

**Examination Year: 2004**

**Federal National Mortgage Association**

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This Report of Examination (ROE) has been made by an examiner appointed by the Director of the Office of Federal Housing Enterprise Oversight (OFHEO) and is designed for use in the supervision of the Enterprise. This copy of the ROE is the property of OFHEO and is furnished to the Enterprise examined solely for its confidential use. The Enterprise's component and composite ratings are strictly confidential and may not be disclosed to anyone not directly associated with the Enterprise. Disclosure of the ROE or its contents by any of the Enterprise's directors, officers, employees, lawyers, auditors, or independent auditors, without authorization by OFHEO, will be considered a violation of 12 CFR §1703.8 and subject to penalties under 18 U.S.C. § 641.

The information contained in this ROE is based on the books and records of the Enterprise, statements made to the examiner by directors, officers, and employees, and information obtained from other sources believed to be reliable and presumed by the examiner to be correct. The examination is not an audit and should not be construed as such. Neither the examination nor the ROE relieves the directors of their responsibility for providing for adequate audits of the Enterprise.

Each director, in keeping with his or her responsibilities, should thoroughly review this ROE. If the directors are not in substantial agreement with the contents and conclusions of this ROE, a request should be made promptly for a conference between selected directors and officers of the Enterprise and the Examiner-in-Charge to review these matters.

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## **EXAMINATION AUTHORITY AND SCOPE**

### Examination Authority and Reporting Convention

The Report of Examination contains the results and conclusions of OFHEO's 2004 annual examination of the Federal National Mortgage Association ("Fannie Mae" or "Enterprise") performed under section 1317(a) of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (12 USC 4517(a)). The OFHEO annual examination program assesses the Enterprise's financial safety and soundness and overall risk management practices. OFHEO utilizes the "CAMELS" methodology (Capital Adequacy, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk) adopted by the federal depository institution regulators to report examination results and conclusions to the Board of Directors and to Congress.

### Examination Scope

Examination activities conducted during 2004 were primarily devoted to the evaluation of the policies, practices, and controls in the business lines managed by the Chief Financial Officer (CFO) and related functions. Examinations conducted in other areas of the Enterprise focused on policies, risk management, and reports for the Board and executive management. The scope in other areas was not comprehensive so that resources could be allocated to evaluating the business lines managed by the CFO in accordance with OFHEO's risk-based examination approach. Additional key areas will be evaluated in future examination cycles. The lack of cooperation in attorney client privilege issues limited OFHEO's ability to assure the Enterprise's safety and soundness, and the expeditious conclusion of the special and annual examination process.

Care should be taken in evaluating the conclusions. The conclusions are based on the areas examined, and the reader should not assume conclusions beyond those specifically stated. Also, this report is structured so that the first few paragraphs in each section provide an overview of the conclusions and scope, and the following paragraphs provide the detail and support for the overview.

## **EXAMINATION RESULTS AND CONCLUSIONS**

Overall, the Enterprise's condition warrants significant supervisory concern. The quality of policies, controls and communication varied among the business lines due to weaknesses in executive management's program. Their program did not establish an explicit baseline of standards that ensured all Enterprise activities consistently met industry standards in policies, controls and communication. These weaknesses coupled with a focus on expense control impeded or prevented the Enterprise from building aspects of the organizational structure and culture needed to effectively manage and control a company through significant business growth and changes. The full extent of Fannie Mae's condition cannot be determined at this time. However, deficiencies noted

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during the year indicate Fannie Mae's program needs strengthening in several areas. Strengths and weaknesses generated by their program include:

- The quality of policies varies due to the lack of standardization in their production and review.
- Several Board reports need more meaningful and complete information.
- The lack of a centralized authority in Operations and weaknesses in independent risk oversight prevented several deficiencies from being detected, reported, and corrected. The organizational structure failed to provide fundamental controls for the Controller department.
- Deficiencies identified inadvertently or through reviews conducted by the Enterprise and OFHEO indicate several areas in operations controls need strengthening.
- Information Technology in the areas of business continuity planning, crisis management, data center, core, and e-business activities are managed satisfactorily.
- Credit risk management is satisfactory for processes concerning counterparty risk management, multifamily operations, and new product development. However, deficiencies noted in several areas indicate that business line management and Internal Audit need to strengthen their oversight functions.
- Liquidity management is satisfactory but requires strengthening in some areas of policies and procedures, contingency planning, and systems issues that impact some process efficiencies.
- Interest rate risk (IRR) is managed satisfactorily, and risk levels remain within management's limits. IRR policies and Board report content should be strengthened.

The Board and management have initiated actions to address the issues noted in this report, and have already devoted significant resources to correct the deficiencies noted in OFHEO's September 2004 special examination report.

### **MANAGEMENT SUPERVISION**

The former CEO, CFO, and Controller were weak due to their implementation of inadequate policies, controls, and systems in the Controller department. The former head of Internal Audit was weak due to compromised independence, the lack of audit experience, and the quality of his program. The interim and new management team has begun to implement a program to correct these deficiencies, but it is too early to determine the effectiveness of their management or program.

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The former executive management's program generated weaknesses in communication and controls. Some Board reports and presentations needed additional information and/or better risk metrics. The lack of a centralized authority in operations and independent risk oversight prevented some deficiencies from being detected, reported, and corrected. Poor controls in the Controller Department coupled with inadequate oversight from Internal Audit contributed to problems in financial reporting continuing for years.

The former executive management fostered a culture of frugality throughout the Enterprise, which led to inadequate policies, controls, and systems in the Controller department and other business lines. The Controller department's deficiencies were particularly acute due to the former Controller's program of extreme expense control. Excessive expense controls prevented several systems, processes, and controls from being properly implemented or updated, and impeded business line management's ability to prepare for future changes and/or growth in business activities and GAAP. Also, Internal Audit was significantly understaffed.

**Several Board reports need more meaningful and complete information. Several deficiencies were not reported to the Board.**

While performance and many key risks were reported to the Board, several key functions produced Board reports with marginal information. Internal Audit's reports to the Audit Committee omitted or downplayed the importance of some deficiencies, and omitted information on Internal Audit's own resource deficiencies. Operations risk metrics reported to the Board did not provide effective information to focus members on key risks and issues. Interest rate risk reports contain risk information understood by industry professionals, but is not easily understood by those outside the industry. Inaccurate and marginal information impeded the Board's ability to effectively oversee the Enterprise's activities.

**Former executive management allowed an organizational structure that failed to provide fundamental controls for the Controller department and internal auditor. Management's actions contributed to the development of accounting policies and practices that were overly aggressive or noncompliant with GAAP.**

Organizational structure and control deficiencies contributed to the use of accounting policies and practices that were overly aggressive or noncompliant with GAAP. These deficiencies include:

- No policies and procedures to formally establish personnel responsibilities for the development, review, and approval of accounting policies.
- No Controller department procedures to formally detail actual practices in applying accounting methodologies, or recording transactions.
- Poor segregation of duties in the Controller Division for the authorization and recording of transactions, the modeling and recording of transactions, and financial reporting and forecasting.

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- Lack of accounting technical expertise in the CFO, and many of the Controller department's management and staff.
- Lack of internal audit independence because the head of audit's compensation was influenced by the former CFO, and the head of audit's oversight of Controller department audits, a department he formerly managed.
- Excessively low staff levels in the Controller department and Internal Audit.
- Systems limitations created by excessive expense controls over systems and staff resources. Issues in Treasury's systems that fed information to the Controller department systems.
- Inadequate communication with the Board and its Audit Committee on accounting policy, and the resulting impact on public disclosures and compliance with GAAP.

**The lack of centralized authority in Operations and independent risk oversight prevented deficiencies from being detected, reported, and corrected.**

Internal control standards were left to individual managers to establish, and accountability for detection of deficiencies primarily fell on Internal Audit. Internal Audit failed to accurately report several deficiencies, including its own resource deficiencies to the Audit Committee.

