



FY 2004  
PERFORMANCE REPORT

February 25, 2005

## 2004 DIRECTOR'S MESSAGE

I am pleased to report that during Fiscal Year 2004, OFHEO achieved seven 2004 Performance Goals and substantially achieved the eighth while managing other important aspects of the safety and soundness oversight of Fannie Mae and Freddie Mac. Throughout the fiscal year, OFHEO kept to its mission and thereby contributed to a stable and financially strong housing market.

In FY 2004, OFHEO continued its special examination of Freddie Mac, begun in 2003 after the Enterprise announced its intention to restate its financial results for a period of several years. OFHEO's Report of the Special Examination of Freddie Mac, issued in December 2003 uncovered: a disregard for accounting rules; poor internal controls; a lack of adequate disclosure; and a senior management compensation system that directly contributed to these problems. As a result of the findings of this examination, the Board of Directors of the Enterprise entered into a remediation plan with OFHEO that, among other requirements, directs Freddie Mac to maintain a 30 percent capital surplus. OFHEO continues to monitor the company's compliance with the remediation plan.

During FY 2004, OFHEO began a special examination of Fannie Mae focusing on several key accounting rules. In September 2004, OFHEO issued a report of findings to date. While the special examination is still ongoing, the findings revealed that Fannie Mae: inappropriately used a "cookie jar" reserve; applied accounting principles that did not conform to generally accepted accounting principles; and deferred expenses to enable executives meet annual bonus targets. The Board of Directors of Fannie Mae entered into an agreement with OFHEO to address the serious issues raised in the examination. This agreement requires Fannie Mae to build and maintain a 30 percent capital surplus in addition to making improvements in internal controls and other matters. We are currently working with the Board to ensure that these important steps are implemented quickly and completely.

In the midst of all of this, OFHEO continued its work of ensuring that the Enterprises are adequately capitalized and examined. During FY 2004, OFHEO created an Office of Compliance and an Office of the Chief Accountant to support and enhance the focus of the ongoing examinations of the Enterprises. These two new offices will, in cooperation with the Offices of Examination and Capital Supervision, ensure that all relevant issues raised during the annual examinations of each Enterprise are thoroughly investigated.

OFHEO continues to fulfill the statutory mission that Congress has set out for the agency. The agency's oversight ensures that the nation's housing finance system remains strong and is able to meet the needs of the American people.

Armando Falcon, Jr.  
January 13, 2005

## FY 2004 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>**

During FY 2004, OFHEO continued to accomplish its long-term strategic goals. With a budget of \$39.9 million and a staffing level of 152 full-time equivalent work years, the Office achieved seven of its performance goals planned for FY 2004 and substantially achieved the eighth. OFHEO determined through examinations for calendar year 2003 that both Enterprises were financially sound and initiated calendar year 2004 examinations of both Enterprises. During the year, OFHEO monitored Freddie Mac's remediation plan and capital position, after identifying unsafe and unsound practices there in 2003. OFHEO classified Freddie Mac as adequately capitalized for each quarter of the fiscal year and Fannie Mae as adequately capitalized for the first three quarters. However, after OFHEO identified areas of concern at Fannie Mae requiring restatements of current and prior financial statements, OFHEO classified the Enterprise as significantly undercapitalized for the last quarter of FY 2004.

In FY 2004, OFHEO continued its special examination of Freddie Mac, begun in 2003 after the Enterprise announced its intent to restate its financial results for a period of several years. OFHEO issued a "Report of the Special Examination of Freddie Mac" in December 2003. The findings included 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. OFHEO required the Board of Directors at Freddie Mac to propose a remediation plan and issued a capital directive to the Enterprise in January 2004 to maintain a 30 percent capital surplus, with which Freddie Mac has complied. During the year, OFHEO monitored Freddie Mac's progress with its remediation plan, including weekly monitoring of Freddie Mac's capital position. Freddie Mac has restated its financial results for the years 2001, 2002 and 2003 and is planning to issue its 2004 financial results in 2005.

The Director of OFHEO announced a special examination of Fannie Mae following the findings at Freddie Mac in 2003 regarding accounting irregularities. While the review is still ongoing, in September 2004, OFHEO issued a "Report of Findings to Date: Special Examination of Fannie Mae" with findings that include: Fannie Mae improperly created a "cookie jar" reserve, applied accounting methods that did not comply with Generally Accepted Accounting Principles, and deferred expenses to help executives make bonuses. Shortly after receiving the report, the

<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.

Fannie Mae Board of Directors signed an agreement with OFHEO to address the issues identified. The actions the Board agreed to take included: building up a 30 percent capital surplus over 270 days, appointing an independent Chief Risk Officer, conducting an independent review of Fannie Mae's accounting policies and practices, changing specific accounting treatments and separating the accounting function from other functions at the Enterprise. The special examination of Fannie Mae continues into FY 2005.

As a consequence of the OFHEO findings, Fannie Mae has also been directed by the Securities and Exchange Commission to restate its published financial statements for the last three years to reflect a correction in accounting treatments. This restatement will affect their capital calculations and may affect their capital classification. In December 2004, OFHEO determined that Fannie Mae was significantly undercapitalized as of September 30, 2004. Fannie Mae submitted a capital restoration plan to OFHEO on December 31, 2004.

