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The Beginning of the End for Fannie Mae

We like to say we are in the American dream business.

This was the way in which Franklin Raines, Chairman and CEO of Fannie Mae, introduced his testimony before the Congressional hearing on the OFHEO report: “Allegations of Accounting and Management Failure at Fannie Mae on October 6, 2004.”¹ In this chapter, the events leading up to this unprecedented hearing will be set out, as well as the hearing itself. The latter illuminates the relationship between the GSE and members of the relevant committees of the House of Representatives, and the position of the regulator. It also shows the way in which Fannie Mae conducted its business, and the reasons for growing anxieties about the systemic risks arising from the key position in the market that it occupied.

2004: A year of troubles for Fannie Mae

2004 was to be a year of battles for Fannie Mae, and especially for Franklin Raines. It did not begin well. Plans for the reforming regulation of the GSEs were debated in the House and Senate throughout the year, but the importance of the role of Fannie Mae and Freddie Mac in providing lower-cost mortgages was undermined by a study carried out by a Federal Reserve economist, Wayne Passmore.² Chairman Greenspan used the results of the study in his testimony before the Committee on Banking, Housing and Urban Affairs.³

The GSE implicit subsidy and the value of government ambiguity

The study carried out by Wayne Passmore once again analysed the implications of the implicit government guarantee, together with the basis for it in the eyes of the market; the context and extent of the government subsidy constituted a fundamental critique of the role of Fannie Mae and Freddie Mac. This perception was reinforced by the size of the GSEs’ portfolios; the fact that

the government mandates housing goals for them; and the fact that the government provides a line of credit from the Department of the Treasury, fiscal agency services through the Federal Reserve, US agency status for GSE securities, exemptions from securities registration, and bank regulation on securities services. As indicated earlier, all of this gives the GSEs a funding advantage over private financial institutions, an advantage that amounted to some 40 basis points between 1998 and 2003. According to Passmore's estimates, this lowered interest rates on mortgages by some 7 basis points, at an immense cost to the Treasury of between \$119bn and \$164bn, of which the shareholders retained between \$50bn and \$97bn. He calculated that between 42% and 81% was due to the implicit government subsidy, and noted that if the GSEs were private financial institutions, then their behavior would change: they would hold fewer of their own mortgage-backed securities, and their capital-to-asset ratio would be more than double. Some of the members of the House and Senate committees understood that, as can be seen from references to the fact that the GSEs were relatively thinly capitalized.⁴

Calculation of the subsidy is difficult and complex, as Chairman Alan Greenspan acknowledged; Passmore's estimate is certainly larger than that provided in 2000 by the Congressional Budget Office of \$13.6bn.⁵ The differences may be due to methodology, and were certainly disputed by Fannie Mae and Freddie Mac.

The Congressional Budget Office's analysis

Richard Shelby, Chairman of the Senate Committee on Banking, Housing and Urban Affairs, requested the Congressional Budget Office in April 2004 to carry out further work, to see if the CBO's research supported the Federal Reserve's analysis. The CBO estimated that the total budget subsidy for the GSEs rose to \$23bn in 2003, an increase of nearly 70% from the estimate of \$13.6bn in 2002. This was due to their rapid expansion in 2001.⁶

These estimates are based on the assumption that any increase in the GSEs' outstanding debt and mortgage-backed securities is sustained only until the acquired mortgages mature. On the basis of the assumption that the GSEs issued debt and MBSs are reissued when they mature, the federal subsidy for 2003 would be over \$46bn, up from \$20bn in 2000. For the CBO, the value of the total subsidy represents the capitalized value of interest savings on newly originated securities in the year. The increase in the estimated subsidy over the past three years was mainly due to the growth in debt and MBSs, as well as to an increase in the value of the state and local tax exemptions, and a decline in discount rates. CBO's base case assumes that mortgages purchased by GSEs

and the securities that they issue to finance them have an average life of seven years. That span is longer than the average realized life of mortgages originating in the mid-1990s, when there was a refinancing boom due to the sharp drop in mortgage rates. At that time, Fannie Mae expected the mortgages on its books to run off in three years (the CBO notes that this was information received from a staff member at Fannie Mae in March 2004). It would be interesting to know exactly what assumptions Fannie Mae retained. The GSEs' outstanding securities and assets grew year on year over recent years, so it was not unreasonable to assume continued growth.

The CBO compared its results with the Passmore study, and noted that while the gross estimates differ between the two studies, the results are consistent. This is because the Passmore study capitalizes on the benefit to the GSEs on all outstanding debt and the MBSSs, whereas the CBO's capitalizes the benefit on the incremental change in the outstanding issues for the current year. That difference, the value of the stock, rather than the change in value, or the flow, is the principal reason why Passmore's estimate of the gross subsidy is so much higher. He also estimates the subsidy pass-through at a much lower, at 7 basis points instead of the 25 basis points used by the CBO. There are two steps in the method he uses; first, estimated the spread between jumbo and conforming mortgages and found that the difference is between 15 and 18 basis points. The methodology is the same as the CBO's but the time period for Passmore is extended to May 2003. The second point is that factors other than the GSEs' sponsored status, such as the difference in transaction costs, credit risk and prepayment risk determine the size of the subsidy. The CBO concludes that the point is the same: the housing GSEs receive large subsidies and that only a small proportion of the subsidies reach borrowers in the conforming market.⁷

But as the GAO pointed out in February 2004, "without clearly defined measures of GSEs' benefits, it is not possible for Congress, accountability organizations, and the public to determine whether the federal government should be subject to the financial risks associated with the GSEs' activities ... First, isolating the GSEs' effects on mortgages ... is a complex and technical undertaking. Second, the GSEs' financial activities have evolved over the years and have become increasingly sophisticated, which further complicates any analysis of the GSEs' benefits and costs."⁸

In his testimony to the Senate Committee, Chairman Alan Greenspan offered a way forward. "As noted by the General Accounting Office, the task of assessing the costs and benefits associated with the GSEs is difficult. One possible way to advance the technical discussion would be for Congress to request disinterested parties to convene groups of technical experts in an effort to better understand and measure these cost and benefits."⁹ Neither Fannie Mae nor Freddie Mac took up the offer. The "subsidies" received by Fannie Mae and Freddie Mac were off-balance sheet as far as the federal budget was concerned. Despite the best efforts of the Federal Reserve, the CBO and Richard

Shelby, neither the Congressional nor the Senate committees were interested in assessing the costs, except to deny that so little was done to lower the costs of mortgages to the low paid and to minorities.

The risks to which Chairman Alan Greenspan referred frequently from 2003 until the end of his tenure, namely, the growth and scale of the GSEs' mortgage portfolios, concentrating interest rate risk and prepayment risk at these two institutions, coupled with the fact that they did not manage that risk by holding greater capital, were simply not recognized by any of those involved. OFHEO considered that its risk-based capital requirement was more than sufficient to guard against potential problems, and too many politicians were primarily concerned about the alleged increase in the cost of mortgages if the GSEs had to hold more capital (especially when they were persuaded to hold that view by Fannie Mae and Freddie Mac). The GSEs themselves "have chosen not to manage that risk by holding greater capital. Instead they have chosen heightened leverage, which raises interest rate risk but enables them to multiply the profitability of subsidized debt in direct proportion to their degree of leverage ... without the expectation of government support in a crisis, such leverage would not be possible without a significantly higher cost of debt."

Chairman Greenspan continues, noting that the management of such risks with very little capital "requires a conceptually sophisticated hedging framework."¹⁰ It is in this context that the OFHEO report discussed later in this chapter has to be seen. Not only did Fannie Mae clearly lack the necessary skills, systems and qualified staff, but the drive behind all the hedging (and other) strategies was to smooth earnings in order to ensure payment of bonuses, not to manage the risks the organization faced. That was a secondary concern.

