it was doing to replace the capital spent and whether the repurchases were made pursuant to normal policy. Marron noted that the transactions sometimes caused the company to incur losses in the magnitude of "billions" of dollars. However, Marron said that he was told that management had "all bases covered" and that the Company's policy regarding buying back debt had been around a long time.[134]

Mr. Marron's challenge to management was summarily dismissed with further assurances by Mr. Howard.

The Board did not respond appropriately in the face of those assurances. That failure to ensure adequate controls of those transactions, which can affect executive compensation directly, is contrary to OFHEO corporate governance regulation. Under applicable law, the Board should not have accepted dismissive assurances from management. Given the oversight responsibility and authority vested in Boards of Directors, it is incumbent on Board members to carefully delegate authority but retain their ability to stay informed of and provide oversight of Enterprise business activities. The Board's failure to insist upon guidelines requiring that such major

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[133] *Id.*

[134] Paul Weiss Memorandum of interview with Donald Marron, February 8, 2006, FM SRC OFHEO 01561804, p. 11.

transactions receive Board approval was a significant dereliction of duty and a safety and soundness violation.

Failure to Ensure that Committees Functioned Effectively

The delegation of duties to its Committees does not absolve the full Board from ultimate responsibility for the Committee activities or from the full Board's own significant operational shortcomings. The Board's lax oversight of key committees contributed to their failures. As documented earlier in this chapter, the Auditing and Compensation Committees failed the Board and Fannie Mae in the performance of their delegated duties. The Committee failures meant that the delegated areas of responsibility were not receiving an appropriate level of attention and care. Further, because of the Committee failures, the full Board received inaccurate reports based upon inadequate information from poorly functioning Committees.

Failure to Act as a Check on Chairman and Chief Executive Officer Raines

As established in Chapters VII and VIII, during Mr. Raines' tenure accounting and internal control irregularities were not disclosed appropriately to the Board of Directors. Many of those irregularities involved inappropriate financial manipulation conducted to attain EPS targets to enrich senior executives. CFO Howard's tight control of accounting personnel and informal control over the Office of Auditing were fundamental to the control of information presented to the Board. That control of information to the Board meant that (i) the accountants were not performing accounting duties appropriately, (ii) the Office of Auditing was not reviewing the accounting operations appropriately, (iii) the Office of Auditing was not reporting adequately to the Audit Committee, (iv) the Audit Committee failed to adequately oversee the internal audit and risk management functions and was not reporting adequately to the full Board of Directors, and (v) the full Board of Directors did not have complete information at its disposal. In short, the Board did not hear about all important issues, particularly financial ones, and often had a distorted view of those issues. Despite those impediments, this chapter has identified instances when it was incumbent upon the Board to either insist upon the receipt of more information or to act upon the information that it was provided.[135]

Mr. Raines violated applicable standards of corporate governance by concentrating excessive power and conflicting responsibilities in the hands of Mr. Howard, who then used that power to stifle criticism and manipulate earnings to enrich senior executives. The Board's acquiescence to that concentration of power was a failure of Board oversight. Key person dependencies and failures to segregate duties are internal control weaknesses and, thus, unsafe and unsound practices. As described earlier, the Board failed to curtail the concentration of authority in Mr. Howard. As CFO, Mr. Howard was responsible for all accounting and financial reporting, policy and financial standards, budgeting, the mortgage and credit portfolio business, treasury operations, and corporate financial strategies. Organization charts showing Mr. Howard's responsibilities were routinely included in packages of materials distributed to

[135] The Business Roundtable notes that "[e]ffective directors maintain an attitude of constructive skepticism; they ask incisive, probing questions and require accurate, honest answers; they act with integrity and diligence; and they demonstrate a commitment to the corporation, its business plans and long-term shareholder value." Business Roundtable, "Principles of Corporate Governance 2005," p. 7.

Directors before Board meetings. Members of the Board knew of and had the opportunity to object to the extent of Mr. Howard's authority.

In 2000, Mr. Raines increased Mr. Howard's area of responsibility further by consolidating all of Fannie Mae's financial risk responsibilities under the CFO. Mr. Howard informally referred to himself as the Enterprise's "Chief Risk Officer."[136] As described in the discussion of the Audit Committee's failures, the combination those functions is a serious internal control weakness and is contrary to OFHEO regulations, and contravenes industry best practices.

The 2002 change in the administrative reporting relationship of Senior Vice President for Operations Risk and head of the Office of Auditing Sampath Rajappa to Mr. Howard was a signal to the Board that the independence of the internal audit function was an issue. The Office of Auditing is the internal "watchdog" for the Enterprise and, largely, for operations under the CFO's purview.[137] The Board failed to challenge Mr. Raines' reorganization of that reporting relationship. That failure is particularly noteworthy in light of the inherent conflict of an internal auditor reporting to the CFO and the fact that, in his previous position as controller, Mr. Rajappa had reported directly to Mr. Howard.

Mr. Howard's appointment to the Board of Directors provides another example of the Board's failure to check the actions of Chairman and CEO Raines. Board member Mr. Duberstein stated during the Special Examination that he had objected to the idea of having Mr. Howard elevated to the position of Director. He stated that other Board members agreed with his position but were not as vocal. However, there is no record in the Board meeting minutes of any objections from the Board members over that decision. Mr. Duberstein explained that "with rare passion" Mr. Raines stated he needed Mr. Howard's expertise on the Board.[138] Thus, Mr. Raines' passion overcame the initial judgment of some Board members, and Mr. Howard was appointed a member of the Board of Directors during 2003.

In another example, in August 2004, Mr. Howard announced a significant reorganization of Fannie Mae's Credit Policy function that moved the responsibility for all risk management to Finance, which reported to him. Following a presentation by Mr. Mudd to the Board of Directors on the reorganization, Board Member Stephen Ashley contacted fellow Board member and COO Mudd, to express his concerns that Mudd had not clearly identified where the responsibility for credit risk oversight would reside in the organization.[139] The failure to segregate the responsibilities of the Chief Financial Office and Chief Risk Officer eliminated the inherent checks and balances in having different lines of responsibility for those areas. The failure of the Board to adequately address this issue was an abdication of the Board's duties.

[136] OFHEO Interview, Timothy Howard, August 5, 2004, p. 7. "I also serve informally as the company's chief risk officer."

[137] OFHEO Interview, Sampath Rajappa, February 23, 2005, at page 56.

[138] Paul Weiss Interview with Kenneth Duberstein, November 17, 2005 FM SRC OFHEO 1377890 – 1377898 at 93.

[139] OFHEO Interview, Stephen Ashley April 20, 2006, p. 54-56.

Between 1998 and 2004, the ratio of directors considered independent by the Enterprise to insiders fell from 14:4 to 8:4. The change was due primarily to Presidentially-appointed positions remaining unfilled when incumbents left, but the Board never considered that Mr. Howard's appointment would have a significant impact on the ratio of inside directors.

