



FY 2003  
PERFORMANCE REPORT

February 27, 2004

## 2003 DIRECTOR'S MESSAGE

Fiscal Year 2003 was a time of numerous important actions and accomplishments by the Office of Federal Housing Enterprise Oversight (OFHEO) and the agency is well on track to achieve our long-term goals.

OFHEO achieved six of our eight 2003 Performance Goals for accomplishing our long term strategic objectives, and one of our three resource management goals. OFHEO was close to our targets for the unmet goals. During this same period the agency was also managing other important aspects of GSE oversight. OFHEO undertook a resource intensive special examination of Freddie Mac following the Enterprise's announcement that completion of its 2002 financial audit would be delayed and that earlier periods would be reaudited.

OFHEO's investigation found that Freddie Mac cast aside accounting rules, internal controls and disclosure standards by using a variety of techniques to push earnings into future periods and meet earnings expectations. As a result of our examination, OFHEO recommended a number of changes for both the Enterprise and this agency in order to improve systems and controls in the future.

Through all of this, OFHEO continues our ongoing work of making sure the Enterprises are adequately capitalized and examined. OFHEO classified Fannie Mae and Freddie Mac as adequately capitalized during each quarter of the 2003 fiscal year. In addition, our examination process determined that the Enterprises were financially sound. During the year, OFHEO completed the report, "Systemic Risk: Fannie Mae, Freddie Mac, and the Role of OFHEO", and with the Department of the Treasury and Securities and Exchange Commission, a staff report entitled, "Enhancing Disclosure in the Mortgage-Backed Securities Markets". OFHEO also contributed to the discussions on proposed legislation to improve GSE oversight, and I testified before congressional committees on these issues.

OFHEO remains committed to fulfilling the statutory mission that Congress has set out for us and to further enhancing supervision of the Enterprises. The agency's oversight plays a vital role in ensuring that the nation's housing finance system remains strong, and I remain committed to the goal of OFHEO being a strong and capable regulator.

Armando Falcon, Jr.  
February 27, 2004

## FY 2003 Performance Report

### OFHEO MISSION

OFHEO PROMOTES HOUSING AND A STRONG ECONOMY BY ENSURING THE SAFETY AND SOUNDNESS OF FANNIE MAE AND FREDDIE MAC AND FOSTERING THE STRENGTH AND VITALITY OF THE NATION'S HOUSING FINANCE SYSTEM.

### **OFHEO Performance Highlights<sup>1</sup>**

In FY 2003, with a \$30 million budget, the accomplishments of OFHEO continued to contribute to the Office achieving its long-term strategic goals. At the end of FY 2003, two key indicators for achieving the mission were again realized.<sup>2</sup> The Office classified both Enterprises as adequately capitalized each quarter, determined through examinations for calendar year 2002 that they were financially sound, and initiated calendar year 2003 examinations of the Enterprises. However, as the events of FY 2003 unfolded, OFHEO identified unsafe and unsound practices at Freddie Mac.

In January 2003, Freddie Mac announced a delay in the completion of its 2002 financial audit, its intent to reaudit prior years and restate its financial results. The Board of Directors of Freddie Mac began an inquiry of the related circumstances. In June 2003, as Freddie Mac announced the abrupt departure of three of its principal officers, The Director of OFHEO ordered a special examination of the conditions and activities that led to the accounting failures and management changes, required OFHEO review and approval of the Board's remediation plan, and ordered the Enterprises to withhold compensation from the departing executives pending approval by OFHEO. While its review is ongoing, OFHEO issued a Report of the Special Examination in early FY 2004. The findings include a disregard of accounting rules, internal controls, and disclosure standards; that senior executives' compensation plans contributed to the accounting and management problems; and that the Board of Directors failed to execute adequate oversight. The report also made a series of recommendations to the Director, which he is addressing.

In order to undertake a special examination of Freddie Mac, OFHEO was forced to redirect many of its staff and resources. The Director set priorities and reallocated resources away from some planned activities. OFHEO kept most of its activities on track, however, and was able to achieve most of its planned performance goals.

To streamline its performance plan, for FY 2003, OFHEO had established eight performance goals to achieve its three strategic objectives (down from 18 performance goals in FY 2002).

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<sup>1</sup> The Office of Federal Housing Enterprise Oversight ("OFHEO" or the "Office") was established as an independent office within the Department of Housing and Urban Development by the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (Title XIII of P.L. 102-550). The Office is headed by a Director appointed by the President for a five-year term.

<sup>2</sup> OFHEO is charged by law to ensure the capital adequacy and financial safety and soundness of two government-sponsored enterprises ("GSEs" or the "Enterprises") – Fannie Mae and Freddie Mac.

OFHEO also established a crosscutting Resource Management Strategy with three performance goals. OFHEO achieved six of its eight FY 2003 performance goals directed at its strategic objectives, and achieved one of the three resource management goals. OFHEO results were close to its targets for each of the other unmet goals.

OFHEO is funded by assessments on the Enterprises at no cost to the taxpayer. However, the OFHEO budget is subject to the appropriations process, unlike the budgets of other financial regulators. Given the rapid growth of the Enterprises in volume, complexity, and new activities, this process limits the flexibility of OFHEO to adapt quickly to the changing risk profiles of the Enterprises. Again during FY 2003, when presenting the OFHEO FY 2004 budget to Congress, the Administration supported direct funding for OFHEO with mandatory assessments on Fannie Mae and Freddie Mac. The Administration continues to support direct funding for Enterprise regulation for FY 2005.