The former strategic plan did not adequately coordinate all business lines for new business growth and changes in accounting requirements. Business line management sometimes made decisions independently, and addressed systems upgrades or deficiencies with manual work-arounds and end user computers, rather than implementing improvements within a comprehensive, pre-established framework.

The former Controller addressed many of the accounting changes through the use of numerous end user systems, but did not inform the Information (IT) support staff. IT did not learn of the Controller's end user systems until early 2004 when Internal Audit compiled a list of these systems throughout the Enterprise. Despite IT staff's offers during 2004 to help improve the systems and controls, the former Controller continued to use the end user systems. Extreme expense control and poor strategic planning limited the former Controller's resources available to upgrade the systems.

Former executive management did not establish a satisfactory Internal Audit function or an independent, centralized function for risk management oversight. Internal Audit shouldered the responsibility for independent review since the Enterprise had no independent risk management function. However, Internal Audit did not adequately detect or report several operations deficiencies, contributing to the Controller department's deficiencies remaining uncorrected for years.

**The Board has initiated significant action to correct the deficiencies noted in OFHEO's special examination.**

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After the release of OFHEO's special examination report in September 2004, the Board began taking action in October by establishing the Compliance committee to oversee corrective actions and initiating analysis of compensation, organizational structure, and their capital plan. Once the SEC concurred with OFHEO's conclusions that accounting methodologies were noncompliant with GAAP guidelines, the Board established a program to correct accounting policies and methodologies. The Board has devoted significant resources to develop and monitor a program to correct deficiencies noted in the special examination by:

- Appointing a non-executive Chairman to the Board and establishing separate positions for Chairman and CEO.
- Establishing the Board Compliance and Review committees and a team that monitors and reports to the Compliance committee efforts made to comply with OFHEO's September 2004 agreement and March 2005 supplemental agreement.
- Hiring consultants to recommend an organizational structure and compensation plan that meet or exceed industry standards.
- Removing key executives who managed the accounting activities, appointing interim managers and a permanent Controller, and hiring search firms to help replace the interim CEO, CFO, and the head of Internal Audit.
- Replacing the external auditor. The new auditor has initiated a comprehensive, substantive audit of the Enterprise's processes, controls, and accounting policies and methodologies.
- Hiring an accounting firm to assist management in a comprehensive review of all accounting policies.
- Changing the organizational structure of the departments managed by the CFO to establish appropriate internal controls and segregation of duties in the areas of internal audit, Chief Risk Officer, accounting, policies, reporting performance, and performance planning, forecasting, and modeling.
- Strengthening independent risk management by establishing a centralized risk management unit, establishing appropriate separation of duties in the Controller department, developing a stand-alone ethics and compliance function, and making internal audit independent both in organization structure and function.
- Centralizing the line of business management of operations.
- Eliminating hedge accounting for derivatives until systems can be upgraded to properly apply the rules and document compliance required by SFAS 133.

**The quality of policies varies significantly due to the lack of standardization in their production and review. The lack of formal procedures for accounting policy development contributed to the former CFO's incomplete disclosure of critical accounting policies to the Board's Audit Committee. A program has been implemented to address policy deficiencies with the new Controller addressing the accounting policies, and the interim CRO developing a policy providing standards for all Enterprise policies.**

The process for generating and reviewing policies governing management of the Enterprise is weak but improving. The quality of policies varies widely, with policies for

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several different lines of business or functions missing fundamental components such as limits, objectives, and credit approval authority. There are no standards for development of policy and procedures, formal identification of those responsible for current and accurate policies, the review and approval protocol, or the frequency that policies and procedures will be revised. Some of the policies that need to be improved are:

- Policies and procedures for the Controller department are inadequate and/or inaccurate in addressing accounting policies, journal entry documentation, journal transaction entries and review, internal controls and segregation of duties, and procedures for informing the Board's Audit Committee about accounting policies.
- The accounting policy for consolidation is inconsistent with FIN 46 in several respects.
- The loan accounting policy is inconsistent with SFAS 65 because it classifies all loans as Held for Investment (HFI) even though many were sold before maturity.
- The policy for the amortization of premiums and discounts is inconsistent with SFAS 91.
- The securities accounting policy is inconsistent with SFAS 115, allowing Held to Maturity (HTM) securities to be reclassified after purchase date.
- The hedge accounting policy for derivatives is inconsistent with SFAS 133.
- The accounting policy for financial assets is inconsistent with SFAS 140, allowing inadequate monitoring of collateral in dollar roll transactions.
- The operations policy does not provide guidance for managing risks on a consolidated basis.
- The Board's interest rate risk policy does not provide risk tolerance objectives or limits.
- The liquidity policy contains incomplete contingency funding plans.

The policies examined that define the Board's structure and responsibilities are satisfactory. These policies address such areas as the charters that establish Board committee responsibilities, independence criteria that meet the standards of the New York Stock Exchange, and member term limits and defined exceptions for extension of a member's term.

The Board has engaged consultants to provide expert advice on how it should revise policies for compensation for executive and senior management, per requirements of the OFHEO agreement. The interim CRO has begun to develop a policy that will address all policy content, development, and maintenance as well as establishing a program to ensure

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policies and procedures are properly generated, revised, and approved. The new Controller is reviewing and revising the accounting policies.

**The technical competence of previous executive management varied greatly. The Board and the current executive management team have shown satisfactory leadership by initiating a program to address deficiencies, and managing normal operations through a period of high change.**

In the previous management team, several managers exhibited satisfactory technical skills, such as those managing retained portfolio risks. However, several lacked experience or had insufficient technical skills for the areas they managed. The former CEO and CFO had no experience in managing regulated financial institutions prior to working at the Enterprise. Several managers and staff in the Controller department were unqualified for their job responsibilities, including the former Controller, who authorized accounting policy but was not certified as a CPA. The former head of Internal Audit had no audit experience prior to accepting this position. The Board is in the process of hiring personnel with appropriate skill sets for all key management positions open.

The Board has begun to address the leadership and technical competence issues, and the problems former executive management created by replacing deficient management noted in OFHEO's special examination.

**Reports generally provide the information necessary to conduct day-to-day business activities. However, improvement in several risk metrics and some systems are needed to improve the quality and timeliness of some reports for the Board and executive management. Management is in the process of assessing the content and format of regular management reports.**

Reports for lower level management are satisfactory because they generally provide the detail needed to manage the business lines. However, reports received by executive management and the Board vary widely in quality, with quality generally better for the profit-generating business activities. Some risk metrics in reports for executive management do not provide meaningful or forward-looking information. In addition, systems deficiencies caused some reports to be produced excessively beyond the report date or to contain incomplete or less than optimal information. Systems deficiencies have contributed to the following:

- The Early Warning report is produced three to four months after the report date, and the Risk Profile report for credit risk is produced two and a half months after report date.
- Cashflow forecast reports use some information that is less than optimum because Treasury cannot get timely information from some business lines.
- Interest rate risk reports do not always contain all reported scenarios because of difficulties with analytics systems.

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The Board receives the report package sufficiently in advance for review, and Board committees satisfactorily report to the full Board. The Board and executive management have begun to develop formal processes to ensure management provides them with all necessary information. However, the Board currently receives several reports with information that is incomplete or could be more meaningful. Some reports do not contain meaningful risk metrics and/or brief narratives that focus them on key issues. Poor quality reports force the Board to rely on executive management to present accurate and complete information in verbal presentations.

The Board does not receive written reports on operations risk and incomplete reports from internal audit activities. These reports should, at a minimum, include the following:

- Operations risk reports should include key risk indicators, loss and near loss event data, fraud information, and progress in implementing an operational risk framework.
- Internal Audit reports should include major audit deficiencies outstanding, trends and current composition of audit ratings and the root causes of those ratings, as well as variances in completion of the internal audit's program, and staff levels and turnover.

