



**Office of Federal Housing Enterprise Oversight
(OFHEO)**

NEWS RELEASE

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**OFHEO Releases 2005 Performance and
Accountability Report**

WASHINGTON, D.C. — Stephen Blumenthal, Acting Director of the Office of Federal Housing Enterprise Oversight (OFHEO), safety and soundness regulator for Fannie Mae and Freddie Mac, today released its first Performance and Accountability Report (PAR). In prior years, OFHEO issued separate annual performance reports and annual audited financial statements. The PAR combines the two. This year, OFHEO chose to issue the PAR to improve transparency and the public's understanding of how OFHEO operates.

The report provides a three-part summary of OFHEO's operations and accomplishments in achieving its goals as well as financial information for FY 2005. The next OFHEO annual Report to Congress - detailing examinations and regulatory oversight of Fannie Mae and Freddie Mac - will be issued in June 2006.

The Full 2005 Performance and Accountability Report Follows

To request a printed copy, please send your mailing address to:
ofheoinquiries@ofheo.gov.

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OFHEO's mission is to promote housing and a strong national housing finance system by ensuring the safety and soundness of Fannie Mae and Freddie Mac.



2005 PERFORMANCE AND ACCOUNTABILITY REPORT

NOVEMBER 2005



OFHEO

2005 PERFORMANCE AND ACCOUNTABILITY REPORT

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MESSAGE FROM THE ACTING DIRECTOR



I am pleased to present the Performance and Accountability Report for Fiscal Year 2005 for the Office of Federal Housing Enterprise Oversight. This report describes how OFHEO met its performance goals during the fiscal year and contains the audited financial statements for fiscal year 2005. For eight years in a row, OFHEO has received an unqualified opinion from its independent, outside auditor. Except as noted, all the financial and performance information in this report is accurate and complete.

The mission of OFHEO is to ensure that Fannie Mae and Freddie Mac operate in a safe and sound manner and contribute to a stable and financially strong housing market. OFHEO met its performance objectives for the fiscal year 2005.

Fiscal year 2005 was an important year for OFHEO. In October 2004, OFHEO presented testimony to Congress on the results, as of that date, of the special examination of Fannie Mae's accounting and internal controls. These included evidence of pervasive and willful misapplication of Generally Accepted Accounting Principles (GAAP) and documentation of critical operational deficiencies. Subsequently, OFHEO entered into an agreement with Fannie Mae requiring the company to restate prior period financial statements and address other issues raised in the special examination. The special examination will continue into 2006.

OFHEO maintained its focus on compliance by Freddie Mac with the consent order agreed to by its Board of Directors in December 2003. Freddie Mac restated its prior financial statements. OFHEO is now monitoring progress at Freddie Mac in becoming a timely filer of financial information and in addressing internal control issues that were identified in the special examination.

The special examinations of both Enterprises led OFHEO to require each of them to maintain a capital surplus of 30 percent over their minimum capital requirements. This capital cushion provides protection against an adverse impact resulting from unexpected developments that could arise from operational deficiencies discovered at each company. Freddie Mac maintained this 30 percent capital surplus for the first three quarters in FY 2005, and Fannie Mae met the requirement as of September 30, 2005.

OFHEO addresses challenges presented by the accounting and internal control problems at both Enterprises with the firmness and flexibility expected of a safety and soundness regulator. The Office of Chief Accountant and Office of Compliance give OFHEO the capacity to examine issues in more depth. These offices join the Office of Examination and the Office of Capital Supervision to ensure that all relevant information raised in the annual examinations of the Enterprises is fully investigated.

OFHEO supports the efforts currently underway in Congress to create a regulator that has additional authorities and, like other financial safety and soundness regulators, is not subject to the vagaries of the Congressional appropriations process.

OFHEO continues to fulfill its mission. The dedicated men and women of OFHEO will continue to rise to the challenges of regulating these important financial institutions, doing their part to keep the housing finance system of this country strong and able to meet the needs of the American people.


Stephen A. Blumenthal
Acting Director



MANAGEMENT'S DISCUSSION & ANALYSIS

Overview

Fiscal year (FY) 2005 marks the first time that the Office of Federal Housing Enterprise Oversight (OFHEO or the Office) has issued a Performance and Accountability Report (PAR). In prior years, OFHEO issued separate annual performance reports and annual audited financial statements. OFHEO elected to issue a PAR to improve transparency and the public's understanding of how OFHEO operates.

This report provides a three-part summary of OFHEO's operations for FY 2005:

Chapter One, the Management's Discussion and Analysis:

- ▲ *Explains OFHEO's purpose and structure,*
- ▲ *Provides highlights of the year's accomplishments,*
- ▲ *Describes the Office's management challenges,*
- ▲ *Summarizes OFHEO's performance, and*
- ▲ *Presents a financial summary for FY 2005.*

Chapter Two, the Performance Section:

- ▲ *Describes OFHEO's planning process,*
- ▲ *Presents performance information for each goal,*
- ▲ *Provides OFHEO's historical performance for the past three years, and*
- ▲ *Explains how OFHEO achieved its goals.*

Chapter Three, the Financial Section:

- ▲ *Accounts for how OFHEO spent its funds,*
- ▲ *Describes how OFHEO complied with relevant laws and regulations, and utilized proper internal controls, and*
- ▲ *Includes letters from the Office's external auditors.*

About OFHEO

OFHEO 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 13 of P.L. 102-550). The Office is headed by a Director appointed by the President for a five-year term. Pursuant to statute, with the resignation of Director Armando Falcon, Jr. on May 20, 2005, Deputy Director Stephen A. Blumenthal assumed the role of Acting Director.

OFHEO's primary mission is ensuring the capital adequacy and safe and sound operation of two government-sponsored enterprises (GSEs) – the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). Fannie Mae and Freddie Mac are Congressionally-chartered, publicly-owned corporations whose shares are listed on the New York Stock Exchange.

Fannie Mae and Freddie Mac are the nation's largest housing finance institutions. They buy mortgages from commercial banks, thrift institutions, mortgage banks, and other primary lenders, and either hold these mortgages in their own portfolios or package them into mortgage-backed securities for resale to investors. These secondary mortgage market operations play a major role in creating a ready supply of mortgage funds for American homebuyers. Combined assets and off-balance sheet obligations of Fannie Mae and Freddie Mac were more than \$3.96 trillion at the end of 2004.

OFHEO's oversight responsibilities include:

- ▲ *Conducting broad-based examinations of Fannie Mae and Freddie Mac;*
- ▲ *Maintaining a risk-based capital standard, using a "stress test" that simulates interest rate and credit risk scenarios;*
- ▲ *Making quarterly findings of capital adequacy based on a minimum capital standard and a risk-based capital standard;*
- ▲ *Prohibiting excessive executive compensation;*
- ▲ *Issuing regulations concerning capital and other supervisory standards; and*
- ▲ *Taking necessary enforcement actions.*

OFHEO Benefits Citizens

OFHEO helps ensure that Fannie Mae and Freddie Mac are financially strong enough to support our nation's housing markets, which are among the most vibrant in the world.

Fannie Mae and Freddie Mac are chartered by Congress to provide liquidity to the U.S. mortgage market. To do this they buy mortgages from lenders or guarantee mortgages sold to other investors, freeing the lenders to make more loans to households. Together, the Enterprises own or guarantee over one-third of all single-family mortgages. They also help lower interest rates on most single-family mortgages by passing on to borrowers a portion of the government subsidies they receive.

OFHEO's job is to make sure the Enterprises are a source of stability to mortgage markets by examining the Enterprises and assuring that they are financially safe and sound, responsibly managed, and adequately capitalized.

OFHEO's 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's Organizational Structure

OFHEO's operations are structured efficiently to accomplish its mission. Its component offices have specific responsibilities and work together to ensure effective oversight of Fannie Mae and Freddie Mac. Generally, offices with supervision-related responsibilities report to the Deputy Director and offices with infrastructure-related responsibilities report to the Deputy Director through the Executive Director. OFHEO is located at 1700 G Street NW in the District of Columbia.

- ▲ **The Office of Examination** leads annual examinations for each Enterprise under the direction of two Examiners-in-Charge, and with contributions from the Offices of Compliance, the Chief Accountant and Capital Supervision.
- ▲ **The Office of Compliance** leads special examinations that focus on specific compliance, safety and soundness, and accounting-related issues, working with the other supervision offices.
- ▲ **The Office of the Chief Accountant** develops policy on and monitors safety and soundness issues related to accounting and financial reporting at the Enterprises, and supports other OFHEO offices to ensure that accounting policy interpretation and implementation are consistent across OFHEO offices.
- ▲ **The Office of Capital Supervision** focuses on capital adequacy, risk analysis and model development, working closely with all of the supervision-related offices and relying on the support and assistance of the Office of Technology and Information Management.
- ▲ **The Office of Policy Analysis and Research** analyzes the housing finance system and regulatory policies to support the other supervision offices and to advise the Director on policy issues, and reviews executive compensation packages of senior Enterprise management.
- ▲ **The Office of the General Counsel** advises the Director and all OFHEO staff on legal matters related to the functions, activities and operations of OFHEO and the Enterprises.

- ▲ **The Office of External Relations** works with OFHEO’s external stakeholders to ensure effective communication, respond to public and Congressional inquiries and release pertinent information.