Another cogent issue is the independence of non-management Board members. Although the Board of Directors adopted the NYSE standards for independence and adhered to them in all material respects, both business relationships and donations from the Fannie Mae Foundation created an appearance of less than total independence. For example, Frederic Malek, an independent Director from 2002 through 2004, and whose job it was to oversee the performance of Mr. Raines, was a business partner with Mr. Raines in the Washington Baseball Club, an organization that attempted to bring major league baseball to Washington D.C., during the time Mr. Malek was a director. While the Nominating and Governance Committee took steps to address that appearance of a conflict of interest by changing Mr. Malek's committee assignments, he retained his position as an independent Board member. Another Board member, Kenneth Duberstein, a Director since 1998, continued to have a lobbying contract with Fannie Mae while he was a Director. Although the Fannie Mae proxy statements fully disclose that relationship, Mr. Duberstein participated in Executive Session discussions with independent directors including discussions involving Mr. Raines' compensation, despite recommendations to the contrary from outside consultants.[140]

Contributions of the Fannie Mae Foundation also eroded at least the appearance of independence of other board members. When members of the Board began their service, they filled out forms listing charities and other organizations with which they were affiliated. The form was resubmitted annually to the company and the Foundation.[141] Fannie Mae Foundation grants to organizations to which Board members were affiliated more than doubled from ($4 million to $14 million) after members accepted their assignments to the Fannie Mae Board of Directors. A number of those organizations only received Fannie Mae Foundation grants after an affiliated member was appointed to the Board.[142]

Examples include Mr. Duberstein who has served on the Boards of various organizations which, according to the Fannie Mae Foundation web site, were awarded grants totaling $5.4 million since he joined the Fannie Mae Board of Directors. Similarly, Ann McLaughlin Korologos, an independent, non-management Director since 1994, held senior posts at the Aspen Institute from 1996 through 2000, during which time the Aspen Institute received $280,000 in grants from the Fannie Mae Foundation. Ms. Korologos was also a Visiting Fellow with the Urban Institute, which received approximately $2.6 million in grants since she has been on the Fannie Mae Board. Ms. Korologos also was assigned to Chair of the Board's Corporate Governance Committee and the Special Review Committee charged with the internal investigation resulting from the OFHEO Special Examination Report in September 2004. Both Ms. Korologos and Thomas Gerrity, chairman of the Audit Committee, were affiliated with Wharton School of Business at the University of Pennsylvania which received $687,500. H.

[140] OFHEO Interview of Monica Medina, December 14, 2005, p. 118. Memorandum from Gibson, Dunn & Crutcher dated May 2004, FMSE-KD 078793.
[141] OFHEO Interview of Thomas Donilon April 24, 2006, p. 191 to 205.
[142] www.fanniemaefoundation.org

Patrick Swygert, an independent, non-management Director since 2000, is the President of Howard University. Howard University has received more than $225,000 in grants from the Fannie Mae Foundation since 2000.[143]

The Board was aware that donations to director-affiliated charities could compromise independence, but appeared reluctant to allow scrutiny of such donations. In 2003 the Board enacted guidelines to define an "independent" director, which included number of conflicts that would preclude a director from being considered independent. One of these conflicts was defined to be annual donations of $100,000 or more by Fannie Mae or the Foundation to charities affiliated with the Board members. All the other financial conflict provisions (i.e., employment by Fannie Mae or receipt of large contracts from Fannie Mae) looked back 5 years to determine whether the director was independent. The charitable contribution limit alone was prospective--the only one of the guidelines that did not include a five-year look-back period; thus defining board members as independent no matter how large the prior contributions that Fannie Mae had made to their affiliated charities. If the five-year look back period had been applied, at least three directors considered "independent" by Fannie Mae would not have qualified under the guidelines.

Failure to Order Independent Investigations of Fannie Mae

The Board failed to exercise prudent oversight over Fannie Mae as demonstrated by its ineffective and complacent response to the Freddie Mac accounting missteps and subsequent restatement. The similarities between the two Enterprises in terms of markets, business risks, products, and history of uniquely steady earnings growth should have made Board members skeptical about management assertions that Fannie Mae had none of the accounting issues of its sister Enterprise. The Board should have initiated immediately its own independent investigation into accounting practices at Fannie Mae rather than waiting for OFHEO to investigate.

On January 22, 2003, Freddie Mac announced that an accounting restatement of its 2002, 2001, and 2000 financial results was required due to the misapplication of GAAP. The restatement was required after Freddie Mac's newly appointed external auditor, PricewaterhouseCoopers, recommended changing certain accounting policies that were approved by its previous external auditor.[144] (In March 2002, Freddie Mac had hired PricewaterhouseCoopers to replace Arthur Andersen LLP). Freddie Mac publicly reported that the restatement would result in changes to the timing of the recognition of income that related primarily to a change in accounting policies involving the hedge accounting treatment of certain transactions including those occasioned by the implementation of FAS 133.[145] In late January 2003, in response to the audit findings, the independent, non-management members of the Freddie Mac Board of Directors retained Baker Botts, LLP, to investigate the facts and

[143] The Foundation contribution data was taken from the Fannie Mae Foundation Web site in March 2006.
[144] Freddie Mac Press Release, January 22, 2003, available at http://www.freddiemac.com/news/archives/investors/2003/4Q02.html.
[145] *Id*.

circumstances relating to certain of the principle accounting errors identified during the Enterprise's previously announced restatement process.[146]

Fannie Mae Board meeting minutes reflect no discussion regarding Freddie Mac's restatement for approximately six months after the announcement. That level of complacency on the part of the Board is particularly disturbing since the two Enterprises share the same business objectives and associated risks. The first documented discussion of the Freddie Mac situation is at the June 9, 2003 Board meeting, three days after Freddie Mac had announced the resignations of its CEO and CFO and the firing of its COO. According to the Board minutes:

> Mr. Raines noted the Freddie Mac and related statements released to the public that morning, copies of which were sent to the Board prior to the conference call. He asked Mr. Donilon to brief the Board. Mr. Donilon reviewed the Freddie Mac management announcements with the Board and media, industry, regulatory, and policymaker reactions. Mr. Raines noted that he did not believe that the company had the financial management or accounting issues outlined in the Freddie Mac announcement and was a full SEC registrant having filed Fannie Mae's initial Form 10K on March 31, 2003 and 10Q in May.
>
> Members of the Board discussed the Freddie Mac situation and Freddie Mac's response. Members asked to be kept informed of developments.[147]

The Board minutes do not reflect any actions directed by the Board for management follow-up. The minutes do not reflect any challenge to the assertion made by Mr. Raines that Fannie Mae did not have similar issues to Freddie Mac. That assertion was made without the benefit of sufficient analysis or documentation. The Board met again the following week. According to the Board minutes:

> Mr. Raines asked Mr. Donilon to brief the Board members on the Freddie Mac situation. Mr. Donilon reviewed the regulatory, legal, and congressional developments of the last week arising out of the Freddie Mac management shake-up and accounting announcements. He reviewed Fannie Mae's statements and information provided to investors, policymakers, and the public, differentiating Fannie Mae from Freddie Mac. Mr. Raines and Mr. Donilon answered questions from Board members. Members of the Board noted the importance of close monitoring of the situation by the Board.[148]

Again, the minutes do not reflect any substance of questions asked, management responses, or any specific actions directed by the Board for follow-up.