**Control systems are weak due to a culture that deemphasized line of business management's accountability for controls, and generated a weak independent oversight function. The Board has begun to correct these issues.**

The former executive management failed to provide sufficient comprehensive oversight for internal controls in both the line of business and independent oversight functions. The lack of a corporate-wide program for internal control standards and monitoring requirements left it to business line management to set and monitor many of its own controls and reporting requirements. Control quality varied widely since individual managers established their own programs. Internal audit lacked sufficient independence, and failed to properly report several of the deficiencies it found. Independent risk management and some aspects of model validation fail to meet industry standards. The Board and executive management are in the process of correcting the control deficiencies.

Internal Audit lacked independence due to its prior reporting structure and relationship with executive management. The head for Internal Audit reported to the Board's Audit Committee, but the CFO provided day-to-day management and had significant influence over his performance evaluation. The lack of independence was shown in instances where audit reports omitted deficiencies or deemphasized their significance. The former Internal Audit head failed to accurately inform the Board about several deficiencies in the business lines, or in Internal Audit's own staffing levels. Management recently corrected the control deficiency in which the Information Technology's business continuity planning reported to the head of Internal Audit.

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Audit processes are satisfactory in rating the inherent risks and mitigating controls in auditable entities, and in tracking audit work. However, audit is weak in defining auditable entities and audit frequency control, and needs to strengthen staff levels.

- Insufficient staff levels and insufficient skill sets in some areas prevent a comprehensive and accurate analysis of the Enterprise's risks and controls.
- Internal Audit has divided the Enterprise into too few and thus too large separate functions to audit, making it difficult to communicate and control audit coverage.
- Audit frequency is risk-based but is not controlled with defined maximum time periods, making it difficult to monitor and control the time periods between audits of a particular function.

Because of deficiencies in the work previously completed by the internal and external auditors, the new external auditor will not be able to attest to the accuracy of the Enterprise's financial statements until it completes a thorough evaluation of the Enterprise. They have begun a comprehensive, substantive audit of issues surrounding financial statements, accounting and other areas, and will not rely on previous work conducted by internal audit or the previous external auditor.

## **OPERATIONS**

Operations risk management for the Controller department's transactions, accounting, and financial statement records is weak but improving. Because operations examinations outside of the Controller department were limited this year, OFHEO cannot rate the quality of operations risk management in the other lines of business. However, deficiencies discovered through reviews conducted by OFHEO and Enterprise management, or identified in the Enterprise by chance or litigation indicate that operations controls need strengthening in several areas. The full extent of quality of operations risk management will not be known until the Board's consultants and the external auditor complete their analyses, and OFHEO completes a full examination cycle.

Operations risk management for business lines managed by the CFO is weak based on:

- Accounting policies that are noncompliant with GAAP.
- Inadequate systems used to record transactions and produce financial statements.
- The lack of a standardized program requiring business line management to review and maintain controls.
- The lack of centralized operations management in the business lines.
- A culture fostered by the former CEO and CFO that impeded communication of operations risk deficiencies to the Board.

Operations risk under the interim CFO is improving due to the significant resources employed by the Board and the new executive management team to identify and correct deficiencies. The program is in its initial stages, and will take considerable time to fully

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implement. Issues such as the segregation of duties and hiring of new personnel have been or can be corrected within a few months. However, new accounting policies, temporary manual work-arounds for systems deficiencies, and implementation of new systems for financial records and other areas will require several months to one or more years to address.

Information technology (IT) in the areas of business continuity planning, crisis management, data center, core, and e-business activities are managed satisfactorily. Systems are secure, and management has established effective systems redundancies and business continuity processes. The IT strategic plan is satisfactory and appropriately integrated with corporate objectives. Policies for the areas examined were generally satisfactory, but some contained old and inaccurate information. The interim CRO is in the process of developing a policy that will standardize policy content, development, and maintenance. Management recently corrected the control deficiency in which the IT's business continuity planning reported to the head of Internal Audit.

This year's examinations centered on the evaluation of internal controls, systems, communication, and culture in the lines of business under the CFO, and the Board's corrective actions taken to address the deficiencies noted. Limited operations reviews were conducted in cash flow forecasting, credit risk measurement, and IT in the areas of business continuity planning, crisis management, data center, core, and e-business activities.

**Operational structure for accounting, financial records and transactions, and other functions under the CFO recently were or remain weak due to poor internal controls and segregation of duties, and systems limitations.**

Many aspects of the operational structure do not or recently did not meet industry standards in the areas of segregation of duties, personnel expertise, and systems limitations and controls. The inadequate segregation of duties and poor clarification of personnel responsibilities coupled with decision makers with inadequate technical expertise and a willful disregard of accounting rules contributed to the use of accounting policies and practices that were overly aggressive or noncompliant with GAAP. The former CFO reporting lines generated conflicts of interest by combining the following functions:

- The authorization and recording of financial transactions.
- Modeling and recording of security amortization.
- Financial reporting and forecasting.
- Risk taking, risk management, and financial controls.

The lack of expertise and deficient staff resources in the Controller department contributed to the use of accounting practices that were noncompliant with GAAP. The lack of expertise reduced the potential for management and staff to question the Enterprise's accounting practices. The Controller department manager who approved accounting policies was not a CPA. Also, the Financial Standards department, which

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wrote accounting policies, as well as reviewed, and supported counterparty and investment company due diligence, had only four employees until 1Q03. Executive management kept resources low despite numerous changes to and an increase in accounting rules between 1999 and 2003 that significantly impacted the Enterprise. Staff levels were increased to eight employees by 3Q04 after it was widely recognized that the department could not adequately complete its work.

The former CFO used poor controls and improper practices to record transactions for several years. The amortization policy, which was noncompliant with SFAS 91, was written by the former CFO and Controller rather than Financial Standards, the department responsible for writing accounting policies. Manually prepared “on top” adjustments to security amortizations were entered into official records after closing date. The “on top” adjustments were authorized by reviewers who did not understand the purpose of the transactions, by an individual who had no formal responsibilities relating to amortization, or by an individual who forged the authorization signatures.

Systems limitations contributed to the deficiencies in journal entry controls. The former Controller’s excessive cost control prevented or slowed down upgrades to integrated systems, and prevented the integration of end user systems into the systems’ infrastructure. Because these systems were not upgraded, the Controller department remained overly-reliant on end user applications and other systems with deficient controls.

Systems limitations permitted adjustments to the amortization schedule, and technical personnel to overwrite database records without recording the occurrence of the adjustment or overwrite. Database overwrites were common, and any error in the overwrite could easily go undetected because there is no report that specifically shows changes or the author of those changes.

Software written for the portfolio accounting system included accounting methodologies that were noncompliant with GAAP, did not automatically input the fair value of securities, and did not automatically include mortgage revenue bond forwards in the Enterprise’s official records. Accounting that was impacted by this software includes:

- Estimate amortization of deferred price adjustments per SFAS 91.
- Account for dollar roll transactions per SFAS 140.
- Account for interest-only strips per EITF 99-20.

**OFHEO has not concluded on the quality of operations risk management in other business lines. However, deficiencies identified inadvertently or through reviews conducted by the Enterprise and OFHEO indicate that several areas in operations controls need strengthening.**

The corporate-wide standards for business line oversight of operations risk management are weak due to a lack of centralization in operations oversight, and non-standardization in controls and reporting requirements. Individual managers often determined their own

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controls and report quality, which led to non-standardized and uncoordinated solutions that generated work-around fixes rather than coordinated solutions built for long term viability. The Board and executive management are in the process of correcting these deficiencies.

