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STATEMENT OF
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ON "OFHEO'S REPORT OF THE SPECIAL EXAMINATION OF FANNIE MAE"
BEFORE THE SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE,
AND GOVERNMENT SPONSORED ENTERPRISES,
U.S. HOUSE OF REPRESENTATIVES
JUNE 6, 2006

Good afternoon. Chairman Baker, Ranking Member Kanjorski and members of the Subcommittee, thank you for the opportunity to discuss the findings of our Special Examination of the Federal National Mortgage Association, better known as Fannie Mae. I will also discuss the settlement agreements reached by the OFHEO and the Securities and Exchange Commission (SEC) with Fannie Mae.

As a Government Sponsored Enterprise (GSE), Fannie Mae has a special position among American corporations and an extremely important mission—facilitating the growth of affordable housing in the United States. Despite its recent downsizing, Fannie Mae remains one of the largest financial institutions in the United States. As a GSE, Fannie Mae has a special mandate and position of public trust. The previous management team, led by Chairman and Chief Executive Officer (CEO) Franklin Raines, violated that trust. By encouraging rapid growth, unconstrained by proper internal controls, risk management and other systems, they did serious harm to Fannie Mae while enriching themselves through earnings manipulation.

Let me provide a little history about OFHEO's Special Examination. Despite Fannie Mae's protests, in July 2003 OFHEO informed the Senate Committee on Banking, Housing, and Urban Affairs that it intended to conduct a special accounting review of Fannie Mae to evaluate whether it complied with Generally Accepted Accounting Principles or GAAP.

In September 2004, OFHEO issued an interim report that detailed serious problems relating to Fannie Mae's accounting. Importantly, OFHEO found that Fannie Mae did not comply with GAAP for FAS 91, which deals with amortization of loan fees, premiums and discounts, and FAS 133, which covers derivatives and hedge accounting. The SEC concurred with OFHEO's findings and ordered Fannie Mae to restate its financial statements filed with the Commission.

Since then, OFHEO and the Board of Directors of Fannie Mae have entered into three agreements requiring remedial steps. The last agreement was signed on May 23, 2006.

The OFHEO report details an arrogant and unethical corporate culture. Perhaps the best written record of this culture is a memo from the Chief Operating Officer to the CEO two months after OFHEO's interim report. He was discussing the need to change and wrote: "The old political reality was that we always won, we took no prisoners…" and he added, "we used to … be able to write, or have written rules that worked for us."

Fannie Mae's management directed employees to manipulate accounting and earnings to trigger maximum bonuses for senior executives from 1998 to 2004. The image of Fannie Mae as one of the lowest-risk and 'best in class' institutions was a façade. The examination found an environment where the ends justified the means.

As reported in the Special Examination Report, senior Fannie Mae executives were precisely managing earnings per share (EPS) to the one-hundredth of a penny to maximize their bonuses while neglecting investments in systems, internal controls and risk management. The combination of earnings manipulation, mismanagement and unconstrained growth resulted in an estimated $10.6 billion of overstated profits, well over a billion dollars in expenses to fix the problems, and ill-gotten bonuses in the hundreds of millions of dollars.

To update the old English saying, they were "a hundredth of a penny wise and tens of billions of dollars foolish." Actually, their actions were much worse than foolish. They were flat-out wrong, or, to use the proper regulatory phrase, they were managing Fannie Mae in an "unsafe and unsound" manner. Senior management manipulated accounting; reaped maximum, undeserved bonuses; and prevented the rest of the world from knowing about it. They co-opted their internal auditors and other managers. They stonewalled OFHEO.

The executive compensation program at Fannie Mae sent senior executives the message to focus on increasing earnings rather than controlling risk. Indeed, during much of the period covered by the report, Fannie Mae took significant amounts of interest rate risk and, when interest rates fell in 2002, incurred billions of dollars in economic losses, despite the smooth reported earnings. Fannie Mae also had significant operational risk exposures.

The Board of Directors, the last line of defense, failed to be sufficiently informed and independent. Their oversight failings meant that they did not discover, let alone correct, the redundant variety of unsafe and unsound practices at Fannie Mae, even after the Freddie Mac problems became apparent.

Management Manipulated Earnings

During the period covered by this report, Fannie Mae reported extremely smooth profit growth and hit earnings per share targets with uncanny precision each quarter. This was deliberately and systematically done by the senior management of Fannie Mae through the use of inappropriate accounting and improper earnings management.