Setting up the review was not plain sailing for OFHEO

Having announced its proposals for a special review, which would "independently evaluate the accounting policies at Fannie Mae and examine whether their implementation is resulting in a high level of conformance to GAAP," OFHEO issued a request for an accounting firm to assist in planning and completing the work.¹¹ Deloitte & Touche was appointed in February 2004. Later in the month, Armando Falcon, Director of OFHEO, expressed concerns about the possible destruction of documents, and indeed about access to documents; OFHEO had to resort to issuing subpoenas in order to obtain co-operation with its investigation. Chairman Oxley stated that he was "dismayed to learn" that OFHEO had had to turn to such measures, adding "it is my sense that if OFHEO had the tools possessed by other regulators, this investigation would not have reached the subpoena stage. If we had a

GSE regulator with the power and authority of a world class regulator, it is possible that these problems at Fannie Mae would have been remedied earlier and today's hearing would not be necessary."¹² In the end, OFHEO had to review over 200,000 documents and e-mails as well as hundreds of interviews and depositions of current and former staff of Fannie Mae. One of the many warning signs was that Fannie Mae had to correct an accounting error to the tune of \$1.1bn in October 2003.

Fannie Mae's outdated accounting systems

In a letter to Franklin Raines dated February 24, 2004, Armando Falcon stated that Fannie Mae relied on 70 outmoded manual accounting systems, and pointed out the potential problems in the use of so many manual systems ("end user computer systems"), as opposed to fully automated and integrated systems. The former have a significant risk of error and should only be used with "strong controls and as an interim step to full automation. The recent error with Fannie Mae's 3Q03-8-K filing occurred in an end user computing application and highlights a basic flaw of these systems: a lack or failure of change control processes." It was not just one accidental error, as the rest of the letter makes clear; the mistake occurred during the process of marking the SFAS 149 settled commitments designated as available for sale (AFS).

The error was the result of a computational miscalculation contained in a spreadsheet formula that calculates the gain/loss of the AFS. More specifically, the error resulted when *an employee made an unapproved change to a formula contained within a Microsoft Excel spreadsheet*. The formula error went undetected during the normal management review process ... and was ultimately discovered during the course of the standard review in preparation of the SEC Form 10-Q for the third quarter ... Other flaws found in this specific end user system were lack of technical and user documentation, insufficient testing, and inadequate back-up and recovery techniques.

Director Falcon demanded a remediation plan which would include a schedule for the development and implementation of a fully automated FAS 149 accounting commitment process, and a plan of action to address all financial reporting end user systems. That plan should particularly include (a) an internal assessment of all financial reporting end user computing applications, including the risks and controls surrounding these applications; and (b) a plan and time-table for full automation of the financial reporting end user computing applications and controls. Alternatively, if Fannie Mae believed that any of these systems should not be automated, then an explanation of the special circumstances preventing their full automation should be provided. The plan had to be submitted within 30 days.¹³

A missing balance sheet

In April, Fannie Mae announced its results for the first quarter 2004, but failed to release its balance sheet at the same time, contrary to standard practice, which it was claimed was due to the need to complete a review of the complex figures related to shareholder equity. The GSE announced that the balance sheet would be available on May 10, when it was due to file its IOQ report with the SEC. Franklin Raines stated that the company's financial performance "continued to benefit from the balance and flexibility of our business model. We are well-positioned to continue to support our mission and to capitalize on opportunities for profitable growth in the coming quarters."¹⁴ Its profits fell by 2.1% between March 2003 and March 2004, that is, from \$1.94bn to \$1.9bn. Losses on derivatives as marked to market reached \$959.3m as compared with \$624.6m in the previous year. Its profits, derived from its core business, that is, buying home mortgages from lenders and packaging them as securities for sale on Wall Street, rose by 9.2%. Against that background, which lasted from February to July, when Fannie Mae was clearly resisting OFHEO's request for documents, it seems extraordinarily unwise to publish accounts with a missing balance sheet in April of the same year. This did not go unnoticed by the financial press, leading to a scathing *Wall Street Journal* editorial: "There she goes again ... Fannie Mae, the leveraged hedge fund that calls itself a housing finance company."¹⁵

Losses on derivatives

The publication of their incomplete financial statement followed a series of articles about Fannie Mae's derivative losses, especially in the *Financial Times*. On March 9, Stephen Schurr of the *FT* set out the paper's analysis of Fannie Mae's accounts, which suggested that "it may have incurred losses on its derivatives trading of \$24bn between 2000 and the third quarter of 2003. That figure represents nearly all of the \$25.1bn used to purchase or settle transactions in that period. Any net losses will eventually have to be recognized on Fannie Mae's balance sheet, depressing future profits."¹⁶ This met with a sharp response from Jayne Shontell, a senior Vice President, in a Fannie Mae press release on March 10, dismissing the claims in no uncertain terms. She stated that "[this] story is based on wholly invented methodology that we told the reporter is wrong. His calculation and methodology are flawed and the subsequent implications are wrong. The methodology he employed incorrectly calculated unrealized losses and as a result he arrived at an erroneous conclusion. This has resulted in a gross misrepresentation. Anyone who is seriously interested in looking at this should wait for our 10-K filing next week."

When the results were released a week later, they revealed for the first time details of the GSE's derivative trading, including losses on positions that could not be recouped. In its SEC filing, Fannie reported losses of \$6.86bn as at the end of 2003 from closed hedges. Total losses, including \$5.33bn in open hedge positions, were \$12.19bn for that period. In his article of March 16, 2004, Stephen Schurr explained that the *Financial Times* estimated Fannie Mae's losses on derivative positions that had been closed but not yet recognized at \$24bn. The *FT* also used third-quarter numbers in its assumptions. Fannie Mae's losses in accumulated other comprehensive income, the broad category, which includes realized and unrealized losses, narrowed from \$16.1bn to \$12.1bn in the fourth quarter. Bloomberg News noted that Fannie Mae's derivatives holdings surged by 59%, to more than \$1 trillion by the end of 2003 as the biggest buyer of US mortgages tried to cushion the effect of swings in interest rates on its earnings.¹⁷

Fannie Mae improperly accounts for its assets

On May 6, 2004, OFHEO announced that it required Fannie Mae to account for manufactured housing and aircraft lease impairments in the periods in which they occurred. OFHEO stated that its examination of Fannie Mae had determined that the Enterprise was not applying the appropriate accounting with respect to determining asset impairments and revenue recognition for these securities. "Fannie Mae improperly accounted for these assets in a way that fails to recognize losses," noted Armando Falcon; they were to be restated by May 14.¹⁸ However, the SEC did not require Fannie Mae to restate its earnings, but agreed with OFHEO that its process for determining impairments was "more rigorous and objective" for "determining other-than-temporary impairment, and the SEC encouraged that conclusion." Franklin Raines went on to state that "during the second quarter of 2004, we will implement this new estimation process ... in accordance with the Director's directive."¹⁹

The results of applying the required method was a reduction in the value of \$8bn of securities backed by manufactured housing loans, and \$300m of securities backed by aircraft leases. This resulted in a loss of \$217m due to an increase in defaults by mobile home owners, and a potential \$353m in additional unrealized losses on securities for which OFHEO required a recalculation. Fannie Mae recognized that losses of a further \$260m in the second quarter might occur. Franklin Raines insisted that such losses were very small in relation to a trillion-dollar balance sheet.