To better accomplish its mission, in FY 2005 OFHEO established the Office of the Executive Director with responsibility for OFHEO-wide management and oversight of all administrative matters.

- ▲ **The Office of the Executive Director** coordinates its component offices – with responsibilities that include human capital management, budget and financial management, technology and information management, and strategic planning and management – in support of the supervisory offices that focus on examination, supervision and oversight of the Enterprises.

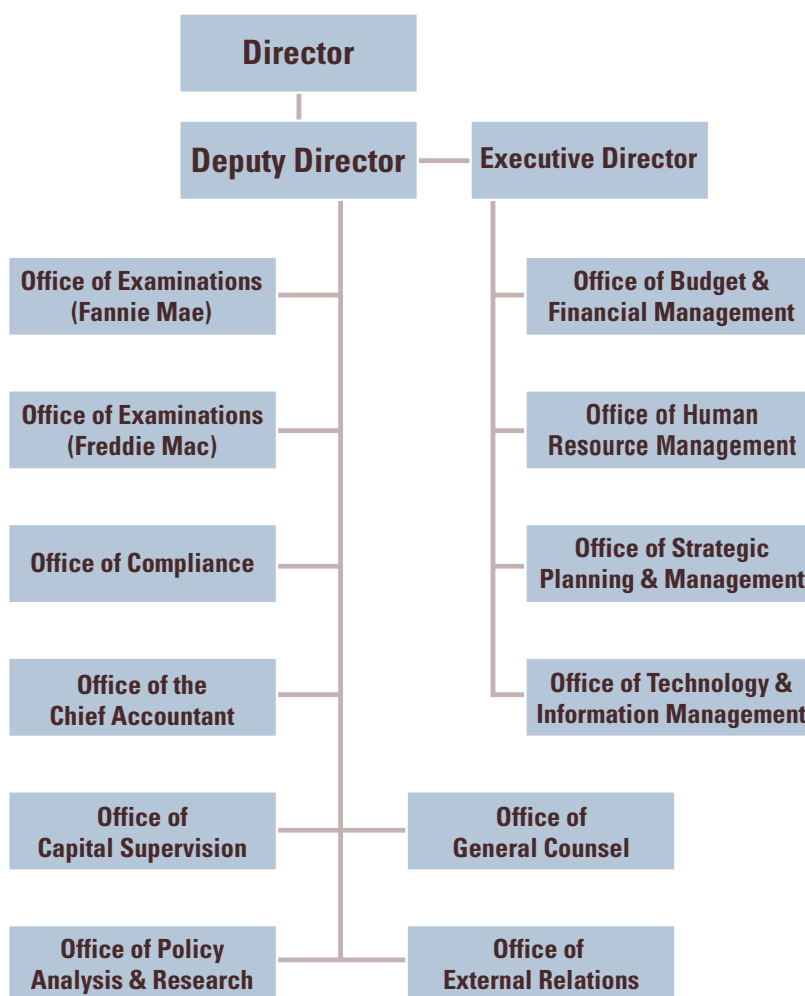


Figure 1 – OFHEO Organizational Chart

Performance Highlights

OFHEO achieved its goals in FY 2005 by focusing on its core mission and paying close attention to progress at the Enterprises to correct significant accounting and internal control weaknesses, many of which were identified in prior years. OFHEO sought corrective action by each Enterprise while continuing oversight of their operations, policies, procedures, and risks. Over the past two years, OFHEO has successfully dealt with major accounting scandals at both Freddie Mac and Fannie Mae, requiring that plans be put in place and implemented to return the companies to reporting timely, certified financial statements to the public.

Fannie Mae Restating Its Results

OFHEO continued its special examination of Fannie Mae in FY 2005, identifying internal control issues and weaknesses in accounting policies and financial reporting. In October 2004, Director Falcon testified to Congress on OFHEO's report of findings-to-date from the special examination, which documented pervasive and willful misapplication of Generally Accepted Accounting Principles (GAAP), as well as critical operational deficiencies. OFHEO entered into two agreements with Fannie Mae to recalculate prior period financial statements, achieve a 30 percent capital surplus by the end of the fiscal year and focus attention on other issues raised by OFHEO's special examination. In December 2004, the Chief Accountant for the SEC issued a statement supporting OFHEO's determination that Fannie Mae did not comply in material respects with specific accounting requirements. In response, Fannie Mae began the intensive process of restating earnings and improving internal controls.

Freddie Mac Makes Progress Toward Restatement

Over the past two years, Freddie Mac has been working to improve the internal controls issues OFHEO identified in its special examination of the Enterprise. In FY 2005, OFHEO examination activities continued to focus on compliance by Freddie Mac with the requirements of the consent order agreed to by the Board of Directors on December 9, 2003, which outlined 29 specific items for remediation. Freddie Mac has made progress improving its internal controls and restating its financial results for prior years. To date, Freddie Mac has restated financial results for 2000, 2001 and 2002, and published its financial results for 2003 and 2004 late. While considerable remediation efforts have been made by the Board and management, significant additional work remains for Freddie Mac to fully implement improvements.

Both Enterprises Required to Hold More Capital

The Enterprises are required to meet certain statutory capital adequacy standards: ratio-based minimum and critical capital levels and a risk-based capital level. Due to the findings of operational inadequacies during the special examinations for both Fannie Mae and Freddie Mac, OFHEO required each Enterprise to hold 30 percent more capital than its minimum requirement in FY 2005. This additional capital provides a cushion to mitigate the potential effects of corrections made during the restatement process and to address operational risks. Freddie Mac has maintained this 30 percent capital surplus for the first three quarters of FY 2005. Fannie Mae was required to achieve the 30 percent capital surplus by September 30, 2005. Data for the last quarter of the fiscal year (the quarter ending September 30, 2005) will be available by December 30, 2005.

Fannie Mae Significantly Undercapitalized for the Quarter Ending December 31, 2004

For the quarter ending December 31, 2004, OFHEO determined that a significant risk existed that accounting adjustments could deplete Fannie Mae's core capital to an amount below the required minimum. OFHEO's concerns were due to the significant control weaknesses and the remaining uncertainties associated with the ongoing review of Fannie Mae's financial controls and accounting policies. OFHEO classified Fannie Mae as significantly undercapitalized for this period and received and approved a Capital Restoration Plan. Fannie Mae brought its capital back up to the required minimum level by the next quarter.

OFHEO Improves Supervisory Structure

On September 1, 2005, Fannie Mae and Freddie Mac entered into formal agreements with OFHEO to establish enforceable commitments, to be overseen by OFHEO, in the areas of subordinated debt, liquidity management and public disclosures. These enforceable commitments replace voluntary commitments that the Enterprises made in 2000. OFHEO also issued final regulations related to corporate governance and mortgage fraud. The corporate governance regulation enhances the disclosures required of the Enterprises and reduces the potential for future corporate misconduct. The mortgage fraud rule requires the Enterprises to report suspected mortgage fraud to OFHEO on a timely basis and to undertake training programs for fraud detection.

OFHEO Facilitates Hurricane Response

OFHEO helps Fannie Mae and Freddie Mac make responsible efforts to assist the mortgage markets through its supervision, examination and oversight of both Enterprises. After the recent hurricanes in the Gulf states, Fannie Mae and Freddie Mac responded to the disaster by offering certain flexibilities to mortgage borrowers. Freddie Mac assumed the risk of delinquent payments for up to 90 days for Hurricane Katrina victims and agreed not to report delinquencies or begin foreclosure proceedings during this time while the hurricane victims struggle to re-establish themselves. Fannie Mae also developed a plan to help its mortgage borrowers, providing up to 90 days forbearance and up to 18 months of partial payments while homeowners are struggling. Fannie Mae has also agreed to work with seller/servicers who are severely impacted by the hurricanes on a case-by-case basis. OFHEO expedited its review of these measures to allow the Enterprises to offer this flexibility promptly, while remaining in compliance with safe and sound operating practices. OFHEO also approved Freddie Mac's decision to provide liquidity to the market by continuing to buy mortgages that were already in the pipeline before Hurricane Katrina, even though the mortgaged properties may have experienced storm damage. OFHEO determined quickly that these purchases were legally permissible and consistent with Freddie Mac's charter. OFHEO is monitoring on an ongoing basis each Enterprise's risk exposure in those regions and other actions the Enterprises take to assist hurricane victims.

Freddie Mac Signs Consent Agreement With OFHEO

On September 12, 2005, OFHEO and Freddie Mac entered into a consent agreement to settle the administrative enforcement action against the Enterprise involving the role of certain former executives in improper accounting practices and failure to maintain internal controls. Freddie Mac previously paid a related \$125 million civil money penalty. As part of the agreement, Freddie Mac will provide increased cooperation with OFHEO in enforcing orders in OFHEO's administrative actions against the former executives. This cooperation also includes obtaining interviews and testimony of present and former employees who might have relevant information and providing OFHEO access to documents the Enterprise has produced in numerous shareholder lawsuits and investigations.

OFHEO Produces House Price Index

OFHEO provides useful information and analysis to the public throughout the year, including the House Price Index (HPI). The HPI has become the pre-eminent government source for data on house price appreciation, a respected and widely-used tool for individual citizens, businesses and government agencies. Originally developed for the risk-based capital stress test, OFHEO releases the quarterly HPI calculations to the public, sharing information and analysis about changes in house prices for cities, states, census divisions and the U.S. (A more in-depth explanation of the HPI can be found in Chapter 2.)

