

**Examination Year: 2005**

**Federal National Mortgage Association**

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**TABLE OF CONTENTS**

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	<i>Page</i>
Examination Authority and Scope	1
Examination Results and Conclusions	1
Management Supervision	4
Operations	6
Model Risk	10
Independent Oversight	12
Asset Quality – Credit Risk Management	15
Liquidity	21
Sensitivity to Market Risk	23
Earnings	27
Capital Adequacy	28

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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.

Report of Annual Examination  
Federal National Mortgage Association

## **EXAMINATION AUTHORITY AND SCOPE**

### Examination Authority and Reporting Convention

The Report of Examination contains the results and conclusions of OFHEO's 2005 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 Enterprise's Board of Directors and to Congress.

### Examination Scope

Examination activities conducted during 2005 were primarily devoted to the progress in remediation to meet OFHEO's Agreement requirements, and a broad-based review of several activities in each business unit to obtain an overview of the Enterprise's strengths and weaknesses. Target examinations included reviews of business centers involved in several aspects of credit risk management, processes used to develop and validate models, front and back office activities for liquidity and interest rate risk management, information technology controls over end user computing applications and database modification, and several systems supporting Finance and the retained portfolio. The examination of many key areas in counterparty risk will be completed in 2006.

The scope was limited in several areas due to the broad-based examination approach used this year, and the extensive use of resources to complete the Special Examination. Board supervision and specifics concerning accounting issues are covered in the Special Examination released May 23, 2006.

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**

The Enterprise is a supervisory concern due to enormity of issues that management must prioritize and address to improve data, systems, controls, communication, and risk measurement and management as well as process efficiency and systems flexibility to remain competitive in the future business environment. The pervasive deficiencies stem from past management actions that deemphasized internal controls and risk management, focused on expense control, established an organizational structure that impeded internal controls, and employed too few personnel who emphasized or understood industry standards for internal controls and risk management. Issues noted during 2005 include:

Report of Annual Examination  
Federal National Mortgage Association

- Non-existent, poor, or manually intensive controls for business processes constituted deficiencies or inefficiencies in most business activities. The focus on front office activities and emphasis on expense control adversely impacted the development and review of controls. The IT function's lack of authority to control business units' IT decisions allowed the business units to develop a poorly integrated mesh of databases and systems without common rules or practices.
- Deficiencies in data, systems, controls, practices, risk metrics, and reports prevented or impeded many aspects of performance and risk management. Current systems do not fully support new products. Despite these deficiencies, the major risks in interest rate, liquidity, and credit were controlled at reasonable levels.
- Restatement work strained resources and significantly delayed important model and systems projects until the restatement work is completed. The implementation of several important models and the independent validation of several models of moderate to higher significance have been delayed until late 2007.
- Staff levels for future ongoing operations are deficient, and will require a significant increase in personnel to properly conduct controls and risk management in many business lines. Critical staff shortfalls existed in the Treasurer, Controller and Chief Risk Officer divisions at YE05. Consultants addressing restatement and organizational structure issues represent more than 40% of the Enterprise's workforce, and are approaching the maximum level that can be effectively managed.
- Management's and staff's knowledge and practice of financial industry standards for controls, risk management, and operational discipline vary widely throughout the Enterprise, and contributed to deficiencies in operational, performance, and risk management. Cultural change throughout the Enterprise will require continuing effort.
- Business unit policies and written procedures are deficient. The Board approved several risk policies around YE05, but the policy for operational risk is still in its initial stages. The lack of clear, concise, or documented policies and procedures contributed to risk management deficiencies.
- Several Board and management reports lacked meaningful, accurate, or complete information. Performance and risk metrics are deficient or incomplete for many areas, impeding the analysis and communication of risk.
- Significant deficiencies in credit risk management in the Single-Family and HCD business units' functions impact management's ability to optimize their control over expenses. Data and systems deficiencies produce some incomplete or

Report of Annual Examination  
Federal National Mortgage Association

inaccurate reports, impeding effective performance and risk management, and limit the ability to respond competitively.

- Critical components of the methodology used to estimate loan loss reserves were not complete at YE05.
- Processes and controls for obtaining asset liquidity in a stress environment are satisfactory but inefficient.
- There was lack of independence in wire transfer cash disbursements, Capital Markets back office access to and confirmation of subsequent event transactions, and the pricing of financial instruments in the process from the Capital Markets business unit through the Controller department.
- Capital Markets data and/or systems deficiencies required manually intensive and inefficient generation of information that introduced some level of uncertainty in interest rate risk measurement, impacted access controls to some systems, and contributed to two missed debt call dates.
- The internal audit program was weak but improving at YE05. The Chief Risk Officer and Compliance functions were in their initial stages, and require additional staffing, and significant time and effort to become fully operational.

Management has begun implementation of their program to address the Enterprise's deficiencies. However, project management and coordination is complex, and will require significant time, effort, and resources to complete. Restatement delays and new projects with hard deadlines impact and delay important but necessarily lower priority projects such as the implementation and validation of several models, and the replacement of legacy systems used for ongoing operations. Resources will remain strained until restatement efforts are completed.

Many milestones should be achieved in short and mid-term timeframes in such areas as management policies, written procedures, risk metrics, interim controls, staffing levels, and deficiencies and inefficiencies in reports, processes and controls associated with stand alone information technology systems. However, full correction of issues impacted by the main database, platform, and systems integration are expected to require three to five years.

### **MATTERS REQUIRING BOARD ATTENTION**

The year 2005 focused on meeting the restatement and other requirements in OFHEO's agreements, discovery of issues within the Enterprise, and developing a plan to address them. Management's efforts during 2006 will be centered on the prioritization and implementation of that plan, and ensuring that industry standards; a formal structure for risk communication, decision making, and strategic planning; and accountability in clearly defined responsibilities are firmly embedded in the Enterprise. When monitoring

Report of Annual Examination  
Federal National Mortgage Association

management's programs to address these issues, the Board should provide strong oversight for the following key activities:

- Monitor project management for operations, information technology, and internal control issues. Evaluate the Enterprise-wide plan for the prioritization and coordination of projects, and the impact and reasons for delays. Ensure interim processes and controls are implemented and regularly audited until long term, sustainable solutions for data and systems are complete.
- Ensure management addresses cultural issues in committee and business units impacting accountability, responsibilities, controls, coordination, and risk management. Ensure management completes a formal structure for decision making, business unit risk management, optimized pricing and expenses, and coordinated and rationalized strategic planning. Ensure business unit policies and written procedures are completed, and that all policies and limits are periodically updated, and incorporated into business practices.
- Ensure management improves the measurement and communication of risks, performance, and operational errors through corporate wide and business unit metrics, and reports for the Board and management that meaningfully display key metrics and issues.
- Ensure management expeditiously incorporates financial industry standards throughout the Enterprise through new hires and a comprehensive training program. Ensure management fills the remaining vacancies in critical management and staff positions, and contractors have sufficient time to pass on needed information to the permanent staff before they leave.
- Ensure management has completed an infrastructure that has sufficient data, systems, controls, reports, and personnel in place before the Enterprise significantly engages in new products.

