

Stephen B. Ashley Chairman of the Board

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TO:

Fannie Mae Board of Directors

FROM:

Stephen B. Ashley

DATE:

July 6, 2006

As we prepare for the forthcoming board meetings I wanted to share with you the remarks I gave at the Senior Management Retreat on June 26. There were approximately 60 management personnel in attendance. As you can tell from the text I attempted to strike a balance of remediation, forward movement, and support. There were a number of good questions following.

The planning portion of our July meetings will enable us to engage with management on the next 12 to 24 months. As you review the pre-meeting materials, I would like to suggest that we keep 4 categories of challenge in mind—1) the challenge of global capital markets; 2) the challenge of remediation, restatement and getting current; 3) the challenge of industry change and consolidation; 4) the challenge of the current public policy debate.

I look forward to our meeting.

SBA: jad

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Remarks Prepared for Delivery by Stephen B. Ashley, Chairman Fannie Mae Senior Management Meeting Cambridge, Maryland June 27, 2006

Good Morning.

I bring with me this morning both a challenge and a message from your Board of Directors.

The challenge – simply stated – is to get this business running as a business on all cylinders – that means achieving our mission objectives and delivering shareholder value.

But side-by-side with the challenge, I bring a message to you; and that message is this: we believe in each individual in this room.

As many of you know, for the past 18 months or so, I've been spending 2 to 3 days a week onsite, at 3900 Wisconsin Avenue. So my confidence in you is not faith-based; it's based on what I see every week ... all the hard work ... all the long hours ... all the determination under very adverse conditions. I believe – and the Board believes – that this is the group that can continue on the road of improvement to the position of excellence, market share, and shareholder return that is demanded by our mission, our charter, and our investors.

Let me spend the next few minutes exploring these two items – both the challenge and the Board's belief in your abilities to meet the challenge – in more depth.

## First - The Challenge

For the past 21 months this company has been on a trajectory of discovering problems, starting to fix problems, and attempting to put the past behind us.

A year ago, the organization chart of the company was in flux. There were a number of empty boxes and we were still in the process of designing the kind of operational matrix, especially in the Risk Management and Compliance areas, that would suit Fannie Mae best. And Dan had been your permanent CEO less than 30 days.

Today, a year later, one thing has not changed: Dan continues to enjoy the full confidence of the Board. But the senior management team looks very, very different. Almost all of the positions have been filled, albeit work is still going on in systems and technology. The relationship between Board and management has evolved significantly,

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and there are no questions about the openness of management, or the Board's ability to get the information that it needs.

2006 is a transition year. To be sure, there are still issues to resolve. The consent order with OFHEO is demanding. And from a strategy standpoint, it is clear that until we have eliminated operations and control weaknesses, taking on more risk or opening new lines of business will be viewed dimly by our regulators.

But the settlements with the SEC and OFHEO did bring the investigation phase to a close and this allows us to move forward. And we <u>must</u> move forward, management and Board together, turning our attention more and more to the big strategic business challenges and the substantive work of forging the next Fannie Mae. This is in spite of the unresolved issues and in spite of the uncertainties. The Board sees our business challenges through the lens of recent history – history that I'm sure you're familiar with.

- For the past 15 years or so Fannie Mae operated in a very sweet spot. Mortgage debt outstanding was growing; the charter enabled this company to pitch its tent on profitable turf, the company was a leader. It led in initiatives related to technology that simplified the mortgage process and reduced costs while at the same time reaching underserved markets. The company led in product development and most importantly, the company was at the center of any housing policy discussion.
- But that picture has changed dramatically. The markets have moved fast and away from Fannie Mae in the past three years. Customers are now competitors and others with access to global capital took the lead in subprime, layered-risk products, and most important, a burgeoning privatelabel market for securities.
- Banks are continuing to get bigger, are playing on the global stage, and are marginalizing Fannie Mae in ways that only a few years ago would have been unthinkable. The company is at risk of becoming a utility a commodity company if you will. Here when somebody needs us, but at their option; not ours. We can't force the gas or electricity into their homes. So my friends, it is not simply the Board that is demanding Fannie Mae redefine itself as a business. It is the market. Markets are unforgiving and they do not snap back to the configurations that they were previously.