Management Challenges

Over the past two years, OFHEO has successfully dealt with major accounting problems at both Freddie Mac and Fannie Mae, putting in place plans at the Enterprises that will lead to a return of reporting timely, certified financial statements to the public. During this period of intense regulatory activity, OFHEO experienced significant growth in its budgetary resources, and increased its examination and other regulatory staff levels.

Optimizing OFHEO's Focus on Its Regulatory Mission

Over the last few years, OFHEO has faced the challenge of investigating accounting and internal controls problems at the Enterprises. OFHEO has met these challenges with perseverance and innovation. OFHEO established an Office of the Chief Accountant to broaden and improve its expertise in accounting, and created an Office of Compliance to provide the agency with

the institutional capacity to examine specific regulatory issues with greater depth and focus. Upon discovering irregularities at Freddie Mac, OFHEO embarked on an in-depth review of Fannie Mae to see if it had similar difficulties. This special examination required effective leadership, teamwork and more resources, including additional staff with strong supervisory experience in the examination and legal areas.

Looking ahead in the short term, OFHEO continues its work on the Fannie Mae special examination and the ongoing legal work related to the enforcement cases against former Freddie Mac executives. The Office has issued regulations and guidances to avert similar problems in the future. As the Enterprises restate financial results and improve processes and internal controls, OFHEO will examine these changes and results, while continuing to focus on potential risks.

In the longer term, one of OFHEO's challenges is to identify, through continuous risk assessment, high-risk areas that could lead to unsafe conditions. OFHEO must also acquire resources needed to examine the issues thoroughly and to seek remediation where appropriate. OFHEO will continue to improve its risk assessment and examination framework, and to increase the examiners' presence at the Enterprises. To improve examiner efficiency, OFHEO will implement an examiner workstation that will house electronically, in a single database, OFHEO examination work papers and accompanying source documentation. OFHEO's skilled staff continues to be its most valuable resource. In the current competitive environment, another challenge is to attract and retain skilled staff. OFHEO must ensure that staff get the training to keep their skills up-to-date on important regulatory, accounting, legal, and economic developments affecting the Enterprises.

Keeping the Risk-Based and Minimum Capital Standards Current and Effective

OFHEO was the first regulator to develop a capital standard that modeled in detail the risks and exposures in the entire book of business of complex financial institutions like Fannie Mae and Freddie Mac. OFHEO implemented its risk-based capital standard in September 2002, following a lengthy development and regulatory approval process. After 12 quarters of experience applying the risk-based capital stress test to calculate the required capital levels for the Enterprises and analyzing the results, OFHEO is now in a position to reevaluate the effectiveness of the stress test. OFHEO has begun a multi-year project to reevaluate and propose regulatory updates, as necessary, on all aspects of the stress test. Concurrently, OFHEO is reevaluating the minimum capital standard to ensure that it remains an effective measure of capital adequacy as well.

Managing Technology to Maintain Regulatory and Operational Efficiencies

OFHEO uses technology to regulate capital adequacy at the Enterprises and to enhance its regulatory oversight of the Enterprises. OFHEO also relies on technology to ensure the maintenance of an efficient infrastructure that can support achievement of OFHEO's mission. In order to effectively manage its technology investments, OFHEO will create an Investment Review Board to evaluate the need for and effectiveness of all new technology investments and to ensure that the benefits to the Office justify their costs.

Availability of Adequate Resources When Required

OFHEO, unlike any other financial regulator, is required by law to seek its budgetary resources through the appropriations process, even though OFHEO does not receive any taxpayer dollars. This often poses problems at key times in the Office's regulatory operations. The appropriations process is lengthy and inflexible, with budget requests developed two years in advance of implementation. The process does not allow the necessary flexibility to respond to current developments at the Enterprises that may require changes to the budget. The appropriations process can restrict OFHEO's ability to react quickly with the necessary resources for special examinations, enforcement and litigation efforts. When the appropriations bill is not completed prior to the start of the fiscal year, the short-term continuing resolution often cuts funding that impacts OFHEO's budget and key initiatives, and effectively stops momentum on achieving goals. Any disruption or delay in the appropriations process can affect OFHEO's ability to carry out its mission. Other safety and soundness regulators avoid this problem because they are funded directly by their assessments on the regulated entities. Given the size of the Enterprises and their importance to the nation's housing finance system, it is critical that OFHEO have the same funding flexibility as the other financial institution regulators.

Proposed Legislation to Create New Combined Regulatory Agency

Legislation is under consideration by Congress to combine the two regulating agencies of government-sponsored enterprises – OFHEO and the Federal Housing Finance Board (FHFB) – into a single entity with all the powers and responsibilities of other financial regulators. Certain GSE-oversight functions of the Department of Housing and Urban Development also would be transferred to the new entity. Should this legislation be enacted, OFHEO will face policy-related, people-related and systems-related challenges similar to those that confront private companies in mergers. These challenges include the need to merge information technologies and systems, administrative functions and human resources functions to meet the needs of the new entity.

Performance Summary

Strategic Planning at OFHEO

OFHEO uses strategic planning and performance planning to set long-term goals and annual goals, and monitors progress throughout the year to produce results. The second chapter of this report describes in greater detail OFHEO's results and efforts to achieve its 2005 performance goals.

OFHEO has three Strategic Goals:

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

OFHEO set eight performance goals to reach its strategic goals and three performance goals to support its resource management strategy. The FY 2005 Performance Budget outlines the means and strategies to achieve these annual performance goals. As for all regulators, the outcomes or results of the work of OFHEO depend on the actions of the Enterprises and others. The Office provides regulation, supervision, guidance, review and a variety of products that influence the Enterprises and the financial markets. Highlights of the accomplishments for each strategic goal are described below.

OFHEO Achieved Its Performance Goals

OFHEO achieved all of its performance goals in FY 2005. During the year, OFHEO strengthened its supervisory program while addressing the issues identified at both Enterprises through special examinations in previous years, and monitoring progress on remediation plans and agreements at both Enterprises to resolve those issues. OFHEO continued to provide useful information and analysis to the public throughout the year, including the housing finance and investor analyst communities. OFHEO also worked with other Federal agencies on various issues throughout the year. The following table shows selected performance goals for each strategic goal.

**Figure 2 –
Selected Performance Goals
for FY 2005**

Selected Performance Goals for FY 2005	
STRATEGIC GOAL 1 ■ Ensure the Enterprises comply with safety and soundness standards, are adequately capitalized, and comply with other legal requirements.	
GOAL 1.1 Ensure the Enterprises comply with safety and soundness standards.	<ul style="list-style-type: none"> ■ Completed annual examinations. ■ Continued special examinations at both Enterprises. ■ Required Fannie Mae to recalculate its financial results.
GOAL 1.2 Ensure the Enterprises are adequately capitalized.	<ul style="list-style-type: none"> ■ Freddie Mac adequately capitalized for the first three quarters* of the year and maintained a capital surplus 30% over the regulatory minimum capital levels, as required. ■ Fannie Mae significantly undercapitalized for one quarter and adequately capitalized for two other quarters*; achieved a 30% capital surplus by September 30, 2005, as required.
GOAL 1.4 Ensure the Enterprises comply with applicable laws, regulations and directives, including corporate responsibility and disclosure.	<ul style="list-style-type: none"> ■ Issued Corporate Governance regulation. ■ Issued Mortgage Fraud regulation.
STRATEGIC GOAL 2 ■ Enhance public understanding of the nation’s housing finance system.	
GOAL 2.2 Communicate effectively with all stakeholders on regulatory issues.	<ul style="list-style-type: none"> ■ Issued OFHEO’s Annual Report to Congress, describing the findings of the calendar year 2004 examinations of both Enterprises. OFHEO is unique among regulators, as it is required by law to make public its examination findings. ■ Responded to requests for information from the public and Congress within the required timeframe.
STRATEGIC GOAL 3 ■ Contribute to Federal efforts to promote efficient and effective financial markets and homeownership.	
GOAL 3.1 Cooperate with other Federal financial agencies on regulatory issues.	<ul style="list-style-type: none"> ■ Worked with other Federal agencies by responding to their requests for information and participating in task forces and other interagency efforts on regulatory issues.

* Data for the quarter ending September 30, 2005 will be available by December 30, 2005.

Managing OFHEO's Resources

Resource Management Strategy:

- ▲ *Manage OFHEO resources effectively to enable the office to fulfill its mission.*

OFHEO's management philosophy reflects government-wide management goals. OFHEO's focus on human capital management, effective information technology resource management, and strong program controls, including integrating financial systems, form the critical foundation for achieving its strategic goals. OFHEO identified three performance goals as indicative of an effective support infrastructure.

Human Capital Management. During the year, OFHEO shifted its resources to better achieve its goals, including reorganizing staff when necessary and hiring additional staff in critical areas related to supervision and oversight of the Enterprises. In order to maintain a high-caliber workforce, OFHEO staff members and their managers updated their individual development plans. OFHEO also began to develop a Human Capital Strategic Plan that provides a vision and structure for future workforce planning.