OFHEO measured its progress against eight performance goals, similar to those in FY 2003, established to achieve its three strategic goals. OFHEO also established a crosscutting Resource Management Strategy with three performance goals. Before FY 2004 began, OFHEO requested additional funds to undertake the special examination of Fannie Mae and to continue the litigation arising from the continuing Freddie Mac examination. Although the request was enacted in appropriations, in order to continue these activities the Director was also forced to redirect many OFHEO staff and resources. Nevertheless, OFHEO was able to achieve all of its planned performance 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. This process limits the flexibility of OFHEO to adapt quickly to the changing risk profiles of the Enterprises at a time of rapid growth in volume, complexity and new activities. In addition, the issues that have arisen from the special examinations of both Enterprises also contribute to a dynamic and challenging regulatory environment. In the President's Budget for FY 2005, the Administration proposed a restructuring of OFHEO, including direct funding with mandatory assessments on Fannie Mae and Freddie Mac. The Administration continues to support direct funding for Enterprise regulation.

### **Mortgage Markets and the Enterprises in FY 2004**

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 2004, Fannie Mae and Freddie Mac held or guaranteed \$3.8 trillion in mortgages and mortgage-backed securities (MBS). That total represented a 6.4 percent increase from the end of FY 2003, and about 46 percent of the total residential mortgage debt outstanding as of June 30, 2004.

Mortgage market activity was substantially lower in FY 2004 than in FY 2003. Mortgage rates were slightly higher on average than in the previous year, so that borrowers had less incentive to refinance existing loans. Lower refinancing dampened mortgage originations, which declined 34 percent from the record high of \$4 trillion in FY 2003. Housing activity increased in FY 2004,

however, as interest rates remained below or close to 6 percent throughout the year. Home sales rose 9 percent and housing starts jumped 10 percent from their levels in FY 2003.

The trends and events in the primary mortgage market affect Enterprise operations and results throughout the year, changing the risk profiles of the Enterprises. The changes to the risk profile and business practices of Fannie Mae and Freddie Mac pose operational risks that the Enterprises must actively monitor and manage. OFHEO has focused increasingly on ensuring that Fannie Mae and Freddie Mac are addressing those risks appropriately.

Consistent with the drop in activity in the primary mortgage market, new business activity by Fannie Mae and Freddie Mac—mortgage-backed securities (MBS) issuance plus purchases of loans and MBS—fell by 44 percent to \$1.3 trillion in FY 2004. As a result, the Enterprises' combined mortgage portfolios increased only slightly, by 0.2 percent. Fannie Mae and Freddie Mac issued approximately \$1 trillion of MBS and purchased sizable volumes of their own MBS issues to replace assets that matured or were prepaid. Fannie Mae purchased about \$70 billion of its MBS in FY 2004, while Freddie Mac purchased over \$114 billion of its securities.

Fannie Mae and Freddie Mac continued to fund their portfolios with a program of regular issuances of Treasury-like notes and bonds and with innovative debt products, including instruments denominated in foreign currencies. As in the past, the Enterprises also issued sizable amounts of callable debt, which helps them manage the prepayment risk of their mortgage portfolios. The Enterprises also continued to use very large amounts of financial derivatives, both to lower funding costs and manage interest rate and prepayment risks. The combined derivatives book of the Enterprises exceeded \$1.6 trillion in September 2004, down 9 percent from September 2003. The Enterprises kept their exposure to interest rate risk at manageable levels in FY 2004, despite volatile interest rates, through the use of callable debt and derivatives. Through active management, Fannie Mae and Freddie Mac also limited their credit exposures to derivatives counterparties to very low levels.

Since the early 1990s, the Enterprises have increased the asset management side of their business operations more rapidly than the credit guarantee side. At year-end 1992, Fannie Mae and Freddie Mac held 19 percent of their book of business (defined to include 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 2004, the proportion of the book of business held in portfolio had increased to 42 percent, with a corresponding decline in the guarantee business to 58 percent of the total. That change has significantly altered the risk profile of each Enterprise and required Fannie Mae and Freddie Mac to shift from focusing primarily on managing mortgage credit risk to emphasizing interest rate risk management. As the safety and soundness regulator of the Enterprises, OFHEO has had to realign its oversight activities to concentrate more on interest rate risk management and the use of derivatives as funding and hedging tools.

Issues of disclosure and corporate governance have become more significant for corporate America in recent years, leading to the passage of the Sarbanes-Oxley Act of 2002. Complex new accounting rules related to the financial impact of derivatives have heightened scrutiny of the financial reports of firms that use derivatives to hedge mortgage prepayment risk. Those developments, in combination with the findings to date of the Freddie Mac and Fannie Mae special examinations, have underscored the key role OFHEO plays in ensuring that the Enterprises adhere to the highest standards of financial reporting and corporate governance.

## **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 supports these functions through its regulatory framework. The OFHEO Annual Performance Plan describes how OFHEO conducts these activities to achieve its goals. The best measure of overall performance of OFHEO 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 documented status and accomplishments and met with the Director quarterly. 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, the Director was able to use real-time budget information to redirect resources in a timely manner to facilitate achieving the OFHEO performance goals and to address emerging issues, such as the special examinations of Freddie Mac and Fannie Mae. During FY 2004, OFHEO began converting to a new financial management system and started using the system in FY 2005. With the functionality and flexibility of the new system, OFHEO can improve its capabilities for reporting and managing budget and performance during the year.