## **MANAGEMENT SUPERVISION**

Past executive management established an organization that provided insufficient monitoring, control, and coordination of business units. These deficiencies led to significant issues in operations controls, information technology (IT) effectiveness and flexibility, and risk measurement, management, and communication throughout the Enterprise. The quality of management and controls varied widely due to the lack of corporate standards and the relative autonomy of the business units. The ability to communicate within the Enterprise was impeded by an insufficient committee structure, poorly defined authority and responsibilities, deficient risk metrics, and a lack of a common language or universal understanding of terms used to communicate risk and performance. Issues noted in 2005 include:

Report of Annual Examination  
Federal National Mortgage Association

- Corporate risk policies did not exist until late 2005, and business policies and written procedures were deficient throughout the Enterprise.
- Rigid and uncoordinated databases, systems, and applications in business units because Enterprise Systems and Operations did not have sufficient authority to standardize business unit IT projects.
- Business units focused on front office activities and corporate pressure for expense control led to deficient operational controls and staff levels needed to implement controls.
- Poor coordination of products, services, and projects that crossed business lines.
- Committee structures that varied in sufficiently vetting the risks and performance of products, models, and projects.
- Performance and risk metrics were deficient or incomplete for many areas, impeding the analysis and communication of risk.
- Insufficient analysis of some credit risks due to poor data and systems coupled with insufficient rigor by the analysts.
- Expertise in controls, risk management, and operational discipline varied widely among management and staff. Cultural change throughout the Enterprise will require continuing effort.

Executive management has prioritized the Enterprise's issues and devoted significant resources to develop a roadmap and initiate a program that addresses the requirements in OFHEO's Agreements and other deficiencies within the corporation. Organization structural changes mandated in the Agreements are nearly complete. A substantial number of personnel in key positions have been replaced with technically competent management and staff who bring needed industry standards, and the knowledge and drive to develop programs that correct the Enterprise's significant deficiencies.

Management has begun implementation of their longer term program to address the Enterprise's deficiencies. Project management and coordination is complex, and will require significant time, effort, resources, and several years to fully complete. Multiple, concurrent projects strain resources, and increasingly delay projects that are critical but lower priority than the restatement. However, several aspects of the restatement can be leveraged into completing the financial transformation project for systems that will produce financial statements in the future. New corporate priorities and objectives appropriately focus on stabilizing the Enterprise, instilling operational discipline and changing the corporate culture.

Organizational changes that have revised or created new management committees have improved the structure, and begun to improve the communication and coordination in

Report of Annual Examination  
Federal National Mortgage Association

business practices and risk management. Revised or new committees have been established for all business units, and several executive and senior management level committees coordinate products, practices, and responsibilities across business lines. In addition, executive management has begun to change the corporate culture, in part, through knowledgeable new hires who have injected industry standards and practices into the areas in which they work.

Management has achieved or is near compliance with the Agreements' requirements regarding organizational structure, corporate risk policies, hiring key management to fill new or vacant positions, and interim controls on end user computing applications and database modifications. However, compliance will take time and major effort for other Agreement provisions concerning restatement, data, systems, controls, and accounting methods and policies.

***Operations***

Operations controls are weak. Nonexistent, poor or manually intensive controls for many processes constituted moderate to significant deficiencies throughout the Enterprise. The pervasiveness of operational deficiencies stems from a culture that deemphasized internal controls, focused on expense control, established an organizational structure that impeded internal controls, and employed too few personnel who emphasized or understood industry standards for internal controls. The recent Sarbanes Oxley (SOX) review identified pervasive control deficiencies, which must be addressed before the external auditor can provide an unqualified opinion on the Enterprise's internal control structure.

Most of the Enterprise's information technology (IT) back-end and accounting applications are legacy systems. The legacy systems were deficient for accounting and several types of transactions, but provided stable performance for traditional loan product transactions due to support by experienced teams with the knowledge and skills to meet production challenges. In addition, the Enterprise has invested heavily in running a reliable foundation technology environment and implemented their second production data center in 2005. However, their legacy business systems are proprietary or heavily modified vendor systems built to rigidly meet business unit specifications from years past. This approach adversely impacted internal controls and the quality of some information used to manage the Enterprise, and resulted in the use of systems that were difficult and expensive to modify and control. In addition, these systems have made the Enterprise increasingly uncompetitive due to their limitations in accommodating new products and higher volumes of transactions.

The Enterprise Systems and Operations' (ESO) lack of authority to control business units' IT decisions allowed the business units (BU) to develop a poorly integrated mesh of databases and systems without common rules or practices. While ESO has technology standards, the BUs' focus on expense control resulted in BUs defining narrow, single purpose applications that were poorly integrated. In 2H05, ESO began implementing several control efforts to improve standardization over time.

Report of Annual Examination  
Federal National Mortgage Association

Executive management employed massive resources during 2005 to discover or address the plethora of internal control and IT deficiencies. Actions and resources have been appropriately focused on controls related to SOX compliance. Efforts to address internal controls in 2005 were centered in identifying and cataloging the issues, defining and initiating an organizational structure for better control and risk management, and allocating a dedicated staff to address the most significant of the known deficiencies. The strain on resources has delayed needed changes to ongoing operations, but has been partially mitigated through the hiring of additional qualified staff and extensive use of consultants. Consultants provide sufficient IT support, but they are approaching maximum levels that can be effectively managed.

Restatement timelines are aggressive and employ the use of many overlapping work streams. Needed changes outside of the SOX and restatement efforts are necessarily a lower priority, and have been delayed or will not be fully implemented until resources can be shifted from the restatement. However, many of these changes have been coordinated with the restatement project, and some of the restatement results can be leveraged into the resolution of other systems issues. Full correction of issues impacted by the main database, platform, and systems integration are expected to require three to five years.

**Nonexistent, poor or manually-intensive controls for business processes constituted significant weaknesses throughout the Enterprise.**

The organization structure was largely decentralized, with operations managed within uncoordinated silo business lines. Business unit (BU) management invested in single purpose applications developed using non-standard rules and practices. The rigid systems impeded coordination of shared information, functionality, or product lines among BUs, and led to the extensive use of inadequately controlled adaptations such as end user applications, database modifications, and on top adjustments in accounting and risk management to meet changing business needs. In addition, BU management's focus on front office activities and emphasis on expense control prevented the development of sufficient controls or the allocation of sufficient resources to review controls.

Systems deficiencies led to inefficient manual work arounds for processes in many areas. These manual processes were subject to error, prevented or impeded necessary controls, and generated key person dependencies. In addition, systems changes were sometimes not documented, creating unanticipated errors when the systems were later modified. These errors occurred because the system modifiers had limited documentation to help them understand the impact of code changes. Errors noted in 2005 include:

- Single-family securities at \$7 billion were misclassified as multi-family securities in the interim financial information report released to the public monthly.
- Mortgage revenue bond commitments at \$1.7 billion were not recorded in trading room systems.

Report of Annual Examination  
Federal National Mortgage Association

- Errors in adjustable rate mortgage (ARM) features were released to the investor public that impacted investors' ability to re-securitize some ARM MBS into larger securities.
- Personnel were paid three times in one pay period.

BU policies and written procedures were incomplete, poorly written, or nonexistent. The lack of and the varying quality in policies and procedures were due to the BU's control of this function and the lack of requirements and standardization by executive management. Many policies do not provide basic objectives, strategies, or risk tolerances for the BU. In some cases, policies and written procedures were intermixed, with procedures difficult to follow because they stopped and started again throughout the document. Reviews being conducted by the CRO, internal audit, and the SOX compliance function in 2006 are expected to ensure management develops and employs the necessary policies and procedures.

In 2005, the CRO's SOX review revealed pervasive deficiencies in controls that fall within and beyond the scope of SOX. Deficiencies in IT controls were high: in 64 financial reporting applications, over 90% had deficiencies in access control, logging and monitoring, and change management. In addition, 96% of the 110 financial reporting end user computing applications failed SOX control tests.

An operations risk framework was developed in late 2005 that is expected to establish appropriate BU and CRO oversight, and centralized major operations in all but the Capital Markets BU: the Capital Markets BU operations are likely to be included in the centralized structure in 2006. The CRO division's new Operations function began in 2006 to develop Operations Risk corporate policy, and establish delegations of authority to address deficiencies in Enterprise processes. The new CFO began oversight of a dedicated SOX review function in early 2006. In addition, a dedicated team in ESO is in the process of cataloging the known SOX deficiencies, and is grouping them by root cause to ensure consistent remediation throughout the Enterprise. In early 2006, management developed and began implementing a rationalized and prioritized program to provide permanent solutions for known deficiencies. ESO and business unit management have implemented effective interim controls in areas such as database modifications and end user computer applications.