Information Technology. OFHEO maintains a five-year strategic plan for information technology. This plan allows the Office to stage and upgrade the information technology that is appropriate for the work planned each year. During FY 2005, OFHEO continued to automate manual processes by enhancing the electronic recruitment tool currently in use and beginning to develop a time and attendance system within the integrated financial management system. OFHEO accomplished all projects planned for FY 2005 in the Information Technology Five-Year Strategic Plan, including letting a contract to develop the examiner workstation.

Internal Controls. OFHEO received an unqualified audit opinion on its FY 2005 financial statements, and its FY 2005 independent review of information security found no significant weaknesses. OFHEO received a positive audit report from the Office of Personnel Management on the Delegated Examining Unit in the Office of Human Resource Management. In its March 2005 report, the HUD Inspector General concluded that OFHEO's compensation, staffing and the skills and expertise of OFHEO staff are comparable to other regulatory agencies. During FY 2005, OFHEO followed up on its commitment to design and conduct an employee time usage study to validate OFHEO managers' estimate of the personal services cost of achieving each strategic goal. OFHEO also used its new financial management system to capture non-personal services by strategic goal. The results of that effort are displayed in this report (see Compliance with Appropriation Mandate in the next section).

Financial Summary

OFHEO's Budget for Fiscal Year 2005

As mandated by the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, OFHEO receives its funding through assessment collections from Fannie Mae and Freddie Mac. Congress sets the appropriated funding level; however, no taxpayer funds are used. Fannie Mae and Freddie Mac bear the full cost of OFHEO operations through an annual assessment based on the annual operating budget as appropriated. Each Enterprise pays a pro rata share of the annual assessment, paid in semi-annual payments, October 1 and April 1. The combined assets and off-balance sheet obligations of each Enterprise determine the pro rata shares. In the event that OFHEO is operating under a continuing resolution, the Enterprises are assessed for operating funds based on the provisions of the continuing resolution.

In FY 2005, OFHEO's appropriation was for \$64.2 million, which included a supplemental appropriation of \$5 million for increased costs of the special examinations of Fannie Mae and Freddie Mac and associated litigation. Including \$0.2 million of prior year unspent obligations recovered, OFHEO had \$64.4 million available for obligations during FY 2005. The budgetary resources for FY 2005 represents a significant increase from the prior year of \$40.1 million, an acknowledgement of the significant events and results of the recent examinations of Fannie Mae and Freddie Mac and the importance of providing adequate resources for supervision of the Enterprises. The funding appropriated to OFHEO is collected from Fannie Mae and Freddie Mac, and deposited in the U.S. Treasury for paying OFHEO expenses. The net cost of OFHEO operations increased in FY 2005 by 15 percent, as reflected in the Statements of Net Cost for the Fiscal Periods Ended September 30, 2005 and 2004. The increase in the authorized funding level for OFHEO represents budget authority. The increase in net cost represents actual expenses paid and year-end accruals booked by OFHEO during the year, plus imputed costs for retirement plans, health benefits and life insurance paid by the Office of Personnel Management for OFHEO.

As reflected in the graph of net cost (Figure 3), the increase between years is primarily due to:

Augmented Workforce. OFHEO significantly increased its workforce in FY 2005, as demonstrated in the graph (Figure 4). Of the 30 percent increase in

full-time equivalent workyears (FTE), the majority of staff added during the year filled examination and regulatory positions to support and strengthen OFHEO's regulatory oversight capabilities. This increase in staff allowed OFHEO to carry out the special examination and litigation efforts throughout the year.

Special Examinations. During FY 2005, OFHEO focused on its special examinations of each Enterprise. OFHEO contracted for accounting consulting services, related legal services and document management services that directly supported the collection, analysis and review of documentation related to the findings of the special examinations.

Litigation Expenses. As OFHEO pursued administrative proceedings against former Freddie Mac officers, the Office needed additional attorneys and contracted for litigation support and expert witnesses required in its case preparation.

Additional Facility Space. As OFHEO's staff grew, additional space was required. In August 2005, OFHEO moved a portion of its workforce to 1750 Pennsylvania Avenue, a nearby building. Prior to moving to this facility, funds were expended to configure the workspaces, purchase and set up computer workstations, office equipment and furniture and install telecommunications. OFHEO leases this facility from a commercial entity.

Examiner Workstation Software. OFHEO contracted for development of an examiner workstation software application designed to assist OFHEO's examiners by providing a systematic methodology for documenting and monitoring the examination process. It will also serve as a retrieval system for critical documents and as an institutional knowledge database.

Figure 3 – OFHEO Net Cost, 2004 - 2005

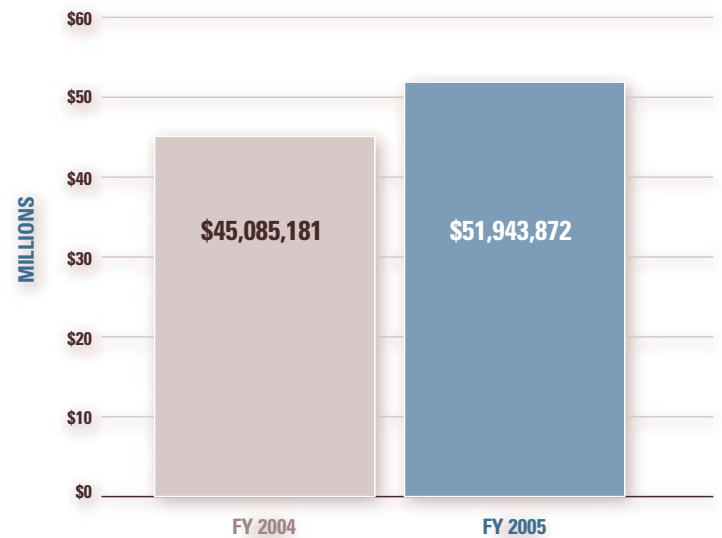
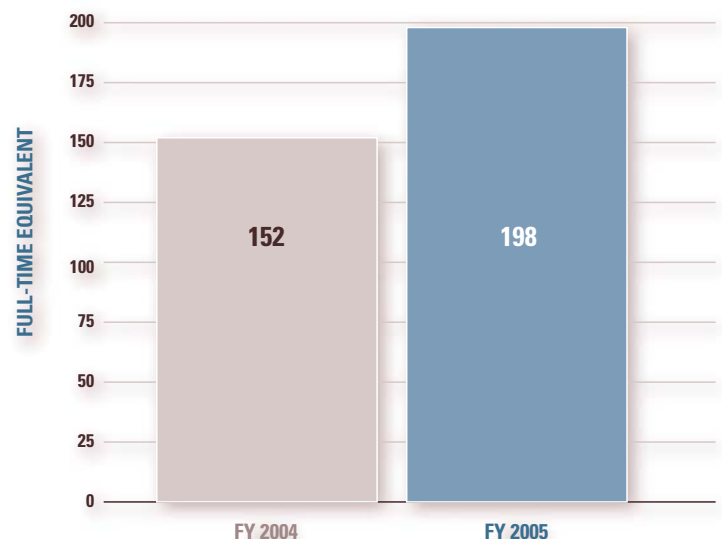
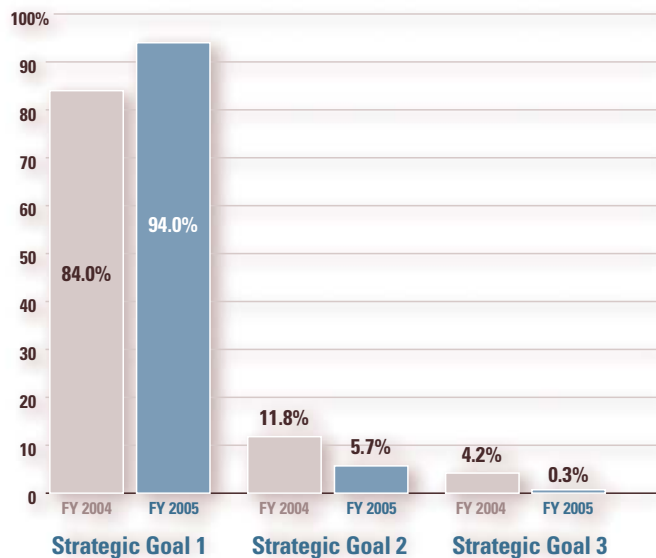


Figure 4 – OFHEO FTE, 2004 - 2005



**Figure 5 –
OFHEO Obligations by
Strategic Goal, 2004 - 2005***



* FY 2004 data are estimates. FY 2005 data are based on actual obligations, using the data captured in the time study and financial management system. (See Managing OFHEO's Resources in the previous section.)

Compliance with Appropriation Mandate

OFHEO is in compliance with language in OFHEO's FY 2005 appropriation that requires "(T)hat not less than 80 percent of total amount made available ... shall be used only for examination, supervision, and capital oversight of the enterprises." OFHEO dedicates the vast majority of its staff and financial resources to achieving its first strategic goal, which focuses on examinations, capital adequacy and compliance. OFHEO captures the allocation of resources through quarterly staff time studies and financial management system data recorded at the transaction level by strategic goal. The graph (Figure 5) demonstrates that OFHEO used 94.0 percent of its available resources toward the examination, supervision and oversight of Fannie Mae and Freddie Mac during FY 2005. OFHEO had a similar appropriations requirement in FY 2004, which it met.