Fannie Mae's co-operation "has been spotty"

Meanwhile OFHEO's inquiry was continuing, but without much help from Fannie Mae. Chairman Richard Baker took the opportunity to ask the OFHEO

Director about the “forensic audit” of Fannie Mae and “whether the agency is providing access to documents, personnel or other matters as may be deemed appropriate to the accounting firm or to your own inspectors as appropriate, given the circumstance they find themselves in? Are they being co-operative in your view?”

Mr Falcon replied, “I think the cooperation has been spotty, but there are many demands we have placed on them for documents and to employees for scheduled interviews. Given that we find that co-operation has been less than adequate, whether it is deadlines being met or data submissions not being complete, we have taken steps to address these problems and will continue to be as forceful as necessary to make sure we get full co-operation.”²⁰ OFHEO later found that it had no option but to issue subpoenas on August 20, which could be enforced by the Justice Department (it later asked for assistance from the Justice Department in doing so, but neither OFHEO nor Fannie Mae was prepared to comment on the outcome).

At the hearing, Chairman Baker raised a number of other issues, some of which he followed up in a letter to Armando Falcon. He noted the matter of the level of guarantee fees, fees which the Enterprises charge originators when they purchase their loans. The data to which Baker had access indicated that “their credit loss ratios have declined due to improvements in their underwriting and risk management ... while loan loss reserves in the same period of review have declined, principally attributable to reduced losses (from 1995 to 2003). Yet the income flow to the corporation would appear on its surface to have been increased rather dramatically.”²¹ Later, in response to Chairman Baker’s letter, OFHEO stated that Fannie Mae’s income from such fees rose in 2003 by a third to a record \$2.4bn, or 33% of core earnings totaling \$7.5bn.

OFHEO’s report of findings to date

Of much greater importance in 2004 was the publication in September of OFHEO’s “Report of Findings to Date: Special Examination of Fannie Mae.”²² In its executive summary, OFHEO singled out characteristics of the culture and environment which led to the accounting problems at Fannie Mae, citing a number of characteristics, of which two were key: management’s desire to portray Fannie Mae as a consistent generator of stable and growing earnings; and an executive compensation culture which rewarded management for meeting goals tied to earnings-per-share, a metric subject to manipulation since the level of compensation depended on the stability of the earnings stream. However, an examination of the structure of compensation shows that increasing the levels of compensation was the overriding aim, and the presentation of stable earnings was simply a means to that end.

“You must have 6.46 branded in your brain”

For the top five executives, there were four main categories of compensation: (i) salary; (ii) annual bonus; (iii) option/restricted stock grants; and (iv) long-term incentive plan payouts (LTIPs). The last category referred to the number of shares given each year, depending to a substantial extent on the previous year's earnings, with the weight given to earnings determining how many shares to award. Items (ii) to (iv) were a more important part of the total compensation than the actual salary. The arrangements also allowed considerable freedom for executives to sell vested options and shares, which Timothy Howard, the Chief Financial Officer, frequently exercised; in the six-month period before the SEC's announcement that Fannie Mae grossly misstated earnings, he realised about \$6m in selling them.

Over 700 employees benefitted from the Annual Incentive Plan, which from 2000 onwards took the form of a special option grant program termed “Earnings per Share Challenge Option Grants.” Under the terms of this plan, the options would be vested and would be realized in January 2004, if the reported EPS equalled or exceeded \$6.46 by December 31, 2003. Staff were continually exhorted to meet the challenge, which they did: earnings per share reached \$7.91 by the end of 2003, and they were able to realize the options. As OFHEO's later report spells out, the commitment by Franklin Raines to the achievement of the EPS targets overrode all other objectives, even to the extent that the December 2001 job descriptions for Mr Raines, Chief Operating Officer Daniel Mudd, CFO Timothy Howard, and Vice Chairman Jamie Gorelick each listed the EPS targets as the primary performance indicator for their positions. They and other senior executives spent a substantial amount of time and effort “managing reported financial performance, at the expense of other goals and objectives associated with safety and soundness and internal control, so that Fannie Mae's reported EPS would hit the announced targets.”

That same objective permeated all other levels in the organization; it was the “corporate mantra.” Everyone had to play their part in achieving that goal. In 2000 Mr Rajappa, Senior Vice President for Operations Risk and Internal Audit, who became head of the Office of Auditing, made the following speech to the internal auditors: “By now every one of you must have 6.46 branded in your brains. You must be able to say it in your sleep, you must be able to recite it forwards and backwards, you must have a raging fire in your belly that burns away all doubts, you must live, breathe and dream 6.46, you must be obsessed on 6.46 ... After all, thanks to Frank, we have a lot of money riding on it ... We must do this with a fiery determination, not on some days, not on most days but day in and day out, give it your best, not 50%, not 75%, not 100%, but 150%. Remember, Frank has given us an opportunity to earn not just our salaries, benefits and raises, ESPP, but substantially over and above if we make it 6.46. So it is our moral obligation to give well above our 100% and, if we do this,

we would have made tangible contributions to Frank's goals."²³ This is a quite extraordinary speech for the Head of Internal Audit to make, especially one who had experience in the company actually with internal audit.

In the OFHEO report, the accounting "irregularities" were presented as being part of the aim, or as with the aim, of persuading investors that the GSE's earnings were steady, predictable and insulated from excessive volatility; and also to ensure specific levels of compensation for executives. They were not designed to hide fundamental problems with the company, such as was the case with Enron and Worldcom. However, the effect of the constant manipulation of earnings and the company's financial position in general may have contributed to just such problems in the longer term, if for no other reason than they absorbed so much of the energy and attention of the senior executives and staff at every level, and may have distorted any proper understanding of the company's true position. Inevitably, as OFHEO pointed out in its executive summary, the manipulation of earnings was serious, since it raised "concerns regarding the validity of previously reported financial results, the adequacy of regulatory capital, the quality of management supervision, and the overall safety and soundness of the Enterprise."²⁴

Fannie Mae's failure to conform to accounting standards

The report first of all sets out the events leading up to the development of Fannie Mae's current amortization policies and practices. When Fannie Mae buys mortgages or MBSs, it does not pay the exact amount of the unpaid premium balance outstanding on the loans. If the interest rate (or coupon rate) is below the current market rates, the loan is less valuable and will sell at a discount. To calculate the effective yield on the loan, Fannie Mae must take these premiums and discounts into account. (A loan bought at a premium is less valuable than the coupon rate would imply, and vice versa for loans purchased at a discount.) According to SFA 91, the amount of these premiums and discounts must be amortized, or recognized over the estimated life of the purchased loans or MBSs. The amounts recognized appear on the income statement as an adjustment to current interest income.

In the autumn of 1998, interest rates fell sharply, as central banks sought to manage the effects of the Russian and Hong Kong financial crises and the turbulence in the global financial markets. In such a period of low interest rates, borrowers paid off their mortgages and refinanced them at lower rates. The effect on the unexpected increase in prepayments was an additional expense of \$400m, which according to the accounting rule, SFAS 91, should have been recognized and set against the 1998 earnings. However, Fannie Mae chose not to do that and only set \$200m against its earnings for that year, deferring the other \$200m. Later their auditors, KPMG, identified the \$200m deferred expense (the unrecorded amount) as an "audit difference," subsequently agreeing to waive

that difference on the grounds that it was immaterial. Partners Ken Russell and Julie Theobald, and senior manager Eric Smith, signed the following statement in waiving the \$199m PDA and other audit differences as of December 31, 1998: "I have evaluated the above audit differences individually and in the aggregate, and determined that the waived audit difference would not have material affect on the financial statement as a whole." As it turned out, it *was* material, since not booking that expense increased the EPS by about 12.5 cents, from \$3.11 to the \$3.23 that was actually reported to the public on January 14, 1999, and in the 1998 Annual Report, including the audited financial statements.²⁵

In its Report of Findings to Date, OFHEO refers only to an "audit difference," which is then portrayed as a trivial matter in the course of the December hearing before the House subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises on October 6, 2004. As a consequence, some members of the Subcommittee regarded the failure to record expenses totaling \$200m in 1998 as a relatively trivial issue. OFHEO appears to spend too much time on a past event which then seems trivial; it is not, of course, as OFHEO makes it plain that this was the beginning of a whole series of accounting policies which were designed to fulfil the objectives which Fannie Mae had set itself.