Operations risk management is not standardized or fully centralized. Management in many business lines supervises both the front office and operations functions. IT provides oversight for all operations in single family lending, and systems throughout the Enterprise. However, management has significant influence over the level of IT resources devoted to their business lines, creating varied quality in IT support and systems. Decentralized operations adversely impacts operations by:

- Reducing the focus/importance and controls on operations quality. Business line senior management's expertise is generally centered in front office and customer service functions.
- Decreasing the level of independence necessary in some functions.

The quality of policies and key performance indicators has been adversely impacted by lack of centralized operations risk management. Policies and procedures vary in quality, with some nonexistent or noncompliant with GAAP, or industry standards for controls. No one set of reports provides corporate-wide, consolidated information on the strength of internal controls. Key performance indicators vary in quality and do not provide forward looking information where appropriate.

The former CEO and CFO did not inform the Board of significant operations risk deficiencies. In early 2004, the operational risk working group of management's Operations, Transaction and Investment Committee completed a study that concluded the Enterprise's process to control operational risks did not meet industry standards, and provided recommendations to correct the noted deficiencies. Former executive management began implementing a program to correct these deficiencies, but did not communicate the study's findings to the Board. The study concluded that a structure was needed to provide:

- Enterprise-wide operational risk oversight, and the creation of a unit responsible for enterprise-wide operational risk assessment, reporting, and management.
- Oversight by and reporting of operational risk to the office of the chairman.
- Standardized operational risk measures that include loss/incident tracking, forward looking metrics, and defined escalation triggers and reporting protocols.
- A strengthened process to achieve compliance with Sarbanes-Oxley section 404.

OFHEO noted effective internal controls in several areas of the Enterprise. However, the number and significance of internal control deficiencies noted in several different activities indicate deficiencies in the Enterprise's internal control program. Deficiencies outside of the Controller department include:

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- Varied completeness in business line management's response to Sarbanes Oxley questionnaires.
- Nonexistent or incomplete Board policies for areas such as IRR and model validation.
- The lack of reports that show corporate-wide, consolidated information on the strength of internal controls.
- Systems limitations and non-centralized data sources require the manual consolidation of data from several non-integrated systems. Manual data normalization and consolidation generates inefficiencies, and reports that are late, incomplete, or use less than optimum information. For example, two key reports for credit risk management are produced several months after their report date.
- Weaknesses in model validation for the Loan Loss Reserve model generated a loan loss allowance methodology correction requiring a \$50 million net adjustment.
- Weak controls for management of seller/servicer mortgage fraud that resulted in the First Beneficial forfeiture agreement at \$7 million.
- Failure to record mortgage revenue bond forwards initiated by Community Development in the Enterprise's official records.
- The lack of a centralized risk rating function prevented 50% of the multifamily loans from being risk rated.
- Standards for grading counterparties need enhancement so that large and small counterparties are graded with different criteria. Management had begun correction prior to OFHEO's examination.

**The Board and new executive management have devoted significant resources to develop a program to improve operations risk management.**

The Board and new executive management are implementing a program to address the operational deficiencies noted in the formal agreements with OFHEO, as well as a program to identify and address issues throughout the Enterprise. They are in the initial stages of developing and implementing a comprehensive, corporate-wide framework for monitoring and controlling operational risks. Management has already begun to implement improvements noted in the independent organizational study conducted by independent consultants hired by the Board, and tracking reports have been developed to help monitor progress in meeting time lines for correction. The corrective actions to address operations risk issues include:

- Operations risk management centralized in one business line.

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- Integration of the Controller department's systems into the corporate-wide program for information technology.
- An organization structure that meets or exceeds industry standards.
- Improved controls and clarified accountability within the lines of business.
- A centralized independent risk management function that evaluates all risks within the Enterprise, including operations risk.
- Improved reports, and risk metrics to better communicate risk levels and trends.
- Improved policies and procedures to better communicate standards, controls, and risk limits.

**IT in the areas of business continuity planning, crisis management, data center, core, and e-business activities are managed satisfactorily. IT risk will increase in the short term but decrease in the long term due to significant systems changes implemented in the near future. Regular business coupled with projects associated with changes in the core system and the Controller Department systems have strained personnel resources.**

The business continuity planning policy's updates in August 2004 appropriately reflect major changes. The crisis management plan details the Enterprise's responses to a region-wide catastrophe. The user ID and password construction policies deter hacking. The information security standards provide a framework for adhering to security philosophy and practices. Policies for the areas examined were generally satisfactory. However, several policies were old, and need to be included in a process that ensures they are formally reviewed and approved on a regular schedule.

Systems are secure, and management has established effective systems redundancies and business continuity processes. The IT strategic plan is satisfactory and appropriately integrated with corporate objectives. Former executive management had excluded the Controller department's systems from IT's strategic planning, but new management has corrected this issue.

Processes for crisis management, contingencies, and continuity of operations are satisfactory and include:

- Plans for senior executive succession, and relocation to a remote command center.
- A Treasury operations contingency data center facility in Texas.
- Routine dual site testing for securities operations.
- Information tape auditing and restoration conducted during regular production and periodic testing.
- Strong protection from access and physical attacks for their remote data center.
- Escalation procedures for e-business to avoid system outages and degraded operational performance.
- Regularly scheduled contingency exercises to proactively identify and resolve issues.

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Regular business coupled with projects associated with changes in the core system and the Controller Department systems are straining personnel resources. Personnel have been working at peak capacity for many months to properly implement significant projects. However, the CIO has access to additional resources and has reorganized the department to manage systems changes needed for financial statement production.

### **ASSET QUALITY AND CREDIT RISK MANAGEMENT**

Credit risk management is satisfactory for processes concerning counterparty risk management, multifamily operations, and new product development. However, most of these areas exhibited deficiencies that were not discovered by credit risk managers, indicating that management in both the single family and multifamily lines of business and Internal Audit need to strengthen their oversight functions. Process deficiencies have increased costs and risks to the Enterprise.

Most deficiencies noted were minor, but significant deficiencies exist in several areas:

- Detection and management of mortgage fraud in seller/servicers.
- Loan loss reserve calculation methodology.
- The validation program for credit risk models.
- Policy content and the review process for policy completeness and accuracy.
- Systems issues that impact the efficiency and timeliness of report production, and the data integrity within the Risk Net model.

Management in the lines of business and independent risk management have already begun to address many of these issues. The interim EVP for Housing Community Development (HCD) has proposed structural changes for HCD that are expected to generate better controls and more efficient operations through the centralization of functions. Management in multifamily lending recently corrected issues in the previously unsatisfactory risk rating system. The interim Chief Risk Officer (CRO) has begun to establish a program to regularly review policies and validate models.

The quantity of credit risk is low but increasing in both single family and multifamily loans. Single family loan (SFL) losses in 2004 were about \$176 million or 0.008% of the SFL portfolio. Increasing trends in single family REO were seen in 2004 and are forecasted for the next four years. REO acquisition growth was 23% in 2004, and is estimated to increase 15%, 19%, 25%, and 15% for each year respectively from 2005 to 2008. The average loss per case at about \$3,000 is down considerably from previous years, but will likely increase given slowing house price appreciation and the potential for localized declines in house prices from rising market interest rates.

Credit risk indicators also reflect a decline in multifamily portfolio quality. Although the percentage of severe delinquencies declined in the last year, REO inventories, balances, and the dollar amount of losses increased. The credit issues are centered in the apartment sector because of a decline in property income from lower rents and consumer demand,

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and renters with lower credit quality. Year end 2004 shows multifamily credit losses at \$47 million or 0.03% of the unpaid balance versus \$12 million in 2003.

The methodology used to determine some of the numbers in the above paragraphs changed during 2004. Thus, many of these numbers are not precisely correct, but are accurate enough to convey the levels and trends in the topics covered.