### **Mortgage Markets and the Enterprises in FY 2003**

Fannie Mae and Freddie Mac (formally named the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation, respectively) are publicly held companies chartered by Congress. They were established to create a secondary mortgage market to ensure a ready supply of mortgage funds for housing, including housing for low-and moderate-income families. At the end of FY 2003, Fannie Mae and Freddie Mac held or guaranteed \$3.5 trillion in mortgages and mortgage-related securities. This was an increase of 15 percent from the end of FY 2002.

This has been an important year for OFHEO, as it monitors and assesses the dynamics of the Enterprises and the secondary and primary mortgage markets. Over the past decade, the Enterprises have emphasized the asset management side of their business operations rather than credit guarantee side. At year-end 1992, Fannie Mae and Freddie Mac held 19 percent of their book of business (defined to include mortgage-backed securities (MBS) held by other investors plus mortgages and MBS held by the Enterprises) in portfolio and guaranteed 81 percent in the form of mortgage-backed securities. By September 2003, the proportion of the book of business held in portfolio had increased to 45 percent, with a corresponding decline in the guarantee business to 55 percent of the total. This realignment in business strategy significantly alters the risk profile of the Enterprises, shifting risk management from credit guarantee to both credit risk and interest rate risk management. Thus, OFHEO has had to shift its oversight activities to focus more on interest rate risk management, even as credit exposures were growing rapidly.

In FY 2003, the combined mortgage portfolios of Fannie Mae and Freddie Mac increased 19 percent. The Enterprises issued approximately \$2 trillion of MBS and purchased sizable volumes of its own MBS issues. Fannie Mae purchased about \$440 billion of its MBS in FY 2003, and Freddie Mac purchased over \$280 billion of its securities. The Enterprises funded their expanded portfolios with innovative debt products, including instruments denominated in foreign currencies, and a program of regular issuances. Callable debt played an important role in both the funding and hedging activities of Fannie Mae and Freddie Mac in FY 2003. To manage the prepayment risk of their mortgage portfolios, the Enterprises also increased their use of derivatives. The combined derivatives book of the Enterprises increased over 41 percent to \$1.8 trillion in September 2003. That increase reflects an increase in the use of option-based derivatives. Despite volatile interest rates, through the use of callable debt, derivatives and other

risk mitigation efforts, the Enterprises kept their exposure to interest rate risk at manageable levels in FY 2003. The changes to their books of business and funding strategies represent a heightening of the sophistication and complexity embedded in the risk profiles of Fannie Mae and Freddie Mac.

In the last few years, issues of disclosure and corporate governance have become more significant for corporate America, leading to the passage of the Sarbanes-Oxley Act of 2002, a reform of corporate governance standards for publicly held corporations. Also, investors and market analysts have recently increased their focus on earnings management and accounting issues, particularly accounting for off-balance sheet activities due to changes in accounting standards. As a result of these general trends, as well as the Freddie Mac restatement of earnings, management changes, and various investigations, the Enterprises will continue to face pressure to increase transparency in order to maintain access to funding in the capital markets. OFHEO has adapted its approach during FY 2003 to take into consideration these developments. Through its examinations, capital assessments, and research and analysis, OFHEO has and will continue to provide oversight in these emerging areas as the Office carries out its mission.

### **Managing and Measuring Performance**

OFHEO accomplishes its mission primarily by conducting examinations of the Enterprises, by assessing their capital adequacy, and by conducting research and analysis about the Enterprises and the markets in which they operate. OFHEO's role as a regulator, among other things, is to establish, monitor and implement regulations that will ensure that both Enterprises are adequately capitalized and operate in a safe and sound manner. These activities, and the strategies and processes used to develop and implement them, are included in OFHEO's Annual Performance Plan. The best measure of OFHEO's overall performance is whether its actions result in safe and sound operations and adequate capital levels at each Enterprise.

During the year, OFHEO managers maintained ongoing communications about their progress in achieving the OFHEO performance goals. They also documented progress formally on a quarterly basis and met with the Director to discuss progress in achieving the goals. In virtually all cases, senior management was aware of progress toward achieving performance goals in real time--before the quarterly report was prepared. Because the OFHEO appropriation is for a single account, and management has access to real-time budget information, management was able to redirect resources in a timely manner to facilitate achieving most of the OFHEO performance goals and address emerging issues, such as the special examination of Freddie Mac. OFHEO did not conduct any program evaluations in FY 2003.

The performance information in the OFHEO Annual Performance Report is complete and reliable. Performance information is available and reported for all goals. Managers report their performance and progress against the performance goals, and can rely on this information as they manage their operations. Most of the performance indicators reflect data and milestones internal to the Office. The data used as input to the capital calculations are an exception. For the minimum and risk-based capital calculations, senior officers of each Enterprise transmit their data and attest to their completeness and accuracy. Under normal circumstances, OFHEO is able to validate the minimum capital data through comparison with published Enterprise data with a high level of integrity. Numerous accounting errors, however, led to substantial understatement of the Freddie Mac core capital numbers in CY 2000, 2001, and 2002. After the Freddie Mac

November 2003 financial restatement for 2000, 2001 and 2002, OFHEO validated and recalculated its capital levels for those years. Once the audits of the financial statements are public, OFHEO will again validate and recalculate if necessary. Calendar year 2003 results are based on estimates for which OFHEO has reviewed the methodology, and the results are subject to change after Freddie Mac issues the 2003 financial statement. For the risk-based capital standard, OFHEO uses data validation protocols to ensure consistency and integrity of the data received. This allows ready identification of data issues, which OFHEO resolves with the Enterprises. OFHEO will continue to improve the sophistication of its validation checks. OFHEO has determined that the Freddie Mac accounting errors did not substantially affect the risk-based capital outcomes for the Enterprise. OFHEO had the financial simulation model used in its risk-based capital regulation independently tested during FY 2001. Since FY 2002, OFHEO and the Enterprises have continuously worked in concert to ensure the replication of model results by OFHEO and the Enterprises.