Fannie Mae provided a variety of reasons why the deferral in expenses occurred, such as the fact that it was necessitated by limitations in models and infrastructure, which caused the estimate of expenses to be overstated. However, these did not hold water. For example, in interviews with Mr Howard and Leanne Spencer, Controller, it was indicated that one of the reasons for not recording the additional expenses was that not all REMIC securities (that is, a real estate mortgage investment conduit) are structured into separately traded securities.²⁶ But then the records show that upon increasing the percentage of REMIC securities which could be modeled, the amount of catch-up expenses actually increased. OFHEO also discovered that, despite insisting that the estimate of loss was overstated, Fannie Mae developed a strategy to record monthly "on-top adjustments" (that is, adjustments made directly to the general ledger during the financial statements close process) to the financial statements to recognize the estimated \$200m deferred expense in the subsequent fiscal years, 1999 and 2000.²⁷

To see the significance of the catch-up, we need to return to the issue of compensation, which includes the Annual Incentive Plan (AIP) awards, that is bonuses linked to the size of the bonus pool for meeting the annual earnings per share target. For 1998, the size of the annual bonus payout pool was linked to specific EPS targets: \$3.13 minimum payout; \$3.18 target payout; and \$3.23 maximum payout. If Fannie Mae was to pay out the maximum amount in AIP awards in 1998 (about \$27.1m), the EPS would have to be \$3.23. Bang on target: the 1998 EPS figure turned out to be \$3.2309, so this allowed the maximum payout. The annual EPS figure is calculated by dividing the net annual earnings by the average number of shares of common stock outstanding for the year. The 1998 \$3.23 EPS was established by dividing the net income

available to common shareholders (\$3.352bn) by the weighted average number of common shares outstanding (1.037m). If the net income available to common shareholders had been reduced to \$125m, the EPS for 1998 would have fallen to \$3.11, below the minimum payout level.

Then the “catch-up” of deferred expenses in 1999 began, but with the aim of not exceeding a negative £100m by the end of the year. Fannie Mae had learnt its lesson; it did not want to face any further surprises in sudden interest rate changes which would incur expenses, which it would then have to handle by managing the process of calculating amortization. Part of the \$200m that had been deferred was placed into an account described as a “reserve against future interest rate changes.”²⁸

In its report OFHEO includes various staff memoranda in which they discussed the SFAS 91 accounting standards. They decided not to adopt most of the standards, but only those which allowed them, or could be interpreted as allowing them to: (a) not recognize estimated income or expenses up to certain thresholds, and (b) defer the recognition of income or expenses that exceeded recommended thresholds over a several-year planning horizon.²⁹ These accounting methods are neither supported by SFAS 91 nor GAAP more broadly, but they were adopted in December 2000 and were still in force at the time of the report. At that time, OFHEO was unable to find any evidence that the policy had been used, although Mr Jonathon Boyles, then Senior Vice President Financial Standards, acknowledged that the methods were not in accordance with GAAP.

OFHEO also noted that the active modeling and management of the catch-up required more robust systems than Fannie Mae had in place. However, Fannie Mae installed a system called BancWare Convergence, “as a tool to facilitate the scenario analysis of our purchase discount/premium and deferred/prepaid fee position ... These upgrades created enhanced cash flows, which improved our catch-up forecasting ability.” A specific enhancement was added to BancWare which allowed it to produce modeling reports in dollars, and therefore to bypass PDAMS (purchase discount amortization system), which was used at the time to model catch-up. In his memorandum, Mr Juliane added, “BancWare amortizes premium and discount using an interest proxy method based on a proportionate amount of principal collected. This generates an amortization amount that ensures that the purchase price is maintained throughout the life of the instrument. Consequently, the normal amortization factors BancWare produces assume that you record catch-up in the period when incurred. *However, even though the normal factors assume that you will recognise catch-up in the period incurred, BancWare gives you the flexibility to manipulate factors to produce an array of recognition streams.* With this manipulation you can ‘bleed’ the catch-up within a specified time period and affect both the subsidiary ledger as well as the general ledger equally. This strengthens the earnings management that is necessary when

dealing with a volatile book of business.”³⁰ It is interesting to note that, given OFHEO’s later criticism of the number of manual systems and lack of computer systems, one of the earliest robust systems Fannie Mae installed was designed to assist with the preparation of financial reports which suited them and their objectives, rather than providing reliable financial reports for investors.

How Fannie Mae accounted for derivatives

Much of the report is taken up with various difficulties in the way in which Fannie Mae dealt with derivatives accounting. Under SFAS 133, derivatives, including futures, contracts, swaps, and caps, are all financial instruments whose value is linked to changes in a particular economic variable, usually interest rates. Fannie Mae used derivatives to manage interest rate risk. According to the above accounting rule, changes in fair value from the previous accounting period must be reported as current income, unless the derivatives are used for hedging. SFAS 133 allows a company to recognize as earnings both the change in the derivative’s value and the offsetting change in the value of the hedged item. If the gains and losses are closely correlated, the net effect on reported earnings will be very small or zero. The report analysed a number of these transactions, and found many practices that did not conform to SFAS 133. It also found that a number of staff involved in the whole process did not understand the accounting practices with which they were dealing, and were even unfamiliar with SFAS 133.

Fannie Mae used a number of shortcuts, which appeared to provide the “perfectly effective” hedge, that is, one which eliminates the risk of an existing position entirely, or which eliminates all market risk from a portfolio. Many would regard “perfect hedges” as being extremely rare, and would refer instead to “effective hedges.” OFHEO notes that a great deal of emphasis was placed on treating hedges as “perfectly effective,” by which Fannie meant that the hedging relationship was not in any way ineffective, an unlikely occurrence. Fannie Mae, however, did not carry out any assessment or measurement of the effectiveness of the hedging relationship. According to the interview OFHEO conducted with Jonathon Boyles, Senior Vice President of Accounting Standards and Corporate Tax, in August 2004, Mr Boyles stated that he “would guess over 90% of Fannie Mae’s hedges are perfectly effective at any point in time.”³¹ What Fannie Mae did was set aside the very limited circumstances in which SFAS 133 allows for the treatment of hedges to be perfectly effective, with the result that at the end of December 2003, it “had a notional of \$1.04 trillion in derivatives of which a notional of only \$43m was not in a hedging relationship.”³²

OFHEO identified at this stage in its examination a wide range of examples in which accounting rules had been intentionally misapplied in order to minimize

earnings volatility and simplify operations. Fannie Mae failed to carry out a proper assessment of effectiveness, or a measurement of the ineffectiveness with many of its hedges. These calculations together with proper documentation of hedges are essential for hedge fund accounting treatment under SFAS 133. If these derivatives are not to count as hedges then their fair value (or market value) changes should be recorded directly as earnings.

Before 2004, Fannie Mae treated some offsetting derivatives as hedges when they did not qualify as such. In 2001–2002 in particular, the GSE did not properly account for certain purchased interest rate caps, which might have led to significant misstatements of its earnings and Accumulated Other Income Statements (AOI) during those years. They knew that their accounting treatment did not accord with GAAP.