The performance information in the OFHEO Annual Performance Report available and reported for all goals and is complete and reliable with exceptions related to capital classifications (described in the last section of Performance Goal 1.2). OFHEO managers report their performance and progress against the performance goals, and can rely on this information as they manage their operations. With the key exception of data used as input to the capital calculations, most of the performance indicators reflect data and milestones internal to the Office.

OFHEO did not conduct any program evaluations in FY 2004, however the HUD Inspector General (IG) issued a report finding that OFHEO was in compliance with the provisions of the 2004 VA/HUD Appropriations Act requiring that no less than 60 percent of total funds appropriated be used for the examination, supervision and capital oversight of Fannie Mae and Freddie Mac. The IG also recommended that OFHEO improve its reporting of actual expenses. The Office of Personnel Management reviewed the delegated examining unit authority during the fiscal year and gave OFHEO a clean audit opinion. The agency also received an unqualified audit opinion from an independent, external financial auditor and a clean review on the OFHEO information security program.

## **FY 2004 Performance Plan and Report**

The FY 2004 Performance Report describes what OFHEO accomplished, as compared to its FY 2004 Performance Plan, to achieve the goals and objectives in the FY 2000-2005 Strategic Plan.

OFHEO 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.

***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.

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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.

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 Enterprise 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:            Each Enterprise responds appropriately to 100% of OFHEO’s safety and soundness concerns.

**Actual Performance:**

2004	<b>Goal Met.</b> Both Enterprises met safety and soundness standards, however, OFHEO continued to monitor required remedial actions based on unsafe and unsound practices identified by OFHEO at Freddie Mac in FY 2003. OFHEO identified safety and soundness concerns at Fannie Mae and took remedial action. OFHEO continues its review, monitoring and remedial steps into FY 2005.
2003	Both Enterprises were financially sound, however, OFHEO identified unsafe and unsound practices at Freddie Mac and undertook remedial actions.
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.
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OFHEO completed its Calendar Year (CY) 2003 annual examination and began its CY 2004 examination of both Enterprises in FY 2004. OFHEO found both Enterprises financially sound in CY 2003, but raised concerns through the targeted special examinations of both Enterprises. Where issues arose during the year, OFHEO identified these and worked with the Enterprises to address them. Results and conclusions from the CY 2003 examination of Fannie Mae and Freddie Mac were detailed in the Report to Congress OFHEO published in June 2004. The report explained the results of the examinations through the CAMELS framework traditionally used by financial regulators to assess key areas of risk: Capital adequacy, Asset quality, Management, Earnings, Liquidity, and Sensitivity.

As described more fully in the highlights section and in Performance Goal 1.3, OFHEO continued a special examination of the accounting practices and financial reporting control issues at Freddie Mac and launched a special examination of similar issues at Fannie Mae during FY 2004. OFHEO released reports on the findings to date of these special examinations in December 2003 for Freddie Mac and September 2004 for Fannie Mae, although both special examinations continue. Due to the resource requirements of the special examinations, the scope of the annual, risk-based examinations for 2003 and 2004 were revised. However, these revisions did not impair the ability of OFHEO to assess safety and soundness and risk management activities for key financial risks. The examination strategies and work plans for the 2004 examinations include continuous review of the accounting practices of both Enterprises and oversight of Enterprise remediation plans into FY 2005. OFHEO will formally reassess the safety and soundness ratings for both Enterprises when the regular annual examination work for CY 2004 is completed.

During FY 2004, OFHEO created an Office of Compliance and an Office of the Chief Accountant in order to support and enhance the examination and supervisory activities of the Office. OFHEO also significantly strengthened and restructured the Office of Examination supervisory program by creating two units with a separate staff for each Enterprise. The dedication of staff to each Enterprise will result in the development of greater expertise in the operations, structure, and regulatory issues of that particular company. OFHEO is also hiring additional experienced examiners, increasing its on-site presence at the Enterprises, and providing a more in-depth analysis of Enterprise performance, risks, processes and controls. This reorganization supports the supervisory needs of OFHEO and provides necessary resources for both special examinations and annual, risk-based examinations at the Enterprises.

<p><b>Performance Goal 1.2:            Each Enterprise is adequately capitalized.</b></p>
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Performance Measure 1.2(1): Each Enterprise meets the minimum capital standard at least quarterly.

Performance Measure 1.2(2): Each Enterprise meets the risk-based capital standard at least quarterly.

Performance Measure 1.2(3): Continually review the capital standards and risk-based capital model and change them as needed to reflect new risk measurement techniques and new Enterprise risks.

Performance Measure 1.2(4): Using the capital standards, a variety of analytics, environmental scans and early warning indicators, each Enterprise is determined by the OFHEO Director to be adequately capitalized on at least a quarterly basis.

Performance Measure 1.2(5): Whenever an Enterprise does not comply with the OFHEO Director's determination of capital adequacy, OFHEO receives an acceptable capital plan.