By deliberately and intentionally manipulating accounting to hit earnings targets, senior management maximized their bonuses and other compensation, which came at the expense of shareholders. In 1998, management *should* have recognized significant losses from the amortization of premiums and the impairment of guaranty-fee buy-ups, but much of the actual loss was deferred so that management could meet bonus targets, as well as the expectations of analysts. In other years, such as 2001, when very low short- term rates resulted in higher-than-forecasted earnings, management engaged in various manipulations, including debt repurchases and structured transactions with no legitimate business purpose, to save earnings for a rainy day. The report details the various ways in which these EPS numbers were massaged and manipulated in order to precisely hit these targets.

Senior management of Fannie Mae benefited greatly from these manipulations. For example, the total compensation of former Chairman and CEO Frank Raines exceeded $90 million from 1998 through 2003. Of that amount, more than $52 million was directly tied to achieving earnings per share targets.

Senior executives at Fannie Mae consistently reminded managers and other employees of their personal stake in meeting EPS targets. Indeed, the head of the Office of Auditing told his staff, in reference to Chairman Raines' goal of doubling earnings per share from $3.23 to $6.46 by 2003, that they must have "$6.46 branded in their brains." That statement implies a blatant conflict of interest for an internal auditor.

The report also found that senior management did not make adequate investments in accounting systems and staffing that the Enterprise needed to support a sound internal control system and GAAP-compliant accounting. These failures came at a time when Fannie Mae faced many operational challenges related to its rapid growth and a changing accounting and legal environment. In fact, this under-investment in internal controls, accounting systems, risk management and staff helped them to manage earnings as it made it much easier to hide improper actions that smoothed earnings.

That gives some flavor as to the inappropriate "tone at the top" and corporate culture that existed at Fannie Mae, and the executive compensation program that provided the incentive for the inappropriate behavior detailed in the report. Now, I want to spend a few minutes briefly describing the accounting tools that management used to achieve their desired earnings targets and the control environment – or lack thereof.

Specific Accounting and Earnings Management Issues

In brief, 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 management. The real question is how was management able to accomplish this when their business is volatile by nature and the accounting literature was moving toward measuring and reporting assets and liabilities at fair value?

First, they had to assure that large unpredictable changes in fair value were not recognized. FAS 115, *Accounting for Certain Investment in Debt and Equity Securities* and FAS 133, *Accounting for Derivative Instruments and Hedging Activities* are examples of accounting standards, if implemented properly, that would have recognized and recorded earnings volatility. Faced with that outcome, Fannie Mae chose to implement these and other accounting standards in a fashion that reduced volatility while ignoring the fact that these practices did not comport with GAAP.

During this same period, Fannie Mae management went to extraordinary lengths to avoid recording GAAP required impairment losses on assets whose values had declined. Examples of such assets are manufactured-housing and aircraft-lease-backed securities, interest only securities and “buy-ups.” Not only did they not record these losses but the report details the extraordinary measures management took to keep this information off the books and out of the view of their external auditor and regulatory bodies while tracking it for their own information and use.

By utilizing the above strategies, management was able to keep earnings within a predictable range, placing management in a position to employ several techniques to manipulate and manage earnings more directly. Those strategies included the use of cookie-jar reserves, income shifting transactions and inappropriate debt repurchases. 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 natural question at this juncture is where were the internal controls that should have prevented this type of behavior and where were the internal and external auditors?

The report details the conscious decision made by management to use existing systems even when proper implementation of new accounting pronouncements and rapid growth necessitated the need for new systems. It also discusses the weak internal control environment that management created or allowed to exist including a detailed discussion of the lack of journal entry controls.

The report also discusses the serious failures in the Office of Auditing. Internal Audit failed to properly confirm compliance with GAAP as specified in its audit objectives or to consistently audit critical accounting policies, practices, and estimates in a timely way. When Internal Audit did find shortcomings they were not adequately addressed or communicated. The Audit reports consistently understated problems and overstated work accomplished. Internal Audit failed to perform its primary task and issued misleading reports about its work. Finally, it failed to exercise due professional care in investigating allegations of accounting improprieties raised by two employees in the Office of the Controller.