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[146] Baker Botts L.L.P. report entitled, *Report to the Board of Directors of the Federal Home Loan Mortgage Corporation, Internal Investigation of Certain Accounting Matters-December 10, 2003 – July 21, 2003*, July 22, 2003.

[147] Minutes of the Meeting of the Board of Directors of Fannie Mae, June 9, 2003. FMSE 010214.

[148] Minutes of the Meeting of the Board of Directors of Fannie Mae, June 13, 2003. FMSE 010218.

The next Board meeting took place on June 27, 2003. According to the minutes of that meeting, "Frank Raines asked Tim Howard, CFO, to report and to comment specifically on Freddie Mac accounting issues that have been raised publicly." The minutes reflect that Mr. Howard discussed seven accounting issues that Freddie Mac disclosed in public statements; however, only five were described in the minutes. The five accounting issues described included security classification, accounting for derivative instruments, asset transfers, asset securitizations, and valuation of financial instruments. Mr. Howard "contrasted Freddie Mac practices with Fannie Mae practices, concluding that Fannie Mae did not have the same practices and approaches disclosed by Freddie Mac to date. Messrs. Raines, Howard, and Donilon responded to questions from various Board members."[149] Again, the minutes of the meeting do not document the nature of the questions and the names of the Board members asking questions, and the answers provided by management. Neither do they indicate any action items for management follow-up.

As reported in *The Washington Post* on July 10, 2003, the events unfolding at Freddie Mac showed a Board whose members struggled, and sometimes hesitated, to take tough action against top executives they had known and respected for years. The *Post* also reported that Baker Botts had told the Freddie Mac Board at its March 2003 meeting that the "accounting issues continued to broaden and . . . included the possibility that senior management had made some transactions solely to manipulate reported profits so the company could meet earnings targets expected by Wall Street."[150]

On July 14-15, 2003, at the Fannie Mae Board of Directors Strategic Retreat, Mr. Howard made his annual presentation on risk management objectives. Mr. Howard stressed that a key corporate financial discipline objective of Fannie Mae was to ensure a "high degree of net income stability." Mr. Howard's message to the Board was clear: for Fannie Mae to capitalize on its unparalleled debt market access and capital requirements, Fannie Mae "must be, and be perceived to be, a low-risk company," and must achieve a stable pattern of earnings. Mr. Howard then compared the standard deviation of Fannie Mae's earnings per share to the trend shown by Standards & Poor's 500 Companies. He showed how Freddie Mac had a slightly less than four percent standard deviation from the median, while Fannie Mae was much closer to the trend with a standard deviation of less than one percent.[151]

On July 18, 2003, *The Washington Post* reported that Freddie Mac's former auditor, Arthur Andersen had warned management and key Board members about a lack of accounting expertise at the Enterprise.[152] On July 22, 2003, one week after the above described Strategic Retreat, Baker Botts, LLP, published its report on the internal investigation of Freddie Mac. That report disclosed critical findings regarding Freddie Mac's efforts to defer income

[149] Minutes of the Meeting of the Board of Directors of Fannie Mae, June 27, 2003. FMSE 010995.
[150] Kathleen Day, "A Reluctant Coming to Grips at Freddie Mac: Auditors and Financial Restatements Forced the Board to Reassess its Longtime Executives," *The Washington Post*, July 10, 2003.
[151] Presentation by Timothy Howard, "Corporate Risk Management Objectives," July 14 & 15, 2003, FMSE 017263.
[152] David S. Hilzenrath and Kathleen Day, "Freddie Was Told it Lacked Accounting Expertise," *The Washington Post*, July 18, 2003.

recognition and avoid earnings volatility.[153] Despite the media attention surrounding the Baker Botts report and their knowledge that Fannie Mae shared Freddie Mac's objective of mitigating income volatility, members of the Fannie Mae Board of Directors again failed to exercise adequate oversight. They again failed to request all material information necessary to conclude that Fannie Mae was GAAP compliant and was not improperly managing its earnings.

Mr. Gerrity, Chair of the Audit Committee, told OFHEO that he was not aware, at the time that the Board was discussing the Freddie Mac restatement, that Freddie Mac had been criticized for improper earnings management. Mr. Gerrity also stated that he did not read the Baker Botts report.[154] While Mr. Donilon gave the Board a copy of the executive summary of the report, he told the Board members (including Mr. Gerrity) that the full report was publicly available on the Freddie Mac web site.[155] Board member Stephen Ashley also received the executive summary of the report with the reference to the Internet location of the full report, yet he, too, told OFHEO that he did not read the full Baker Botts report.[156]

The Board convened an additional nine times in 2003 after the release of the Baker Botts report, but the minutes to the Board meetings reflect no additional discussion about the Freddie Mac situation and whether Fannie Mae had any similar problems.

On January 23, 2004, almost one year from the date that Freddie Mac announced its intention to restate its financial statements (and one month after OFHEO issued its own detailed report), the Audit Committee reported to the Board on a study conducted by Controller Spencer. That study compared the accounting treatments of Fannie Mae to those of Freddie Mac for four of the 31 specific issues publicly disclosed by Freddie Mac. The Board minutes reflect the following report by the Audit Committee

> Mr. Gerrity reported that the Committee had received a report on a thorough analysis of the Freddie Mac accounting issues and a comparison of Fannie Mae approaches. Mr. Gerrity reported that KPMG was fully involved in the study. The review highlighted differences between Fannie Mae and Freddie Mac securities structures and business processes that can lead to accounting differences. Mr. Gerrity reported that the study identified 31 specific issues with Freddie Mac's accounting; Ms. Spencer reviewed four issues in detail with the Committee. Mr. Gerrity reported that the company was comfortable with its accounting approaches. [157]

In reality, Fannie Mae had many accounting errors in common with Freddie Mac. Freddie Mac was criticized for accounting related to allowance for loan losses, securities

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[153] Baker Botts L.L.P. report entitled, "*Report to the Board of Directors of the Federal Home Loan Mortgage Corporation, Internal Investigation of Certain Accounting Matters-December 10, 2003 – July 21, 2003*," July 22, 2003.
[154] OFHEO Interview, Thomas Gerrity, March 14, 2006, p. 120.
[155] Memorandum from Thomas Donilon to the Board of Directors, "The Freddie Mac Report," July 25, 2003, FM SRC M-OFHEO 00020830-842.
[156] OFHEO Interview, Stephen Ashley, April 20, 2006, p. 111.
[157] Minutes of the Meeting of the Board of Directors of Fannie Mae, January 23, 2004, FMSE 504353-90 at 504375.

classifications, accounting for derivatives, securitizations, and accounting for purchase premium and discount amortization. Each of those accounting areas are listed as significant accounting policies in the Notes to Financial Statements in Fannie Mae's 2003 10-K.[158] Determining the adequacy of the allowance for loan losses and calculating the amortization for deferred price adjustments (purchase premiums and discounts) are critical accounting estimates for both Enterprises. The Board should have required detailed information related to each of those critical accounting policies and estimates that Fannie Mae shared Freddie Mac. The Board should have challenged Ms. Spencer's assertion that only four of the 31 issues identified by Freddie Mac were significant for Fannie Mae.

