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Office of Federal Housing Enterprise Oversight Report : Fannie Mae Facade - Fannie Mae Criticized for Earnings Manipulation

James B. Lockhart

United States: Office of Federal Housing Enterprise Oversight (OFHEO)

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FOR IMMEDIATE RELEASE
May 23, 2006

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OFHEO REPORT: FANNIE MAE FAÇADE **Fannie Mae Criticized for Earnings Manipulation**

Washington, DC – James B. Lockhart, Acting Director of the Office of Federal Housing Enterprise Oversight (OFHEO), today released its Report of the Special Examination of Fannie Mae. The report details an arrogant and unethical corporate culture where Fannie Mae employees manipulated accounting and earnings to trigger bonuses for senior executives from 1998 to 2004. The report also prescribes corrective actions to ensure the safety and soundness of the company.

“The image of Fannie Mae as one of the lowest-risk and ‘best in class’ institutions was a facade,” said Lockhart. “Our examination found an environment where the ends justified the means. Senior management manipulated accounting; reaped maximum, undeserved bonuses; and prevented the rest of the world from knowing. They co-opted their internal auditors. They stonewalled OFHEO,” Lockhart said.

“Fannie Mae’s executives were precisely managing earnings to the one-hundredth of a penny to maximize their bonuses while neglecting investments in systems internal controls and risk management,” Lockhart said. “The combination of earnings manipulation, mismanagement and unconstrained growth resulted in an estimated \$10.6 billion of losses, well over a billion dollars in expenses to fix the problems, and ill-gotten bonuses in the hundreds of millions of dollars.”

The OFHEO report is the product of more than two years of in-depth review involving nearly 8 million pages of documents. The report includes the following key findings:

- Fannie Mae senior management promoted an image of the Enterprise as one of the lowest-risk financial institutions in the world and as “best in class” in terms of risk management, financial reporting, internal control, and corporate governance. The findings in this report show that image was false.
- A large number of Fannie Mae’s accounting policies and practices did not comply with Generally Accepted Accounting Principles (GAAP). The Enterprise also had serious problems of internal control, financial reporting, and corporate governance. Those errors resulted in Fannie Mae overstating reported income and capital by a currently estimated \$10.6 billion.

- During the period covered by this report—1998 to mid-2004—Fannie Mae reported extremely smooth profit growth and hit announced targets for earnings per share precisely each quarter. Those achievements were illusions deliberately and systematically created by the Enterprise’s senior management with the aid of inappropriate accounting and improper earnings management.
- By deliberately and intentionally manipulating accounting to hit earnings targets, senior management maximized the bonuses and other executive compensation they received, at the expense of shareholders. Earnings management made a significant contribution to the compensation of Fannie Mae Chairman and CEO Franklin Raines, which totaled over \$90 million from 1998 through 2003. Of that total, over \$52 million was directly tied to achieving earnings per share targets.
- Fannie Mae’s Board of Directors contributed to those problems by failing to be sufficiently informed and to act independently of its chairman, Franklin Raines, and other senior executives, failing to exercise the requisite oversight over the Enterprise’s operations, and failing to discover or ensure the correction of a wide variety of unsafe and unsound practices, even after the Freddie Mac problems became apparent.
- Senior management did not make investments in accounting systems, computer systems, other infrastructure, and staffing needed to support a sound internal control system, proper accounting, and GAAP-consistent financial reporting. Those failures came at a time when Fannie Mae faced many operational challenges related to its rapid growth and changing accounting and legal requirements.
- Fannie Mae senior management sought to interfere with OFHEO’s special examination by directing the Enterprise’s lobbyists to use their ties to Congressional staff to improperly generate a Congressional request for the Inspector General of the Department of Housing and Urban Development (HUD) to investigate OFHEO’s conduct of that examination and to insert into an appropriations bill language that would punish the agency by reducing its appropriations until the Director of OFHEO was replaced.

“As a government-sponsored enterprise, Fannie Mae has a unique position among American corporations and an extremely important mission,” said Lockhart. “It is also the second largest borrower in the world, only behind the U.S. government. As such, Fannie Mae has a special mandate and position of public trust. The previous management team violated that trust and did serious harm to Fannie Mae,” Lockhart said.

The report ends with recommendations from OFHEO’s staff to the Acting Director, which he has accepted. Some of the key recommendations include:

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

- Fannie Mae must review OFHEO's report to determine additional steps to take to improve its controls, accounting systems, risk management practices and systems, external relations program, data quality, and corporate culture. Emphasis must be placed on implementation of those plans.
- Fannie Mae must strengthen its Board of Directors procedures to enhance Board oversight of Fannie Mae's management.
- Fannie Mae must undertake a review of individuals currently with the Enterprise that are mentioned in OFHEO's report.
- Due to Fannie Mae's current operational and internal control deficiencies and other risks, the Enterprise's growth should be limited.
- OFHEO should continue to support legislation to provide the powers essential to meeting its mission of assuring safe and sound operations at the Enterprises.

OFHEO will announce a settlement with Fannie Mae before 10 a.m.

The full text of the OFHEO report can be found at www.fhfa.gov.