**Rigid legacy systems have adversely impacted controls, the quality of information and systems functionality, and have made the Enterprise increasingly uncompetitive over time. Executive management employed massive resources during 2005 to address IT deficiencies and issues, and implement base capabilities for servicer and investor reporting.**

The legacy systems' deficiencies prevent or impede accuracy or completeness in reports, risk management, performance measurement, and transactions. A lack of integrated, end to end processes generates limited transparency in information and transaction flow. Data is processed through multiple transfers among systems with manually intensive procedures, and several files hold disparate data. Several reports cannot be produced

Report of Annual Examination  
Federal National Mortgage Association

with sufficient information or formatting to view detail or grouped information to analyze components within activities or positions. Some risk and performance information is less than optimum because books and financial instrument valuations cannot be done daily. Some systems cannot produce GAAP compliant accounting for several types of transactions.

Three major, high-priority initiatives compete for resources from both ESO and the BUs; the restatement, new systems development, and production support for the current systems. ESO's staff focused on restatement projects represented 25% of staff resources. Consultants easily meet additional resource requirements, but planning is needed to ensure that their knowledge of the Enterprise is passed on to permanent staff before they are finished. However, critical staff shortfalls existed in the Treasurer's and Controller's division, which is expected to be partially mitigated in 2006 by a program to train new hires to develop business requirements and related systems development activities.

ESO developed an overall plan in 2006 to address IT over the next three to five years. The highest priorities are stabilizing IT and producing financial statement for the years 2004 through 2006, completing the daylight overdraft project by July 2006, identifying and addressing Sarbanes Oxley issues, documenting exiting processes and data flows, and implementing a rules-based accounting framework. Interim controls for end user computing applications and database modifications were effectively addressed by early 2006. Finance Transformation will leverage the results of restatement projects, and will address the Capital Markets BU as well as the Controller department's accounting operations, and controls, systems, and reporting for current financial statements.

Records management was significantly deficient, with no formal, Enterprise-wide systems or program in place. The project had originally been assigned to the Legal department, but did not receive proper funding, scope, and planning until after OFHEO evaluated their program. This project was transferred to ESO and now has proper funding, scope, and management.

**The project conducted between 2001 and 2005 to design a new IT application for Single Family (SF) acquisitions, securitizations, and servicer and investor reporting failed due to unrealistic objectives, budget, and time frame set by the former CEO and Chairman Franklin Raines, as well as poor project and vendor management. Mr. Raines initiation and sponsorship of the project made it difficult to terminate despite its poor results, protracted timelines and increasing costs.**

The former Chairman and CEO Franklin Raines directed ESO to replace 35 twenty-year-old loan processing legacy systems in 18 months. He set the 18 month deadline before sufficient cost or project analysis was completed. The project was planned with a single implementation in part to meet this tight timeframe. The project ran overtime due to the unrealistic timeframe, and poor project and vendor management. The completion deadline was delayed and formally extended twice to address project deficiencies. The approach was abandoned in June 2005, 45 months after the project was initiated and cost

Report of Annual Examination  
Federal National Mortgage Association

overruns at 80% increased the project's total cost to \$373 million. However, \$100 million in software and database code were reusable in other areas.

Personnel began writing code before business specifications were completed. The poorly planned launch coupled with the protracted completion time increased the number of times business units were allowed to change their specifications. The high number of subsequent code changes slowed the project even further. In addition, the single implementation generated no interim milestones for testing, masking significant problems until most of the project was done.

Poor vendor management contributed to the project's problems. Unlike other Enterprise projects, an unusually high percentage of vendors were used to provide the unique skills needed for this large project. The use of multiple vendors made it difficult to coordinate and manage these resources. In addition, many of the vendors were contracted for their time rather than project results and/or a fixed cost. These vendor issues coupled with inadequate acceptance criteria led to a poor quality product. Vendor costs accounted for 90% of the total overrun.

Corporate culture constrained communication of the project's failures to management and the Board. The 18 month, single implementation approach and project delays created extraordinary pressure to meet deadlines, which led to compromised project management controls. Also, staff did not raise issues or voice dissenting views because of their view that management discouraged this type of information in the project's early stages. Project management made presentations to the Board that did not fully communicate the seriousness of the project's deficiencies. Although the delays and issues were mentioned, the presentations focused on the corrective actions that would address the problems.

In 2005, ESO initiated an effective program to replace the 35 back-end SF legacy systems applications. The first project was the cash release of servicer and investor reporting. The project was well planned with manageable sections that are conducted by teams with both IT and BU personnel to ensure Enterprise needs are met. Testing was completed at regular milestones before the project progressed.

***Model Risk***

The massive shift of BU and CRO model personnel to restatement-related model development and validation has significantly delayed the BU's model implementation and the CRO's independent model validation program. The program's delay has prevented the production implementation of several developed models, and postpones critical components of CRO division's program into the year 2007. Management reforecasted a June 2007 deadline for the BU's and CRO's completion of these critical functions, but now estimates a YE07 deadline due to continued restatement work. Issues noted in 2005 included:

Report of Annual Examination  
Federal National Mortgage Association

- Strong corporate model policies, but incomplete or nonexistent policies in several business units. Business units are in the process of developing the new policies in compliance with corporate policy deadlines.
- No formal, unified oversight to coordinate the development of separate models that are interfaced for use in one model system.
- No control documentation to indicate end user communication and vetting of model design and development goals.
- Model documentation that was satisfactory for use by technical experts, but unsatisfactory for use by end users and internal audit.

The new CRO division initiated the program to independently control model development, verification, and validation during 2H05. They completed the corporate-wide policy and the inventory and risk rating for all models used in the Enterprise, and initiated the queue for independently validating models with priority given to models which represent the highest risks to the Enterprise. The majority of CRO division personnel hired for model validation was shifted to validate models used in the restatement, delaying the validation of high risk models. However, several of the models they are validating for the restatement are intended to be used in future ongoing operations, reducing future validation efforts.

The business unit model development processes in both Credit Finance and Applied Portfolio Research meet or exceed industry standards, and both departments produced models that were generally effective in meeting the developers' goals for estimating risks, prices, and performance. In addition, the program structure established for ongoing validation within the credit and portfolio business units (BU) is satisfactory. The BU model departments and the Chief Risk Officer (CRO) division have made substantial progress in initiating a program to address deficiencies in policies, communication, controls, validation, and project management for the development, implementation, and ongoing validation of models throughout their life cycle. However, many aspects of the program are in their initial stages, and will require considerable, time, effort, and resources to fully implement. Management corrected or is in the process of correcting issues listed above.

**Corporate-wide model policies are strong, but business unit model-specific policies are incomplete or nonexistent. Business units are in the process of developing the new policies in compliance with corporate policy deadlines.**

The CRO division completed in 4Q05 a comprehensive and detailed policy that requires the Enterprise to meet industry best practices, and addresses roles and responsibilities, and ongoing validation of models and applications. Dates were established for compliance with the policy's requirements for model registration and placement in the validation queue. However, deadlines have not been established for the business units' compliance with several other policy requirements.

Most existing business unit policies and written procedures were not complete or accurate. Previous policies did not address several key areas, contributing to inconsistent

Report of Annual Examination  
Federal National Mortgage Association

and/or deficient practices in several areas, including development, validation, implementation, the approval process, project oversight responsibilities, approval process, documentation requirements, implementation, testing, validation, performance analysis, and monitoring of overrides. Per the new corporate policy requirements, management is in the process of writing business unit policies and procedures.