**Actual Performance:**

2004	<p><b><u>Goal Substantially Achieved.</u></b>                  Freddie Mac: classified as adequately capitalized each quarter.                  Fannie Mae: classified as adequately capitalized for the first three quarters and classified as significantly undercapitalized for the quarter ending September 30, 2004.</p> <p>Quarterly minimum capital classification ratios                  Fannie Mae: 0.906 to 1.158 <sup>i</sup>                  Freddie Mac: 1.355 to 1.421<sup>ii</sup></p> <p>Quarterly risk-based capital classification ratios                  Fannie Mae: 1.292 to 1.511                  Freddie Mac: 4.894 to 8.575</p>
2003	<p>Quarterly minimum capital classification ratios                  Fannie Mae: 1.032 to 1.052<sup>i</sup>                  Freddie Mac: 1.298 to 1.444<sup>iii</sup></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<sup>i</sup>                  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>

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<sup>i</sup> *The Fannie Mae minimum and risk-based capital classifications are based on financial information and the application of accounting policies currently under review by OFHEO and subject to restatement.*

<sup>ii</sup> *The Freddie Mac CY 2004 numbers are based on financial information not yet published and are subject to change.*

<sup>iii</sup> *OFHEO reaffirmed Freddie Mac's capital classification and restated minimum capital results after Freddie Mac published restated results in June 2004.*

For each quarter of FY 2004, Freddie Mac was adequately capitalized; Fannie Mae was adequately capitalized for the first three quarters of FY 2004, but failed to meet the minimum capital standard for the quarter ending September 30, 2004 resulting in a classification of significantly undercapitalized. OFHEO is statutorily required to determine capital adequacy of the Enterprises on the basis of both minimum and risk-based capital standards. 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 its web site, [www.ofheo.gov](http://www.ofheo.gov).

Based on the findings of the special examination begun by OFHEO in 2003 (see discussion under performance goal 1.3), in January, 2004, OFHEO required Freddie Mac to maintain a 30 percent capital surplus over its minimum capital requirement to address operations risk. OFHEO monitors this on a weekly basis and Freddie Mac continues to meet this surplus target. During FY 2004, after Freddie Mac restated its financial results for 2000, 2001, 2002 and 2003, OFHEO reviewed the capital classifications for those years and determined that Freddie Mac remained adequately capitalized during those time periods. OFHEO posted revised minimum capital requirements on its web site.

The Fannie Mae capital classifications during FY 2004 were based on financial information and the application of accounting policies currently under review by OFHEO. On December 15, 2004, the Securities and Exchange Commission directed Fannie Mae to correct certain accounting deficiencies identified by OFHEO and restate published financial statements for 2001, 2002, 2003 and 2004. This restatement resulted in an estimated \$9 billion cumulative reduction in core capital as of September 30, 2004 which led to the Enterprise's classification as significantly undercapitalized for the last quarter of FY 2004. Fannie Mae submitted a capital restoration plan to OFHEO at the end of December, replacing the capital plan required by the September 27, 2004 agreement with the Board of Directors. In that agreement, OFHEO directed Fannie Mae to maintain a 30 percent capital surplus over its minimum capital requirement due to uncertainties in the financial statements and operational weaknesses (see discussion under performance goal 1.3). Fannie Mae must maintain a minimum capital surplus no lower than its August 30, 2004 level and has 270 days from the day of the agreement to reach the 30 percent target, subject to revisions or modifications by the Director. OFHEO is currently reviewing the capital restoration plan and will determine whether modifications to the agreement will occur.

Minimum capital represents an essential amount of capital needed to protect an Enterprise against broad categories of business risk. For purposes of regulatory 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 2004 Minimum Capital Requirement  
(Dollars in billions)<sup>i</sup>**

***Fannie Mae*<sup>ii</sup>**

	12/03	3/04	6/04	9/04
Actual Core Capital	34.405	35.701	36.115	28.856 <sup>iii</sup>
Required Capital	31.520	31.354	31.188	31.837
Surplus (Deficit)	2.885	4.347	4.927	(2.981)
Ratio (Actual/Required)	1.092	1.139	1.158	0.906

***Freddie Mac*<sup>iv</sup>**

	12/03	3/04	6/04	9/04
Actual Core Capital	32.985	34.781	32.884	34.227
Required Capital	23.774	24.472	24.266	24.404
Surplus (Deficit)	9.211	10.309	8.619	9.823
Ratio (Actual/Required)	1.387	1.421	1.355	1.403

<sup>i</sup> Numbers may not add due to rounding

<sup>ii</sup> Fannie Mae's capital classifications during FY 2004 were based on financial information and the application of accounting policies currently under review by OFHEO and subject to restatement.

<sup>iii</sup> This number reflects the actual core capital of \$38.032 billion less the \$9.176 billion required estimated adjustment related to FAS 133.

<sup>iv</sup> The Freddie Mac CY 2004 numbers are based on financial information not yet published and are subject to change. Freddie Mac is required to maintain 30 percent more than the minimum capital requirement.

For all four quarters of FY 2004, the minimum capital standard was the binding requirement for the Enterprises. During FY 2004, Freddie Mac held between \$8.6 billion and \$10.3 billion (between 35.5 and 42.1 percent) more than its minimum requirement, more than necessary to meet the 30 percent surplus requirement to which Freddie Mac is subject. During the first three quarters, Fannie Mae held between \$2.9 billion and \$4.9 billion (between 9.2 percent and 15.8 percent) more than its minimum requirement. However, for the fourth quarter of FY 2004, Fannie Mae was classified as significantly undercapitalized with a \$3.0 billion shortfall. This shortfall was due to a required estimated accounting correction discussed above.

As shown in the table below, both Enterprises also held substantially more capital than necessary to pass the risk-based capital stress test. Freddie Mac held between \$27.8 billion and \$29.2 billion above its risk-based capital requirement. Fannie Mae continued to meet this measure of adequate capital in all four quarters of the year, holding between \$8.0 billion and \$20.4 billion more than its risk-based capital requirement. 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. OFHEO makes the minimum and risk-based 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 2004 were made in FY 2005.