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Summary of the Report of the Special Examination of Fannie Mae

- Fannie Mae senior management promoted an image of the Enterprise as one of the lowest-risk financial institutions in the world and as “best in class” in terms of risk management, financial reporting, internal control, and corporate governance. The findings in this report show that risks at Fannie Mae were greatly understated and that the image was false.
- During the period covered by this report—1998 to mid-2004—Fannie Mae reported extremely smooth profit growth and hit announced targets for earnings per share precisely each quarter. Those achievements were illusions deliberately and systematically created by the Enterprise’s senior management with the aid of inappropriate accounting and improper earnings management.
- A large number of Fannie Mae’s accounting policies and practices did not comply with Generally Accepted Accounting Principles (GAAP). The Enterprise also had serious problems of internal control, financial reporting, and corporate governance. Those errors resulted in Fannie Mae overstating reported income and capital by a currently estimated \$10.6 billion.
- By deliberately and intentionally manipulating accounting to hit earnings targets, senior management maximized the bonuses and other executive compensation they received, at the expense of shareholders. Earnings management made a significant contribution to the compensation of Fannie Mae Chairman and CEO Franklin Raines, which totaled over \$90 million from 1998 through 2003. Of that total, over \$52 million was directly tied to achieving earnings per share targets.
- Fannie Mae consistently took a significant amount of interest rate risk and, when interest rates fell in 2002, incurred billions of dollars in economic losses. The Enterprise also had large operational and reputational risk exposures.
- Fannie Mae’s Board of Directors contributed to those problems by failing to be sufficiently informed and to act independently of its chairman, Franklin Raines, and other senior executives; by failing to exercise the requisite oversight over the Enterprise’s operations; and by failing to discover or ensure the correction of a wide variety of unsafe and unsound practices.
- The Board’s failures continued in the wake of revelations of accounting problems and improper earnings management at Freddie Mac and other high profile firms, the initiation of OFHEO’s special examination, and credible allegations of improper earnings management made by an employee of the Enterprise’s Office of the Controller.
- Senior management did not make investments in accounting systems, computer systems, other infrastructure, and staffing needed to support a sound internal control system, proper accounting, and GAAP-consistent financial reporting. Those failures came at a time when Fannie Mae faced many operational challenges related to its rapid growth and changing accounting and legal requirements.
- Fannie Mae senior management sought to interfere with OFHEO’s special examination by directing the Enterprise’s lobbyists to use their ties to Congressional staff to 1) generate a Congressional request for the Inspector General of the Department of Housing and Urban Development (HUD) to investigate OFHEO’s conduct of that examination and 2) insert into an appropriations bill language that would reduce the agency’s appropriations until the Director of OFHEO was replaced.
- OFHEO has directed and will continue to direct Fannie Mae to take remedial actions to enhance the safe and sound operation of the Enterprise going forward. OFHEO staff recommends actions to enhance the goal of maintaining the safety and soundness of Fannie Mae.

Recommendations from the Special Examination of Fannie Mae

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

1. Fannie Mae should be subject to penalties and fines consistent with the findings of this report.
2. Fannie Mae must meet all of its commitments for remediation and do so with an emphasis on implementation—with dates certain—of plans already presented to OFHEO.
3. Fannie Mae must maintain a capital surplus until the Director determines a change in the surplus amount is warranted.
4. Fannie Mae must continue to use independent consultants acceptable to the Director to validate and assure compliance with requirements. Cyclical targeted exams by independent consultants, at least every two years, are needed to assure systems and practices are being implemented properly.
5. Fannie Mae must develop new structures and operational plans for its Board of Directors related to Board reporting, maintenance of minutes, and other changes that will enhance Board oversight of the Enterprise's management.
6. Fannie Mae must review OFHEO's report to determine additional steps to take to improve its controls, accounting systems, risk management practices and systems, external relations program, data quality, and corporate culture. Once OFHEO has approved the Enterprise's plans, an emphasis must be placed on implementation of those plans.
7. Fannie Mae must undertake a review of individuals currently with the Enterprise that are mentioned in OFHEO's report and provide OFHEO a report as to conclusions regarding terminations, transfers, or other remedial steps (such as disgorgement, restitution, or alteration of benefits) in cases of misconduct.
8. Fannie Mae must assure that departments are fully and appropriately staffed with skilled professionals who have available regular training opportunities in financial services industry standards.
9. Due to Fannie Mae's current operational and internal control deficiencies and other risks, the Enterprise's growth should be limited.

10. OFHEO should continue to develop its program of regulatory infrastructure to add additional rules and regulations that enhance the transparency of its supervision of the Enterprises. With the end of the special examination, OFHEO staff should be directed to address additional items raised during the preparation of this report as part of the regular examination program.
11. OFHEO should continue to support legislation to provide the powers essential to meeting its mission of assuring safe and sound operations at the Enterprises.
12. Matters identified in this report should be referred to OFHEO's Office of the General Counsel for determination of enforcement actions that the Director may wish to consider.
13. Matters identified for remediation by Fannie Mae should be considered by the Director for application to both Enterprises.