The Board placed too much reliance on Mr. Howard and Ms. Spencer to identify weaknesses within their own areas of responsibility. As discussed elsewhere in this chapter, Mr. Howard was responsible for the development of the financial policies and standards used at Fannie Mae as well as for financial reporting. The reliance of the Board of Directors on Mr. Howard and Ms. Spencer was particularly negligent given that control weakness. Considering the similarities between the two Enterprises, the Board should have commissioned an independent inquiry into the accounting practices of Fannie Mae. Not until eighteen months later, after OFHEO had issued its report of September 2004 and the Securities and Exchange Commission had ruled against Fannie Mae on determinations made by OFHEO, did the Board initiate its own investigation.

The allegations of earnings manipulation by senior management at Freddie Mac that surfaced publicly in *The Washington Post* on July 10, 2003, were serious. Knowing that its regulator had begun an unprecedented special examination on the same issues announced on July 17, 2003, the Board of Directors contravened statute, regulation, and industry best practices by continuing to rely on the representations of senior management until the SEC's ruling of December 2004.

The entire Board was also derelict when, in October 2003, counsel for Mr. Barnes threatened suit, alleging earnings manipulations by senior management and asserting that Mr. Barnes had written the senior management directly about that manipulation a year before. SEC regulations required the Board to conduct an independent investigation, and OFHEO regulations required Fannie Mae to inform the SEC or OFHEO about the charges.[159] Neither requirement was fulfilled, nor is there any record that either was considered. In its passivity, the Board missed its last chance to require an independent investigation or review that would have allowed the Enterprise to resolve its own problems. Here, as in many other instances, the Board simply

[158] Several of Fannie Mae's accounting policies include critical accounting estimates. (In accordance with GAAP, such estimates are considered critical if (1) they require significant management judgments and assumptions about uncertain matters, and (2) the use of a different approach to the estimate or underlying assumption would have a material effect on reported results of operations or financial condition.) Those include Fannie Mae's accounting policies for FAS 91, for derivative instruments and hedging activities, for determining the adequacy of the allowance for loan losses, for estimating the time value of purchased options, and for assessing other-than-temporary impairment. Those accounting policies, along with others, are summarized in the "Notes to Financial Statements" of the Enterprise's Form 10-K filed with the SEC as "Significant Accounting Policies," Fannie Mae 2003 10-K, p. 126 – 135.

[159] SEC 17 CFR Parts 228, 229, 249 and 274, RIN 3235-A175; 12 C.F.R. 1710.15(b)(6).

accepted representations of senior management and exercised no discernable oversight responsibility.

Failure to Ensure Timely and Accurate Reports to Federal Regulators

OFHEO regulations require the Board to have in place adequate policies and procedures to ensure that executive officers are responsive in providing accurate and timely reports to Federal regulators and in addressing the supervisory concerns of Federal regulators in a timely and appropriate manner.[160] Board members are also responsible for ensuring that Fannie Mae submits timely and complete reports of financial condition and operations to OFHEO and other federal regulators.

The Board failed to discharge those responsibilities in numerous instances, including with respect to required disclosures of executive compensation and the allegations made by Mr. Barnes. Issues related to the disclosure of executive compensation are discussed in Chapter VIII of this report. The allegations by Mr. Barnes, when initially made, were not reported to OFHEO. The Board should have sought assurance that the OFHEO was aware of the issues. No such assurance was sought. The accounting and internal control failures at Fannie Mae have impeded the Enterprise's ability to file timely and complete reports of financial condition and operations to OFHEO and other federal regulators. The Board's failure to ensure timely and accurate reports to Federal regulators is a violation of OFHEO's safety and soundness regulation.

Conclusion

The bedrock principle of OFHEO's regulation of Fannie Mae is that the entity must operate safely and soundly. The Board, in turn, must take reasonable steps to assure itself that senior management is operating the Enterprise in accordance with that principle. That requirement is a very broad one, as a widely quoted definition makes clear:

> Generally speaking, an "unsafe or unsound practice" embraces any action, or lack of action, which is contrary to generally accepted standards of prudent operation, the possible consequences of which, if continued, would be abnormal risk of loss or damage to an institution, its shareholders, or the agencies administering the insurance funds.[161]

Judging the actions and inactions of the Fannie Mae Board against that definition, standards of prudent operation clearly were not met. Rather than an active, concerned Board that effectively supervised senior management, the Board of Directors was a passive and complacent entity, controlled by, rather than controlling senior management. As catalogued in this chapter, the Board and its Committees missed a host of opportunities to uncover and control the malfeasance documented in earlier chapters. Instead, Fannie Mae suffered an enormous loss in credibility and reputation and has incurred hundreds of millions of dollars in remedial expense. A Board operating in accordance with generally accepted standards of prudent operation would have prevented much or all of those losses.

[160] 12 C.F.R. 1710.15(b)(6).
[161] *Gulf Federal Savings and Loan Association v. Federal Home Loan Bank Board*, 651 F.2d 259, 264 (1981).

Appendix to Chapter IX: Board Composition

BOARD MEMBER	TENURE	BACKGROUND	COMMITTEE ASSIGNMENTS, 1998-2004[1]
Stephen B. Ashley	1995-Present	• Chairman, Fannie Mae (2004-present) • Chairman & Chief Executive Officer, the Ashley Group (1975-present) • President, Mortgage Bankers Association (1993-1994) • Board of Trustees o Cornell University • Boards of Directors o Exeter Fund, Inc. o The Genesee Corp.	Executive: 2003-2004 N&CG: 1995-2004 Technology: 1996-2002 HCD: Chair, 2003-2004 SRC: 2004
Thomas P. Gerrity	1991-Present	• Professor of Management, Wharton School, University of Pennsylvania (1990-present) • Dean, Wharton School, University of Pennsylvania (1990-1999) • Boards of Directors o CVS Corp. o Internal Capital Group, Inc. o Knight-Ridder, Inc. o Sunoco, Inc. o Hercules, Inc.	Executive: 1996-2004 Audit: Chair, 1998-2004 N&CG: 1996-2004 Technology: 1996-1999
Ann McLaughlin Korologos	1994-Present	• Chairman, RAND Board of Trustees (2004-present) • Chairman emeritus, Aspen Institute (2000-present) • Senior Advisor, Benedetto, Gartland & Company, Inc. (1995-2005) • Chairman, Aspen Institute (1996-2000) • U.S. Secretary of Transportation (1987-1989) • Boards of Directors o AMR Corporation o Microsoft Corp. o Harman International Industries, Inc. o Host Hotels & Resorts, Inc. o Kellogg Company	Executive: 2001-2004 Compensation: 1998-2004 N&CG: 1998-2004, Chair, 2001-2004 SRC: 2004; Chair, 2004

[1] A&L = Assets and Liabilities; N&CG = Nominating and Corporate Governance; HCD = Housing and Community Development; SRC = Special Review Committee

Sources: Fannie Mae Annual Reports and Proxy Statements – 1998 through 2003. Fannie Mae Web site, Corporate Governance.