OFHEO continues to engage in research and analysis related to risk and capital. Throughout the year, OFHEO conducted additional analyses of trends and relationships between movements in market interest rates, changes in the Enterprises' portfolios and their capital requirements, and the sensitivity of the Enterprises' capital to more and less severe scenarios of interest rate stress than that required by the stress test. OFHEO realigned resources in FY 2004 to direct more of its research and analysis to these areas, which ensures that the capital standards OFHEO applies to the Enterprises, including the risk-based capital stress test, continually reflect new risk measurement techniques and new Enterprise risks.

### FY 2004 Risk-Based Capital Requirement

(Dollars in billions)<sup>i</sup>

#### *Fannie Mae*<sup>ii</sup>

	12/03	3/04	6/04	9/04
Actual Total Capital	35.182	36.481	36.862	38.762 <sup>iii</sup>
Required Capital	27.221	25.961	24.391	18.342
Surplus (Deficit)	7.960	10.520	12.471	20.420
Ratio (Actual/Required)	1.292	1.405	1.511	2.113

#### *Freddie Mac*<sup>iv</sup>

	12/03	3/04	6/04	9/04
Actual Total Capital	33.436	34.898	33.081	34.397
Required Capital	5.426	7.131	3.858	5.749
Surplus (Deficit)	28.010	27.767	29.224	28.648
Ratio (Actual/Required)	6.162	4.894	8.575	5.983

<sup>i</sup> Numbers may not add due to rounding

<sup>ii</sup> Fannie Mae's capital classifications during FY 2004 were based on financial information and the application of accounting policies currently under review by OFHEO. The outcome of the review may result in a restatement of prior period results and a revision of the respective capital calculations..

<sup>iii</sup> OFHEO made a decision not to adjust Fannie Mae's risk-based capital results to reflect the reduction in core capital because the risk-based capital surplus would not change. The adjustment to Fannie Mae's risk-based capital results for the reduction in core capital would result in corresponding identical reductions in total capital and the risk-based capital requirement. Since total capital and the requirement change by identical offsetting amounts, the risk-based capital surplus would not change as a result of the adjustment. This illustrates that the risk-based capital requirement is working as intended to tie capital requirements to risk. Since the choice of accounting method for reporting the affected instruments does not change the risk associated with the instruments, the risk-based capital surplus does not change based on choice of accounting method.

<sup>iv</sup> The Freddie Mac CY 2004 numbers are based on financial information not yet published and are subject to change.

## **Completeness and Reliability of Performance Measures**

OFHEO relies on data from the Enterprises to determine their capital adequacy. Because this Performance Report is issued several months earlier than in prior years, data for the quarter ending September 30, 2004 are not yet available. OFHEO expects to release this information publicly in FY 2005 and include it with the other performance information for 2004 in the OFHEO Performance Budget that accompanies the President's FY 2006 budget.

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. 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.

However, numerous accounting errors led to substantial understatement of the Freddie Mac core capital numbers in CY 2000, 2001, 2002 and 2003. After the Freddie Mac November 2003 financial restatement for 2000, 2001 and 2002, and June 2004 restatement for 2003, OFHEO validated and recalculated Freddie Mac's capital levels for those years. Calendar year 2004 results for minimum and risk-based capital are based on estimates for which OFHEO has reviewed the methodology, and the results are subject to change after Freddie Mac issues 2004 financial statements. Freddie Mac provided preliminary data to OFHEO which served as the basis for the capital classifications. OFHEO has determined that the Freddie Mac accounting errors did not substantially affect the risk-based capital outcomes for the Enterprise for the years that have been restated.

At this point, both minimum and risk-based capital data for Fannie Mae for 2001, 2002, 2003 and parts of 2004 are subject to change based on the outcome of the OFHEO review of the accounting practices of the Enterprise and a restatement of published financial statements as directed by the Securities and Exchange Commission. Fannie Mae will change its application of Financial Accounting Standards 91 and 133 which may affect their core and total capital calculation. As Fannie Mae determines the impacts from these accounting changes, OFHEO will reevaluate Fannie Mae's capital position and determine the need for resubmission of Fannie Mae capital data for the affected years and reclassification, if necessary.

Going forward, OFHEO will continue to improve the sophistication of its data validation checks. 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.

<b>Performance Goal 1.3:</b>	<b>Ensure the Enterprises comply with applicable laws, regulations and directives, including corporate responsibility and disclosure.</b>
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**Performance Measure:** Any identified instances of non-compliance with laws, regulations or directives are resolved to OFHEO's satisfaction.

**Actual Performance:**

2004	<b><u>Goal Met.</u></b> Reviewed Enterprise compliance with applicable laws, regulations and directives, including corporate responsibility and disclosure requirements. Each Enterprise responded appropriately to issues identified by OFHEO.
2003	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 2004, OFHEO continued the special examination of Freddie Mac and launched a special examination of Fannie Mae to review its accounting polices and related practices. OFHEO initiated these special examinations, which include ongoing review of internal controls and management practices, to determine the Enterprises' compliance with accounting standards in order to ensure appropriate accounting and related practices.