Improvements to Financial Systems and Operations

OFHEO implemented a new core accounting system – the Financial Information and Management System (FIMS) – at the beginning of FY 2005. FIMS is a Joint Financial Management Improvement Program-certified commercial off-the-shelf software that OFHEO has configured to meet its accounting, business processes, reporting, administrative and internal control needs. Some of the system functions that have benefited OFHEO are in-house payment processing, electronic procurement approval, flexible management information and reporting data, such as capturing expenses by strategic goal and user-defined financial analysis. Having ownership of the system allows OFHEO to establish specific internal controls within FIMS, such as segregating duties by restricting access to particular functions.

Unqualified Audit Opinion for FY 2005

For fiscal year 2005, OFHEO again received an unqualified ("clean") audit opinion on its financial statements, which the agency has received continuously since its initial financial statement audit in fiscal year 1998. No material weaknesses were noted in internal controls nor any non-compliance with laws and regulations. OFHEO voluntarily submits to an audit of its financial statements by an independent certified public accounting firm.

Compliance with Laws and Regulations

Federal Managers Financial Integrity Act (FMFIA). During FY 2005, OFHEO's managers continued to monitor internal controls and reported on the effectiveness of controls to the Director. In the internal control compliance letters received by Acting Director Blumenthal from senior management, no reportable material weaknesses were identified. Acting Director Blumenthal will advise the President and the Congress that OFHEO complied with the FMFIA as of the end of September 30, 2005.

Federal Financial Managers Improvement Act (FFMIA). The Federal Financial Managers Improvement Act of 1996 requires that "each agency shall implement and maintain financial management systems that comply substantially with Federal financial management systems requirements, applicable Federal accounting standards, and the United States Government Standard General Ledger at the transaction level."

FIMS, the new core accounting and financial system to which OFHEO converted in FY 2005, meets these standards established by FFMIA. OFHEO also uses the National Finance Center (NFC), a service provider agency within the Department of Agriculture, for its payroll and personnel processing. OFHEO is working with NFC toward electronically interfacing the NFC payroll and personnel system data with FIMS.

Federal Information Security Management Act (FISMA). Title III of the Electronic Government Act of 2002, entitled the Federal Information Security Management Act (FISMA), requires that all Federal agencies develop and implement an agency-wide information security program. The program provides the framework to protect the government's information, operations, and assets. Annually, OFHEO reviews the Office's information security program through an independent contractor and reports the results to the Office of Management and Budget (OMB). The independent review found no material weaknesses for FY 2005. OFHEO's report showed that the Office improved its overall security posture with respect to safeguarding its information assets and systems. Specific recommendations in the report included devoting increased efforts to the management of the information security program and enforcement of associated policies, reviewing separation of duties among the technical staff, implementing a comprehensive monitoring program, and addressing specific technical deficiencies for OFHEO's information systems that were noted during the review.

Erroneous Payments. The Improper Payments Act of 2002 requires that agencies: 1) review activities that are susceptible to significant erroneous payments, 2) estimate amount of annual erroneous payments, 3) implement a plan to reduce erroneous payments, and 4) report the estimated amount of erroneous payments and the progress to reduce them.

The Act defines significant erroneous payments as the greater of 2.5 percent of program activities or \$10 million. OFHEO has no activities that are susceptible to significant erroneous payments. Furthermore, the Office has implemented and continues to maintain internal control procedures that ensure disbursement of Federal funds for services and goods rendered under valid obligations and established through proper requisition and procurement processes.

Prompt Pay. The Prompt Payment Act requires Federal agencies to make timely payments to vendors and improve the cash management practices of the government by taking discounts when they are justified. This means that OFHEO must pay its bills within a narrow window of time – not too early and not late. In FY 2005, the dollar amount subject to prompt payment was \$14.2 million, an increase from \$8.9 million in FY 2004. The amount of interest penalty paid increased from \$875 in FY 2004 to \$4,149 in FY 2005, or less than 0.03 percent of total dollars disbursed that were subject to prompt payment.

Financial Statement Requirements. OFHEO has elected to prepare financial statements and submit those statements for annual audit. The statements have been prepared from the books and records of OFHEO in the format prescribed by OMB, and reflect financial activities that were recorded in compliance with Generally Accepted Accounting Principles for Federal government agencies. These statements supplement the periodic financial reports used to monitor and control budgetary resources that were prepared from the same books and records. The statements should be read with the understanding that they are for a component of the U.S. Government and an entity of the Department of Housing and Urban Development in its consolidated financial statements.

PERFORMANCE SECTION

Overview

OFHEO's 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's three strategic goals support the clear and important mission of the Office. They recognize the critical role that OFHEO plays in ensuring the safe and sound operations of the Enterprises. The goals also recognize 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.

OFHEO's Strategic Goals:

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

Each year, OFHEO develops performance goals that lead to the accomplishment of the strategic goals. OFHEO's performance goals reflect key program areas and challenging yet achievable targets. Each performance goal has at least one corresponding performance measure that may be outcome- or output-based. Performance measures provide an indication of the achievement of the larger performance goal. This hierarchy of goals ensures that OFHEO is constantly working to achieve its mission in practical and measurable ways.

Figure 6 – OFHEO's Goal Hierarchy



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 Budget describes how OFHEO conducts these activities to achieve its goals. 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.

Each quarter during the year, OFHEO managers reported their progress in achieving the OFHEO performance goals and then met with the Director to review status and accomplishments. In most 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 throughout the year to redirect resources in a timely manner to facilitate achieving OFHEO's goals and to address emerging issues, such as the special examinations of Freddie Mac and Fannie Mae and related litigation. Last year, 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 improved its capabilities for reporting and managing budget and performance during the year.

Most of the performance indicators OFHEO reports reflect data and milestones internal to the Office with the key exception of data used as input to the capital calculations. The performance information reported in this Performance and Accountability Report is complete and reliable, with exceptions related to capital classifications (described in the last section of Performance Goal 1.2).

OFHEO did not conduct any program evaluations in FY 2005. However, the HUD Inspector General (IG) issued a report in March 2005 finding that OFHEO's allocation of resources and staffing are comparable to other regulatory agencies. The HUD IG also found that OFHEO staff's education and expertise, and their compensation, was reasonably comparable to other regulators. The Office also received an unqualified audit opinion from an independent, external financial auditor and a clean review on the OFHEO information security program for FY 2005.

Performance Budget

OFHEO dedicates the majority of its resources to achieving its first strategic goal focusing on examinations, supervision and capital oversight. In FY 2005, OFHEO had an appropriation of \$59.2 million, a recovery of \$0.2 million of prior year unspent obligations and a supplemental appropriation of \$5 million. This supplemental appropriation covered additional expenses related to the special examination of Fannie Mae and litigation efforts related to Freddie Mac. OFHEO met its requirement, which was part of the 2005 Appropriations Act, to use at least 80 percent of its resources on examination, supervision and capital oversight (strategic goal 1). The chart (Figure 7) shows the allocation of OFHEO's fiscal resources by strategic goal.

Figure 7 –
OFHEO 2005 Obligations
by Strategic Goal



STRATEGIC GOAL 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 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.

GOAL 1.1 ■ Ensure the Enterprises comply with safety and soundness standards.

Performance Results Key:
Goal Fulfillment

Fully Achieved 




Substantially Achieved 

Not Achieved 


2005 Performance Results

MEASURE 1.1 **Each Enterprise responds appropriately to 100% of OFHEO’s safety and soundness concerns.** 

Prior Year Performance

YEAR	COMMENTS	RESULTS
2005	Both Enterprises met safety and soundness standards, however, OFHEO found inadequate controls and improper accounting at Fannie Mae and took remedial action. OFHEO continued to monitor both Enterprises’ progress in completing remedial actions to address special examination findings. OFHEO continues its review, monitoring and remedial steps into FY 2006.	
2004	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. In FY 2004, OFHEO identified safety and soundness concerns at Fannie Mae and took remedial action.	
2003	Both Enterprises were financially sound, however, OFHEO identified unsafe and unsound practices at Freddie Mac in FY 2003 and undertook remedial actions. OFHEO identified inadequate controls and improper accounting at Fannie Mae in FY 2004 that dated back to 1998.	

Prior Year Performance

YEAR	COMMENTS	RESULTS
2002	Both Enterprises were financially sound, however, OFHEO identified unsafe and unsound practices at Freddie Mac in FY 2003 that dated back to 2000. OFHEO identified inadequate controls and improper accounting at Fannie Mae in FY 2004 that dated back to 1998.	

2005 Performance Discussion

OFHEO completed its calendar year (CY) 2004 annual examination and began its CY 2005 examination of both Enterprises during fiscal year (FY) 2005. The annual examinations encompass examination program areas grouped by category of risk (see sidebar). OFHEO found both Enterprises financially sound for CY 2004, but continued to monitor resolution of the concerns raised in the previous year through the targeted special examinations of both Enterprises. As issues were identified during the year, OFHEO worked with the Enterprises to address them. Results and conclusions from the CY 2004 examination of Fannie Mae and Freddie Mac were detailed in the Report to Congress OFHEO published in June 2005. The report explained the results of the examinations through the CAMELS framework traditionally used by financial regulators to assess key areas of risk: **C**apital adequacy, **A**sset quality, **M**anagement, **E**arnings, **L**iquidity, and **S**ensitivity.