That was changed in 2004, but without any reference to possible misstatements in the previous years. Fannie Mae disclosed in its first quarter 2004 10-Q that the impact of classifying certain derivatives as non-hedging was approximately \$13m on that quarter's pre-tax net income. OFHEO considers that the impact may have been larger. In 2002, Fannie Mae disclosed another change in its methodology in accounting for changes in time and intrinsic value of its purchased interest rate caps. Once again, no reference was made to the implications of such changes on its past financial statements. Again in December 2003, the balance in the AOI includes \$12.2bn in deferred losses relating to cash flow hedges.

OFHEO, with respect to the improper application of hedge fund accounting, correctly comments that this led them to “question the validity of the amounts reflected in AOI; as well as the amounts reflected as carrying value adjustments, at any point since the adoption of SFAS 133. For hedges which do not qualify for hedge fund accounting, fair value changes should be reflected in earnings in the period in which the value change occurred, and with no offset to AOI or hedged item carrying value. Additionally, the possible reclassification of these amounts into retained earnings could have a *substantial impact on Fannie Mae's compliance with regulatory capital requirements*.”³³

There are two further reasons to be concerned. The first is the lack of adequate documentation, which might appear as a regulatory burden, but the rationale is clear enough: without such documentation, it would be impossible to determine the effectiveness of the hedge. For example, SFAS 133 requires that at the beginning of a hedge, the following information should be recorded:

- Management objective and strategy for entering into a hedge
- Identification of the hedging instrument
- The risk being hedged
- How the hedge effectiveness will be assessed

Fannie Mae's system involves entering the hedging instrument with the hedged item in a term sheet, which identifies the hedged item and the linkage between the derivative and the hedged item. Their system also includes the transaction descriptions for the permitted hedging strategies. What is lacking is any reconciliation between the term sheet and ultimate hedge fund linkage in the system. As a result of one of its interviews with a senior financial analyst in the Treasury Middle Office, OFHEO noted that the final decision about the nature of the hedging relationship is made by the Controller's Financial Accounting Group. Clearly this mode of operations with the linkage in what Fannie Mae calls the DEBT system, allows the Financial Accounting Group to change the ultimate treatment of a hedge's designation, and contradicts the regulatory requirements.

In examining the whole process, OFHEO concluded that there were a number of inadequacies in the various systems Fannie Mae employed. These included:

- Ambiguity of the hedging relationship
- Hedged risk not properly defined
- Hedged items not specifically identified in certain fair value hedges
- No term sheet produced for re-linkages
- Designation not contemporaneous
- Unclear definition and probability of hedged transaction in cash flow hedges
- Retroactive linkage of hedging instruments with hedged items

With regard to the latter item, OFHEO includes e-mails which showed that they were given permission by the Controllers to go back and change the linkages to the trader's intent at the time of the buyback.³⁴ This illustrates the ease with which descriptions could be changed retroactively to achieve a certain accounting result, which is clearly and expressly ruled out under SFAS 133, where paragraph 385 states that the concurrent designation and documentation of a hedge is critical; without it, an entity could retrospectively identify a hedged item, a hedged transaction, or a method of measuring effectiveness to achieve a desired accounting result.

Did the hedge accounting failures matter?

The OFHEO report spells it out: the lack of adequate, contemporaneous hedge designation documentation precludes a company from hedge accounting,

which in turn means that the fair value changes for such derivatives should be recorded through the income statement, without receiving any offset, or matching with, the earnings affect of the hedged item. All of this is complex and esoteric stuff. Does it matter beyond that? OFHEO answers: "Given the billions of dollars of mark-to-market value of Fannie Mae's derivatives and the fact that the vast majority of them are currently receiving hedge accounting, the potential impact of these documentation issues on Fannie Mae's reported financial results and regulatory capital appears to be substantial."³⁵ In other words, Fannie Mae could not be certain of the risks it faced or the capital it had at its disposal at any one time. It also undermines confidence in any other aspect of Fannie Mae's reports of its achievements, including the nature of the loans it purchased, the guaranty fees it charged lenders and, of course, the whole issue of compensation, something Fannie Mae was reluctant, to say the least, to reveal.

The role of senior managers

In the 2004 report, OFHEO concentrates on the responsibilities of senior management and systems and controls, rather than on the role and responsibilities of the Board. That is covered in much more detail in the 2006 report. The issue of systems and controls is tackled in part through accounting policy development and financial reporting responsibilities, which ultimately was the responsibility of the Chairman and Chief Executive, Franklin Raines, Tim Howard, Chief Financial Officer (CFO), and Leanne Spencer, Senior Vice President and Controller. Ms Spencer reported to the CFO; Sam Rajappa, Operations Risk and later Head of Internal Audit, had a dotted line of reporting to the CFO over the previous two years, although he also reports to the Chairman of the Audit Committee. There were two other Senior Vice Presidents: Janet Pennewell, Financial Reporting, and Jonathon Boyles, Financial Standards and Tax, with one vacancy for the SVP of Financial Accounting and Mary Lewers as the Vice President of Financial Accounting.

Jonathon Boyles was responsible for the initial accounting policy development, taking on board the rule changes at the FASB and the SEC, and the impact on business units at Fannie Mae and their views. A draft would then go to the Controller, who would be responsible for reviewing the policies for compliance with GAAP. No formal procedures for the development of accounting policy existed at Fannie Mae, and sometimes the policies which had been developed in such a disorganized fashion were not in accordance with GAAP. What Boyles recognized as "known departures from GAAP" were simply characterized as a "practical application of accounting standards." The CFO claimed in interviews with OFHEO that he was not aware of any departures from GAAP.

Any internal review of proposed accounting policies was conducted by the Controller, Leanne Spencer, whose job it was to decide which policies to approve and implement. Leanne Spencer was not a Certified Public Accountant, but in the event of a difference of opinion between the Controller and the Financial Standards Group, then the CFO is the final arbiter. Nor was the CFO, Tim Howard, a Certified Public Accountant, and his technical background did not include any accounting-related experience. Mr Howard's testimony made it clear that he did not rely on Leanne Spencer for technical expertise, but rather as "an engaged participant" in the process, with Jonathon Boyles being the subject matter expert.³⁶ However, none of these individuals was regarded as a real expert: the CFO, the Controller, the VP of Financial Accounting and the Head of the Office of Auditing (internal audit) all made it quite clear that they referred to KPMG as the final arbiter of Fannie Mae's compliance with GAAP, which meant that KPMG was effectively auditing itself. The Controller revealed during interviews that she was hardly in a position to do anything else, since when asked about the company's treatment of interest-only and principal-only securities, she admitted that she did not have a detailed understanding. Even the Head of Internal Audit did not consider it his responsibility to ensure compliance with GAAP, but rather "to do audits to ensure that the policies are followed by those they govern in a fashion consistent with our [internal] standards."³⁷ Neither the Controller nor the Head of Internal Audit were able to or wished to comment on the regulatory accounting standards for which it was the Controller's responsibility to decide which policies to approve and implement. She also ran an under-resourced department and once again admitted that "once we get overloaded, things slip. They don't get done as thoroughly."³⁸

OFHEO turned to Tim Howard. As Vice Chairman and CFO, he was able to produce a long list of responsibilities, which included risk management, the retained portfolio, the accounting function, investor relations, Treasury, financial reporting, and evaluating and making compensation recommendations for the Head of the Office of Auditing. As Vice Chairman, he also had a wide range of corporate strategy oversight management responsibilities, and served informally as Fannie Mae's Chief Risk Officer, in flagrant contradiction to the principles set out by the Group of Thirty, of which he was a member: "financial control and risk management must be fully independent of the risk-taking business."³⁹ Mr Howard also referred to the Steering Committee dealing with the issue of fair value versus historical cost accounting, which Paul Volcker, as Chairman of the Board of Trustees had asked him to join, a group which included Susan Bies from the Federal Reserve.