### **FY 2003 Performance Plan and Report**

The FY 2003 Performance Report describes what OFHEO accomplished, as compared to its FY 2003 Performance Plan, to achieve the goals and objectives in the FY 2000-2005 Strategic Plan.

OFHEO has developed a strategic goal and three\* strategic objectives to achieve its mission.

#### **STRATEGIC GOAL**

**TO ENSURE FANNIE MAE AND FREDDIE MAC REMAIN SAFE AND SOUND THROUGH EFFICIENT AND EFFECTIVE REGULATION AND BY FOSTERING A STRONG AND VITAL HOUSING FINANCE SYSTEM.**

The OFHEO strategic goal supports the clear and important mission of the Office. It recognizes the critical role that OFHEO plays in ensuring the safe and sound operations of the Enterprises. The goal also recognizes that OFHEO must foster the health of the nation's housing finance system in order to ensure the safety and soundness of the Enterprises. Without a strong housing finance system, the Enterprises could face limitations on their ability to buy and sell financial instruments, which could affect their safety and soundness.

#### **STRATEGIC OBJECTIVES**

OFHEO established three\* strategic objectives to support the achievement of the strategic goal and ultimately, the accomplishment of OFHEO's mission.

1. Ensure the Enterprises comply with safety and soundness standards, are adequately capitalized, and comply with other legal requirements.\*
2. Enhance public understanding of the nation's housing finance system.
3. Contribute to Federal efforts to promote efficient and effective financial markets and homeownership.

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\*OFHEO developed its strategic objectives for the FY 2000 – 2005 Strategic Plan and made a revision in the FY 2003 Performance Plan.

***STRATEGIC OBJECTIVE 1: ENSURE THE ENTERPRISES COMPLY WITH SAFETY AND SOUNDNESS STANDARDS, ARE ADEQUATELY CAPITALIZED, AND COMPLY WITH OTHER LEGAL REQUIREMENTS.***

The primary duty of OFHEO as a regulator is to ensure that the Enterprises have the financial strength to fulfill their important role in the nation's housing finance system. Providing a comprehensive and effective oversight program requires attention to the Enterprises, the dynamic environment in which they operate, the risks inherent in their activities, and their management. Maintaining risk-based standards and understanding the risk profiles of the Enterprises is basic to the ability of OFHEO to ensure their continuity.

OFHEO must maintain its ability and capacity to ensure that specific issues and emerging trends that may affect safety and soundness are identified early and that potential vulnerabilities are appropriately addressed. Critical to accomplishing its mission are the knowledge, skills and expertise OFHEO acquires through its examinations and the insights gained from its research and analysis. Maintaining a solid understanding of Enterprises exposures, risk management techniques, operating strategies, and financial condition is critical to a rapid and effective OFHEO response.

Ensuring capital adequacy is a key part of the oversight program. Adequate capital protects an Enterprise from severe losses due to unexpected events such as economic crises or management missteps. Without sufficient capital, a company could fail under such circumstances. The Enterprises must be sufficiently capitalized to withstand severe economic conditions, which is when they would be most needed to support the nation's housing finance system. Regulatory capital standards may require an Enterprise to hold more capital than the Enterprise might otherwise choose to hold, thereby providing greater protection for the nation's housing markets.

OFHEO maintains a prospective focus to identify potential problems at the Enterprises or in the marketplace before they can cause significant harm. Also, OFHEO is committed to ensuring its supervisory practices are both up-to-date and adaptable to the rapid changes in the environment and the evolution of products and services provided by the Enterprises.

**Performance Goal 1.1:           The Enterprises meet or exceed safety and soundness standards.**

Performance Measure 1:       The number of safety and soundness concerns not having an appropriate action taken is zero.

**Actual Performance:**

2003	<b>Goal Met.</b> Both Enterprises were financially sound, however, OFHEO identified unsafe and unsound practices at Freddie Mac and undertook remedial actions. OFHEO continues its review and remedial steps into FY 2004.
2002	Both Enterprises were financially sound, however, OFHEO identified unsafe and unsound practices at Freddie Mac in 2003 that dated back to 2000.
2001	Both Enterprises were financially sound, however, OFHEO identified unsafe and unsound practices at Freddie Mac in 2003 that dated back to 2000.
2000	Both Enterprises were financially sound, however, OFHEO identified unsafe and unsound practices at Freddie Mac in 2003 that dated back to 2000.

OFHEO completed its CY 2002 examination and began its CY 2003 examination of both Enterprises. Both Enterprises were financially sound during FY 2003. Where issues arose during the year, OFHEO identified these and worked with the Enterprises to address them.