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BOARD MEMBER	TENURE	BACKGROUND	COMMITTEE ASSIGNMENTS, 1998-2004[1]
Joe K. Pickett	1996-Present	• Chairman and Chief Executive Officer, HomeSide International Inc. (1996-2001) • President, Mortgage Bankers Association (1994-1995)	Executive: 1998-2004 A&L: 1998-2001 Audit: 2003-2004 Compensation: 2002-2004 Technology: Chair, 1998-2002
Kenneth M. Duberstein	1998-Present	• Chairman & Chief Executive Officer, The Duberstein Group, Inc. (1989-present) • White House Chief of Staff (1988-1989) • Boards of Directors o Boeing Company o Conoco, Inc.	Executive: 2000-2004 A&L: 1989-2004; Chair, 2000-2004 Technology: 1998-2002 HCD: 2003-2004
Daniel H. Mudd	2000-Present	• President & Chief Executive Officer, Fannie Mae (2004-present) • President & Chief Operating Officer, Fannie Mae (2000-2004) • President & Chief Executive Officer, GE-Capital, Japan (1996-1999) • Boards of Directors o Fannie Mae Foundation o Ryder Systems, Inc.	None
H. Patrick Swygert	2000-Present	• President, Howard University (1995-present) • Board of Directors o United Technologies Corporation o The Hartford Financial Services Group, Inc.	A&L: 2000-2004 Technology: 2000 HCD: 2003-2004 N&GC: 2000
Donald B. Marron	2001-Present	• Chairman & Chief Executive Officer, Lightyear Capital (2001-present) • Chairman & Chief Executive Officer, UBS PaineWebber Inc. (2000-2001) • Chairman & Chief Executive Officer, Paine Webber (1981-2000) • Board of Directors o Shinsei Bank • Chairman, Collegiate Funding Services, Inc.	A&L: 2001-2004 N&GC: 2001-2004 SRC: 2004

Sources: Fannie Mae Annual Reports and Proxy Statements – 1998 through 2003. Fannie Mae Web site, Corporate Governance.

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BOARD MEMBER	TENURE	BACKGROUND	COMMITTEE ASSIGNMENTS, 1998-2004[1]
Leslie Rahl	2004-Present	• President & Founder, Capital Market Risk Advisors, Inc. (1991-present) • Vice President and Division Head, Citibank (1972-1991) • Boards of Directors o International Association of Financial Engineers o MIT Investment Management Company o New York State Common Investment Advisory Committee	A&L: 2003-2004 HCD: 2003-2004
John K. Wulff	2004-Present	• Chairman of the Board, Hercules Inc. (2003-present) • Member, Financial Accounting Standards Board (2001-2003) • Chief Financial Officer, Union Carbide Corporation (1996-2001) • Board of Directors o Moody's Corporation o Republic Financial	
Bridget A. Macaskill	2005-Present	• Principal, BAM Consulting LLC (2005-present) • Chairman & Chief Executive Officer, Oppenheimer Funds, Inc. (2000-2001) • Chief Executive Officer, Oppenheimer Funds, Inc. (1995-2000) • Boards of Directors o J. Sainsbury PLC o Prudential PLC o College Retirement Equities Fund	
Greg C. Smith	2005-Present	• Vice Chairman, Ford Motor Company (2005-present) • Executive Vice President, Ford Motor Company (2004-2005) • Chairman & Chief Executive Officer, Ford Motor Credit Company (2002-2004) • Boards of Directors o Hertz Corporation o Detroit Investment Fund	

Sources: Fannie Mae Annual Reports and Proxy Statements – 1998 through 2003. Fannie Mae Web site, Corporate Governance.

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BOARD MEMBER	TENURE	BACKGROUND	COMMITTEE ASSIGNMENTS, 1998-2004[1]
Franklin D. Raines	1991-1996 and 1998-2004	• Chairman & Chief Executive Officer (1998-2004) • Director, U.S. Office of Management and Budget (1996-1998) • Vice Chairman, Fannie Mae (1991-1996) • Co-Chairman, The Business Roundtable (2003-2004) • Chair, Corporate Governance Task Force, The Business Roundtable • Boards of Directors o Revolution Health Group o Pfizer, Inc. (1998-2004) o AOL Time Warner, Inc. (2001-2004) o PepsiCo, Inc. (1999-2005); Chair, Audit Committee (2003-2005) o TIAA-CREF (1999-2005)	Executive: Chair, 1998-2004
Timothy Howard	2003-2004	• Vice Chairman & Chief Financial Officer, Fannie Mae (2003-2004) • Executive Vice President & Chief Financial Officer, Fannie Mae (1990-2003) • Board of Directors, CarrAmerica Realty Corporation	None
Anne M. Mulcahy	2000-2004	• Chairman and Chief Executive Officer, Xerox Corporation (2002-present) • Chief Executive Officer, Xerox Corporation (2001-2002) • President and Chief Operating Officer, Xerox Corporation (2000-2001) • Boards of Directors o Citigroup, Inc. o Fuji Xerox Co. Ltd. o Target Corporation	Executive: 2002-2004 A&L: 2000 Audit: 2001-2004 Compensation: 2000-2004, Chair, 2002-2004

Sources: Fannie Mae Annual Reports and Proxy Statements – 1998 through 2003. Fannie Mae Web site, Corporate Governance.