The report sets out clearly a senior team, many of whom were not qualified for the roles they had; a heavy workload; and a weak review environment, all leading to dependence on a small number of key persons, without a proper segregation of duties or adequate levels of control. But apart from this first report from OFHEO, there were no signs that any one really understood the

extent of the disorganization and incompetence (or worse) at the top of such a vast Enterprise.

Testimony of the whistle-blower

Further insights into what this meant for many of those on the inside were provided by Roger Barnes, the whistleblower, who worked at Fannie Mae as Manager of Financial Accounting, Deferred Assets, until his resignation in October 2003. His testimony highlights the extent of false accounting in Fannie Mae, and also indicates that it was deliberate. It was also one of the factors leading to the OFHEO inquiry and obviously indicated the direction in which the inquiry should look. Mr Barnes had begun his employment at Fannie Mae in 1992, in a spirit of idealism; and also to advance, as he says, his own professional career. The testimony itself is a study of growing disillusionment over the years from 1999 onwards.

He was involved in the development of the Amortization Integration Modeling System (AIMS), designed to determine cash flows and income generated by Fannie Mae's deferrals on mortgage and mortgage-backed securities. Mr Juliane led the development of the system, although he was not a certified public accountant. Roger Barnes had doubts about the system from the start, but these were ignored; they were rejected by Ms Pennewell, Ms Lewers and Mr Juliane, as they were working to achieve the objective set by Leanne Spencer and Tim Howard, namely, to reduce earnings volatility. His accounts of specific meetings show the extent of manipulation. One such meeting took place on January 4, 2001, which included Ms Lewers, Richard Stawarz, Director of Financial Reporting and Mr Juliane, with the aim of considering the effects of the Fed's cut in interest rates. The rapid fall in interest rates led senior management to consider adjusting the "on-tops," a term referring to manual journal entries that could be used to adjust arbitrarily Fannie Mae's income as the books were closed each month. Senior management had stated that the "on-tops" could be used to reflect a desired level of income for December 2000. He expressed his concerns about these and other reporting matters to Mr Stawarz, who agreed with him but did nothing about it.

In November 2001, an amortization factor change requested by management resulted in a \$100m increase in the company's interest income. "I recognized this increase as concrete evidence that the AIMS system, as developed and used by the company, produced grossly inaccurate and unreliable results when calculating the Fannie Mae's income and expenses."⁴⁰

By September 23, 2002, "it was clear to me that management in the Controller's division had no intention of responding to my disclosures of accounting impropriety. Indeed, the culture in the Controller's division was such that many employees knew or suspected that the company was engaging in

improper income management and it became a joke that the Controller's division could produce any income statement the company wanted."⁴¹ Mr Barnes set out all of these practices he had discovered to Mr Raines and Mr Howard, but none was ever investigated; instead, from November onwards, Mr Barnes found that he was excluded from meetings, refused monetary rewards to which he and his staff were entitled, and was not promoted to a position for which he was well qualified.

In April 2003, he again discussed his concerns about Fannie Mae's accounting practices with Mr Stawarz, who advised him not to raise his concerns in a "corporate climate in which employees actually joked about improper incomes management because it was such a regular occurrence," and in which "employee morale suffered because management offered promotions, bonuses and perks only to employees who supported management's improper goals."⁴²

After that, Mr Barnes set about researching irregularities as part of his responsibility for 400 ledger accounts, and reviewed the company's amortized transactions, finding "abundant evidence of the same kinds of problematic and unlawful financial practices" that he had identified in his memorandum to Mr Raines and Mr Howard on September 23, 2002. The evidence was presented to the internal auditors and a meeting sought in July with the Head of Internal Audit, Mr Rajappa. The meeting did not take place until August 2003, during which Mr Barnes gave full details of all the errors he had discovered (over 60) and stated that based on his research, he had concluded that Fannie Mae's amortization accounting was not in accordance with GAAP. A copy was given to Ms Spencer, Ms Pennewell, Ms Lewers and Messrs Stawarz and Juliane at a meeting on August 5. He was greeted with anger that he had taken matters to internal audit, and it was claimed that he was "overstating the case." However, the factors generated by AIMS were still used in the amortization processing. After that, a further meeting was held which was not designed to rectify problems, but rather to justify the practices so that Mr Raines could sign off on the financial statements by the August 15 deadline. Franklin Raines did certify the financial statements, which contained all the matters Roger Barnes had questioned. After that, he was excluded from all meetings and even information about OFHEO's investigation, and so felt he had no choice but to leave the company.

Standard & Poor's gives top marks to Fannie Mae's corporate governance

In stark contrast to OFHEO's findings and the testimony of Roger Barnes, Standard & Poor assigned its first Corporate Governance Score to a US company on January 30, 2003, to Fannie Mae. On a scale from 1 to 10, Fannie Mae was given a score of 9. The scores were described on Standard & Poor's website as

“independent assessments” resulting from an “interactive process that does not follow a ‘check the box’ approach.” The score is made public at the company’s discretion, although according to S&P, a “good majority” of firms do not reveal their scores. Again the website made it clear that, “The resulting report can either be used as a confidential diagnostic by the company or published as a Corporate Governance Score ... funded by the company being analysed and is currently free of charge to investors, insurers and other interested parties.” In effect, companies pay a fee to hire S&P, then a score is produced, and the company may decide to disclose this at no extra fee.

The report was based on an examination of Fannie Mae in four key areas: ownership structure and external shareholder influence; investor rights and relations; transparency and disclosure; and board structure and process. It is worth quoting one or two excerpts; although the work was carried out in late 2002 and January 2003, enough had happened in relation to Freddie Mac (see previous chapter) for a somewhat more sceptical approach to have been adopted. With regard to transparency and disclosure, S&P stated that though Fannie Mae’s size and the complexity of its particular accounting practices, notably SFAS 133, “make its financial practices subject to a very high level of external scrutiny ... the company’s website and the annual report provide a very strong basis of disclosure that meets or in some cases exceeds SEC requirements ... We assess positively Fannie Mae’s audit process and how its independence is achieved, but note the high level of non-audit fees paid to the company’s auditor.”⁴³ The report notes that KPMG have been the company’s auditors since 1968.

The report also notes that although the influence of its regulators and Congress may not materially affect Fannie Mae’s corporate governance at present, there is a possibility that this could change in the future. It refers dismissively to Richard Baker, as Chairman of the Capital Markets, Insurance and Government Sponsored Enterprises Subcommittee of the House Financial Services Committee, and his efforts to obtain a Congressional review of Fannie Mae’s corporate governance, linking him, for example, to FM Watch, described as a “micro-lobby, backed by some of Fannie Mae’s competitors, upset at what they view as unfair government support for the company and for Freddie Mac.”⁴⁴

However, the report concludes, “Fannie Mae to this point has been able to use persuasion, its political connections and supportive legal opinion to maintain the status quo that it clearly believes serves the interests of its shareholders ... dealing with external political, regulatory and legislative risk is something the company is quite good at: a skill that has helped the company and its shareholders over the long term.”⁴⁵ Indeed! The form the application of its political skills took would be revealed to an ever greater extent in the years to come. Even in January 2003, the storm clouds were gathering, and were there to be seen and considered.

A “political lynching” of Franklin Raines?