In December 2003, OFHEO issued a "Report of the Special Examination of Freddie Mac" that identified a pattern of misconduct and improper management of earnings that led to the Enterprise's restatement of financial results for 2000, 2001 and 2002 in November 2003. Freddie Mac also restated financial results for 2003 in June 2004 and is expected to restate results for quarters in 2004 as it works to correct and improve its accounting systems. The findings in the special examination report included:

- The corporate culture and "tone at the top" at Freddie Mac resulted in improper efforts to manage its reported earnings.
- Freddie Mac disregarded accounting rules, internal controls and disclosure standards in order to pursue steady earnings growth.
- The incentive compensation plans of senior executives at Freddie Mac contributed to the improper accounting and management practices.
- The accounting practices and policies, internal audit function and internal controls at Freddie Mac were inadequate.
- Freddie Mac circumvented appropriate public disclosure standards.
- The Board of Directors of Freddie Mac failed to exercise adequate oversight.

During the special examination, in FY 2003, OFHEO took specific actions regarding several former executives of Freddie Mac, including freezing compensation packages, imposing civil money penalties on the Vice Chairman, and initiating the process to sanction the former CEO and CFO. This effort continued through FY 2004. As a result of the initial OFHEO findings, in December 2003, Freddie Mac agreed to implement corrective measures and pay a \$125 million civil money penalty as part of a Consent Order with OFHEO. In January 2004, in order to

ensure that Freddie Mac continued to maintain an adequate capital surplus until certified financial statements could be produced and operational issues were addressed, OFHEO directed the Enterprises to maintain a mandatory target capital surplus of 30 percent over its minimum capital requirement. Freddie Mac was also required to seek pre-approval from OFHEO for certain corporate transactions and to make weekly reports on its projected capital position. OFHEO continues to monitor progress by Freddie Mac on its remediation plan and its capital position.

In September 2004, OFHEO released a “Report of Findings to Date: Special Examination of Fannie Mae.” Through the special examination, which is expected to continue beyond FY 2005, OFHEO found that Fannie Mae:

- applied accounting methods and practices that do not comply with GAAP in accounting for the Enterprise’s derivatives transactions and hedging activities,
- employed an improper “cookie jar” reserve in accounting for premium and discount amortization under GAAP,
- tolerated related internal control deficiencies,
- deferred expenses apparently to achieve bonus compensation targets, in at least one instance, and
- maintained a corporate culture that emphasized stable earnings at the expense of accurate financial disclosures.

As a result of the special examination, in May 2004 OFHEO also directed Fannie Mae to change the way it accounts for manufactured housing and aircraft lease securities in order to recognize losses in the periods in which they occur. Fannie Mae made this change to their accounting practices.

OFHEO entered into an agreement with Fannie Mae in September 2004 in which the Enterprise agreed to implement corrective measures to address the improper accounting and inadequate controls detailed in the report. The agreement requires Fannie Mae to implement accounting treatments to bring the Enterprise into compliance with Financial Accounting Standards 91 and 133, maintain and increase the existing capital surplus to 30 percent of its required minimum capital within 270 days, appoint an independent Chief Risk Officer, separate other key business functions currently performed jointly by certain individuals and departments, implement policies to assure adherence to accounting rules and internal controls, and undertake a top-to-bottom review of staff structure, responsibilities, independence of functions, compensation and incentives. OFHEO continues to monitor Fannie Mae’s compliance and capital position.

In February 2004, in response to an error in the Enterprises’ determination of the 2004 conforming loan limit, the OFHEO Director issued a Supervisory Guidance establishing a regulatory process for annual adjustments to this limit. The conforming loan limit establishes a ceiling on the size of loans the Enterprises may purchase or guarantee. In calculating the 2004 conforming loan limit the Enterprises failed to incorporate an adjustment factor made necessary by methodological changes in the Federal Housing Finance Board (FHFB) Monthly Interest Rate Survey. The calculation by the Enterprises resulted in a conforming loan limit \$2,300 higher than it would have been if the adjustment had been made. The 2004 conforming loan limit was \$333,700.



Beginning with 2005, OFHEO will announce its annual calculation of the maximum conforming loan limit based on the FHFB survey. The adjustment that should have been made in 2004 will be incorporated into the 2005 calculation.

OFHEO proposed to amend its regulation for corporate governance at the Enterprises in order to update and strengthen the governance infrastructure of the Enterprises. The proposed amendment would separate the CEO and Chairman of the Board positions at the Enterprises; establish term and age limits for the Board of Directors; require audit partner rotation every five years and auditor rotation every ten years; and set other standards and requirements for the conduct and operations of the management and Boards of the Enterprises. OFHEO posted on its web site comments received from the public and expects to issue a final corporate governance regulation in FY 2005.

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

Enhancing the public's understanding of the nation's housing finance system, including the roles and activities of the Enterprises and OFHEO, contributes directly to the strength and vitality of that system. The public—borrowers, investors, market participants, policymakers, and other stakeholders—will make better decisions about the allocation of their resources if they are well informed. OFHEO, with its expertise in housing finance, is uniquely positioned to provide the public with information and analysis that leads to more informed decision-making by the public.

**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): Report on OFHEO activities, examination results and conclusions, and the secondary mortgage market in the OFHEO annual Report to Congress.

**Actual Performance:**

2004	<b><u>Goal met.</u></b> Annual Report sent to Congress on June 15, 2004. HPI Report issued quarterly.
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2003	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.

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 2004, OFHEO updated the public and Congress on the findings regarding the Fannie Mae special examination and the Freddie Mac restatement through public statements and testimony to Congress by the Director.