Responding to this new market requires leadership, it requires new constructs, and it requires new thinking and big thinking. It is about not just meeting the market, for if that is our goal I can assure you we will lose more of the market.

We have to think differently and creatively about risk, about compliance and about controls. Historically these have not been strong suits of Fannie Mae, and indeed, your Board bears some responsibility here. Today's thinking requires that these areas

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become active partners with the business units and be viewed as tools that enable us to develop product and address market needs. Enrico Dallavecchia was not brought onboard to be a business dampener.

But let me be very real about this. First, in the near term, our regulators will not look favorably on new initiatives beyond basic blocking and tackling.

Second, even beyond the near term, any new place we try to take this company will cause friction and sparks. That simply is part of what we are.

But third, let's not kid ourselves – the riskiest course of action for this company would be to stand still and hope that the old sweet spot returns to us.

So if you as management are to undertake new courses of action, how and along what lines do you engage your Board? Frankly, it's not that complicated.

- The Board needs to be assured that in all areas of risk management, operational controls, and compliance that management is putting in place best-in-class mechanisms that are tested, vetted, and benchmarked to be so.
- The Board needs to know the true profitability of programs and products not simply that they are earnings accretive.
- The Board needs accurate information about the various potential costs credit costs, legal and regulatory costs, political and competitive costs.

The Board appreciates that this can be challenging work that requires an intensity of effort. Indeed, it can be harder than fixing problems. These efforts require more creativity. They require that we achieve greater operational discipline; they require willingness to challenge each other – no more silos. I have observed remarkable improvement in the working atmosphere and teamwork. But teams can only be as strong as the creative tension that holds them together.

In closing out my discussion of the challenge from the Board to you, let me address the subject that I am most concerned about longer term. This will come as no surprise to Dan or to a few others of you in the room. To achieve our future, management must integrate our business strategy with our information and technology strategy. A major overhaul of our systems isn't just needed. It is required. We can have the greatest strategy in the world, but if we are not able to implement it and to report our results on a timely basis and to have unqualified SOX 404 opinions, we will fail to meet our obligations to both shareholders and regulators. Our information and technology structure must support our business development and application. It must support the controls appropriate to this company and it must support the accounting and financial reporting.

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## Second, The Message

Now I'd like to turn to a fuller discussion of the second item I brought with me today – the message from the Board. Why do I say that the Board believes so strongly in the company and in you? Let me ask a few questions:

- 1) How many people weren't in this room last year?
- 2) How many people were here but in a different job?
- 3) How many people have been at Fannie Mae ten years or longer?

When I look out, I don't see the faces of the Fannie Mae of the past. Yours are the faces of change, of dedication, and of accountability.

Together we have had a tough couple of years and the Board sees tough going ahead. Each person here has to ask themselves, "Why am I in this room?" For those who are new to the company and have followed the news, why did you come to a place that was facing such big hurdles? For those of you who have been asked to learn a different job, why did you choose to accept a new challenge? For those of you who have been here a number of years, what is it you are hanging on to? Wouldn't it be attractive to take a break and look around for an easier vineyard in which to toil?

I've asked myself these kinds of questions and I know my answer. I've worked in the mortgage markets for four decades and there has never been a more exciting time.

The fact that it is a fiercely competitive market also means that we have to seek out and find more opportunities:

- More opportunities for using global capital in the US housing market;
- More opportunities for slicing and dicing risk more efficiently;
- More opportunities for bringing mortgage credit to underserved markets;
- More opportunities for customization where each potential home buyer receives the mortgage best suited for his or her situation;
- More opportunities for bringing minorities and immigrants into the main stream of credit finance and homeownership;
- And more opportunities to address America's toughest housing issues.

Bottom line: if your head is drawn toward the intellectual challenges of mortgage finance, and if your heart is drawn toward the emotional rewards of providing Americans

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with homes, then there is no better place to be than in today's mortgage market and at Fannie Mae.

Whatever your motivation for being here this morning, thank you. All of you were hired or reassigned or retained because you are the kind of people who like to make a difference – a difference in this company, a difference in the housing markets and a difference in the greater world at large. You are the kind of people who care and who relish the opportunity to work at the edge and at critical junctures.