The Hearing of the Subcommittee on Capital Markets, Insurance and the Government Sponsored Enterprises took place on October 6, 2004. The hearing was dramatic indeed, with one of its members, Rep Lacy Clay, describing it as being “about the political lynching of Franklin Raines ... We are having a trial by OFHEO leaks, trail by newspaper articles, and trial without due process.”⁴⁶ Others, such as Maxine Waters, echoed the point that the primary motive of the report was political when she said, “I feel like I’m in another round of the battle between FM Watch and the GSEs.⁴⁷ FM Watch, financial institutions that decided a long time ago to wage a political war to reduce the GSEs’ share of the mortgage market, and of course I must say, Mr Chairman, waged by you.”⁴⁸ She added, “It is critical that we ensure any action that we may consider not impair the housing mission of the GSEs.”

Mr Arthur Davis followed on, saying, “You have imputed various motives to the people running the organization. You then went to the Board and put a 48-hour ultimatum on them without having the specific regulatory authority to put that kind of ultimatum on them. That sounds like some kind of invisible line has been crossed ... as if you have gone from being a dispassionate regulator to someone who is very much involved and has a stake in this controversy ... the political context ... [is] that serious doubts were being raised about the OFHEO.”⁴⁹

The focus shifted from claiming that the report was a political attack on Fannie Mae to claims that releasing the report was likely to damage Fannie Mae. Mr Davis asked if it were possible that the “market standing of Fannie Mae could be weakened by your testimony?” He was followed by Rep Joseph Crowley, who said, “I know that Mr Raines has pledged to create 6 million new homeowners, including 1.8 million minority homeowners, by 2014. Do you believe that this goal may be threatened now because of this report?”⁵⁰ Mr Falcon gave the obvious answer that the course of action taken by OFHEO was because of the actions of the company, and it is of course those actions which were described in the report.

Mr Kanjorski, a long-standing member of the Committee, who had already lived through the Savings & Loans crisis, adopted a more cautious approach, urging his colleagues on both sides of the aisle to “demonstrate patience and caution.” Recognizing the serious nature of the matters raised in the report, he wanted to wait for the process to work itself out, whilst warning against “hyping the initial findings,” since they could also raise the price of home ownership.⁵¹

Apart from Messrs Capuano, Kelly, Toomey, Bachus, Watt and Congresswoman Hart, who all sought to clarify one or other aspect of the report or to emphasize the failings of Fannie Mae, few other issues of substance were raised. These did, however, include the points made by Barney Frank and Maxine Waters. Barney Frank challenged Mr Falcon on the grounds that when he read the Director’s

testimony, “it seems to me almost boilerplate in his report that he says at the end of every specific, ‘and this could raise questions of safety and soundness issues’. It could, but nothing in here seems to me to say that it does ... I think it serves us badly to raise safety and soundness as a kind of general shibboleth.”⁵²

Later in the hearing, after testimony from Frank Raines and Tim Howard, Barney Frank was again dismissive, both of the report and of the difficulties he alleged in the report’s treatment of derivative accounting: “My sense of accounting for derivatives ranges somewhere in between alchemy and astrology. You are accused of being on the alchemy end.”⁵³

Far from being a challenge to the OFHEO report, this comment indicates the lack of understanding about the whole issue of safety and soundness, which is not just a matter of having sufficient capital, but is also a matter of the reliability of the financial information and the management of risk throughout the whole organization.

With unreliable financial reporting, it is impossible to know what an organization’s true assets and liabilities are, and hence to be able to assess the risks to which the organization is exposed. That is why the report, having shown that in respect of key elements of financial reporting, Fannie Mae’s figures were unreliable, states that “safety and soundness” were in question. It found an “operating environment that tolerated weak or non-existent internal controls; key person dependencies and poor segregation of duties; ineffective reviews of the Enterprise’s office of auditing; and an inordinate concentration of responsibility ... in the Chief Financial Officer.”⁵⁴ Indeed, any one of these would pose some risk to the safety and soundness of an organization, and the combination could be lethal. It is not clear whether Barney Frank and his colleagues on the Committee understood that; chose not to appear to understand it, preferring to make political points; or could not face up to the fact that Fannie Mae, being in the “American dream business” to which they were all committed, could do anything wrong.

Senior executive compensation at Fannie Mae

As has been discussed, one of the issues raised in the report was that of compensation paid to senior executives. At the beginning of the hearing, Chairman Richard Baker advised the Committee that some 12 months previously, he had corresponded with the Director’s office, making enquiries about the levels of compensation for the top 20 executives, information which had not been made public at that time. Within a few days of his enquiries, Fannie Mae had engaged the services of Ken Starr, legal counsel, to warn him and his staff that such information should not be made public and, if it were, civil legal action would follow. He did not reveal the information at the time, because it was not directly relevant to reforming the institutions; nor did he understand why, until he read OFHEO’s report.

The extent of systemic risk

A glimpse of the possible extent of systemic risk was revealed by answers to questions posed by Rep Douglas Ose, about the extent to which banks held Fannie Mae's securities and the possible indirect impact. Chairman Baker answered the question in more detail than Armando Falcon did, pointing out that of the 8,400 insured federal depository institutions, more than 3,000 held over 100% (not 50, not 70, but 100%) of their required Tier One capital in GSE securities.⁵⁵

Fannie Mae's defense

Franklin Raines and Tim Howard were also questioned at the same hearing. They spent much of the time denying the contents of the OFHEO report, claiming, for example, "We have looked for the facts. There were no facts in the OFHEO report. None. Other than their calculation that says, 'Oh there seems to be if we subtract one number from another you get this result'."⁵⁶ Mr Howard denied that he had the range of roles he had claimed in his interview with OFHEO. Both claimed that they had co-operated all along with the OFHEO, and that the subpoenas had not been necessary. They complained that they had not seen a copy of the report, and that OFHEO had not consulted with them or their very long-standing auditors about the report; also, that it had been presented to Fannie Mae's Board of Directors with 48 hours' notice for reasons that they did not understand. One of the committee members, Congressman Joe Baca, concurred with these complaints, stating, "It seems odd that they did not contact you. Yet ... they have gone to the media and they have gone everywhere else."⁵⁷ However, under further questioning from Congressman Douglas Ose, Franklin Raines admitted that, prior to the hearing, he and some of his agents, employees or counsel visited members of the committee and discussed the substance of the hearing. In answer to a further question as to whether he, his agents, employees or counsel provided questions to members of the subcommittee for the purpose of having them posed to witnesses during this hearing, Mr Raines admitted that "I believe we talked to members of staff about the questions they might want to pose."⁵⁸ That is clear from the hearing, where the lines of attack on the credibility of OFHEO and the manner of its release to the public were obviously planned in advance.

The only issue for which Franklin Raines and Tim Howard were not prepared was the question as to why, if the report consisted of entirely unsubstantiated allegations, the Board had so readily entered into the September 27 agreement, according to which the Board was required to implement correct accounting treatments, hold the 30% capital surplus, recalculate prior period financial statements, using correct accounting, appoint an independent risk officer, and

put in place policies to ensure effective adherence to accounting rules and new internal controls. They could not explain in any satisfactory way why that had been agreed.

The final matter of substance raised in the hearing referred to the fact that the issues raised in the report were “brand-new issues” to Fannie Mae, and that they were new to their relationship with OFHEO. In that, Franklin Raines was correct, and the reasons lay with the weakness of the regulator, together with Fannie Mae’s resistance to any attempts to strengthen the regulator. The reasons for this will be discussed more fully in the next chapter.

Fannie Mae and the SEC

It was plain from Raines and Howard’s statements during the hearing that, knowing the matter was going to be referred to the SEC for a final assessment of the alleged accounting irregularities, they expected to receive favorable treatment from the SEC. Indeed, Fannie Mae requested guidance from the Commission’s accounting staff regarding policy matters associated with its compliance with SFAS 91 and SFAS 133. The SEC statement acknowledged that it was unusual for the accounting staff to issue such guidance, whilst there are pending investigations. However, given that Fannie Mae had requested it, “because, in its view, these accounting issues have received extraordinary public attention and resulted in the mortgage and capital markets experiencing uncertainty,” the staff agreed to issue guidance, based solely on information provided by Fannie Mae and OFHEO.