During FY 2003, as described more fully in the highlights section and in Performance Goal 1.4, OFHEO initiated a special examination of the accounting practices and financial reporting control issues at Freddie Mac, leading to the restatement of financial results for 2002, 2001, and 2000. OFHEO identified instances of unsafe and unsound practices at Freddie Mac, issued a report on the special examination in the first quarter, FY 2004, and undertook supervisory actions and required remedial steps. The OFHEO review of Enterprise practices and oversight of remediation will continue into FY 2004. In the summer of 2003, OFHEO also determined that it was prudent to launch a special examination of the accounting policies and practices at Fannie Mae. This examination includes a review of the controls surrounding the end user accounting systems that led to the misstatements of September 2003 financial results that Fannie Mae announced in October.

**Performance Goal 1.2: Each Enterprise is adequately capitalized.**

Performance Measure 1.2(1): Using the OFHEO minimum capital standard, the ratio of core capital to required minimum capital is equal to or greater than one on at least a quarterly basis for each Enterprise.

Performance Measure 1.2(2): Using the OFHEO risk-based capital standard, the ratio of total capital to required risk-based capital is equal to or greater than one on at least a quarterly basis for each Enterprise.



**Performance Measure 1.2(3):** Whenever an Enterprise does not comply with the OFHEO capital requirement, OFHEO receives an acceptable capital plan.

**Actual Performance:**

2003	<p><b><u>Goal Met.</u></b>                      Quarterly minimum capital classification ratios                      Fannie Mae: 1.032 to 1.052                      Freddie Mac: 1.170 to 1.298 *</p> <p>Quarterly risk-based capital classification ratios                      Fannie Mae: 1.204 to 1.831                      Freddie Mac: 5.100 to 21.597</p>
2002	<p>Quarterly minimum capital classification ratios                      Fannie Mae: 1.02 to 1.03                      Freddie Mac: 1.051 to 1.310 *</p> <p>Third Quarter CY 2002 risk-based capital ratios (first enforceable application of the risk-based capital standard)                      Fannie Mae: 1.332 (increasing interest rate scenario is binding)                      Freddie Mac: 4.696 (decreasing interest rate scenario is binding)</p>
2001	<p>Quarterly minimum capital classification ratios                      Fannie Mae: 1.02 to 1.03                      Freddie Mac: 1.068 to 1.130 *</p>
2000	<p>Quarterly minimum capital classification ratios                      Fannie Mae: 1.01 to 1.03                      Freddie Mac: 1.025 to 1.086*</p>

*\*The capital data for Freddie Mac for 2000, 2001 and 2002 are based on restatement of previously issued consolidated financial statements and reflects adjustments to previously reported results. These numbers are subject to change pending publication of the audited financial statements. The capital data for 2003 are based upon financial information and application of accounting policies currently involved in the Freddie Mac restatement process. The 2003 numbers are subject to change.*

For each quarter of FY 2003, both Fannie Mae and Freddie Mac were adequately capitalized, and have been each quarter since OFHEO began determining capital adequacy. OFHEO is statutorily required to determine capital adequacy of the Enterprises on the basis of both minimum and risk-based capital standards. This was the first year for which the risk-based capital standard was fully enforceable throughout the year. Because the minimum capital requirement was larger than the risk-based capital requirement, in accordance with the OFHEO capital regulations and the 1992 Act, the minimum capital requirement was the binding requirement each quarter. OFHEO publishes both the minimum and risk-based capital requirements for each Enterprise on the website.

Minimum capital represents an essential amount of capital needed to protect an Enterprise against broad categories of business risk. For purposes of minimum capital, an Enterprise is considered adequately capitalized if core capital—common stock; perpetual non-cumulative preferred stock; paid-in capital; and retained earnings—equals or exceeds minimum capital. The OFHEO risk-based capital standard is the amount of total capital—core capital plus a general allowance for foreclosure losses—that an Enterprise must hold to absorb projected losses

flowing from future severe interest-rate and credit risk conditions, plus 30 percent to cover management and operations risk.

**FY 2003 Minimum Capital Requirement  
(Dollars in millions)\***

***Fannie Mae***

	12/02	3/03	6/03	9/03
Actual Core Capital	28.079	29.516	30.675	32.752
Required Capital	27.203	28.226	29.147	31.435
Surplus (Deficit)	0.877	1.291	1.527	1.316
Ratio (Actual/Required)	1.032	1.046	1.052	1.042

***Freddie Mac\*\****

	12/02	3/03	6/03	9/03
Actual Core Capital	28.990	26.107	28.958	28.129
Required Capital	22.338	21.773	22.688	24.052
Surplus (Deficit)	6.652	4.334	6.270	4.077
Ratio (Actual/Required)	1.298	1.199	1.276	1.170

\* Numbers may not add due to rounding

\*\* CY 2002 numbers are based on financial information in the Freddie Mac financial restatement issued in November 2003 and are subject to change pending publication of their audited financial statements. CY 2003 numbers are based on financial information and the application of accounting policies currently involved in the restatement process and are subject to change.

During FY 2003, the Enterprises continued to successfully manage to their capital requirements. For each quarter, each Enterprise held between \$877 million and \$6.27 billion more than their minimum requirement. As shown in the table above, the ratios of actual core capital to required minimum capital for Fannie Mae ranged from 1.032 to 1.052. The ratios for Freddie Mac ranged from 1.17 to 1.298. OFHEO makes the minimum capital determinations after the Enterprises complete their quarterly reconciliation and submit data to OFHEO for review. The final determinations for the quarter ending in September of 2003 are made in FY 2004. During the year, OFHEO also monitored the minimum capital levels of each Enterprise on a monthly basis and found that they met the standard at those points as well.