As described more fully under Performance Goal 1.4, OFHEO continued a special examination of the accounting practices and financial reporting control issues at Fannie Mae during FY 2005. Throughout the year, OFHEO monitored progress on the September 2004 agreement with Fannie Mae to improve the Enterprise's accounting procedures, develop a 30 percent capital surplus and make organizational changes that improved internal controls. OFHEO also closely monitored the process that Fannie Mae began at the end of 2004 to restate its financial results from 2001 through 2004, including monitoring progress and reviewing the work of the Enterprise's external auditor. OFHEO and Fannie Mae entered into a supplemental agreement in March 2005 stemming from additional findings from the special examination communicated to the Fannie Mae Board of Directors. The supplemental agreement requires additional improvements in internal controls, corporate governance and accounting systems.

Risk-Based Examination

A crucial element of OFHEO's supervision of Fannie Mae and Freddie Mac is the examination program. OFHEO completes annual, risk-based examinations of each Enterprise, focusing on significant risk areas as determined by the Enterprise's risk profile. While emphasis may differ over time, OFHEO covers fundamental risk areas with every annual exam and reports on the findings in an annual report to Congress in June of every year. These key risk areas include:

Credit

Credit Risk Program – the risk that borrowers and counterparties will fail to meet their contractual or other obligations to the Enterprise.

Market

Interest Rate Risk Program – the risk from movements in interest rates, including changes in: the level of interest rates; the shape of the yield curve; the level of volatility; and the relationships or spreads among various yield curves or indices.

Liquidity Management Program – the risk that could arise from the Enterprise's inability to efficiently meet its obligations as they come due and to transact the next incremental dollar of business cost effectively.

Modelling

Model Exposure Program – the exposure that arises when using computer models and quantitative techniques to select, price and manage risks.

Operations

Information Technology Program – the infrastructure, or the general controls, needed to safeguard data, protect computer application programs, prevent system

Continued, next page

Risk-Based Examination, continued

software from unauthorized access, and ensure continued computer operations in case of unexpected interruptions.

Business Process Controls Program – assesses the process employed to ensure business initiatives and endeavors are considered and evaluated within a complete business context with particular attention directed to risk assessment and risk management framework.

Internal Controls Program – the plan of organization, methods and procedures adopted by management to ensure that: goals and objectives are met; resource use is consistent with laws, regulations and policies; resources are safeguarded against waste, loss and misuse; and reliable data are obtained, maintained and fairly disclosed in reports.

Corporate Governance

Audit Program – the risk that the Board or management’s reliance on internal or external audits is misplaced.

Management Information Program – the risk that management will make decisions based on ineffective, inaccurate or incomplete information or reports.

Management Processes Program – the processes used to drive behaviors to support the Enterprise’s defined corporate goals, standards and risk tolerances.

Board Governance Program – the manner in which the Board discharges its duties and responsibilities.






Financial Reporting – the policies, procedures and practices used for financial recordation and reporting.

Throughout 2005, OFHEO continued to monitor progress on the December 2003 consent order with Freddie Mac and worked to verify safety and soundness controls related to the Enterprise’s remediation plan. Freddie Mac has resolved many of the 29 items specified in the consent order and will continue to address the others throughout 2006. The examination strategies and work plans for the 2005 examinations include continuous review of the accounting practices of both Enterprises and oversight of Enterprise remediation plans into FY 2006.

OFHEO significantly strengthened its supervisory program by increasing its on-site presence at the Enterprises, hiring additional experienced examiners to provide a more in-depth analysis of Enterprise performance, risks, processes and controls. OFHEO also worked to improve examiner efficiency through the ongoing development of an examiner workstation.

GOAL 1.2 ■ Ensure the Enterprises are adequately capitalized.

2005 Performance Results

MEASURE 1.2(1)	Each Enterprise meets the minimum capital standard at least quarterly.	
MEASURE 1.2(2)	Each Enterprise meets the risk-based capital standard at least quarterly.	
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.	
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.	
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.	

Prior Year Performance

YEAR	COMMENTS	RESULTS
2005	<p>Freddie Mac: classified as adequately capitalized each quarter. Fannie Mae: classified as adequately capitalized for two quarters and classified as significantly under-capitalized for the quarter ending December 31, 2004.</p> <p>Quarterly minimum capital classification ratiosⁱ Fannie Mae: 1.015 to 1.199ⁱⁱ Freddie Mac: 1.451 to 1.501ⁱⁱⁱ</p> <p>Quarterly risk-based capital classification ratiosⁱ Fannie Mae: 1.567 to 5.585ⁱⁱ Freddie Mac: 3.123 to 4.674ⁱⁱⁱ</p>	▲
2004	<p>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 1.158ⁱⁱ Freddie Mac: 1.355 to 1.421ⁱⁱⁱ</p> <p>Quarterly risk-based capital classification ratios Fannie Mae: 1.292 to 1.511ⁱ Freddie Mac: 4.894 to 8.575ⁱⁱⁱ</p>	▲
2003	<p>Quarterly minimum capital classification ratios Fannie Mae: 1.032 to 1.052ⁱⁱ Freddie Mac: 1.298 to 1.444</p> <p>Quarterly risk-based capital classification ratios Fannie Mae: 1.204 to 1.831ⁱⁱ 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 Freddie Mac: 4.696</p>	▲

Performance Results Key: Goal Fulfillment

Fully Achieved



Substantially Achieved



Not Achieved



ⁱ The data for the quarter ending September 30, 2005 will be available by December 30, 2005.

ⁱⁱ 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.

ⁱⁱⁱ OFHEO reaffirmed Freddie Mac's capital classification and restated minimum capital results after Freddie Mac published results in May and August 2005.

2005 Performance Discussion

For the first three quarters of FY 2005, Freddie Mac was adequately capitalized; Fannie Mae was adequately capitalized for two quarters in FY 2005, but failed to meet the minimum capital standard for the first quarter of the fiscal year (the quarter ending December 31, 2004), resulting in a classification of significantly undercapitalized for that quarter. Data for the quarter ending September 30, 2005 will be disclosed by December 30, 2005. 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.

In addition to the regulatory capital requirements, each Enterprise is under an agreement to develop and maintain a 30 percent capital surplus each quarter. Due to inadequate controls and improper accounting, OFHEO required Freddie Mac to maintain a 30 percent capital surplus over its minimum capital requirement to address operations risk. OFHEO monitors Freddie Mac's capital on a weekly basis and Freddie Mac continues to meet this surplus target. During FY 2005, after Freddie Mac published its financial results late for 2004 and the first two quarters in 2005, OFHEO reviewed the capital classifications for those periods and determined that Freddie Mac had remained adequately capitalized. OFHEO posted revised minimum capital requirements on its web site.

The Fannie Mae capital classifications during FY 2005 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 a multi-billion dollar estimated cumulative reduction in core capital as of September 30, 2004, which led to Fannie Mae's classification as significantly undercapitalized for the last quarter of FY 2004 and first quarter of FY 2005. Fannie Mae submitted a Capital Restoration Plan to OFHEO at the end of December, replacing a capital plan produced under the September 27, 2004 agreement with the Board of Directors. The September agreement also 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 1.4) and to maintain a minimum capital surplus no lower than its August 30,

2004 level. OFHEO approved Fannie Mae's capital restoration plan in February 2005, granting Fannie Mae until September 30, 2005 to reach the 30 percent target. Fannie Mae achieved its 30 percent target in the required timeframe. Throughout FY 2005, OFHEO has held weekly capital assessment meetings with Fannie Mae to closely monitor the capital position.

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.

For all four quarters of FY 2004, the minimum capital standard was the binding requirement for the Enterprises. For the first three quarters of FY 2005, Freddie Mac held between \$11 billion and \$12 billion more than its minimum requirement, more than necessary to meet the 30 percent surplus requirement to which Freddie Mac is subject. During the first quarter of FY 2005, Fannie Mae was classified as significantly undercapitalized because of an estimated multi-billion capital charge due to accounting errors related to Financial Accounting Standard (FAS) 133 and other accounting rulings. For the quarters ending March 31 and June 30, 2005 Fannie Mae held between \$4 billion and \$5 billion more than its minimum requirement. On November 1, 2005, OFHEO announced that Fannie Mae met its 30 percent surplus requirement for the quarter ending September 30, 2005.