OFHEO published the annual Report to Congress on June 15<sup>th</sup>, describing the activities of the Office, including the financial statements for FY 2003. For this report, OFHEO enhanced its descriptions of the results and conclusions of the OFHEO CY 2003 examinations of the Enterprises, explaining the results of the examinations through the CAMELS framework traditionally used by other financial regulators, through which risks are described through Capital adequacy, Asset quality, Management, Earnings, Liquidity, and Sensitivity. OFHEO is unique among financial regulators as it is required by law to make public its examination findings. This report is available on the OFHEO web site. In October 2004, OFHEO published a separate report on the secondary mortgage market, “Mortgage Markets and the Enterprises in 2003.”

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 also released a public version of the software used to run the risk-based capital stress test along with a stylized data set to use in the model in April 2004. By running this “hypothetical firm” through the stress test model, a member of the public can better understand the sensitivities and implications of the stress test.

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

Performance Measure 2.2(a): Meet the Director’s priorities for research as identified in the FY 2004 research plan.

Performance Measure 2.2(b): Prepare special reports on topical issues.

**Actual Performance:**

2004	<b>Goal met.</b> Research to meet the Director’s priorities was completed. A report on the special examination of Freddie Mac and a report with findings to date on the Fannie Mae special examination were published. Other papers and reports on special topics were completed.
2003	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.

In FY 2004, OFHEO targeted its research efforts on the highest priority research projects within the research agenda, as well as topics that emerged during the year that needed immediate attention. At the beginning of the year, the Director identified four priority projects that furthered the OFHEO mission; these were completed within the fiscal year. These projects, as well as numerous others that were completed or had substantial progress made during FY 2004, may result in published papers or presentation, or may be used to inform speeches, testimony and reports that OFHEO makes public.

In December 2003, OFHEO issued a “Report of the Special Examination of Freddie Mac,” outlining findings and recommended actions regarding accounting issues at the Enterprise that lead to a restatement of financial results for 2000, 2001, 2002 and 2003. OFHEO published a “Report of Findings to Date: Fannie Mae Special Examination” in September 2004. This report detailed accounting issues at Fannie Mae.

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 2004, OFHEO published on its web site a research paper entitled “Single Family Mortgage Industry in the Internet Era.” OFHEO also published seven working papers on the OFHEO web site over the course of the year:

- “Drawing Inferences about Housing Supply Elasticity from House Price Responses to Income Shocks”
- “Aggregation Bias and the Repeat Sales Price Index”
- “Market Discipline of Fannie Mae and Freddie Mac: How Do Share Prices and Debt Yield Spreads Respond to New Information?”
- “A Discrete Choice Approach to Measuring Competition in Equity Option Markets”
- “Earnings Management During Distinct Periods of Capital Demand: Evidence from Japanese Banks”
- “Measurement of the Bid-Ask Spread in Equity Option Market”
- “The Value of Foreclosed Property: House Prices, Foreclosure Laws, and Appraisals”

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 at professional and industry conferences.

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

Performance Measure 2.3(a): Consider and respond appropriately to all Congressional inquiries within 14 days.

Performance Measure 2.3(b): Consider and respond appropriately to all public inquiries within 21 days.

**Actual Performance:**

2004	<b>Goal Met.</b> Responded to all inquiries from Congress within 14 days and responded to all public inquiries within 21 days.
2003	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.

During FY 2004, OFHEO continued to respond effectively to inquiries from the Congress and the public, resolving all inquiries within the target timeframe despite increases in volume due to regulatory events. The improvements made to the OFHEO web site in FY 2003, specifically the house price calculator through which members of the public can estimate the value of their house, also added to the increased volume of inquiries. OFHEO continues to post proposed and final regulations, reports, guidelines, speeches, testimony and other pertinent information on its web site 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 examinations of Freddie Mac and Fannie Mae regarding accounting practices. In FY 2004, OFHEO issued public statements on both special examinations, the Freddie Mac restatement of financial results, the agreement for corrective action with the Fannie Mae Board of Directors, directives to the Enterprises and quarterly capital classifications throughout the year. In addition, the Director of OFHEO testified several times before the House Financial Services Committee and also before the House Energy and Commerce Committee.

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

In recent years, consolidation, new technologies, new standards, 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 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:**

2004	<b><u>Goal Met.</u></b> Cooperated with other Federal financial agencies on regulatory issues.
2003	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 Federal Reserve Board and other Federal bank regulators, the Securities and Exchange Commission (SEC), the U.S. Treasury Department, the Federal Housing Finance Board, Farm Credit Administration, as well as the Office of Management and Budget, the Justice Department, Government Accountability Office, and the Department of

Housing and Urban Development on a variety of issues. These include the Freddie Mac restatement, issues related to the Freddie Mac and Fannie Mae special examinations, the OFHEO House Price Index, executive compensation, fair lending, affordable housing, mortgage products, capital requirements for Government-Sponsored Enterprises, supervision and examination practices, issues related to non-mortgage investments, and planning, performance management and performance measurement. While not a Federal agency, OFHEO also consulted with the Financial Accounting Standards Board (FASB) on relevant issues.

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. As part of the Interagency Fair Lending Task Force, in April 2004, OFHEO contributed to a Spanish-language version of a consumer brochure on predatory lending. OFHEO is also a member of the interagency Corporate Fraud Task Force, and briefed the task force on its “Report of Findings to Date: Special Examination of Fannie Mae”.