Fannie Mae’s hopes for SEC support were dashed to the ground by the short and blunt statement issued by Donald T. Nicolaisen, SEC Chief Accountant. “Our review indicates that during the period under our review, from 2001 to mid-2004, Fannie Mae’s accounting practices did not comply in material respects with the accounting requirements in Statements Nos 91 and 133.” With regard to SFAS 91, he concluded that that Fannie Mae had failed to follow proper accounting procedures in relation to the fees associated with loan origination and purchasing. Fannie appeared to recognize adjustments to the carrying amount of its loans only if it exceeded a “self-defined materiality limit,” contrary to the accounting standard.

He added, “Fannie Mae internally developed its own unique methodology to assess whether hedge accounting was appropriate,” but its “methodology of assessing, measuring and documenting hedge ineffectiveness was inadequate and was not supported by SFAS 133.” Then came the final blows:

Fannie Mae should:

- Restate its financial statements filed with the Commission to eliminate the use of hedge accounting.

- Evaluate the accounting under Statement No 91 and restate its financial statements filed with the Commission if the amounts required for correction are material.
- Re-evaluate the information prepared under generally accepted accounting principles (GAAP) and non-GAAP information that Fannie Mae previously provided to investors, particularly in view of the decision that hedge accounting is not appropriate.⁵⁹

Franklin Raines and Timothy Howard leave Fannie Mae

The SEC met with Franklin Raines, three outside directors of Fannie Mae (Stephen Ashley, Joe Pickett and Thomas Gerrity), OFHEO Director, Armando Falcon, KPMG auditors and criminal prosecutors from the Justice Department at the Commission's HQ on December 15. A week later, the Board of Directors finally gave in to pressure from OFHEO to force both Franklin Raines and Tim Howard from office. According to Fannie Mae's public statement, Franklin Raines accepted early retirement and Tim Howard had resigned. Stephen Ashley then became non-executive Chairman and David Mudd, the Chief Operating Officer, became interim Chief Executive, until March 2005 when his appointment was confirmed. Executive Vice President Robert Levin became interim Chief Finance Officer and the auditors, KPMG, were dismissed.

The departures were accompanied by a flurry of announcements of investigations, including the SEC's inquiry into the reasons for the violations and the conduct of the company's senior executives. The SEC would investigate possible violations of the Sarbanes-Oxley Act, which would cover infringements of the certification requirements (this can lead to criminal as well as civil penalties). OFHEO began investigating bonuses and severance pay for Raines and Howard, especially after Fannie Mae disclosed that the former Chairman and CEO was leaving with a severance package of \$24.2m, excluding his \$2.4m annual salary for life; another \$21m in accelerated stock; potential future stock payments valued at up to \$34.6m; and an undisclosed amount in 401(k) benefits. Fannie Mae agreed to maintain a \$5m life insurance policy for Raines until he reached the age of 60 and \$2.5m insurance cover thereafter, and full medical and dental benefits for life for his wife and dependent children. CFO Timothy Howard did not do quite so well with his minimum severance package, valued at approximately \$12m, potential stock payouts valued at up to \$6.4m, 401k benefits; Fannie Mae did not include in its severance deal his annual salary of \$433,000, and another \$15.3m in an accelerated stock payout that he had already earned. His insurance policy would also be maintained at \$2m until 2008 and \$1m thereafter, with full medical and dental benefits for the rest of his life.

Reactions to the restatement of Fannie Mae's assets

The announcement of the restatement of Fannie Mae's accounts led to calls for fundamental regulatory changes by the Senate Banking Committee Chairman, Richard Shelby. "Now more than ever, it is time to create a regulator with sufficient and flexible authority to take the necessary action to ensure the safe and sound operation of these important housing enterprises."⁶⁰ The Chairman of the House Financial Services Committee, Michael G. Oxley, said, "I am deeply disturbed that investors, the markets and Congress were misled by deceptive practices at Fannie Mae. We intend to hold hearings early next year in Chairman Richard Baker's Subcommittee and will continue to work towards sweeping legislative reform."⁶¹

In his December 16 letter, Chairman Richard Baker, amongst other matters, asked Director Armando Falcon to "recapture all bonus payments from executives that were based upon faulty and deeply flawed earnings statements of the Enterprise ... But for the determined and professional work of OFHEO, investors, the markets and Congress would not have knowledge of the serious problems of Fannie Mae, which jeopardizes the national housing system."⁶²

The rating agencies' response was muted, to say the least. Standard & Poor's Governance Services allowed its January 23, 2003 score of 9 to remain, with "negative implications" until discussions with the company had taken place and they had further information about recent events, including the SEC statement, the departures of Franklin Raines and Timothy Howard, and the dismissal of KPMG, the progress of various investigations and the nature of the Board's deliberations, new management and the severance arrangements for departing executives.

On December 23, 2004, Fitch Ratings lowered its credit ratings on Fannie Mae's preferred stock, out of concerns that the company may not be able to pay its dividends in 2005. Fitch also stated that it might reduce that stock from the A+ "materially" if OFHEO forced the company to stop paying dividends, and that it believed further investigations into Fannie may "uncover additional accounting deficiencies."

Moody's Investors Service affirmed Fannie Mae's AAA senior unsecured debt rating and its Prime-1 rating for short-term debt, but said it could cut some of the company's other ratings. The A-Bank Financial Strength Rating remained under review for possible downgrade, reflecting OFHEO's determination that Fannie Mae was significantly under-capitalized, as well as uncertainty about internal control and governance issues. Moody's expected that OFHEO would approve dividend payment and that the non-cumulative dividends would not be interrupted; Fannie Mae's exposure to this risk is inconsistent with the AA rating category for junior securities and A-bank financial rating.

The reaction from the ratings agencies was cautious. The warning from Alan Greenspan was disregarded by most members of the Committee. The treatment

meted out to Armando Falcon by many of the Democrat members showed that they were entirely unwilling even to address such basic issues for Fannie Mae and Freddie Mac as upholding proper accounting standards and good governance. Apart from Richard Shelby and Richard Baker, together with some of the members of their respective committees, most simply did not understand the enormity of the risks posed by the Enterprises, risks which would not be addressed by stronger regulation accompanied by a reduction in the size of their portfolios, since these were not the only problems facing Fannie Mae and Freddie Mac. They were large issuers of debt, and they were feeding the market with mortgage-backed securities based to a much larger extent than ever realized on subprime mortgages.

Other warning voices began to be heard. The Organization for Economic Co-operation and Development (OECD), referring to the “rapid growth and systemic importance” of Fannie Mae and Freddie Mac, recommended that their “regulation and supervision” should be “tightened and the Administration has made proposals to this end, including relocating the regulatory authority to the Treasury Department.” OECD adds that: “reforms should go beyond that by eliminating their special status ... [which] has led to the market perception of an implicit government guarantee and hence slightly lower borrowing costs, allowing them to expand strongly and go beyond their original mandate of supporting the secondary market for residential mortgages. In any case, the marginal funding advantage is an inefficient way of promoting home ownership ... Altering the GSEs’ status, however, may not be sufficient to eliminate their implicit government guarantee. Without reducing the size of the GSEs’ portfolios, investors may still perceive them as ‘too big to fail’. Limits could be placed on the growth of their mortgage-related asset portfolios, so that mortgage-backed securities traded in public markets, and not GSE debt, became the dominant source of secondary market funding for mortgages.”⁶³