**Policies are generally satisfactory, but policy content and the program to review and update them need strengthening.**

The interim CRO has begun to develop policies that will ensure management periodically reviews and updates policies, and they meet content standards. Credit risk policies currently do not adequately define the approval process or authority for counterparty credit risk, the escalation process for credit exceptions in new products and multifamily credits, requirements for establishing risk limits for new products, or specific guidance for the use of certain assumptions in the loan loss reserve calculation.

**The credit risk processes reviewed are generally satisfactory but significant deficiencies exist in data integrity and validation of some models, fraud reporting, credit approval for new products and multifamily loans, and risk limits for new products.**

These processes have successfully limited credit losses and risk exposures to low levels. However, the Risk Net model exhibits data integrity issues, the Loan Loss Reserve and Credit-Works models have not been independently validated, and the Loan Loss Reserve model's results are inaccurate due to the excessive age of the default and loss severity data used in the model. The deficiencies associated with the Loan Loss Reserve model generate an inaccurate but conservative reserve level. The interim CRO has begun to develop a formal program that will independently validate all relevant models on a regular basis and address data integrity issues.

**Most reports are timely but systems issues cause two key reports to be produced excessively beyond their report date.**

The lack of automation prevents the efficient generation of some reports. The information for the Early Warning Report is available in a timely basis, but the generation of the report in the format desired by decision makers delays the delivery of the final report to three or four months after the report date. The Risk Profile report for credit risk is produced two and a half months after report date.

**Management promptly responded to the deficiency OFHEO noted in risk grading the multifamily portfolio. Controls for mortgage fraud are unsatisfactory.**

OFHEO's examination determined that the risk grading coverage for the multifamily portfolio was unsatisfactory because only 50% of the loans had been graded. Management is addressing this issue satisfactorily by increasing the coverage (which they

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had increased to 83% at year end 2004), grading the credits at origination, and increasing the granularity in the risk rating system.

Mortgage fraud management issues noted with seller/servicer First Beneficial indicate that the control systems for fraud at the time of this incident were ineffective. Regional office management failed to react to the early indicators of fraud and escalate the fraud concerns to a higher level. On a company-wide level, policies governing fraud control and reporting were either recently developed or are in process of being developed.

## **EARNINGS**

The analysis below is based on financial statements that will be revised significantly. The Enterprise's restatement of its financial information may change some of the numbers or OFHEO's conclusions.

Earnings for 2004 are satisfactory. The business model exhibits the capacity for sustainable profits, but could be impacted by legislation that mandates the size of the retained portfolio. Earnings capacity benefits from the company's government sponsored enterprise status which lowers borrowing costs and enhances the market's reception to its guarantees. The analysis of earnings is impeded by the lack of GAAP-compliant statements and the limitations in other methods used to estimate performance.

Former executive management's and the former Controller's actions reflected a tendency toward the use of overly aggressive interpretation of GAAP and a willful disregard of accounting rules when compliance would negatively affect the Enterprise. Control deficiencies contributed to allowing this practice to continue, and include:

- Poor internal controls in the Controller department that allowed the use of accounting practices that were noncompliant with GAAP.
- The compromised independence and incomplete Board reporting standards for Internal Audit.
- The former Controller's excessive expense control severely impacted controls and systems efficiency, and human resources for both the Controller department and Information Technology (IT). IT did not know the extent of the Controller department's problems from end user systems until early 2004 when Internal Audit gave IT a list of the department's end user systems.

### **The lack of GAAP compliant financial records and limitations in earnings measurement impede the ability to analyze the Enterprise's financial performance.**

Management is restating its financial statements, and reevaluating the non-GAAP information provided to investors for the years 2001 through 2004. During 4Q04, OFHEO determined and the SEC concurred that the Enterprise used accounting methodologies for derivatives hedging and the amortization of securities and loans that

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are noncompliant with GAAP, and required them to restate their financial statements. While no financial statements are publicly available, management has continued to release monthly business activity reports to aid the public in evaluating the Enterprise's performance. The monthly reports provide information on asset levels and growth, and credit delinquency rates.

Management has used core earnings, an internally generated measure, to help management and the public better understand the Enterprise's performance. Core earnings is a non-GAAP measure because it treats most derivatives as perfect hedges and amortizes the time value of options. However, core earnings has been a useful measure because it has been more consistent with evaluating economic performance than GAAP.

Performance evaluation using GAAP or core earnings need to take into account some weaknesses in the measures' impact on the time pattern of earnings recognition. The time pattern of core earnings is affected by management decisions in debt repurchases and loss provisions, which have little or no effect on the Enterprise's economic condition. In addition, current period gains or losses from changes in market yields are spread out over the lives of the financial instruments, while changes in the shape of the yield curve can produce temporal benefits or costs that are unsustainable.

Management also uses fair value balance sheets to help evaluate performance, and has made significant conceptual and methodological improvements in its calculation. Regular analysis of net assets by source of change would benefit from further development, as changes from different sources can have very different implications.

**Earnings for 2004 are satisfactory, but the rapid earnings growth reported in preceding years was not maintained, as expansion of the mortgage asset portfolio ceased and the guaranty business grew only modestly.**

Impeded earnings growth will likely continue in 2005 due to limited asset growth caused by the need to build capital, and higher expenses from the restatement effort and systems upgrades.

Core earnings for 2004 as measured before the restatement rose modestly from the previous year and remained at a healthy level of roughly one-fourth of the Enterprise's minimum capital requirement. Core earnings in 2004 would have shown a significant decline from 2003 earnings but for management's decision in 2003 to repurchase significant volumes of outstanding debt at a loss.

**Core earnings on the mortgage asset portfolio remained healthy but were lower due to flat growth and a lower spread.**

The lack of growth in mortgage assets in 2004 followed 13 consecutive years of double-digit growth. Unusually tight spreads between market yields on mortgages and the Enterprise's borrowing costs limited profitable purchase opportunities. The strong

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demand for mortgage assets at depository institutions that held down mortgage yields continued through 2004.

The mortgage asset portfolio grew slightly at 0.7% to \$905 billion at YE04 from \$898 billion at YE03, compared to 13% growth seen in 2003. The investment spread, the total investment yield minus total funding costs, compressed to 89 basis points (bp) in 2004 from 101bp in 2003.

Purchases to replace liquidating assets contained a much higher-than-usual proportion of adjustable rate mortgages (ARMs) and related securities, increasing the ARMs share of the portfolio from 5% to 14% over the course of the year. These assets have lower interest rate risk, but also generate lower returns than fixed-rate mortgages (FRMs) have provided in the past. Portfolio earnings in 2004 were also reduced by lower returns on holdings of FRMs, as the Enterprise was unable to reduce debt costs as rapidly as interest earnings have fallen due to replacement of prepaying mortgages with lower yielding mortgages.

**The guaranty business experienced lower growth but higher guaranty fee rates.**

The outstanding MBS grew 8% in 2004 after exceptionally high growth in 2003 at 26%. A shift in primary market production toward ARMs and subprime loans helped drop the Enterprise's share of new business. Private label MBS issues reached record levels at \$864 billion or about 46% of 2004's total MBS issues, up from about 20% each year in 2002 and 2003.

The average guaranty fee (g-fee) rate including fees for buy ups/downs rose to 21.7 basis points in 2004, up from 20.2 basis points the previous year. The increase is in part due to the increase in purchase money mortgages, and the decline in refinancings which have lower g-fees.

The profitability of the guaranty business also increased in 2004 because of implementation of more appropriate loan loss provisions. The new methodology used to determine the amount of the loan loss provisions reduced the amount of the 2004 provision, and will appropriately increase the variance of future provisions. The 2004 provision was \$4.3 million, down from \$100 million in 2003. The former methodology did not meet industry standards, and produced a relatively stable loan loss reserve for years. The reserve had been maintained at about \$800 million since 1999, but dropped to \$510 million after the methodology was changed.