**The shift of model personnel from the business units and the Chief Risk Officer department to restatement-related model development and validation has delayed the implementation of several important models into the year 2007. Management has reforecast the deadline a second time to YE07 for the business units and the CRO division to complete its program to update and control models.**

Significant levels of model personnel were diverted to the development and validation of models used in the restatement, delaying the implementation of several risk assessment models, and risking employee burnout. Restatement efforts used 50% and 30% of two Portfolio directors' time and all Credit Finance Implementation directors, about 80% of the term structure modeling staff resources, and 20% of the Credit Finance model development staff, as well as the entire Common Analytics Platform's testing and requirements group and the VN architecture team. Portfolio Strategy staff are stretched from working on both the PDS and PRiMA projects as well as their regular responsibilities.

The shift in resources prevents the use of the updated Creditworks model because it prevented Credit Finance from completing its work in implementation and validation of the model. Creditworks has not been significantly updated since its development in 2003, with several components still operating on estimates generated from 2001 data. The model developed for subprime loans could not be vetted and implemented for production, requiring the use of a modified model to price these loans. Models development continues, although at a much slower pace. Models in this slowed pipeline will accumulate in a holding status until personnel who work on production return to their regular duties.

Maintaining the regular program for model development and application is critical, and is needed to ensure that models produce reasonable and reliable estimates for pricing, performance, and risks. The date for independent model validation of all critical models had been delayed six months to a June 2007 deadline, and is now reforecast for completion at YE07.

### ***Independent Oversight***

The audit department was weak through most of 2005, the Compliance program was deficient and lacked independence, and the Chief Risk Officer department was insufficiently staffed and not fully developed. Management made progress during the second half of the year in correcting deficiencies in the audit and compliance programs, and building the Chief Risk Officer function. These programs and functions are in their

Report of Annual Examination  
Federal National Mortgage Association

initial stages, and require additional staffing, and significant time and effort to become fully operational.

The Office of Audit (OA) through most of 2005 was weak due to insufficient levels and expertise in staff, and an audit program that did not adequately identify or communicate the risks in the Enterprise. In addition, deficiencies that were identified by audit were sometimes not corrected because auditors would sign off before the business units finished corrections and/or the business units failed to maintain corrections after audit's sign off. In July 2005, a new Chief Audit Executive (CAE) was given appropriate independence and authority, and began implementing a satisfactory program which management expects will address all significant deficiencies by year end 2006.

Previous audit management did not sufficiently staff OA, and staff levels did not keep up with the changing or increasing risks, products, or activities of the Enterprise, or the increasing responsibilities of OA. The need for OA staff levels expanded as increases in new products required different risk measurement methodologies and controls, and major systems projects, such as the core project, continued. In addition, OA's increased responsibilities in extensive non-audit projects took resources away from their core mission. The audit staff conducted lender audits for the Single Family Mortgage business unit, calculated and reported key performance indicators for the company monthly, managed the self assessment questionnaire program for the business units, and conducted the Enterprise's Sarbanes-Oxley review.

The audit program exhibited deficiencies in nearly every process, and several of the auditors did not have the appropriate skills to satisfactorily evaluate many of the deficiencies in the Enterprise. These program and skill deficiencies led to the incomplete identification or reporting of deficiencies, and audit ratings that did not accurately reflect many significant issues in the Enterprise's processes and controls. Program deficiencies included:

- Inadequate methodologies for risk allocation and sample sizes.
- Oversized auditable entities or audit scopes that led to less accurate and less severe audit ratings.
- Audit procedures that often focused on transactions rather than testing controls.
- No maximum time periods between audits, allowing several areas to remain unaudited for extended periods.
- Some deficiencies were recorded as fully corrected if the business unit was near completion in or had a plan to correct the deficiency.
- Improper classification of severe deficiencies in workpapers, which led to less severe ratings for the overall audit.
- Inefficient tracking and controls for the audit program.

Reports for specific audits and management summaries adversely impacted the communication of audit results. Audit reports provided a list of deficiencies, but often did not explain the root causes of the issue, or group the issues by root cause. Audit reports provided overall ratings, but did not rate the individual deficiencies noted in the

Report of Annual Examination  
Federal National Mortgage Association

audits. Summary reports listed deficiencies, but did not group, weight, or otherwise summarize the Enterprise's deficiencies in a meaningful way.

The new CAE began making significant changes to the audit program in July 2005, and plans to complete the significant components of her program by year end 2006. Her new program addresses staff levels and expertise; tracking systems and reports to monitor and control the audit program, and summary reports for management and the Board that meaningfully communicate the issues and their root causes. The program also establishes maximum time periods between audits, and reduced the size of auditable entities so that the total entities now total about four times more than in the former program. In addition, responsibilities that are not part of OA's core mission have been moved to other functions. The CAE has coordinated with external audit, the Chief Risk Officer, and the Chief Compliance Officer to ensure coordinated and complete independent oversight of the Enterprise. OA is independent, and reports directly to the Board's Audit Committee.

The original Compliance function was deficient, failed to provide sufficient oversight, and lacked independence. The function had insufficient staff levels to properly complete its mission, and was run by the lawyer also responsible for defending the Enterprise in litigation brought by employees. In 2H05, a new Compliance department was initiated with functions and an organizational structure that meets the requirements of OFHEO's supplemental agreement. The Chief Compliance Officer plans to train and advise the business units on ethical issues, oversee the compliance function throughout the Enterprise, conduct internal investigations, and oversee reporting to regulatory agencies. However, the program is in its initial stages, and many positions are still vacant. The Compliance department is expected to be fully staffed and functional during 2006.

An independent Chief Risk Officer (CRO) function did not exist prior to 2005. Progress has been made in establishing this function, but significant work and time, and additional staff will be required before the CRO department is fully functional. Progress was made in 2005 but the results of most of these efforts were achieved late in the year.

In 2006, the deputy CRO refined the department's organizational structure and functions, began hiring the managers for each function, and made significant progress in developing many of the Board's risk policies, a risk report package for the Board, and the CRO's model validation processes. Many policies still need to be implemented, and the model validation program is only in its initial stages. Most function managers have been hired, but the CRO position and a significant number of staff positions remain vacant. Additional work is required before risk information can be aggregated.

Slow progress in building out the CRO department stems from the timing of the appointment of the deputy CRO in November 2005, substantial involvement of existing staff in restatement projects, protracted hiring of senior managers from the outside due in part to uncertainties surrounding the Enterprise, and the significant amount of time and resources needed to create this new department. The deputy CRO is concurrently refining the CRO department's responsibilities and is working to educate and coordinate this new risk management function with the business units; developing policies and

Report of Annual Examination  
Federal National Mortgage Association

meaningful reports and risk metrics; and managing a workload which included the Sarbanes-Oxley review, management of Credit Finance, and the validation of models used in the restatement. Those hired to manage the CRO functions exhibit appropriate technical skills and the motivation to make the significant effort needed to build this department. Developing a model inventory and initiating a model validation program was impeded due to resources moved to validate models used for the restatement. However, some of their validation work will be leveraged, saving time when these models are used in ongoing operations.

The CRO department's organizational structure meets the requirements in OFHEO's Agreements. The CRO reports to the CEO, but also communicates directly with the Board's Risk Policy and Capital Committee. The authority of the CRO is similar to that seen in several other financial institutions, which encompasses the monitoring and escalation of significant risks to executive management, but does not give the CRO the authority to stop activities he views as unacceptable.

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

Significant deficiencies in risk management in the Single-Family, and Housing and Community Development (HCD) business units' functions impact management's ability to optimize control over expenses. Risk management deficiencies left uncorrected may result in higher expenses, unplanned losses, and opportunity costs. Data and systems deficiencies produce some incomplete or inaccurate reports, impeding effective risk management.