Over the last several years, the actual core capital and required minimum capital levels for both firms have been higher each quarter than in the previous quarter, with one exception. For Freddie Mac, the required minimum capital and core capital at the fourth quarter of 2002 exceeds the capital numbers for the first quarter of CY 2003, as they are presently stated. Freddie Mac restated its financial statements through the period ending fourth quarter CY 2002, but has not yet restated its CY 2003 numbers. There is an expectation that when the 2003 financial statements are published, the minimum capital and core capital numbers for the first and subsequent quarters of CY 2003 will change commensurately, although the amounts are not yet known. In general, these higher capital levels support the growth of both Enterprises.

For each quarter, both Enterprises held substantially more capital than necessary to pass the risk-based capital stress test. As shown in the table below, for each quarter, Fannie Mae held between \$5.689 billion and \$13.753 billion more than its risk-based capital requirement. Freddie Mac held between \$19.479 billion and \$27.168 billion above its risk-based capital requirement. The Fannie Mae ratios of actual total capital to required risk-based capital ranged from 1.204 to 1.831. The Freddie Mac ratios of actual total capital to risk-based capital ranged from 5.1 to 21.597. The success of both Enterprises in meeting their risk-based capital requirements reflects the effectiveness of their interest rate risk management, the restrained magnitude of stress test interest rate changes in the current low-rate environment and, to a lesser extent, continuing house price appreciation.

### FY 2003 Risk-Based Capital Requirement

(Dollars in millions)\*

#### *Fannie Mae*

	12/02	3/03	6/03	9/03
Actual Total Capital	28.871	30.309	31.469	33.542
Required Capital	17.434	16.555	18.114	27.853
Surplus (Deficit)	11.437	13.753	13.355	5.689
Ratio (Actual/Required)	1.656	1.831	1.737	1.204

#### *Freddie Mac\*\**

	12/02	3/03	6/03	9/03
Actual Total Capital	24.222	26.512	29.340	28.486
Required Capital	4.743	5.198	4.720	1.319
Surplus (Deficit)	19.479	21.314	24.620	27.168
Ratio (Actual/Required)	5.107	5.100	6.216	21.597

\*Numbers may not add due to rounding

\*\* CY 2002 numbers are based on financial information in the Freddie Mac financial restatement issued in November 2003 and are subject to change pending publication of their audited financial statements. CY 2003 numbers are based on financial information and the application of accounting policies currently involved in the restatement process and are subject to change.

<p><b>Performance Goal 1.3:</b></p>	<p><b>Ensure the Risk-Based Capital model and other measures of capital adequacy are updated to incorporate new techniques in measuring risk.</b></p>
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Performance Measure:

New risk measurement techniques relevant to Enterprise risks are identified and incorporated into the OFHEO risk-based capital analysis, as appropriate.

**Actual Performance:**

2003	<b>Goal Met.</b> Amended the risk-based capital rule, continued projects to consider future changes to the rule and initiated projects to develop new risk measurements.
2002	Amended the risk-based capital rule and initiated projects to consider future changes.
2001	Not applicable.
2000	Not applicable.

During FY 2003, OFHEO continued to address emerging issues related to capital adequacy through identifying treatments for new activities in the stress test, engaging in targeted research and analysis, and evaluating commercially available risk measurement software. Once purchased, this software will allow OFHEO to augment the risk analysis currently conducted with new risk measures applying industry standard methodologies and techniques.

The risk-based capital rule includes provision for determining the treatments of new products and activities and updating those treatments in future quarters in order to reflect risk more appropriately. The treatments for new activities determined in FY 2003 are posted on the OFHEO website with the results of the risk-based capital calculations, beginning with the results for the quarter ending September 30, 2002.

OFHEO continued several projects during FY 2003, such as enhancing empirical modeling to measure interest rate risk, evaluating the performance of high loan-to-value mortgages in the risk-based capital stress test, and exploring potential supplementary risk measurement techniques. After research and analysis, OFHEO will incorporate revisions to the model and propose any necessary changes to the risk-based capital regulation, as appropriate, and develop additional measures of capital and risk.

OFHEO amended the risk-based capital regulation to reflect FAS 133 and other technical adjustments in February 2003.

**Performance Goal 1.4:            Ensure the Enterprises comply with applicable laws, regulations and directives.**

Performance Measure:            Any identified instances of non-compliance with laws, regulations or directives are resolved to OFHEO's satisfaction.

**Actual Performance:**

2003	<b>Goal Met.</b> OFHEO identified instances of unsafe and unsound practices at Freddie Mac, undertook supervisory actions, and required remedial steps.
2002	No instances of violation identified.

2001	No instances of violation identified.
2000	No instances of violation identified.

In April 2003, OFHEO published a final regulation entitled “Public Disclosure of Financial and Other Information” to require public disclosures by the Enterprises of information consistent with the Securities Exchange Act of 1934. OFHEO will monitor the Enterprises going forward to ensure compliance with this regulation.

In January 2003, Freddie Mac announced that it was undertaking a restatement of its published financial statements for the last several years based on the recommendation of their external auditors. During the year, OFHEO conducted a special examination of accounting practices and financial reporting control issues of Freddie Mac, leading to the November 2003 restatement of financial results for 2002, 2001, and 2000. The audit of the financial statements has not yet been published. OFHEO determined that Freddie Mac operated with practices that were unsafe and unsound. These practices included poor internal controls regarding accounting, securities transactions that did not meet OFHEO standards, compensation plans with adverse consequences for corporate behavior, weak Board involvement and problems in the conduct of specific employees; these led to an inability to provide certified financial reports, an unsafe and unsound situation. However, there were no instances in which an Enterprise failed to resolve non-compliance in a way that met OFHEO’s expectations.