**Expenses will increase in 2005 to cover financial restatement efforts and systems upgrades, partially offset from cost control in other expense categories.**

Administrative expenses are forecasted at \$1.9 billion for 2005, an increase of \$385 million or 26% increase over 2004. Audit costs associated with the restatement drive the increase at \$200 million, which is comprised of \$90 million for the external auditor and \$110 million for external consultants.

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The increase in systems expenses is primarily from changes to the core systems, and Controller department systems so that they can automatically apply GAAP compliant accounting methodologies. Management recently launched the Finance Transformation initiative to evaluate all Finance systems, processes, and controls, and generate a plan by the end of May 2005 to address identified deficiencies. Management estimates that completion of the plan could take five years, and require significant investment over this time period. Management does not anticipate any cost reductions when the systems improvements are done, but expect to benefit from improvements in processes and controls for closing the financial records and other areas.

Management's goal is to reduce base administrative expenses by \$150 million or more in 2005. Reduced headcount drives the expense reduction. Other reductions will occur by decreasing advertising by \$67 million, eliminating contributions to the FNM foundation, and canceling the relocation of the headquarters building.

**Fair Value net assets increased significantly in 2004.**

The Fair Value Balance Sheet's (FVBS) net asset value increased roughly by \$9 to \$10 billion in 2004 after adjusting for methodological changes and capital transactions (stock issuance less dividends paid). This strong result benefited somewhat from increases in the price of mortgages relative to the price of debt. Such relative price changes will have no ultimate benefits to the Enterprise if it remains a buy and hold investor. The result also benefited from longer expected average lives of its guaranteed mortgages over the course of the year. However, to the extent the Enterprise is able to replace guarantees on prepaid mortgages with new guarantees, this source of increase in fair value is not economically valuable.

**Retained earnings will help the Enterprise build needed capital.**

The Enterprise's strong capacity for future earnings is a key component of management's plan to achieve the capital ratios required in its agreement with OFHEO. The preferred equity issuance near YE04 increased capital by \$5 billion, but as of March 2005, capital levels remained \$5 billion below the required level. Management has also reduced dividend payments by 50%, which will increase retained earnings by roughly \$1 billion per year. Reductions in asset growth to reduce capital requirements, however, may constrain earnings.

**The loss of hedge accounting will increase reported earnings variability.**

Restated GAAP earnings will likely show considerable variability primarily due to the loss of hedge accounting treatment for derivatives. Because accounting for derivatives is mark-to-market and the assets and liabilities they hedge generally use accrual accounting, changes in market interest rates have the potential to generate large swings in reported earnings. Variability in future reported earnings could be substantially reduced if hedging strategies used by management meet GAAP requirements for hedge accounting.

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**Former executive management's and the former Controller's actions reflected a tendency towards an overly aggressive interpretation of GAAP, or in certain instances – when compliance with GAAP would negatively affect the Enterprise – a willful disregard for accounting rules. In some situations, accounting policies actually do comply with GAAP, but personnel failed to follow those policies.**

Former executive management and the Controller department used accounting policies and practices that were aggressive or not compliant with GAAP, and loan loss reserve methodologies that maintained stable allowance reserve levels. The aggressive or noncompliant accounting policies and practices were extensive, and include the following issues. OFHEO's special examination continues, and may reveal additional issues.

- SFAS 65: mortgage loans classification and accounting must be determined at acquisition. Also, loans should be designated as held-for-investment (HFI) only if the entity has the intent and ability to hold the loans until maturity or the foreseeable future.

Although securities were properly classified as held-for-sale (HFS) or HFI at acquisition, a systems upgrade in 2004 revealed that all loans had actually been booked as HFI for twenty-one years. Management corrected the accounting prospectively but did not determine the magnitude of the past error or the impact to the previous financial statements.

To properly record past financial results, management must identify and record these HFS loans at LOCOM and recalculate the gains and losses on the sale of any loans.

- SFAS 91: amortizing premiums and discounts on securities and loans, and reconciliation differences must be done in compliance with GAAP.

Discretionary adjustments to security and loan amortizations were made to avoid the earnings volatility generated by compliance with SFAS 91. The methods used for discretionary adjustments include a materiality threshold for changes in income and expenses, amortization estimation methods inconsistently applied to retrospective and prospective amortizations, and the selection of the most beneficial amortization estimates from multiple estimate methodologies. Reconciliation differences were not recognized in the current accounting period, but instead were capitalized and amortized at the same speeds used for 30 year fixed rate mortgages.

- SFAS 115: Securities classification and accounting must be determined at acquisition. Debt and equity securities are classified into one of three categories, and the appropriateness of the classification is reassessed at each reporting date. Improperly selling or transferring even a single security could cause the reclassification of all held-to-maturity (HTM) securities.

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The Controller department reclassified HTM securities after the purchase date. Securities purchased for the MBS retained portfolio and the Liquidity Investment Portfolio (LIP) were booked as HTM on trade date, but many were moved to available-for-sale (AFS) accounting at the end of the month in which the trade settled.

Selling or transferring securities out of the HTM portfolio taints the portfolio and requires all securities in HTM portfolios to be accounted for as AFS. To properly record past financial results, management must record all securities as AFS.

- SFAS 133: hedge methodologies and documentation must comply with GAAP to qualify for the use of hedge accounting.

The vast majority of hedging relationships were inappropriately assumed to be perfectly effective. The short-cut and matched terms methods were inappropriately used for many hedge transactions. Documentation to justify hedge accounting was poor, with either no or ambiguous records to support the hedges.

- SFAS 140: Dollar rolls can be treated as financings if substantially similar securities are received, and market convention views dollar roll transactions as fails if the delivered security is not received on the redelivery date.

Accounting policies correctly stated the criteria for substantially similar securities as both similar yields and remaining weighted average maturities (WAM). However, the Controller department did not test for substantially similar securities until 2003, and then only tested for compliance with the WAM criteria. In addition, the redelivered securities were tested in aggregate rather than on each individual security.

Personnel do not monitor the levels of dollar roll collateral to ensure sufficient coverage, and accounting policies and written procedures have no provisions addressing the monitoring of cash and collateral levels per EITF Topic D 65.

Market convention views late redeliveries as fails. However, accounting policies state that redeliveries beyond three months past redelivery date are viewed as fails and booked as a sale, and actual practice allows four months.

Dollar rolls are conducted with securities in the HTM retained portfolio, and sales treatment caused by noncompliance with SFAS 140 could taint the entire retained portfolio, requiring all securities in those HTM portfolios to be accounted for as AFS or trading portfolios. Securities in the MBS retained portfolio totaled \$905 billion at YE04.

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- SFAS 149: Effective July 1, 2003, mortgage-related assets commitments are accounted for as derivatives under SFAS 149 because they were no longer scoped out of SFAS 133.

It appears that management has applied cash flow hedge accounting to certain transactions whose occurrence were inappropriately deemed as probable. Documentation in place at the time of SFAS 149's adoption may have been insufficient for many transactions. This documentation may have inappropriately assumed perfect effectiveness in fair value hedges with non-zero fair values, and may have inconsistently accounted for certain transactions since the inception of SFAS 149.

- FIN 46: qualified special purpose entities (QSPEs) are exempt from FIN 46 unless the company has the unilateral ability to liquidate or change the QSPE.

The accounting policy stated that the Enterprise uses QSPEs to issue MBS. In the normal course of business, management purchases loans and offerings of MBS. In certain instances, management obtained 100% of the MBS issued in a particular offering, or through other actions ended up owning 100% of a particular MBS.

In instances where the Enterprise owned 100% of an MBS offering, management avoided complying with FIN 46 by using guidelines inconsistent with relevant literature to determine that the Enterprise did not have the unilateral ability to liquidate its QSPEs.

The Controller department also avoided complying with FIN 46 by transferring wholly-owned MBS pools from AFS to the HTM retained portfolio. The transfer may have allowed the Enterprise to use different methodologies and timing in recognizing impairments.