Management practices and standards and the current business/credit cycle contributed to strong asset quality evidenced by low delinquency rates and loss levels. Single-family business has benefited from well established credit acquisition standards, credit enhancements, and significant home price increases which have minimized losses. Similarly, HCD has benefited from the present demand for distressed properties despite low capitalization rates. Current practices and systems provided adequate service to the Enterprise's clients for traditional loan products.

Key deficiencies in risk management noted in 2005 include:

- Policies do not adequately define risk tolerances or position responsibilities.
- Poor data and systems generated reports that impeded satisfactory management of many aspects of production and risks.
- Poor accountability contributed to the lack of review of critical business center risk reports by the centralized Single-Family Risk Management team.
- Information is typically reported on an aggregate basis that sometimes lacks granularity. Historical risk metrics are not always available, preventing the monitoring of some trends.

Report of Annual Examination  
Federal National Mortgage Association

- Deficient records; and varying quality of internal management over information, loans, lenders, and servicers and vendor management have increased expenses.
- The lack of granularity in risk ratings for HCD loans rated pass or “green” has impeded risk management.
- A robust, risk-based pricing methodology has not been developed for HCD.
- The loss reserve methodology is inappropriate and is still in transition towards a fully GAAP compliant approach. The methodology did not have sufficient independent controls for systems to ensure compliance with GAAP, and the integrity of model results.
- The failure to upgrade systems has hindered the Enterprise from introducing new products. Data, systems, and risk management practices do not fully accommodate the small but growing levels of newer, complex and higher-risk products.
- Substantial use of end user computing applications (EUCs) created key person dependencies and obsolescence issues. Management implemented effective interim controls for EUCs in late 2005.
- Significant levels of staff for risk management and business operations are needed before the credit business lines can become fully operational.

Management recognizes these problems, and has begun to devote significant resources to correct the deficiencies. Progress has been made in revising the organizational structures, and some aspects of risk management in both the Single-Family and HCD business units. In addition, new business unit resources are now devoted to coordinating products and services within and among business lines, and standardizing pricing and risk management practices. However, the corrective actions to both internal and external findings are in their initial stages, and will require significant time, resources, and effort to fully implement. Many issues can be corrected in the short term through permanent corrections or interim work-arounds, but many of the issues related to data and systems will require several more years to address.

The credit risk in new loans is increasing, but overall credit risk is expected to continue to represent a low impact to earnings and capital. The strong quality of the book of business and product acquisitions helps to mitigate the impact from risk management deficiencies. However, credit risk is increasing due to small but growing positions in higher risk loan products such as sub-prime, negative amortization, and manufactured housing. Management is entering into the higher risk products to remain competitive and meet escalating HUD goal requirements. These risks are controlled through higher levels of credit enhancements, limited volume positions, and, in some cases, stronger borrowers. OFHEO began its evaluation of the quantity of counterparty credit risk in 2005, and will provide its conclusions in next year’s report.

Report of Annual Examination  
Federal National Mortgage Association

**Policies provide general guidelines, but do not provide necessary information for job responsibilities, accountability or risk limits. Written procedures are incomplete or deficient for several functions.**

The Chief Risk Officer (CRO) department developed Board policies that provide general guidelines that define goals, objectives, and overall functions for each of the primary business units. However, the Board and business unit policies do not define specific functions or key responsibilities, or delegate authority. Each business unit is responsible for developing, documenting and communicating their policies, written procedures and processes required to operate the business unit. Many of these written procedures are nonexistent, incomplete, or intermixed with other policies. The lack of clear, concise, or documented policies and procedures has contributed to risk management deficiencies.

Changes to the Single-Family seller/servicer guidelines for underwriting and servicing mortgages are satisfactory. However, internal policies and controls do not provide guidance or risk limits for higher risk products that represent areas of growth for the Enterprise.

**The Single Family business unit's underwriting standards ensure that loan losses are not excessive. Deficiencies in staff levels, accountability, data, systems, reports, and in establishing risk tolerances have impacted risk management, and resulted in increasing expenses. Current systems provide adequate service to clients for traditional loan products, but their deficiencies impact the Enterprise's ability to offer new products. Management has begun to address many of these issues.**

Single-Family management has made significant progress in addressing the large number of operations, control, and risk management deficiencies, but will require significant resources, time, and effort to fully address them. Single-Family has restructured its organization, strengthened its structure for risk management, and has begun coordinating related functions. However, job responsibilities need clarification and staffing is incomplete. Outside hires inject knowledge of industry standards and best practices into the business unit, but over-leveraging of new personnel risks burnout.

The Single-Family business unit appropriately centralized many of the operations managing risks in loans and counterparties to better control functions that had been scattered in many offices across the country. The business centers conduct many aspects of their work satisfactorily. However, appropriate controls, data, systems, and risk management practices were not properly implemented in many areas, generating deficiencies in the processes.

The National Property Disposition Center (NPDC) exhibited a number of deficiencies in policies, procedures, data integrity, risk reporting and monitoring, and vendor hiring practices as a result of inadequate oversight by management. Management began to address the deficiencies noted below during 2005:

- Unable to Market (UTM) properties are not actively managed and processes need improvement; controls are not in place to ensure revaluations are performed,

Report of Annual Examination  
Federal National Mortgage Association

vendors do not consistently forward critical information to asset recovery specialists, or repurchases are not always timely. Further, there is no overall policy guiding the management of UTM properties.

- Contract appraisers were hired without robust due diligence and their work was not adequately monitored and documented.
- Procedures for adding new vendors were weak and inconsistently applied.
- The Real Estate Owned (REO) portfolio was not periodically revalued after the initial appraisal; a practice inconsistent with industry standards.
- Management reports do not meaningfully summarize information, and are primarily used to assign workload instead of identifying and managing issues.

The National Underwriting Center (NUC) conducts post-purchase reviews on a model-based, stratified random and discretionary sample for recently acquired loans. The sampling process used to identify loans for post-purchase review was generally satisfactory, but did not capture manually underwritten loans, which represent a higher risk than those from automated channels. In mid-2005, the NUC updated its models to capture more manually underwritten loans.

The business units employ underwriters who evaluate a small percentage of the loans independent of the NUC, producing inconsistent underwriting and review standards. A reorganization of NUC in late 2005 is expected to eliminate quality control reviews done outside of the NUC.

As part of the approval process for the National Business Center (NBC), the NUC reviews smaller seller/servicers at the inception of the business relationship only, and they are not reviewed again until they either generated problems or were randomly selected for review. In mid-2005, NUC began to address these issues with models to capture small lender information, and systems that track quality control reviews and results. However, end-user spreadsheets are still used by the underwriting staff to manage underwriting review activities, which are inefficient and increase the potential for errors.

Regional business units, like the NBC, control the specific actions taken to address ineligible loans, and problem seller/servicers identified through the post-purchase review process performed by the NUC. The NBC also has responsibilities for marketing, which may create a conflict of interest when taking action on ineligible loans and troubled seller/servicers identified by the NUC. This type of conflict of interest could result in the potential for higher losses if action is not taken to address ineligible loans or troubled seller/servicers by the NBC. The NUC developed a detailed plan to correct this issue in 2006 by centralizing the repurchase resolution process.