OFHEO directed the Board of Directors of Freddie Mac to replace CEO Gregory Parseghian and General Counsel Maud Mater, based on information developed by the special examination. OFHEO also initiated a regulatory process leading to the termination for cause of Leland Brendsel and Vaughn Clarke, based on information developed by the special examination.

The OFHEO review of Enterprises practices and oversight of remediation will continue into FY 2004. The Director determined that OFHEO would enhance the information in its Annual Report going forward and indicated support for legislation to improve the ability of OFHEO to ensure Enterprise compliance with laws, regulations and directives.

***STRATEGIC OBJECTIVE 2: ENHANCE PUBLIC UNDERSTANDING OF THE NATION’S HOUSING FINANCE SYSTEM.***

OFHEO must maintain its ability and capacity to ensure that specific issues and emerging trends are identified early and that potential vulnerabilities of the Enterprises are appropriately addressed. Critical to its mission is the knowledge, skills and expertise OFHEO acquires through its Examination Program. Maintaining a solid understanding of exposures, risk management techniques, operating strategies, and financial condition of the Enterprises is critical to a rapid and effective OFHEO response.

OFHEO maintains a prospective focus to identify potential problems at the Enterprises or in the marketplace before they can cause significant harm. Also, OFHEO is committed to ensuring its supervisory practices are both up-to-date and adaptable to the rapid changes in the environment and the evolution of products and services provided by the Enterprises.

**Performance Goal 2.1: Enhance awareness and understanding of housing and mortgage market developments and Enterprise risks and activities.**

Performance Measure 2.1(1): Analyze and report about house price trends quarterly through the House Price Index (HPI) report.

Performance Measure 2.1(2): Analyze and report about the secondary mortgage market annually.

Performance Measure 2.1(3): Report on OFHEO activities and examination results and conclusions in the OFHEO annual Report to Congress.

**Actual Performance:**

2003	<b>Goal met.</b> Annual Report sent to Congress June 4, 2003. HPI Report issued quarterly. No report issued in FY2003 on the secondary mortgage market.
2002	Annual Report sent to Congress June 15, 2002. HPI Report issued quarterly. Report published in September 2002, one quarter later than scheduled.
2001	Annual Report sent to Congress June 15, 2001. HPI Report issued quarterly. Analysis of secondary mortgage market issued separately, July 2001.
2000	Annual Report sent to Congress June 15, 2000. HPI Report issued quarterly.

OFHEO published the annual Report to Congress on June 4, describing the activities of the Office and the results and conclusions of the OFHEO CY 2002 examination of the Enterprises. This report is available on the OFHEO web site.

OFHEO publishes the House Price Index (HPI) quarterly, just two months after the quarter end. It documents changes in the home prices for the nation, each state, many Metropolitan Statistical Areas (MSAs), and the nine census regions. OFHEO has used the HPI to provide pertinent and timely information to the public on the cyclical status of housing prices. The HPI report for each quarter is on the OFHEO web site.

OFHEO did not issue its secondary mortgage market report in FY 2003 due to the delay, caused by the Freddie Mac restatement of its published financial reports, in receiving necessary data. Freddie Mac did not revise its 2002 data until November 2003 and does not expect to publish 2003 data until late in FY 2004. OFHEO staff efforts were appropriately redirected from completing this report to intensive work on the special examination of Freddie Mac. OFHEO will consider the desirability of continuing this report as it balances other work demands. If

OFHEO continues to issue the report in FY 2004, it would also include the data that were not available in 2003.

OFHEO provides valuable information to the public on developments in the housing sector and the primary mortgage market, the secondary mortgage activities of Fannie Mae and Freddie Mac, and the financial performance of the Enterprises through the publication of reports and papers, and other information. During FY 2003, OFHEO updated the public and Congress on the special examination and findings regarding the Freddie Mac restatement through public statements and the Director’s testimony to Congress. In February 2003, OFHEO published a report on systemic risk including the impact of the Enterprises on the nation’s housing and finance markets, the nation’s economy and the role of OFHEO in reducing systemic risk. OFHEO also published jointly with the Department of the Treasury and Securities and Exchange Commission in January 2003, a staff report entitled “Enhancing Disclosure in the Mortgage-Backed Securities Markets” which evaluated current disclosure practices and considered whether disclosure enhancements are desirable in assisting investors to make informed investment decisions.

**Performance Goal 2.2: Undertake research and analysis of risks and emerging issues.**

Performance Measure: Completion of FY 2003 research as called for in the FY 2002 research plan (as revised).

**Actual Performance:**

2003	<b>Goal not met.</b> Several projects on the FY 2003 research agenda were completed. Others were delayed or deferred.
2002	Several projects on the FY 2002 research agenda were completed. Others were delayed or deferred.
2001	Research and analysis have been ongoing. Developed a preliminary research agenda for FY 2002.
2000	Research and analysis have been ongoing.

Although OFHEO revised its preliminary research agenda at mid-year, the expectation to complete the entire agenda proved to be too ambitious. As an agency with a small staffing level, even a small number of emerging issues can require OFHEO to redirect research and analytical efforts. While several projects were completed, others were delayed or deferred so that staff could work on the special examination of the Freddie Mac accounting practices. While some of the OFHEO research and analysis includes projects for internal purposes, all OFHEO reports and staff working papers that can be made available to the public are posted on the OFHEO web site.