To properly record past financial results, the Enterprise must consolidate all wholly-owned MBS pools.

- Methodologies used to determine loan loss allowances and reserve level.

The Controller department's methodology to determine loan loss provisions did not meet industry standards, and generated a reserve level with little change year after year. The methodology was changed in late 2004.

## **LIQUIDITY**

Liquidity management is satisfactory but requires strengthening in some areas of policy, contingency planning, and cash flow forecasting assumptions, processes and systems. OFHEO has tentatively rated the quantity of liquidity risk moderate based on the strong level of liquid assets available for sale or repurchase agreements (repo), potentially offset

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by high levels of short term funding and the currently unknown impact from internal or external events to cash flows. Management is in the process of identifying significant but realistic stress scenarios that could impact the Enterprise. OFHEO did not conduct examinations in liquidity operations.

**Liquidity policies are generally satisfactory, but do not provide funding maturity limits, and need strengthening in contingency funding planning.**

The policies are generally satisfactory because they provide guidelines or limits for the MBS and liquidity asset portfolios, and asset coverage for three tests on liquid asset coverage of liabilities. However, the policies do not provide guidelines or limits for the distribution of liability tenors, limits that set maximum amounts of liabilities maturing daily or other short time periods, or contingency funding plans that estimate realistic causes/scenarios for moderate and extreme stress scenarios. The Liquidity Management and Portfolio Strategy groups are in the process of revising the policies and contingent funding plans.

**Front Office personnel are satisfactory. Processes and controls are satisfactory, but exhibit deficiencies in cash flow information processing, reports, and documentation that impact the efficiency of cash flow reporting.**

Liquidity Management and Portfolio Strategy management and staff are experienced and technically competent, and satisfactorily manage cash flow and the retained portfolios within guidelines in the policies and written procedures.

Reports used for daily management of short term cash flow forecasts provide adequate information for controlling this function. However, lack of automation in systems used to produce these reports needs to be addressed. Management recognizes these deficiencies, and expects to address them by mid-year 2005. Systems deficiencies prevent the automation and integration of some data, requiring some generic cash flow forecast assumptions, and inefficient manual work-arounds.

- Generic estimates for expected MBS activity and other data are used rather than more accurate estimates from the business units.
- Manual work-arounds used for daily forecast reports produce timely reports, but the process is inefficient, increasing the risk of processing errors and key person dependencies.
- Documentation is needed that explains the calculations and assumptions used in determining numbers in the cash flow reports so that the reader can understand and effectively use the information in the reports.

**The quantity of liquidity risk is tentatively rated moderate.**

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Asset liquidity, the strongest source of liquidity, amply covers the liabilities that mature in one year or less. Assets available for sale or repo are comprised of roughly \$500 billion in agency MBS and \$20 billion in short term, liquid securities held in the \$48 billion Liquidity Investment Portfolio (LIP). These liquid assets more than offset the \$300 billion in discount notes that mature in one year or less. However, OFHEO cannot provide a final rating until OFHEO completes an evaluation of Treasury's analysis of cash flow variances from significant events, and their identification of significant but realistic events for use in the contingency funding plan stress scenarios.

Treasury Operations has the capacity to conduct sufficient numbers of sale and repo transactions to cover maturing discount notes, and recently improved the stability to market access by contracting with two principal clearing banks so that FNM has access to the market through two outlets.

Treasury management appropriately views the \$500 billion MBS portfolio as FNM's primary source of asset liquidity. The LIP covers maturing liabilities for a two to three week period, providing management flexibility in covering maturing liabilities in the early stages of liquidity stress.

Treasury management consistently met the non-mortgage asset liquidity guidelines during 2004. LIP portfolio assets appropriately exceeded the guideline at 5% or more of total assets. The total liquid assets available for sale and repo from the combined LIP and mortgage security portfolios far exceed the amount needed to fully cover liability maturities should all cash flows cease for 90 days.

LIP asset credit quality is satisfactory. The credit ratings declined because the percentage of short term assets declined in 2004, and liquidity management is now using a more conservative method to assign a rating. The amount of investments rated A1/P1 or AAA changed little at 69.7% in 2004 and 69% in 2003. However, A rated assets increased to 21% in 2004 from 10.9% in 2003, with the shift coming from AA rated assets decreasing to 8.7% from 18%. All short term assets are rated A1/P1. These changes in the LIP's securities composition do not materially impact liquidity since the MBS retained portfolio provides the vast majority of the asset liquidity.

- The amount of the LIP comprised of short term assets declined to \$8.8 billion or 18.4% of the portfolio at YE04 from \$19.9 billion or 33.5% at YE03. The levels of ABS, municipal bonds, and corporate securities remained essentially stable, causing the portfolio's average maturity to lengthen to 508 days from 401 days.
- The old methodology used to determine the credit risk rating averaged the ratings from three credit rating agencies. The new method uses the worst rating from any one agency, and is consistent with the impairment definition worked out with OFHEO.

In the past, systemic market events have not significantly impacted FNM's liquidity because of the market's perception of FNM's debt as a "flight to quality" product. In

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addition, recent company-specific events concerning financial statement and internal control deficiencies have generated only a small impact to the cost of and market access to funding. Treasury management is working to determine the types of events that might actually impact liquidity, which may be caused by such events as a significant breakdown in the Enterprise's operations, an adverse impact to the options market, or a decline in the credit rating of their AAA-rated senior unsecured debt.

### **SENSITIVITY TO MARKET RISK**

Interest rate risk (IRR) is managed satisfactorily due to effective communication and risk management by competent front office personnel throughout Portfolio Strategy, Portfolio Transactions, Treasury, and the Risk Policy Committee. However, IRR management should be strengthened through:

- More active Board oversight and the formal approval of a more comprehensive policy for IRR.
- Board reports that provide comprehensive risk/return measures and better communicate the Enterprise's total IRR profile.
- More investment in analytic and data systems to improve report accuracy and efficiency in their production.

OFHEO's tentative rating for the quantity of IRR is "moderate" based on OFHEO's preliminary review of risk levels. A final rating will be provided after OFHEO conducts a comprehensive review of data inputs, assumptions, methodologies and models used to estimate risk/return metrics. An evaluation of middle or back office operations, securities valuation methodologies, and IRR model development and use was not done.

**Board IRR policies are weak because they do not state objectives or the approved risk profile, or provide explicit limits for IRR.**

The Board does not have a formal IRR policy that states:

- Its IRR management objectives, or approved strategies or tactics to achieve those objectives.
- A single comprehensive risk metric that measures market value of equity sensitivity.
- Policy limits in terms of market value equity sensitivity.

However, the Board has informally approved IRR guidelines presented to them by management. These guidelines limit duration gap and convexity gap. Management regularly reports compliance with these guidelines and other information on the Enterprise's IRR profile to management's Risk Policy Committee and the Board's Asset Liability Committee.

**Risk management processes and controls are generally satisfactory. However, weaknesses in analytic systems' integration have contributed to weekly reports with incomplete risk profiles, report production inefficiencies, and staff turnover.**

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Management and staff have established an effective program to evaluate and communicate risks through distribution of daily and weekly reports and information. Risk levels have been consistently maintained within management's IRR limits. The Portfolio Strategy group provides daily risk analysis to the heads of the trading desks, and meets weekly with the Portfolio Investment Committee, and the Asset and Liability committee to establish broader portfolio management objectives. The Portfolio Strategy group produces a quarterly report for senior management's Risk Policy Committee that addresses risk metrics, model changes, and other key information.

Analytic systems are poorly integrated into the company's "databases of record" and exhibit some analytic constraints, generating inefficiencies and some incompleteness in report production. Nearly all reports are timely, but occasionally omit certain information, such as internal reports that occasionally include incomplete up/down scenarios for duration gap or missing convexity gap estimates. The significant level of manual work-arounds to produce the reports has contributed to turnover in the Portfolio Strategy staff, and increases the risk of inaccurate risk/return metrics.