NBC reports provided substantially all information needed by the NBC and headquarters management to monitor risks. Ongoing monitoring of approved lenders was satisfactory, but proactive analysis to approve lenders was weak, and the team structure used to

Report of Annual Examination  
Federal National Mortgage Association

interact with customers creates potential conflicts of interest. Headquarters management provided insufficient oversight to NBC management of lender risks, but recognized and corrected the deficiency in 2005. Management began to address other NBC deficiencies in 2005 listed below:

- The operational control functions lacked authority and sufficient independence.
- Headquarters management of NBC risks was insufficient, and personnel did not regularly review key reports. This was corrected during 1Q06.
- Staff levels were insufficient to complete the initial analysis used to approve lenders.
- Individual offices did not share information necessary for others to complete their duties.
- Credit file information was fragmented because each office maintained its own credit file.
- Lender approval analysis was weak due to the lack of financial statement analysis and on-site due diligence for each counterparty.
- Watchlist reports were not an indicator of potential problems, but instead listed lenders that had become problems.

**Housing and Community Development's (HCD) risk management practices ensure that loan losses are not excessive, but deficiencies exist in data, systems, reports, risk ratings, risk metrics, and quality control. Management has begun to address many of these issues.**

HCD has a low degree of automation, which adversely impacts the efficiency of operations, the accuracy of risk management reports, and the ability to manage risks. The lack of pre-planned and integrated systems has required the use of over 130 EUCs for business critical operations. The deficiencies have adversely impacted the quality of reports. During 2005, EUC controls were implemented that provide good controls over security and changes until comprehensive and integrated systems can be installed, but the risk rating and management deficiencies created by the current systems remain.

HCD underwriting policy and standards need updating based on the volume of waivers granted to the DUS lenders. The waiver rate was estimated at 60% and is indicative of a policy that is too restrictive, lending practices that are too liberal, and/or a policy that is not current relative to market conditions. Moreover, this high waiver rate has an adverse impact on earnings given the increase in staff involvement to review and approve these loans and nonstandard pricing decisions. Recent decisions have given the authority to the DUS lenders to review and approve waivers; however, HCD has not yet established a strong and comprehensive quality control process.

The quality control function focused on documentation review, however, new management is desirous of changing the focus to include a credit analysis and

Report of Annual Examination  
Federal National Mortgage Association

assessment. Nevertheless, credit information was incomplete or not readily available. For example, management incurred difficulties in assessing insurance coverage after the Gulf Coast hurricanes because records were incomplete.

Key information was missing from many HCD reports. The omissions were not so severe that management could not reasonably monitor and control most activities and risks. However, the omissions increased expenses and losses and adversely impacted their ability to proactively manage the loans. Most reports are produced on end-user spread sheets and are inadequately controlled for accuracy, increasing the risk of error and key person dependency. Data integrity issues adversely impacted the quality and timeliness of reports. Key performance indicators did not provide all necessary information for effective risk management. Risk management reports provide appropriate information on aggregate performance and the spread, but loan-level analysis is limited and little information is provided for proactive management. The quality of many reports improved during 2005 due to technology investment.

HCD management has made significant progress in restructuring this business unit. Nearly all key management positions are staffed with qualified people who have begun to address the numerous deficiencies in data integrity, origination risk analysis and rating, and back end risk management. However, it will require substantial effort and several years to address all deficiencies.

**The loan loss reserve is sufficient for the risk profile of the Enterprise. Management has made several revisions to the loss reserve methodology, but critical components of the methodology were not complete at YE05.**

Management in both the Single family and HCD has made progress in addressing the deficiencies in the methodology used to determine the level of the reserve. For the single-family analysis, the number of cohort years in the model has been reduced and data from the recent past is weighted to make the model results more responsive to a changing credit environment. At YE05, management had validated the models used in the reserve calculation and had made several enhancements to the current and previous methodologies for the restatement. The governance process is in place, and formal policies, and a final methodology for determining a reserve for loan losses are expected to be finalized in conjunction with the restatement process. Given the low level of risk in both the single-family and HCD businesses at this time, the reserve is sufficient to cover losses.

**The credit risk in new loans is increasing, but overall credit risk is expected to continue to represent a low impact to earnings and capital.**

The level of credit risk represented by risk metrics is low. Acquisitions and the book of business for both single-family and HCD consist mainly of borrowers with good credit capacity. Moreover, collateral coverage and additional credit enhancement provide protection against credit losses. During the past year, serious delinquencies were low and stable for both single family business and HCD. The upward trend noted towards the end

Report of Annual Examination  
Federal National Mortgage Association

of the year is attributable to borrowers affected by the Gulf Coast hurricanes. Loan losses in single family were low aided by house price appreciation and collection of credit enhancements. HCD reduced its REO inventory by almost 50% and incurred minimal losses because of strong demand even for distressed properties. The level of credit risk (default risk) is increasing based on problems created by the Gulf Coast hurricanes in 2005, but also because of the Enterprise's expansion into higher risk products such as subprime, manufactured housing, and nontraditional mortgage products.

## **LIQUIDITY**

Liquidity management is satisfactory but processes are inefficient due to lack of detail in some collateral reports, and manually intensive procedures to transfer securities for repurchase agreements (repo). The wire transfer process exhibited deficiencies in some fundamental controls, but an interim correction was implemented in late 2005. The quantity of liquidity risk is low based on the strong level of liquid assets available for sale or repo to cover a stress event to cash flows as well as the stability in funding costs and availability due to the company's status as a government sponsored entity.

**Processes and controls for obtaining asset liquidity are satisfactory but inefficient and increase the potential for errors. Deficient wire transfer controls were addressed with an interim correction in late 2005.**

Liquidity management and staff are experienced and technically competent, and satisfactorily manage cash flow and the LIP within the limits and guidelines. Treasury management automated the process that produces short term cash flow forecasts in 2Q05, which improved data integration, allowed for the use of more accurate cash flow forecast assumptions, consolidated multiple reports, and reduced the potential for report errors.

The system used to transfer securities for use in repos is cumbersome, and the steps to complete a transfer are not intuitive. The systems' difficulties coupled with infrequent use increase the risk of transaction error during stress events. The risk is reduced by the availability of the manually intensive legacy system, and increased staff training for the new system at headquarters and remote locations. The legacy system has been proven during past stress events, but is limited in its ability to efficiently move large volumes of smaller securities on short notice. A query must be run to identify large blocks of collateral for use in the legacy system because there are no daily reports that accurately show collateral available for repos. Management plans to resolve this issue in 2006 by automating the collateral reservation process, and in the interim maintaining collateral at a third party beginning in July 2006 when the systems used for the FRB daylight overdraft project are in use.

The wire transfer process did not provide appropriate segregation of duties due to systems limitations a lack of segregation of duties, and insufficient controls around wire instructions set up and changes; which exposed the company to unauthorized disbursements of funds. The deficiency occurred due to inadequate systems that do not facilitate this control. Treasury management provided short-term resolution in 2005

Report of Annual Examination  
Federal National Mortgage Association

through manual procedures, and will permanently address the issue in the future by replacing the system.

**Most liquidity reports are satisfactory but some do not provide securities detail needed for efficient asset transfers, and a full understanding of the Enterprise's compliance with the liquidity coverage ratio.**

Reports are satisfactory for monitoring cash forecasts, the weekly Dutch auctions, LIP credit quality and liquidity, limit compliance, funding maturities, costs, and elasticity. However, missing collateral detail in some reports impeded liquidity management's ability to understand the adequacy of the coverage ratio, and the availability of securities for repos. Management addressed the issues noted below during 1Q06.

- The 90 day liquidity coverage ratio report does not identify collateral by asset class, preventing senior management from determining the extent that the coverage ratio limit is met by assets with lower liquidity.
- Daily position reports do not identify asset classes or individual securities, requiring liquidity traders to use their memory or run special queries to identify specific collateral. One position report significantly understated the amount of available securities for repos.