In FY 2003, OFHEO published a report entitled “Systemic Risk: Fannie Mae, Freddie Mac, and the Role of OFHEO” and issued on its website a working paper entitled “Subprime and Prime Mortgages: Loss Distributions.” Working papers are authored by OFHEO economists and analysts. The views in these papers are those of the authors and do not necessarily represent the policies or positions of OFHEO. OFHEO staff also presented papers and led or participated in

panels at professional and industry conferences. Two papers by OFHEO staff were published in housing finance journals during FY 2003.

**Impact on Future Plans:**

OFHEO has taken recent experience with resource availability and emerging issues into account in planning its research agenda. In the future, OFHEO expects to measure its performance in this area by targeting the highest priority research projects within the research agenda, as well as topics that emerge during the year.

**Performance Goal 2.3: Communicate effectively with all stakeholders on regulatory issues.**

Performance Measure 2.3(1): Consider and respond appropriately to all Congressional inquiries within 7 days.

Performance Measure 2.3(2): Consider and respond appropriately to all public inquiries within 7 days

**Actual Performance:**

2003	<b><u>Goal Not Met.</u></b> Responded to nearly all inquiries from Congress and the public within 7 days.
2002	Responded to all inquiries from Congress and the public within 7 days.
2001	Responded to all inquiries from Congress and the public within the 15-day goal.
2000	Responsive to Congress and the public. Data not collected.

OFHEO continued to respond effectively to inquiries from the Congress and the public, resolving approximately 95% of requests for information from the public within seven days. Depending on the complexity and timing of the request, some inquiries took longer than seven days to resolve. In addition, OFHEO revamped its website to make it easier for the public to find information and to provide additional features, such as a house price calculator through which members of the public can estimate the value of their house. With this revision to the website, the volume of inquiries temporarily increased, increasing the turnaround time for responses. OFHEO continues to post proposed and final regulations, reports, guidelines, speeches, testimony and other pertinent information on its web site, [www.ofheo.gov](http://www.ofheo.gov), as soon as it is available.

OFHEO continued briefings with Congressional committee members and staff on issues related to ongoing oversight of the Enterprises, hearings, legislation and the special examination of Freddie Mac accounting practices. OFHEO issued public statements on the special examination and findings regarding the Freddie Mac restatement throughout the year. In addition, the



Director of OFHEO testified several times before the House Financial Services Committee and the Senate Banking, Housing and Urban Affairs Committee.

**Impact on Future Plans:**

OFHEO has initiated improvements in its handling and tracking of public inquiries during FY 2003. OFHEO has also changed the target for FY 2004 for Congressional inquiries to 14 days and for public inquiries to 21 days. This new target is based on experience, and is more realistic, allowing time for complete responses. Responding to both public and Congressional inquiries remains a priority for OFHEO.

***STRATEGIC OBJECTIVE 3: CONTRIBUTE TO FEDERAL EFFORTS TO PROMOTE  
EFFICIENT AND EFFECTIVE FINANCIAL MARKETS  
AND HOMEOWNERSHIP.***

In recent years, new technologies, consolidation, and new approaches to pricing and managing financial risks have transformed the U.S. financial system and made safety and soundness regulation of financial institutions increasingly complex. The Enterprises have become the dominant firms in the housing finance markets and are increasingly important participants in the financial system as a whole. These developments have important implications for the Federal policy objectives of promoting the efficiency of the financial system and mortgage markets, ensuring the safety and soundness of the Enterprises, increasing homeownership, and enhancing the availability of affordable housing. OFHEO will work with other Federal agencies to coordinate efforts to analyze current trends, understand their implications for federal policy objectives, identify and analyze policy options, share regulatory knowledge and expertise, and promote regulatory best practices related to safety and soundness examination issues.

**Performance Goal 3.1: Cooperate with other Federal financial agencies on regulatory issues.**

Performance Measure 3.1(1): Respond within 30 days to requests from other Federal agencies for information about housing finance markets and the Enterprises.

Performance Measure 3.1(2): Participate in on-going task forces and forums with other regulatory agencies.

**Actual Performance:**

2003	<b><u>Goal Met.</u></b> Cooperated with other Federal financial regulators on regulatory issues.
2002	Cooperated with other Federal financial regulators on regulatory issues.

2001	Worked with HUD on regulatory issues of a common interest. Cooperation with Federal financial regulators has been ongoing.
2000	Cooperation has been ongoing.

OFHEO continued work with the other Federal financial regulators, the Office of Management and Budget, the U.S. Treasury, the Securities and Exchange Commission (SEC), the Council of Economic Advisors, the Justice Department, General Accounting Office, Farm Credit Administration, and the Department of Housing and Urban Development on a variety of issues. These include the Freddie Mac restatement, corporate and MBS disclosure, fair lending and credit scoring, supervision and examination practices, standards for Internet banking, risk management techniques and other issues related to non-mortgage investments, and planning, performance management and performance measurement. OFHEO continues to lead an interagency working group on Communication and Coordination for the Financial and Banking Information Infrastructure committee, a standing committee of the President’s Critical Infrastructure Protection Board. OFHEO also worked with the Small Business Administration on revising their 7(a) Loan Guaranty Subsidy model. This effort provided taxpayers significant savings in direct contracting costs and enabled FY 2003 guaranteed lending to small businesses to be increased by \$4 billion.

In March 2003, OFHEO hosted a symposium on House Prices in the U.S. Economy to contribute information and provide a forum for discussion of alternative views to the housing finance community. Participants and attendees included officials from HUD and the Federal Reserve Bank of St. Louis, and others from Federal financial regulators, other federal agencies, the legislative branch, the Enterprises, the housing and housing finance industry, industry analysts, research and policy analysis organizations, and universities.