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BOARD MEMBER	TENURE	BACKGROUND	COMMITTEE ASSIGNMENTS, 1998-2004[1]
Frederic V. Malek	2002-2004	• Chairman, Thayer Capital Partners (1991-present) • Co-chairman, CB Commercial (1989-1996) • President and Vice Chairman, Northwest Airlines (1989-1991) • President, Marriott Hotels (1980-1988) • Board of Trustees, Aspen Institute • Boards of Directors o Automatic Data Processing Corp. o FPL Group o CB Richard Ellis Group o Manor Care, Inc. o Northwest Airlines	A&L: 2002-2004 Audit: 2002-2004
Victor H. Ashe*	2001-2004	• Ambassador, Republic of Poland (2004-present) • Mayor, Knoxville, TN (1988-2003) • President, U.S. Conference of Mayors (1995)	A&L: 2001-2002 NCG: 2003-2004 Technology: 2001-2002 HCD: 2003-2004
Molly H. Bordonaro*	2001-2004	• U.S. Ambassador to Malta (2004-present) • Principal, Gallatin Group (2002-present) • Associate, Norris, Beggs & Simpson (1999-2002)	A&L: 2001-2004 Technology: 2001-2002 HCD: 2003-2004
William R. Harvey	2001-2004	• President, Hampton University (1978-present) • Boards of Directors o Trigon Blue Cross Blue Shield o Signet Bank o Newport News Shipbuilding o Wachovia Bank (Mid-Atlantic Region) o Newport News Savings Bank	Audit: 2001-2004 Technology: 2001-2002 HCD: 2003-2004
Taylor C. Segue, III*	2001-2004	• Partner, Fraser Trebilcock Davis & Dunlap, P.C. (2004-present) • Partner, Howard & Howard Attorneys P.C. (2002-2004) • Partner, Butzel Long, P.C. (1999-2002)	A&L: 2001-2002 Audit: 2001-2004 Compensation: 2003-2004
Manuel Justiz*	2001-2004	• Dean, College of Education at the University of Texas at Austin (1990-present)	A&L: 2002-2004 Technology: 2001-2002 HCD: 2003-2004

Sources: Fannie Mae Annual Reports and Proxy Statements – 1998 through 2003. Fannie Mae Web site, Corporate Governance.

Appendix to Chapter IX: Board Composition

BOARD MEMBER	TENURE	BACKGROUND	COMMITTEE ASSIGNMENTS, 1998-2004[1]
Jamie Gorelick	1997-2003	• Partner, Wilmer Cutler Pickering Hale & Dorr (2003-present) • Vice Chair, Fannie Mae (1997-2003) • U.S. Deputy Attorney General (1994-1997) • Member, National Commission on Terrorist Attacks Upon the United States (2003-2004) • Boards of Directors o United Technologies Corporation o Schlumberger, Ltd.	None
Vincent A. Mai	1991-2002	• Chairman and Chief Executive Officer, AEA Investors, Inc. (1998-present) • Chief Executive Officer, AEA Investors, Inc. (1989-present) • Lehman Brothers (1975-1989) • Chairman of the Board of Directors, Sesame Workshop • Vice Chairman, International Center for Transnational Justice	Executive: 1998-2002 Audit: 1998-2002 Compensation: Chair, 1998-2002
Roger E. Birk	1985-2001	• President and Chief Operating Officer, Fannie Mae (1987-1992) • Chairman and CEO, Merrill Lynch & Co., (1982-1986)	Executive: 1998-2000 N&CG: Chair, 1998-2000 Technology: 1998-2000
Stephen Friedman	1996-2002	• Chairman, President's Foreign Intelligence Advisory Board and Chairman of the Intelligence Oversight Board (2005-present) • Senior Advisor, Stone Point Capital (2005-present) • Assistant to the President for Economic Policy and Director of the National Economic Council (2002-2005) • Senior Principal, Marsh & McLennan Capital Corp. (1998-2002) • Chairman, Goldman Sachs (1992-1994)	Compensation: 1998-2001 N&CG 1998-2001

Sources: Fannie Mae Annual Reports and Proxy Statements – 1998 through 2003. Fannie Mae Web site, Corporate Governance.

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BOARD MEMBER	TENURE	BACKGROUND	COMMITTEE ASSIGNMENTS, 1998-2004[1]
Eli J. Segal*	1997-2001	• Chief Executive Officer, Welfare to Work Partnership (1996-2006) • Assistant to the President (1993-1996)	A&L: 1998-2001 Audit: 1998-2001
Jack Quinn*	1998-2001	• Co-Chairman, Quinn Gillespie & Associates LLC (2000-present) • Partner, Arnold & Porter • White House Counsel (1995-1997)	A&L: 1998-2001 Technology: 1998-2001
Garry Mauro*	1999-2001	• Attorney (1999-present) • Commissioner, Texas General Land Office (1983-1999)	Audit: 1999-2001 Technology: 1999-2001
Maynard Jackson*	2000-2001	• Mayor, City of Atlanta, Georgia (1974-1982; 1990-1994) • Chairman, Jackson Securities (1987-2003)	A&L: 2000-2001 Technology: 2000-2001
Esteban E. Torres*	2000-2001	• Chair, National Latino Media Council (1998-present) • Member, US House of Representatives (1982-1998)	A&L: 2000-2001 Technology: 2000-2001
Lawrence M. Small	1991-2000	• Secretary, Smithsonian Institution (2000-2006) • President and Chief Operating Officer, Fannie Mae (1991-2000) • Former Vice Chairman and Chairman of the Executive Committee, Citicorp/Citibank • Board of Directors, o Chubb Corporation	None
Karen Hastie Williams	1988-1999	• Partner, Crowell & Moring (1982-2005) • Boards of Directors o Chubb Corporation o Continental Airlines, Inc. o Gannett Company, Inc. o Washington Gas Holdings Company o SunTrust Bank	Executive: 1998-1999 A&L: Chair, 1998-1999 Compensation: 1998-1999
Jose H. Villarreal, Esq.*	1993-1999	• Partner, Akin, Gump, Strauss, Hauer & Feld, L.L.P. • Boards of Directors o Wal-Mart Corp. o PMI Group	A&L: 1998-1999 Audit: 1998-1999

Sources: Fannie Mae Annual Reports and Proxy Statements – 1998 through 2003. Fannie Mae Web site, Corporate Governance.

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BOARD MEMBER	TENURE	BACKGROUND	COMMITTEE ASSIGNMENTS, 1998-2004[1]
James A. Johnson	1990-1998	• Vice-Chairman, Perseus, L.L.C. (2001-present) • Chairman of the Board & Chief Executive Officer, Fannie Mae (1991-1998) • Boards of Directors o Enterprise Foundation o Goldman Sachs Group o KB Home o Target Corporation o United Health Group	Executive: Chair, 1998 A&L: 1998 Technology: 1998
* Director was appointed by the President of the United States.			

Sources: Fannie Mae Annual Reports and Proxy Statements – 1998 through 2003. Fannie Mae Web site, Corporate Governance.

X. REMEDIAL ACTIONS AND RECOMMENDATIONS

During the period of the special examination, OFHEO has directed Fannie Mae to take a number of actions, both as a result of the special examination and as part of the agency's continuous supervisory program. Those steps have remedied deficiencies, aimed to reduce the recurrence of improper conduct, and sought to enhance the safe and sound operation of the Enterprise going forward. This chapter reviews OFHEO's remedial actions to date and presents recommendations by OFHEO staff based on the special examination.