**Board liquidity policies were improved during 2005, and are satisfactory. Management policies for the Liquidity Investment Portfolio are in the process of completion.**

The Board formally approved a new liquidity policy in January 2006, which satisfactorily provides guidelines, and limits for the 90 day coverage ratio; and identifies stress scenarios and related contingency plans. In addition, the policy assigns responsibilities for funds maturity diversification limits, size and composition of the liquidity investment portfolio (LIP), and prioritizing asset transactions in a stress event. Management policies for the LIP are in the process of completion, and address the purpose and management of the portfolio, and provide limits on credit and interest rate risks. Policies do not provide limits for the distribution of liability maturities, although informal guidelines exist.

**The quantity of liquidity risk is low.**

Asset liquidity, the strongest source of liquidity, amply covers short term liabilities. Assets available for sale or repo are comprised of roughly \$284 billion in agency MBS and \$19 billion in very short term, liquid securities held in the \$46 billion Liquidity Investment Portfolio (LIP). These liquid assets more than offset the \$155 billion in discount notes that mature within 90 days, and the \$168 billion maturing within a year. The LIP covers maturing liabilities for a two week period, providing management flexibility in covering maturing liabilities in the early stages of liquidity stress. Other mortgage loans and securities available for liquidation total \$443 billion.

Report of Annual Examination  
Federal National Mortgage Association

Treasury management consistently met the non-mortgage asset liquidity guidelines, and LIP assets exceeded 5% or more of total assets throughout 2005.

LIP asset credit quality is satisfactory. The percentage of investments rated A+/P1 or AAA declined from \$33 billion or about 70% at year end 2004 to about \$29 billion or about 64% of the portfolio. Assets rated A1/P1 or AA \$4 billion or 9% of the LIP at year end 2004 increased to \$8 billion or 17%, and those rated A2/P2 or A were relatively stable at \$10 billion or 21% at year end 2004 to \$9 billion or 20%. However, much of the AA rated securities are short-term maturities. Assets rated A3/P3 or BBB were eliminated from the LIP in January 2006.

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 addition, recent and past company-specific events have generated only a small impact to the cost of and market access to funding.

### **SENSITIVITY TO MARKET RISK**

Interest rate risk management is satisfactory due to appropriate risk management for nearly all financial products, and good communication among risk managers, senior management, and the Board. The Board approved satisfactory risk policies and limits, and management is drafting policies for Capital Markets operations and management. Operations processes are generally satisfactory but are inefficient in several areas. Significant deficiencies exist in controls, systems, and data. However, these deficiencies were recently corrected or in the process of correction in the areas of operations, middle office, and risk measurement functions. Issues noted in 2005 include:

- Lack of independence in wire transfer cash disbursements, back office access to and confirmation of subsequent event transactions, and the pricing of financial instruments in the process from the Capital Markets business unit through the Controller department.
- Data and/or systems deficiencies required manually intensive and inefficient generation of information that introduced some level of uncertainty in interest rate risk measurement, impacted access controls to some systems, and contributed to two missed debt call dates.
- Data and systems deficiencies impact some performance information in senior management reports, management of the mortgage revenue bond portfolio, and traders' monitoring of security delivery against negotiated stipulations for private label securities (PLS).
- Roughly 75 additional personnel are needed for risk management, technology, and operations within the Capital Markets business unit.

Report of Annual Examination  
Federal National Mortgage Association

- Wraps on AAA PLS mitigated risk from credit losses, but policies, staff levels, reports, and communication between traders and risk management need strengthening before lower-rated PLS are purchased.

The level of interest rate risk is moderate based on the types of and trigger points on risk limits, some uncertainty in the data and systems used in measuring interest rate risk, the level of delta hedging used in the portfolio management strategy, and anticipated risk levels created by securities purchases during opportunistic market events.

**The Board approved policies in November 2005 that provide satisfactory limits, guidelines, and accountability for risk management. Management is developing other market risk policies and procedures.**

Policy limits control exposure for duration and convexity through market value of equity (MVE) sensitivity, with triggers that notify the Chief Risk Officer department, management, and the Board at increasing thresholds. The policy defines the parties responsible for determining actions when limits are exceeded, along with a time limit for establishing a plan to bring exposures below set limits within a reasonable period of time. Management is developing business unit policies and written procedures for portfolio management, the middle office, and operations that detail limits, guidelines, and procedures that are consistent with the Board approved policies.

**Risk management processes and controls are generally satisfactory. Operations and risk measurement processes are generally satisfactory, but are often manually intensive and inefficient. Systems and data deficiencies introduce some level of uncertainty into interest rate risk measurement.**

Management has established an effective program to evaluate and communicate risks through distribution of daily and weekly reports and information to business line personnel, management committees, and independent risk management oversight. Risk levels have been consistently maintained within limits formally set by the Board, and informal sub-limits used by management. The Capital Markets Strategy (CMS) group provides daily risk analysis guidance on funding, hedging, and asset purchases to the heads of the trading desks; and meets weekly to establish broader portfolio management objectives with the Portfolio Investment Committee, and the Weekly Business Review chaired by the CEO. The CMS group produces a quarterly report for senior management's Risk Policy Committee that addresses risk metrics, model changes, and other key information. The addition of significant but realistic stress scenarios has improved the understanding and management of the Enterprise's interest rate risk.

Board oversight significantly improved over the year with meaningful reports and additional expertise. The Board report package shows compliance with limits and contains several different measurements of interest rate risk that combined, provide the Board's Risk Policy and Capital Committee (RPCC) a fair representation of the Enterprise's interest rate risk profile. A market risk expert, who chaired the RPCC during 2005, actively monitors portfolio activities and risks.

Report of Annual Examination  
Federal National Mortgage Association

Data and systems deficiencies introduce a low and acceptable level of inaccuracy in the numbers used to manage the company's interest rate risk due to multiple on top adjustments made in a manually intensive process to a months-old settled book. Cross trained personnel support the accuracy of manually generated risk numbers, but a large portion of their time is spent on generating numbers rather than conducting risk analysis. Regular backtesting and attribution analysis provide ex-post confirmation that the resulting numbers are reasonably accurate. A taskforce expects to correct these deficiencies during 2006.

Data and systems deficiencies impede management's and traders' ability to optimize the retained portfolio performance. Reports cannot be produced with sufficient information or frequency for effective total return management and attribution analysis. These deficiencies also limit traders' ability to buy, sell, and manage the mortgage revenue bond portfolio. PLS traders negotiate useful delivery stipulations but do not have processes or reports to show that dealers deliver securities with the promised stipulations.

Operations processes were generally satisfactory but inefficient due to manual work arounds for systems and data deficiencies, and an organization structure that was divided by front office activities rather than operations functions. New management began reorganizing the structure and addressing deficiencies during 4Q05.

**Significant deficiencies exist in several fundamental controls for operations, but are being or have been recently corrected.**

Inadequate controls were noted throughout the processes and systems for trade execution, operations, and accounting. The deficiencies stem from rigid proprietary systems that were not revised or maintained over time, and policies, controls, and documentation that were nonexistent or did not meet industry standards. Many systems deficiencies will require one or more years to correct due to their prioritization with the restatement and other significant projects, and integration with other systems that will be bought or developed in the future. Interim, manual controls will be used until the long term solutions are implemented. Key deficiencies include:

- The lack of independence in pricing financial instruments for month end pricing was addressed during 2H05. However the function will need to be revised when the use of total return performance management requires more frequent independent prices.
- The lack of segregation of duties required for the wire transfer function exposed the Enterprise to unauthorized cash disbursements. An interim control is in use until a new system is installed.
- The lack of segregation of duties for the entry and confirmation of subsequent trade events such as terminations, assignments.

Report of Annual Examination  
Federal National Mortgage Association

- Policies and documentation for some financial reporting controls require updating to meet standards for Sarbanes-Oxley.
- Missed debt call dates due to a system deficiency created about \$5 million in lost opportunity cost during 2004 and 2005.
- Information technology deficiencies in access control, change management, and life cycle methodologies allow unauthorized changes in application data.