You are now living one of the oldest stories around and also one that is the hardest to pull off. It is the story of the mighty being brought down by hubris, learning humility, and redefining a set of core values and then rising again. But this ascension cannot be accomplished by average people.

Thirty or so years ago the historian, James MacGregor Burns wrote a book called *Leadership*. In that lengthy text he defines two types of leaders.

The first is the transactional leader who is merely a broker, being good at making trade offs and cutting deals with voters, factions, or stakeholders. These are the leaders that keep an enterprise on an even keel and more or less stay the course hoping that nothing external changes.

The second type of leader Burns identifies is a transformational leader who looks outward to find and understand the motives of others, whether they are customers, employees, regulators, or elected officials. The transformational leader then seeks to satisfy higher needs and to engage the full person. Transformational leaders are best suited to move an enterprise to another place. They are best able to effect changes, as Burns said, that are "so comprehensive and pervasive that new cultures and value systems take the place of old."

We need you to be transformational leaders. Leaders who look for that higher calling and who create the new cultures and value systems to take the place of the old.

This brings me to Dan. It would have been easy for the Board to have gone outside the company with our CEO choice. The harder choice was to go with the individual that we felt was best qualified. What the Board saw in Dan in the spring of 2005 has grown in the year since. He has demonstrated a grace under fire – and an oarsman's competitive spirit. He has a strong sense of duty and obligation; an ability to think big, break old taboos, and to draw upon the better angels of our nature, and he has a humanistic side and a humility that allows him to understand that this company and the cause it serves is bigger than one person including himself or me or you.

We're looking for all of you to build upon these traits and abilities. There is no question that you have the potential. The way you are going about your work here in Cambridge by asking tough questions, engaging, and holding yourselves accountable is evidence of that potential.

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The Board also needs to embrace the new culture and adjust to meet new expectations.

- In the coming months, the Board will be organizing itself differently, aligning our oversight and our committee structures with the new organizational structures of the company.
- You can expect the Board to aim for and meet the highest standards of accountability. That will mean more questions and tougher questions, particularly about the strategy you are developing.
- You can expect that this Board will be more involved in an appropriate
  manner. I like to say that it is the job of the Board to have "its nose in but
  its fingers out".
- You can expect that there will be more checks and balances, but also, more help and more support.

To make this work, we need to trust each other. Trust is the binding agent that is essential to effective board-management relations. Part of my job is to see that that trust is present, that it is earned, and that it is maintained. I'm available to each and every one of you at any time to discuss a Board question or to hear your concerns about the company's progress.

Let me say that I think it is very likely that your Board will enthusiastically endorse your business strategy. But I think that you should also expect that the Board will set a higher bar for achievement.

So what will define a successful Board retreat in July. I have three goals.

- A strategic plan that grows business value, meets its mission objectives, and delivers that value to shareholders.
- An agreed upon set of metrics for monitoring execution of the plan and measuring our performance as a business.
- A Board that comprehensively understands and endorses the plan and has constructively engaged with a management team that knows its stuff.

This little outline is simple to state, but you have a lot of hard work in the next few weeks. I wish you success. I want you to have fun doing this work.

## Conclusion

In closing, let me boil all this down for you.

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When you go back home and try to recall, "What the hell did Ashley talk about in Cambridge?" here's what I want you to think of.

Remember that Ashley said getting Fannie Mac running like a business is essential – and that means forging a sound business strategy for success in today's mortgage market.

And remember that Ashley said he believes in your capacity for success. Success in developing a great strategy, success in executing the strategy, and success in transforming the company.

I've learned that about two miles from here – in Cambridge on Race Street – is the Harriet Tubman Organization dedicated to the vision and memory of Harriet Tubman, the conductor of the Underground Railroad who was born close to here.

I think the adversity experienced by a Harriet Tubman – and the courage she demonstrated – are unimaginable to our 21<sup>st</sup> century minds.

But we can honor her life with how we chose to live ours.

She dedicated herself to leading people – as many as she could shepherd – to a place called freedom.

Fannie Mae, at its best, is about leading people – as many as we can – to a place called home. A place that gives freedom more meaning and substance.

That's good work ... it's work worth doing well. I know you can - and will.

And, I am now happy to take your questions.

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