**Board reports present metrics used by mortgage finance professionals but need to be improved to provide a more comprehensive and intuitive measurement of IRR that permits Board members to determine if IRR remains within Board-approved limits. Management recently began to improve IRR metrics for Board reports.**

Board reports include IRR metrics used by mortgage finance professionals but do not provide the Board with metrics that intuitively reflect the Enterprise's entire IRR profile in terms of market value of equity (MVE) at risk. Management has already begun producing reports that include MVE sensitivity and other information that improves the communication of IRR.

**Management's IRR report metrics are satisfactory but should include better or additional information showing risks from convexity.**

Management reports include a number of useful, relevant measures of IRR that are effective in communicating many aspects of IRR, but reports to the decision makers outside of day-to-day management need strengthening so that they provide a more complete and meaningful description of convexity risk. The management reports better communicate yield curve exposure through the recent addition of key rate duration. However, these reports only show the convexity gap, and not how the composition of the swaptions book impacts convexity risk in the future, or from changes in the market.

**The quantity of managed IRR is tentatively rated as moderate.**

Duration gap is maintained well within the limit of +/- 6 months by rebalancing when the gap exceeds +/- 3 months. The 6 month limit provides management with a high degree of flexibility to avoid delta hedging and the associated hedging expense. The negative convexity gap was maintained within the -1.00 limit and convexity coverage from swaptions is relatively stable.

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The levels and composition of IRR changed in the first quarter of 2005 because management shifted to a more active rebalancing and options strategy to reduce the interest rate risk exposure. The strategy shift is expected to produce less volatile changes in the market value of equity, but has the potential in incrementally lower earnings. Also, during 2004 management increased the use of discount notes to fund floating rate mortgages. This funding strategy decreases interest rate, but also increases the level of liquidity risk for the Enterprise.

**CAPITAL ADEQUACY**

	1Q04	2Q04	3Q04	4Q04
Capital Classification <sup>1</sup>	Adequately Capitalized	Adequately Capitalized	Significantly Undercapitalized	Significantly Undercapitalized

Based upon information provided by Fannie Mae including adjustments for the estimated impact of accounting errors on capital, Fannie Mae's estimated core capital exceeded the minimum capital requirement by a small margin as of December 31<sup>st</sup>, 2004. However, given significant control weaknesses and remaining uncertainties associated with the ongoing review of Fannie Mae's financial controls and accounting policies, a significant risk remains that accounting adjustments could deplete Fannie Mae's core capital from current estimates. The small surplus at year-end leaves little room for discrepancies in the estimated capital position. Accordingly, the Director has classified Fannie Mae as Significantly Undercapitalized as of December 31, 2004.

Subsequent to year-end and as of March 31, 2005, Fannie Mae has achieved an estimated \$4 billion minimum capital surplus through earnings retention and asset sales. Based on current information this surplus is sufficient to absorb the projected but uncertain capital impact of accounting errors. Accordingly, the Director has determined that Fannie Mae is Adequately Capitalized as of March 31, 2005.

**Significant Capital events in 2004**

Capital was classified as Adequately Capitalized at the end of the first two quarters of 2004 by exceeding both the Minimum Capital and Risk-based Capital requirements.

On December 22, 2004, Fannie Mae announced that it would restate its financial statements in response to the SEC's decision that Fannie Mae inappropriately applied

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<sup>1</sup> By statute, OFHEO classifies Fannie Mae and Freddie Mac's capital levels quarterly. The four capital classification levels are Adequately Capitalized, Undercapitalized, Significantly Undercapitalized, and Critically Undercapitalized.

Capital classifications for 2004 are based on financial information provided by Fannie Mae that applies accounting policies currently under review by OFHEO. The capital classifications are subject to change after Fannie Mae issues certified financial statements and OFHEO completes its review of Fannie Mae's accounting policies and practices. Capital classifications for September 30, 2004 and December 31, 2004, are based on the best estimates of Fannie's financial condition as of the respective dates after adjusting for accounting errors, as represented and certified by Fannie Mae's management.

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hedge accounting methodology for certain derivative contracts. The Enterprise indicated that the financial restatement would likely reduce core capital (specifically the retained earnings component of core capital) by approximately \$9 billion in accumulated losses on derivatives that no longer qualified for hedge accounting treatment. Pro-forma for this adjustment, Fannie Mae's core capital at September 30, 2004 was insufficient to meet the minimum capital requirement.<sup>2</sup> As a result, OFHEO classified Fannie Mae as Significantly Undercapitalized at the end of the third quarter of 2004. As part of the Agreement between OFHEO and Fannie Mae on September 27, 2004, Fannie Mae was required to increase its capital surplus over the minimum capital requirement to 30% by June 30, 2005 due to the increased operational risks and the uncertainties surrounding the reliability of the financial statements. As a result of the Significantly Undercapitalized classification as of September 30, 2004, Fannie Mae was required to submit a Capital Restoration Plan to OFHEO.

Fannie Mae's Capital Restoration Plan dated February 10, 2005, which was approved by OFHEO on February 17, 2005, identifies Fannie Mae's strategies to achieve the required capital surplus by September 30, 2005. Fannie Mae plans to actively manage the minimum capital requirement through controlled asset growth, and to increase core capital by accumulating retained earnings and by opportunistic issuances of equity. The plan also identifies contingencies to the primary strategies for achieving the required surplus in the event that market events adversely impact capital growth. In support of the plan, Fannie Mae executed a \$5 billion private placement of preferred stock transaction on December 30<sup>th</sup>, 2004. During 2005, Fannie Mae has continued to increase capital surpluses through earnings retention and selected asset sales. At the present time, Fannie Mae remains on target to achieve the 30% surplus as of September 30, 2005.

### **Capital Assessment Factors**

In the third quarter of 2004, OFHEO expanded its review of capital adequacy from strictly regulatory capital requirements to include analysis of performance on a selection of Capital Assessment Factors. Specifically, the factors include the following:

- The level of capital and the overall financial condition of the institution;
- Prospects and plans for capital growth;
- The level of credit risk exposure;
- Portfolio composition including market risk and risks associated with new products;
- Risk exposure represented by off-balance-sheet activities;
- The quality and strength of earnings;
- Prospects and plans for growth; and
- Access to capital markets and other sources of capital.

OFHEO initiated the process with a review of selected factors at the end of the third quarter of 2004 and plans to expand this effort to cover the remaining factors in 2005.

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<sup>2</sup> Pro-forma for the adjustment, core capital at September 30, 2004 was approximately \$2.2 billion lower than the minimum capital requirement.

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**Capital Planning and Monitoring**

Fannie Mae has taken proactive steps to restore capital levels and achieve the OFHEO directed 30% minimum capital surplus by September 30, 2005. The Capital Restoration Plan submitted to OFHEO by Fannie Mae appropriately details contingent actions that could increase capital levels should primary means become insufficient. Currently, Fannie Mae remains on target to meet the 30% capital surplus mandated by OFHEO.

OFHEO monitors Fannie Mae's capital on a weekly basis and tracks the impact of market or other changes, including accounting errors, on capital volatility. Through the weekly monitoring process and other activities, OFHEO has gained insight into Fannie Mae's capital management practices. Based upon the information obtained and details provided in the Capital Restoration Plan, OFHEO concludes that Fannie Mae has adequate monitoring and management reporting of regulatory capital however operational weaknesses, accounting errors, and internal control deficiencies throughout the company continue to impact capital. As a result, OFHEO will continue to assess Fannie Mae's capital management practices. OFHEO plans to continue active capital monitoring activities in 2005, to include a review of Fannie Mae's processes for capital planning, capital forecasting and reporting of capital-related information to the Board.