Figure 8 – Freddie Mac Minimum Capitalⁱ

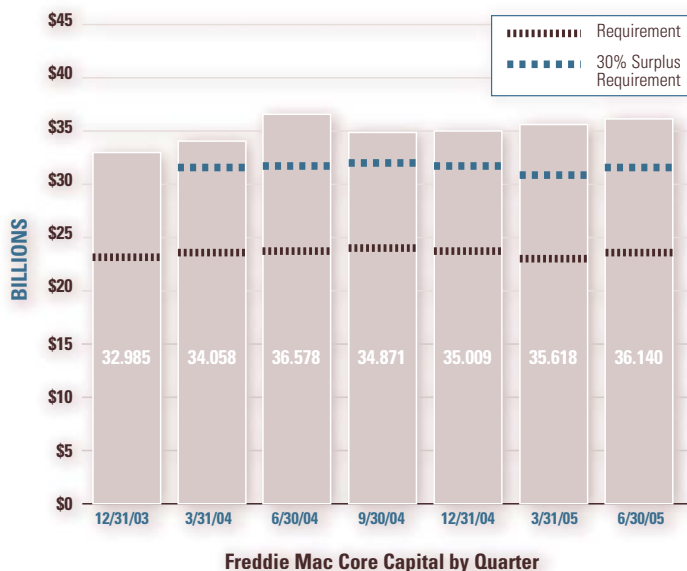
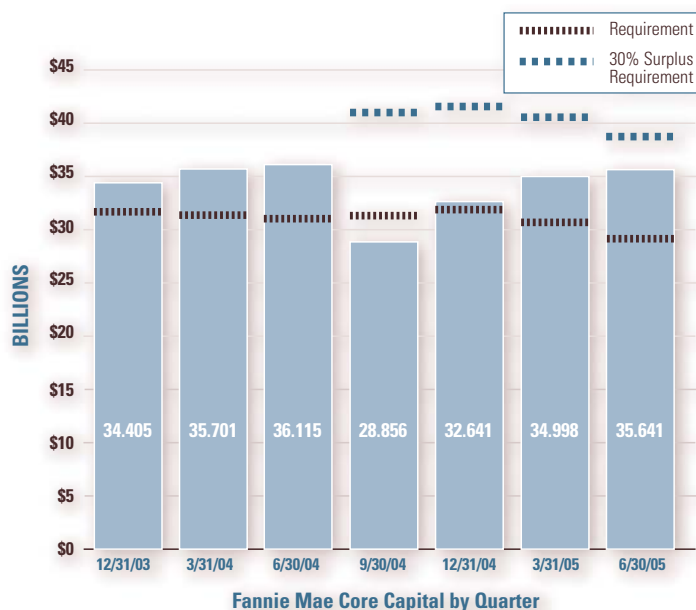


Figure 9 – Fannie Mae Minimum Capital^{i,ii}



ⁱ Data for the quarter ending September 30, 2005 will be available by December 30, 2005.

ⁱⁱ Fannie Mae's capital classifications were based on financial information and the application of accounting policies currently under review by OFHEO and undergoing restatement by Fannie Mae. Fannie Mae was required to reach the 30 percent surplus target by September 30, 2005.

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 \$24 billion and \$28 billion above its risk-based capital requirement. Fannie Mae continued to meet this measure of adequate capital in all three quarters of the year for which data are available, holding between \$13 billion and \$29 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 capital adequacy determinations for the quarter ending in September of 2005 are made in FY 2006.

**Figure 10 –
Enterprise Risk-Based Capital
Requirements, 2005
(Dollars in billions)^{iv}**

Fannie Mae^v

	12/04	3/05	6/05	9/05 ^{vi}
Actual Total Capital	\$35.878	\$35.495	\$36.144	
Required Capital	10.039	6.355	23.061	
Surplus (Deficit)	25.839	29.140	13.083	
Ratio (Actual/Required)	3.574	5.585	1.567	

Freddie Mac

	12/04	3/05	6/05	9/05 ⁱⁱⁱ
Actual Total Capital	\$34.691	\$35.885	\$36.099	
Required Capital	11.108	7.678	11.144	
Surplus (Deficit)	23.582	28.207	24.955	
Ratio (Actual/Required)	3.123	4.674	3.239	

^{iv} Numbers may not add due to rounding

^v Fannie Mae's capital classifications during FY 2005 were based on financial information and the application of accounting policies currently under review by OFHEO and undergoing restatement by Fannie Mae.

^{vi} Data for the quarter ending September 30, 2005 will be available by December 30, 2005.

OFHEO continues to engage in research and analysis related to risk and capital of the Enterprises. 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 directs its research and analysis to these areas to ensure 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. In FY 2005, OFHEO published the risk-based capital treatments for Split-Rate ARM Loans and Pre-refunded Tax-Exempt Municipal Bonds for public notice and comment. OFHEO also published on the web site new versions of the software for the risk-based capital stress test in November 2004 and May 2005.

Completeness and Reliability of Capital Performance Measures

OFHEO relies on data from the Enterprises to determine their capital adequacy. Because this report is issued several months earlier than in prior years, data for the quarter ending September 30, 2005 are not yet available. OFHEO expects to release this information publicly in FY 2006 and include it with the other performance information for 2005 in the OFHEO Performance Budget that accompanies the President's FY 2007 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 for ready identification of data issues, which OFHEO resolves with the Enterprises.

Numerous accounting errors led to substantial understatement of the Freddie Mac core capital numbers in CY 2000, 2001, 2002 and 2003. After Freddie Mac restated financial results for 2000, 2001 and 2002, and published its financial results for 2003, 2004 and the first two quarters of 2005 late, OFHEO reassessed Freddie Mac's capital levels for those periods. OFHEO has determined that the Freddie Mac accounting errors did not substantially affect the risk-based capital outcomes for the Enterprise for the quarters affected.

At this point, both minimum and risk-based capital data for Fannie Mae for 2001, 2002, 2003, 2004 and parts of 2005 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 various Financial Accounting Standards and interpretations, 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 subsequent reclassification.

Going forward, OFHEO will continue to improve the sophistication of its data validation. OFHEO's financial simulation model, used in its risk-based capital regulation, was 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.

GOAL 1.3 ■ Contribute to the supervision and oversight of Enterprise safety and soundness through targeted research and analysis of risks and emerging issues.

Performance Results Key: Goal Fulfillment	
.....	
Fully Achieved	
Substantially Achieved	
Not Achieved	

2005 Performance Results

MEASURE 1.3(1)	Produce and analyze house price trends quarterly through the House Price Index (HPI) report.	
MEASURE 1.3(2)	Meet the Director's priorities for research as identified in the fiscal year 2005 research plan.	
MEASURE 1.3(3)	Prepare special reports on topical issues.	

Prior Year Performance

YEAR	COMMENTS	RESULTS
2005	Research to meet the Director's priorities was completed. Research and analysis of emerging issues have been ongoing and one research paper was published.	
2004	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	Research and analysis of emerging issues have been ongoing. OFHEO made progress on its research agenda.	▲
2002	Research and analysis of emerging issues have been ongoing. OFHEO made progress on its research agenda.	▲

2005 Performance Discussion

In FY 2005, OFHEO targeted its research efforts on the highest priority research projects within the planned research agenda and on vital topics that emerged during the year. 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 2005, may result in published papers or presentations, or may be used in other publicly disseminated information, such as speeches, testimony or reports.



GOAL 1.4 ■ Ensure the Enterprises comply with applicable laws, regulations and directives, including corporate responsibility and disclosure.

2005 Performance Results

MEASURE 1.4 Any identified instances of non-compliance with laws, regulations or directives are resolved to OFHEO's satisfaction. ▲

Prior Year Performance		
YEAR	COMMENTS	RESULTS
2005	Issued corporate governance regulation and mortgage fraud regulation. Issued examination guidance and a Director's Advisory. Reviewed Enterprise compliance with applicable laws, regulations and directives, including corporate responsibility, executive compensation and disclosure requirements. Each Enterprise responded appropriately to issues identified by OFHEO.	▲
2004	Reviewed Enterprise compliance with applicable laws, regulations and directives, including corporate responsibility and disclosure requirements. Each Enterprise responded appropriately to issues identified by OFHEO.	▲

Performance Results Key: Goal Fulfillment	
Fully Achieved	▲
Substantially Achieved	▲
Not Achieved	△

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.	

2005 Performance Discussion

Throughout FY 2005, OFHEO closely monitored the Enterprises' compliance with laws, regulations and directives, including the 2003 Freddie Mac consent order and the agreements made with Fannie Mae in 2004, while continuing the special examinations at each Enterprise. These special examinations include ongoing review of internal controls and management practices to determine the Enterprises' compliance with accounting standards.

During the special examination in FY 2003, OFHEO took specific actions regarding several former executives of Freddie Mac, including freezing compensation packages, imposing a civil money penalty on the former COO, and initiating the process to sanction the former CEO and CFO. In FY 2004, OFHEO also brought enforcement actions to impose civil money penalties, recoup excessive compensation and recoup certain losses from Freddie Mac's former CEO and CFO. Although the effort to freeze compensation was overturned by a U.S. District Court in recent months, the other actions continued through FY 2004 and FY 2005 and one freeze case is currently under appeal. 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, in FY 2004, OFHEO directed Freddie Mac 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. Last year Freddie Mac restated financial results for 2000, 2001 and 2002, and published its financial results for 2003 late. In FY 2005, the Enterprise published late financial results for 2004 and the first two quarters of 2005. Also in 2005, OFHEO entered into an agreement settling charges against Freddie Mac in which the Enterprise agreed to cooperate in the continuing case against its former officers and to enforce any order that may arise from that case.

During FY 2005, OFHEO continued to review Fannie Mae's accounting

policy, internal controls, financial reporting processes and other areas through the special examination still in progress. Last year, OFHEO issued a report of findings-to-date from the special examination and in September 2004 entered into an agreement with Fannie Mae to take corrective action. After OFHEO determined in December 2004 that Fannie Mae was significantly undercapitalized as of September 30, 2004, OFHEO required Fannie Mae to submit a Capital Restoration Plan, which OFHEO approved in February 2005. OFHEO also identified additional issues related to financial reporting, leading to a supplemental agreement on March 7, 2005 between OFHEO and Fannie Mae, in which the Enterprise agreed to address deficiencies in internal controls, corporate governance and accounting systems.