***RESOURCE MANAGEMENT STRATEGY: MANAGE OFHEO RESOURCES EFFECTIVELY  
TO ENABLE THE OFFICE TO FULFILL ITS MISSION.***

The success of OFHEO in achieving the strategic objectives depends on the effective management of resources and seamless financial and administrative support functions. The size of the budget in relation to the mission requires OFHEO to use limited resources efficiently and that resources be tied directly to the achievement of the mission. As a small office, OFHEO relies on staff and management to accomplish its goals through matrix management of cross-organizational teams, timely information for decision-making, and coordination.

The OFHEO management philosophy reflects the government-wide management goals of the Administration. A lean organization, OFHEO has grown considerably over the course of FY 2003, but still relies on private sector services and products wherever practicable. For example, OFHEO continues to purchase where practicable commercially available financial analysis products for use by OFHEO staff, ensuring that OFHEO’s analytical capabilities are consistent with industry standards. The OFHEO procurement processes are increasingly electronic and reliant on performance-based contracting.

**Performance Goal 4.1: Maintain a high-caliber workforce.**

Performance Measure: Revise Individual Development Plans for each staff member annually to ensure OFHEO staff maintains and enhances the expertise and skills necessary to achieve the Office goals.

**Actual Performance:**

2003	<b>Goal Not Met.</b> Completed annual revision of individual development plans for 95% of staff members. Training and development ongoing.
2002	Individual Development Plans were established for all employees. Training and development have been ongoing.
2001	Training and development have been ongoing.
2000	Training and development have been ongoing.

OFHEO staff and management made an extensive effort to revise and update individual development plans (IDPs) for each staff member during FY 2003. All staff members' IDPs were updated and most managers IDPs were updated. Overall, 95% of individual development plans for OFHEO staff were updated. This 5 % gap was primarily due to the increased volume of hiring during the year (from 112 staff on board in September, 2002 to 141 as of September, 2003) and intensive efforts involving the special examination of Freddie Mac, which redirected staff and management resources.

**Impact on Future Plans:**

OFHEO maintains a strong commitment to recruiting and retaining a high-caliber workforce and ensuring that the staff has the skills and expertise necessary to meet the important goals and mission of the agency. As OFHEO builds staffing levels in FY 2004 and beyond, management will ensure that appropriate priority is given to developing and enhancing the knowledge and skills of the staff through the performance review system and individual development plans for each staff member.

**Performance Goal 4.2: Provide effective information resources management services to OFHEO managers and staff.**

Performance Measure: Implement the FY 2003 component of the OFHEO 5-Year IT Strategic Plan.

**Actual Performance:**

2003	<b>Goal Not Met.</b> Implemented four projects from the fiscal year 2003 Component of 5-Year IT Strategic Plan, made substantial progress on two others, and suspended one project.
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2002	5-Year IT Strategic Plan Approved.
2001	Not applicable.
2000	Not applicable.

The OFHEO 5-Year Information Technology Strategic Plan outlines specific improvements or activities for each year of the plan that will be completed. There were seven elements in the FY 2003 component of the plan. Of these, three were completed on time. One was delayed and completed in the first quarter of FY 2004, largely because the late enactment of FY 2003 appropriations delayed OFHEO’s FY 2003 procurement. Two elements were delayed due to extensive work on the special examination of Freddie Mac, which redirected staff efforts. This work is projected to be completed in the first half of FY 2004. The final element is on hold while data confidentiality issues are resolved.

**Impact on Future Plans:**

Given the small staff size of OFHEO and the unexpected examination effort that OFHEO undertook during FY 2003, some projects and activities had to slip despite best efforts. When reviewing the requirements for the FY 2004 component and planning for the FY 2005 component of the IT Strategic Plan, OFHEO has taken into account progress-to-date and recent experience, and made adjustments.

**Performance Goal 4.3:            Maintain a strong internal control and risk management program.**

Performance Measure:            No material weakness identified by external auditors of OFHEO.

**Actual Performance:**

2003	<b>Goal Met.</b> Received an unqualified audit opinion on financial statements, internal controls and compliance with laws and regulations from an independent, external auditor. No material weaknesses were reported during the independent review of the OFHEO information security program. The HUD IG issued a report with two findings: improve oversight of the travel program and implement a space utilization policy (which OFHEO satisfied by early FY 2004).
2002	Received an unqualified audit opinion on financial statements, internal controls and compliance with laws and regulations from an independent, external auditor. Contracted for an independent review of IT security and found no material weaknesses.

FY 2003 Performance Report

2001	OFHEO received a clean audit opinion on its financial statements. OFHEO conducted its first independent review of its IT security program. No material weaknesses were found.
2000	OFHEO received a clean audit opinion on its financial statements.

During FY 2003, external auditors conducted a complete financial audit and issued a clean audit opinion finding no material weaknesses. During the course of the year, the HUD Inspector General reviewed completed target audits based on a request from the Senate Appropriations Committee. The HUD IG audit objectives were threefold: review the appropriateness of travel expenditures, determine whether the compensation levels are comparable to other Federal financial regulators, and evaluate whether the office space utilization is reasonable. HUD IG issued a report with two findings related to oversight of travel expenditures and implementation of a space utilization policy, which OFHEO has addressed. An independent review of the OFHEO information security program found no material weaknesses.