Remedial Actions to Date

This section summarizes the significant changes put in motion by a written agreement between OFHEO and Fannie Mae executed on September 27, 2004; a Supplemental Agreement executed on March 7, 2005; and other actions by the agency. OFHEO continues its examination and oversight to assure that those commitments have firm deadlines for completion and are completed.

Capital

In the September 2004 Agreement, OFHEO directed Fannie Mae to maintain an additional 30 percent of capital above the minimum capital requirement to compensate for the additional risk and challenges facing the Enterprise. OFHEO directed that Fannie Mae submit for approval a plan to manage the enhanced capital requirements. OFHEO directed that the capital plan include Fannie Mae's strategy to preserve and maintain capital levels at the minimum capital requirement, plus 30 percent to address costs and risks associated with problems facing the Enterprise, and projections for growth and capital requirements based upon a detailed analysis of Fannie Mae's assets, liabilities, earnings, fixed assets, and off-balance sheet activities. In addition, the agreement requires the Enterprise to include contingency plans that identify alternative methods for appropriately achieving and maintaining the necessary capital levels should the primary methods prove to be insufficient, an analysis of proposed or undertaken corporate actions, and the impact of those actions upon Fannie Mae's ability maintain the appropriate capital levels.

OFHEO also directed Fannie Mae to obtain prior written permission from OFHEO before undertaking certain corporate actions. Those actions include engaging in any payment to:

- Repurchase, redeem, retire or otherwise acquire any of its shares, including share repurchases,
- Call any preferred stock,
- Pay any preferred stock dividends above the stated contractual rates, and
- Pay capital stock dividends in excess of the prior quarter's dividend (that requirement is eased upon Fannie Mae achieving the required capital levels).

OFHEO directed that Fannie Mae inform the agency of any other significant action that is likely to impair the ability of the Enterprise to manage its capital position to the required capital surplus levels.

Further, OFHEO directed that Fannie Mae continue to submit to OFHEO month-end minimum capital reports, no later than 30 days after the end of each month. Those reports will be reconciled to the general ledger and will continue to contain an official declaration of their accuracy. Additionally, Fannie Mae submits to OFHEO weekly management reports and projections detailing growth and other criteria that impact the maintenance of the capital surplus. OFHEO monitors and validates those reports.

On February 17, 2005, OFHEO approved a remedial capital restoration plan authorized by the Board of Directors of Fannie Mae on February 10, 2005. OFHEO oversees and monitors the Fannie Mae capital position on a weekly basis to ensure compliance. The Enterprise will keep the enhanced capital position until the Director of OFHEO releases or modifies the requirement based upon satisfactory resolution of accounting and internal control issues that are the subject of OFHEO examination.

As a result of those directives, Fannie Mae has taken significant actions to increase its capital. Those actions included the issuance of $5 billion in preferred stock,[1] a reduction in the Enterprise's common stock dividend,[2] and a reduction in its on-balance sheet assets.[3]

Corporate Governance

OFHEO directed the Board of Directors to separate the Chairman of the Board and the Chief Executive Officer positions and to provide to OFHEO the new written requirements for the Chief Executive Officer and the Chief Financial Officer. OFHEO also directed the Board to cause to be conducted a review of committee structures, resources, reporting requirements, procedures, and quality of financial disclosures, as well as any potential changes to management and internal systems to meet the Board's oversight responsibilities.

OFHEO has directed Fannie Mae to create a new Office of Compliance and Ethics that reports to the Chief Executive Officer and independently to the Compliance Committee. The office is directed by an officer that has no other duties at Fannie Mae and who operates independently, including with regard to communication with the Board and OFHEO, particularly on matters of wrongdoing. The office will have a separate internal investigative function that is adequately staffed and resourced to perform investigations regarding internal complaints, whistleblower reports, ethics matters, and related topics. That investigative function will report on its findings to OFHEO in a prompt manner. The head of the office cannot be removed without Board approval .

[1] SEC Form 8-K, filed by Fannie Mae on January 4, 2005.

[2] Fannie Mae News Release ("Fannie Mae Announces Reduction in First Quarter Common Stock Dividend as Company Builds Capital"), January 18, 2005.

[3] See, for example, Fannie Mae Monthly Volume Summary for December 2005, which shows mortgage portfolio balances declining from $904.6 billion at the end of 2004 to $727.2 billion at year-end 2005.

OFHEO directed the Board to establish a Compliance Committee, staffed with a minimum of three independent members of the Board. The Committee monitors and coordinates compliance with the September 2004 agreement and the March 2005 Supplemental Agreement and meets with OFHEO representatives regarding compliance with those agreements. OFHEO directed that the Board or the Compliance Committee establish an appropriate tracking system in consultation with OFHEO to allow for the monthly reporting of material events and the monitoring of the implementation of and progress under the agreements.

OFHEO directed the Board to cause an external review to gather recommended changes to the organizational structures, responsibilities, and personnel required to comply with law and regulation, particularly for regulatory reporting and data processing services. The Board shall consult with, and report to, OFHEO on any proposed changes.

OFHEO directed that the Board establish a program for no less than annual briefings to the Board and senior management on legal and regulatory compliance requirements applicable to Fannie Mae. The briefings are to include reviewing any Enterprise policies and practices that inhibit the effective compliance with those requirements.

OFHEO revised its corporate governance regulation in 2005 to address matters raised in its special examinations of Freddie Mac and Fannie Mae and developments in corporate governance practices. Additional duties and requirements for the Board and senior management were added to that regulation, including a requirement to establish compliance and risk management programs.

OFHEO directed the Board to create a procedure, approved by OFHEO, for the General Counsel of Fannie Mae to report directly to the Board any information relating to actual or possible misconduct by an Executive Officer or member of the Board, or the possibility of significant misconduct by an employee, while keeping counsel's professional and ethical duties to Fannie Mae. The procedure will call for the Board to notify OFHEO of the substance of the allegations, with the Board's comments, in a timely manner. Additionally, if the Board fails to notify OFHEO, the General Counsel will notify OFHEO of the information submitted to the Board.

Organization

OFHEO directed Fannie Mae to create a Chief Risk Officer position and required more direct reporting to the Board and OFHEO by that officer and others charged with audit and audit-like functions. OFHEO also directed a review that led to a stronger policy governing risk tolerance and a revision and enhancement of the Enterprise's internal audit function.

OFHEO directed the Board to separate the function of business planning and forecasting from the Controller's function. Additionally, the Board was directed to separate the modeling and accounting functions.

OFHEO directed the Board to report to OFHEO on any planned revisions in the accounting area that would alter reporting lines, the independence of a function to evaluate models employed in accounting, or the role of the external auditor and internal audit procedures; or add new positions to remedy any determined weaknesses.

OFHEO directed the Board to assure the independence of the internal auditor, including the ability of the internal auditor to report directly to the Audit Committee or the Board. OFHEO directed that the Audit Committee have at least one person with sufficient technical expertise to understand the implications of accounting policies for the Enterprise's financial statements.