**Performance Goal 3.2:            Ensure there is sufficient disclosure of information regarding Enterprise operations to allow market participants to trade their obligations efficiently and effectively in the financial markets.**

Performance Measure 3.2(1): Any identified instances of non-compliance with laws, regulations or directives regarding disclosure are resolved to OFHEO’s satisfaction.

**Actual Performance:**

2004	<b>Goal Met.</b> Accounting irregularities at both Enterprises are in the process of being resolved to OFHEO’s satisfaction. (New performance goal).
2003	Issued final disclosure regulation. Completed joint staff review with the Securities and Exchange Commission and the Treasury Department on disclosure related to Mortgage-Backed Securities.
2002	Drafted proposed disclosure regulation. Participated in joint staff review with the Securities and Exchange Commission and the Treasury Department on disclosure related to Mortgage-Backed Securities.
2001	No related performance goal.

During FY 2004, OFHEO worked with both Enterprises to assure the quality of their disclosures under applicable standards. Through the special examinations of both Freddie Mac and Fannie Mae, OFHEO identified areas for improvement in financial disclosure. As part of the larger restatement effort that motivated the OFHEO special examination, in June 2004, Freddie Mac restated its financial results for 2003. Freddie Mac had restated its financial results for 2000, 2001 and 2002 in November 2003, correcting accounting irregularities that artificially smoothed earnings. The restatement of 2004 financial information is still pending. OFHEO continues to

monitor Freddie Mac's progress on its remediation plan, including its capital position. One recommendation of the "Report of the Special Examination of Freddie Mac," issued by OFHEO in December 2003, was to establish a regulatory system of mandatory disclosures for the Enterprises. OFHEO is considering this possibility.

OFHEO issued a "Report of Findings to Date: Special Examination of Fannie Mae" in September 2004. The findings included concerns about the validity of previously reported financial results and adequacy of regulatory capital. Other findings included control weaknesses in accounting policy development, key person dependencies and poor segregation of accounting duties. OFHEO and the Fannie Mae Board of Directors reached an agreement in September 2004 to remedy the problems identified in the report, including correcting accounting treatments related to Financial Accounting Standards 91 and 133, and to reach a 30 percent capital surplus over the minimum capital requirement. In May 2004, OFHEO also directed Fannie Mae to correct their treatment of manufactured housing and aircraft lease securities impairments.

**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 but growing office, OFHEO relies on staff and management to accomplish its goals through 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 2004, 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 analytical capabilities of OFHEO are consistent with industry standards. The OFHEO procurement processes are increasingly electronic and reliant on performance-based contracting.

**Performance Goal 4.1:           Ensure the staff have the knowledge and skills to fulfill the goals of the agency.**

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's goals.

**Actual Performance:**

2004	<b>Goal Met.</b> Completed annual revision of individual development plans for all staff members. Training and development ongoing.
2003	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.

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. In FY 2004, OFHEO staff and management made an extensive effort to revise and update individual development plans (IDPs) for each staff member, while increasing



overall staffing levels. Over the course of the fiscal year, OFHEO grew from 141 staff on board as of September 2003 to 178 as of September 2004, an increase of 21 percent. During FY 2004, all individual development plans for OFHEO staff were updated and OFHEO managers worked to ensure that new staff had IDPs in place within 30 days of coming on board.

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

Performance Measure: Implement the FY 2004 component of the OFHEO 5-Year IT Strategic Plan.

**Actual Performance:**

2004	<b>Goal Met.</b> Implemented all three projects outlined in the FY 2004 Component of 5-Year IT Strategic Plan
2003	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.
2002	5-Year IT Strategic Plan Approved.
2001	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. In the FY 2004 component of the plan, three elements were planned and all three were completed before the end of the fiscal year. In addition, OFHEO completed the remaining two projects from the FY 2003 component of the plan.

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

Performance Measure: No material weakness identified by OFHEO's external auditor or external review.

**Actual Performance:**

2004	<b>Goal Met.</b> Received an unqualified audit opinion on 2003 and 2004 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 found OFHEO exceeded the requirements of the 2004 Appropriations Act to use no less than
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	60 percent of its 2004 funds for examination, supervision and capital oversight of the Enterprises.
2003	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.
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.

During FY 2004, external auditors conducted a complete financial audit and issued a clean audit opinion finding no material weaknesses for OFHEO for FY 2003. OFHEO also received a clean audit opinion for FY 2004. OFHEO received a clean opinion from an independent review of the information security program.

In FY 2004, OFHEO addressed the recommendations made by the HUD Inspector General on administrative operations in a 2003 report by completing a plan for space at OFHEO, a space utilization policy and improvements in oversight of the travel program. Also in FY 2004, the HUD IG completed a target audit based on a request from the Senate Appropriations Committee to review compliance with the provision of the 2004 VA/HUD Appropriations Act that no less than 60 percent of total funds appropriated be used for the examination, supervision and capital oversight of Fannie Mae and Freddie Mac. The HUD IG concluded that OFHEO exceeded the 60 percent threshold, allocates its funds using a method consistent with other regulators, and uses approximately the same percentage of its funds on examination, supervision and capital oversight as other regulators. OFHEO agreed to work to validate its estimates of actual expenses by strategic goal.

The Office of Personnel Management (OPM) conducted an audit of the OFHEO delegated examining unit, which grants OFHEO authority to hire employees, in September 2004. The final report was issued early in FY 2005, giving OFHEO a clean opinion. OPM found that the OFHEO delegated examining staff provided a high quality work product that supports mission accomplishment.