**Policies, staff levels, reports, and communication between traders and risk management need strengthening before lower-rated private label securities (PLS) are purchased.**

Management relied primarily on subordination levels and additional credit enhancements for AAA PLS to mitigate losses from borrower default: the purchase of credit enhancements further reduced the credit risk in AAA PLS. The risk management program for these enhanced securities is adequate, but should be strengthened for current positions and is not sufficient for the planned expansion into lower-rated PLS. Risk management issues noted in 2005 included:

- Ambiguous servicer and issuer concentration limits in the policies coupled with poor communication of a committee decision on limits created uncertainty in determining and communicating limit breaches.
- Shifting resources to work on the restatement exacerbated already insufficient levels of risk management personnel.
- Data and systems deficiencies prevented the efficient production of management reports with all necessary information.
- Traders performed some pre-purchase analysis. However, risk management did not, completing a post-purchase analysis only after a policy trigger is breached and the risk is more expensive to mitigate.

Management substantially improved its risk management program before it began expanding its position in commercial mortgage-backed securities during 1Q06.

**The quantity of interest rate risk is moderate.**

For a 50bp parallel yield curve shift, MVE sensitivity was maintained well within the Board limit of a 50bp change in the fair value of assets, which represents roughly a \$4 billion or 12% decline in pre-tax equity capital at about \$34 billion. Convexity exposure is controlled with a management limit for delta hedging at \$100 billion in five-year swap equivalents needed to bring the portfolio back to a delta neutral position for a +/-50bp parallel yield curve shift. In addition, business unit limits control duration gap at 6 months or less; the portfolio convexity gap at -1.0 or better; and delta hedging exposure by monitoring swaption maturities within each quarter, and using swaptions and callable debt to hedge at least 50% of the optionality in mortgage purchases.

Report of Annual Examination  
Federal National Mortgage Association

Exposure levels decreased by roughly half during 2005 due to a more conservative hedging strategy used while restating financial statements and significant sales of negatively convex assets to meet the increased regulatory capital requirements. In addition, lower realized market volatility resulted in fewer delta hedging adjustments but also fewer opportunities to increase the portfolio size. The strategy and lower risk in the market produced less volatile changes in the market value of equity.

## **EARNINGS**

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

Earnings (unaudited) for 2005 are satisfactory but are likely to decline in the future. The business model exhibits the capacity for sustainable profits to adequately maintain capital. However, future earnings are likely to be adversely impacted due to margin compression and its impact on portfolio growth coupled with higher expenses for building the infrastructure for the restatement, controls, and ongoing operations, as well as a permanent increase in costs to maintain ongoing operations.

Current requirements and pending legislation have the potential to impact future earnings through escalating HUD goals, and potential mandates on the size of the Enterprises' retained portfolios. Increasing HUD goals require both Enterprises to pay more for qualifying loans due to the market's knowledge of this requirement. In addition, industry players have increased the availability of subprime, manufactured housing, and alternative loan products, which have attracted a large share of goals-rich borrowers. The Enterprises are exposed to higher credit costs and strategic risks to the extent that they acquire alternative loan products with higher credit risks to meet their HUD goals and the lack of adequate expertise and systems to process and monitor these activities.

Management is evaluating the changing market and its business model to determine opportunities for growth that also meet the charter requirements to serve the domestic housing market. Growth opportunities include variable rate loans, alternative loan and securities products with higher credit risks, and structured finance products that provide first loss coverage for higher credit risk products at competitive costs.

### **Earnings for 2005 are satisfactory, but decreased due to a decline in the mortgage asset portfolio and higher administrative expenses.**

Earnings remained at a healthy level of roughly 24% of the Enterprise's minimum capital requirement, and 18% of the capital requirement with the 30% add-on for operations risk. Earnings declined in 2005 due to a smaller retained portfolio caused by the need to build capital ratios, limited purchase opportunities for the retained portfolio due to asset spread compression, higher expenses from the restatement effort, upgrades to systems, and attendant staffing requirements associated with the risk and control remediation areas within the Enterprise.

Report of Annual Examination  
Federal National Mortgage Association

Net interest income (NII) declined about \$1 billion, or 9%, to \$11 billion due to margin compression and a smaller retained portfolio. The NII numbers are very rough estimates as both years are subject to significant restatement. Tight spreads allowed the Enterprise to meet the higher regulatory capital ratio by reducing the retained portfolio at favorable prices by \$177 billion or roughly 20% of the total portfolio. However, tighter spreads and a flattened yield curve resulted in returns below return-on-equity hurdle targets for traditional products, reducing the volume of purchases in these products.

The Gulf Coast Hurricanes slightly reduced guaranty fees, interest income in the retained portfolio, and increased credit losses from properties that were under-insured or had no flood insurance. The amount of allowance for credit losses and guarantee liability attributed to the Gulf Coast Hurricanes totaled \$383MM or 50.8% of total provisions of \$754MM at YE05 to cover potential losses in both single and multifamily properties. An additional \$189MM provision was made in December 2005 to cover a \$120MM allowance and guarantee liability increase resulting from a change in the pattern of make-whole proceeds received from lenders and a \$69MM increase from an accounting policy change which prevents pool insurance proceeds from offsetting potential losses used to estimate reserve levels.

Guarantee fee income of \$3 billion was in line with plan, and slightly above performance in 2004. In 4Q05, guarantee fee income grew due to a recent shift in borrower preferences from adjustable rate mortgage production to traditional fixed rate product.

Higher expenses for restatement effort and upgrades to data, systems, and controls reduced 2005 earnings. Administrative expenses were about \$2.2 billion, an increase of about 47% over 2004 largely due to the \$542MM for restatement and regulatory compliance efforts and \$431MM for controls and systems remediation. Baseline administrative expenses will increase permanently to cover approximately 1,500 additional employees, a 13% increase, for risk management, and current and planned business activities.

**CAPITAL ADEQUACY**

	1Q05	2Q05	3Q05	4Q05
Capital Classification	Adequately Capitalized	Adequately Capitalized	Adequately Capitalized	Adequately Capitalized

Regulatory capital is adequate. OFHEO's Office of Capital Supervision formally classifies capital adequacy quarterly in accordance with Subtitle B of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 and with the requirements set forth in OFHEO's minimum and risk-based capital regulations. The Enterprise is required by Federal Statute to meet both minimum and risk-based capital standards to be classified as adequately capitalized. Fannie Mae remains subject to a September 30, 2004 Agreement with OFHEO that requires the Enterprise to maintain a capital surplus of 30 percent over its minimum capital requirement.

Report of Annual Examination  
Federal National Mortgage Association

On March 31, 2006, OFHEO announced that it had classified Fannie Mae as adequately capitalized as of December 31, 2005. As of that date, the core capital of the Enterprise exceeded its minimum capital requirement by about 34 percent. OFHEO classified Fannie Mae as adequately capitalized for the preceding three quarters of 2005. Fannie Mae steadily increased its minimum capital surplus during the year to achieve OFHEO's 30 percent surplus capital requirement by reducing the size of the mortgage portfolio and accumulating capital through earnings. Fannie Mae reduced its mortgage portfolio by about 24 percent during the year by a combination of asset sales and mortgage portfolio runoff.

OFHEO's capital classification of Fannie Mae is based on Fannie Mae's best estimate of its financial condition, as certified and represented as true and correct to the best of Fannie Mae management's belief and knowledge. The capital classification remains subject to revision during Fannie Mae's re-audit and accounting restatement process, as well as the conclusions for accounting policies and practices in OFHEO's special examination. OFHEO supports its capital classifications through a combination of compulsory capital reporting, weekly monitoring, analysis of changes in the Enterprises' capital requirements and analysis of trends in risk factors that could impact the adequacy of capital.