OFHEO directed that the Board cause an independent review of organizational, structural, staffing, and control issues, focusing on but not limited to the Chief Financial Officer, controller, accounting, audit, financial reporting, business planning and forecasting, modeling, and financial standards functions. OFHEO directed this review in order to enhance accounting and controls and foster a culture of adherence to proper corporate policies and legal and other requirements. Subsequently, Fannie Mae management began a review that addressed the following topics:

- Lines of reporting,
- Independence of functions,
- Segregation of duties,
- Alignment of functions,
- Roles and responsibilities,
- Staff qualifications,
- Key person dependencies, and
- Adequacy of resources.

OFHEO has met frequently and formally with management of Fannie Mae to assess the status of that review. As a result of the review, management has effected significant changes in the organizational structure of the Enterprise. OFHEO will continue to monitor the effectiveness of those changes.

Internal Controls

OFHEO directed Fannie Mae to restate inappropriate past financial statements, meeting all applicable legal and regulatory requirements, including having the new financial statements reaudited by the Enterprise's new external auditor. OFHEO also directed the Board to cause a review of internal controls relating to accounting, staffing, resources, quality, and routine provision of information to senior management and the Board, and of the effectiveness of the corporate code of conduct, and to report the results back to OFHEO. The review scope also includes any planned revisions to avoid actions that do not support appropriate corporate goals and legal requirements.

OFHEO directed the Board to enlist independent outside counsel to conduct a comprehensive review of Fannie Mae's accounting policies and practices to ensure that the policies and practices are in compliance with applicable laws and regulations. The outside counsel reports directly to the Board and has full access to the Enterprise's staff and resources, including records and e-mail. The outside counsel has full access to the company's books and records related to GAAP compliance including, but not limited to, any adjustments made for system/methodology conversion, any "on-top" adjustments, and any other adjustments. OFHEO directed that the agency have full access to all work conducted by the outside counsel, independent of the Enterprise or the Board.

OFHEO directed that Fannie Mae cease inappropriate hedge accounting. The agency also directed the Enterprise to make necessary adjustments to its accounting for derivatives to bring that accounting into compliance with GAAP.

OFHEO directed Fannie Mae to supply a formal, comprehensive summary of existing methods and practices to manage actively the calculation of amortization. OFHEO also directed Fannie Mae to implement an appropriate policy for SFAS 91 accounting that includes amortization of deferred price adjustments in a manner that requires the Enterprise to correctly book the entire amount of the modeled catch-up provision on a quarterly basis.

OFHEO directed the Board to cause a review of the procedures regarding preparing, revising, validating, authorizing, and recording of journal entries and to report back to OFHEO with the results of that review, including a description of how the deficiencies will be corrected. OFHEO also directed the Board to direct management to develop and implement appropriate written policies and procedures for journal entries. Those policies and procedures must include, but are not limited to:

- Prohibition of employees from falsifying signatures in journal entries as well as signing such entries without proper authorization,

- Requirements that any preparer of a journal entry understand the purpose for which the entry is made,

- Requirements that journal entry reviewers and approvers determine that an entry is valid and appropriate,

- Requirements that journal entries be supported with appropriate documentation, and

- Requirements that journal entries are independently reviewed by an authorized person other than the preparer.

OFHEO directed the Board to direct management to develop and implement a plan to address the deficiencies in the accounting systems for Fannie Mae's portfolio. The plan includes, at a minimum, the ability to:

- Automate marking the mortgage-backed securities portfolio to market, to the degree practicable;
- Properly account for mortgage revenue bonds;
- Properly account for dollar roll transactions; and
- Properly account for interest-only strips pursuant to EITF 99-20.

Staff

OFHEO directed a complete review of staffing for skills, past performance, and role in a revised corporate structure and reorganization of accounting. Significant personnel changes have been made. By year end 2005, over 35 percent of officers at or above the senior vice president level have separated or announced separation from Fannie Mae.

OFHEO directed the Board to consult with OFHEO on matters relating to organization and staffing pursuant to the September 2004 Agreement and the March 2005 Supplemental Agreement. The Board directed management to make changes expeditiously, particularly regarding disciplinary or other actions to individuals, and to address concerns raised by OFHEO in the course of its examination of the matters under review and covered by those agreements.

OHFEO directed that Mr. Franklin Raines and Mr. Timothy Howard not be engaged, regardless of compensation arrangements, to provide any service to Fannie Mae subsequent to their separation from the Enterprise. Fannie Mae may apply to OFHEO for the services of any employees separated in connection with the special examination and the agreements.

Recommendations

Based on the special examination of Fannie Mae, OFHEO's staff recommends to the Director that the following actions be taken to enhance the goal of maintaining the safety and soundness of the Enterprise.

1. Fannie Mae should be subject to penalties and fines consistent with the findings of this report.
2. Fannie Mae must meet all of its commitments for remediation and do so with an emphasis on implementation—with dates certain—of plans already presented to OFHEO.
3. Fannie Mae must maintain a capital surplus until the Director determines a change in the surplus amount is warranted.

4. Fannie Mae must continue to use independent consultants acceptable to the Director to validate and assure compliance with requirements. Cyclical targeted exams by independent consultants, at least every two years, are needed to assure systems and practices are being implemented properly.

5. Fannie Mae must develop new structures and operational plans for its Board of Directors related to Board reporting, maintenance of minutes, and other changes that will enhance Board oversight of the Enterprise's management.

6. Fannie Mae must review OFHEO's report to determine additional steps to take to improve its controls, accounting systems, risk management practices and systems, external relations program, data quality, and corporate culture. Once OFHEO has approved the Enterprise's plans, an emphasis must be placed on implementation of those plans.

7. Fannie Mae must undertake a review of individuals currently with the Enterprise that are mentioned in OFHEO's report and provide OFHEO a report as to conclusions regarding terminations, transfers, or other remedial steps (such as disgorgement, restitution, or alteration of benefits) in cases of misconduct.

8. Fannie Mae must assure that departments are fully and appropriately staffed with skilled professionals who have available regular training opportunities in financial services industry standards.

9. Due to Fannie Mae's current operational and internal control deficiencies and other risks, the Enterprise's growth should be limited.

10. OFHEO should continue to develop its program of regulatory infrastructure to add additional rules and regulations that enhance the transparency of its supervision of the Enterprises. With the end of the special examination, OFHEO staff should be directed to address additional items raised during the preparation of this report as part of the regular examination program.

11. OFHEO should continue to support legislation to provide the powers essential to meeting its mission of assuring safe and sound operations at the Enterprises.

12. Matters identified in this report should be referred to OFHEO's Office of the General Counsel for determination of enforcement actions that the Director may wish to consider.

13. Matters identified for remediation by Fannie Mae should be considered by the Director for application to both Enterprises.