Similarly, external audits performed by KPMG failed to include an adequate review of Fannie Mae's significant accounting policies for GAAP compliance. KPMG was aware of the non-GAAP provisions of Fannie Mae's FAS 91 policy as well as the non-GAAP practices the Enterprise was using in the application of FAS 133. That notwithstanding, KPMG issued unqualified opinions on Fannie Mae's financial statements for the years in question when these statements included significant departures from GAAP. Lastly, the external auditor performed a cursory review, at best, of the allegations of fraud raised by Roger Barnes. The procedures performed by the external auditor were not sufficient to make a determination regarding the propriety of the internal investigation performed by Fannie Mae or to evaluate the Enterprise's conclusions regarding Mr. Barnes's assertions.

The Role of the Board

In addition to these accounting and earnings management issues, the report also provides some insight on matters of corporate governance that gave rise to many of these problems. For example, the special examination found that the Board of Directors of Fannie Mae contributed to the Enterprise's problems by failing to be sufficiently informed and failing to act independently of its chairman, Frank Raines, and other senior executives. The Board failed to exercise the requisite oversight over the Enterprise's operations, and failed to discover or ensure the correction of a wide variety of unsafe and unsound practices. These failures occurred even after serious accounting and earnings management problems at Freddie Mac became widely known.

In particular, the Audit Committee did not provide adequate oversight of the internal audit function, and did not monitor the development and implementation of critical accounting policies. These failures resulted from the Committee's own neglecting to develop the specialized financial knowledge necessary for its oversight responsibilities. The Audit Committee also failed to initiate an independent investigation of Roger Barnes' whistleblower 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 this committee is to ensure that senior management is properly compensated for its role in directing the affairs of the Enterprise. Nevertheless, the Compensation Committee approved a compensation structure based on a single measure -- earnings per share that was easily manipulated by management. The Compensation Committee also did not monitor the executive compensation system for signs of abuse by senior management.

Recommendations

Based on the reports findings, staff made specific recommendations to me, as Acting Director, to enhance the safety and soundness of Fannie Mae. I have accepted all of the recommendations. Several of them were directed to OFHEO, including:

- OFHEO needs to continue to strengthen and expand its regulatory infrastructure and regular examination programs.

- Matters identified for remediation by Fannie Mae should be considered for Freddie Mac.

- OFHEO should continue to support legislation to provide the powers essential to meeting its mission of assuring safe and sound operations at Fannie Mae and Freddie Mac.

However, the majority of these recommendations are directed at Fannie Mae and I am pleased to say they have all been incorporated into the agreement that was signed on May 23, 2006.

The settlement represents a major step in correcting a dangerous course that had been followed by one of the largest financial institutions in the world. Unprincipled corporate behavior and inadequate controls simply will not be tolerated.

The key components of the agreement include:

- OFHEO has directed Fannie Mae to pay a $400 million penalty to the government. This level of penalty signals that unsafe and unsound conditions cannot be tolerated at firms that have a public mission and enjoy public benefits.

- OFHEO has directed that Fannie Mae freeze the growth of its portfolio mortgage assets to the level of December 31, 2005. OFHEO's action is based on the ongoing internal controls, risk management and accounting deficiencies and the need for the Enterprise to provide OFHEO an acceptable business plan for managing its market activities. Sole discretion lies with Director of OFHEO to modify or lift the limits based on his assessment of plans and progress. The existing capital requirements and capital planning along with limits on corporate actions such as dividend payments remain in effect.

- OFHEO has directed Fannie Mae to undertake a comprehensive reform program aimed at a top-to-bottom change, from corporate culture and tone to specific changes, including:

- Fannie Mae must strengthen its Board of Directors procedures to enhance Board oversight of Fannie Mae's management. The internal audit, risk management and compliance groups must be strengthened. The external relations program must be reviewed.

- Fannie Mae must take additional steps to improve its internal controls, accounting systems, operational and other risk management practices and systems, data quality, and journal entries. Emphasis must be placed on implementation with dates certain.

▪ Fannie Mae must undertake a review of current and separated employees for remedial actions. At the same time, Fannie Mae is directed to put in place qualified individuals with appropriate skills and adequate resources, and to provide a strong training program.

As you know, the SEC settled with Fannie Mae the same day that we did. Chairman Christopher Cox joined the OFHEO press conference and said, "Fraudulent financial reporting directly undermines the fairness of our capital markets, and the very purpose of those markets to allocate capital to its best uses." He also said, "the accounting fraud charges that the SEC is filing against Fannie Mae reflect the failure by Fannie Mae to maintain the kinds of internal controls that could have prevented what in all likelihood will be one of the largest restatements in American corporate history."

That concludes my prepared remarks. I would be pleased to answer any questions you may have.