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BEFORE THE COMMITTEE ON FINANCIAL SERVICES
United States House of Representatives

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

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

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

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

I. Our Engagement

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

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

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

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

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

II. Our Key Findings

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

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

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

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

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

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

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

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

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

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

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

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

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

III. Corporate Governance and Internal Controls

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

1. The Board

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

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

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

2. Office of the Chair (Senior Officers)

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

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

3. Office of Auditing (Internal Audit)

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

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

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

4. Office of the Controller

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

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

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

5. Ethics and Compliance

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

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

IV. Other Matters

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

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

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

Thank you, Mr. Chairman.