While OFHEO's special examination continued, Fannie Mae began to implement corrective measures outlined in the September 2004 and subsequent agreements to address the improper accounting and inadequate controls detailed in the report of findings-to-date issued last year, including:

- ▲ implementing accounting treatments to bring the Enterprise into compliance with Financial Accounting Standards 91 and 133,
- ▲ maintaining and increasing the existing capital surplus to 30 percent of its required minimum capital,
- ▲ appointing an independent Chief Risk Officer,
- ▲ separating other key business functions currently performed jointly by certain individuals and departments,
- ▲ implementing policies to assure adherence to accounting rules and internal controls, and
- ▲ undertaking a top-to-bottom review of staff structure, responsibilities, independence of functions, compensation and incentives.

In FY 2005, Fannie Mae appointed an interim Chief Risk Officer and met the 30 percent capital surplus target for the quarter ending September 30, 2005. OFHEO continued throughout the year to monitor Fannie Mae's progress on implementing these corrective measures through its annual examination and supervision efforts. OFHEO also continued to actively monitor Fannie Mae's compliance with the Capital Restoration Plan. As required under the capital restoration plan, OFHEO granted approval for specific compensation and awards for executive officers at Fannie Mae.

During FY 2005, as OFHEO worked to ensure compliance at the Enterprises, the Office also strengthened its supervision program.

Throughout the year, OFHEO reviewed executive termination agreements, employment agreements and revisions to them at both Enterprises. OFHEO issued a new corporate governance regulation and related Examination Guidance, which enhance the disclosures required of the Enterprises and reduce the potential for future corporate misconduct by separating the CEO and Chairman of the Board positions at the Enterprises, establishing term and age limits for the Board of Directors, requiring audit partner rotation every five years and auditor rotation every ten years, and setting other standards and requirements for the conduct and operations of the management and Boards of the Enterprises. The regulation requires certification of financial disclosures by the CEO and CFO, and requires the Enterprises to meet the Sarbanes-Oxley corporate standards even if they have not registered with the SEC.

Also in FY 2005, OFHEO published a mortgage fraud rule that requires the Enterprises to report suspected mortgage fraud to OFHEO and to create training programs and operating systems necessary for reporting. OFHEO issued a Director’s Advisory that sets forth procedures for the Enterprises to use in reporting mortgage fraud. OFHEO has also issued a Director’s Advisory requiring the Enterprises to notify OFHEO of investigations, legal proceedings or civil or criminal actions by any governmental authority or private party in a timely manner so that OFHEO may exercise its oversight responsibilities and its supervisory role should changes in operation be merited by litigation.

GOAL 1.5 ■ 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 Results Key:
Goal Fulfillment

Fully Achieved 



Substantially Achieved 

Not Achieved 

2005 Performance Results

MEASURE 1.5 **Review and consider requiring the Enterprises to enhance their disclosure of information regarding the results of their operations, financial conditions and business developments.** 

Prior Year Performance

YEAR	COMMENTS	RESULTS
2005	Accounting irregularities at both Enterprises in process of resolution to OFHEO’s satisfaction.	
2004	Accounting irregularities at both Enterprises in process of resolution to OFHEO’s satisfaction.	

2003	<p>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.</p>	▲
2002	<p>Drafted proposed disclosure regulation.</p> <p>Participated in joint staff review with the Securities and Exchange Commission and the Treasury Department on disclosure related to Mortgage-Backed Securities.</p>	▲

2005 Performance Discussion

During FY 2005, OFHEO worked with both Enterprises to assure the quality of their disclosures under applicable standards. As part of the larger restatement effort, in 2005, Freddie Mac published its financial results for 2004 and the first two quarters of 2005 late. Freddie Mac had previously restated its financial results for 2000, 2001 and 2002, and published late financial results for 2003, correcting accounting irregularities that artificially smoothed earnings. OFHEO continues to monitor Freddie Mac’s progress on its remediation plan, including its capital position.

Based on OFHEO’s findings-to-date in its special examination, and the Securities and Exchange Commission determination that Fannie Mae was not in compliance with Generally Accepted Accounting Principles (GAAP) for FAS 133 and 91, Fannie Mae hired outside auditors to restate its earnings for 2000 through 2005. OFHEO continued to review and monitor Fannie Mae’s restatement efforts as well as the steps Fannie Mae agreed in March 2005 to take to enhance accounting internal controls and make other improvements to ensure its disclosures are GAAP-compliant.

During 2005, OFHEO made significant efforts to improve Enterprise disclosures. OFHEO issued a new corporate governance regulation in 2005 that enhances the disclosures required of the Enterprises and requires certification by the CEO and CFO of financial disclosures. The corporate governance regulation also requires the Enterprises to meet the Sarbanes-Oxley standards on disclosure even if they have not registered with the SEC. OFHEO also issued a mortgage fraud regulation that requires enhanced reporting of suspected mortgage fraud by the Enterprises. OFHEO began work with the Enterprises to develop a reporting system for possible mortgage fraud and a reporting system for lawsuits or investigations brought against either Fannie Mae or Freddie Mac.

In September 2005, OFHEO reached agreements with both Fannie Mae and Freddie Mac regarding disclosures and subordinated debt. The

agreements replaced voluntary commitments made by the Enterprises in October 2000 and commit them to submitting to OFHEO issuance plans for subordinated debt every six months and maintaining a specific ratio of subordinated debt to assets. OFHEO will oversee the Enterprises' liquidity positions and contingency planning. OFHEO will also review Enterprise public disclosures of subordinated debt, liquidity management, interest rate risk, credit risk and risk ratings by nationally-recognized rating agencies.

STRATEGIC GOAL 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 lead to more informed decision-making.

GOAL 2.1 ■ Enhance awareness and understanding of housing and mortgage market developments and Enterprise risks and activities through published research and analysis of risks and emerging issues.

Performance Results Key: Goal Fulfillment	
.....	
Fully Achieved	
Substantially Achieved	
Not Achieved	

2005 Performance Results

MEASURE 2.1(1)	Report about house price trends quarterly through the House Price Index (HPI) report.	
MEASURE 2.1(2)	Publish priority research and working papers as identified in the FY 2005 research plan.	
MEASURE 2.1(3)	Publish special reports on topical issues as appropriate.	

Prior Year Performance

YEAR	COMMENTS	RESULTS
2005	HPI Report issued quarterly. One research paper published as planned.	▲
2004	HPI Report issued quarterly 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	HPI Report issued quarterly. Several projects on the FY 2003 research agenda were completed. Others were delayed or deferred.	▲
2002	HPI Report issued quarterly Several projects on the FY 2002 research agenda were completed. Others were delayed or deferred.	▲

2005 Performance Discussion

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. In October 2004, OFHEO published a separate report on the secondary mortgage market, "Mortgage Markets and the Enterprises in 2003" and in September 2005 published "Mortgage Markets and the Enterprises in 2004." OFHEO also issued the maximum 2005 conforming loan limit for single family mortgage purchases by Fannie Mae and Freddie Mac, \$359,650, in November 2004. The conforming loan limit establishes a ceiling on the size of loans an Enterprise may purchase or guarantee. Last year, OFHEO established a regulatory process for annual adjustments to the conforming loan limit in response to an error in the Enterprises' determination of the limit.

OFHEO publishes the House Price Index (HPI) quarterly, just two months after the quarter end. It documents changes in home prices for the nation, each state, most Metropolitan Statistical Areas (MSAs), and the nine census divisions. OFHEO has used the HPI to provide pertinent and timely information to the public on the cyclical status of housing prices. In FY 2005, OFHEO enhanced the HPI to include additional

House Price Index

As part of its strategic goals, OFHEO aims to enhance the public's understanding of the nation's housing finance system and to promote efficient financial markets. OFHEO's House Price Index (HPI) is one of the primary tools that it uses to satisfy these goals. The index, which is provided two months after the close of each fiscal quarter, provides a measurement of changes in house prices at the national level, as well as for census divisions, states, and several hundred metropolitan statistical areas (MSAs). The HPI data are accompanied by a press release, an extensive discussion of the underlying methodologies and data, and a "Highlights" section describing interesting trends or data anomalies. The report and the index data are provided to the public in hardcopy form and are also available on OFHEO's web site.

The index is a commonly cited barometer of housing market conditions and is used by the public in a variety of ways. Academic and industry researchers use the index to understand the magnitude and sources of trends in housing markets in specific parts of the country. The finance industry uses the index to measure changes in the value of loan collateral and to attempt to predict mortgage default rates. Homeowners can use the index to estimate changes in the value of their homes or keep abreast of price trends in other areas of the country. After every quarterly HPI update, OFHEO fields a multitude of inquiries, some from consumers about these and many other applications of the data.

The HPI results for the quarter ending June 30, 2005 provide a glimpse at the richness and relevance of the data provided to the public. The release revealed that house prices grew at an exceptionally quick pace during the second quarter of this year. National prices grew approximately 3.2 percent during the quarter and were up 13.4 percent relative to the same quarter in 2004. Four-quarter appreciation rates in seven states and the District of Columbia exceeded 20 percent, an exceptionally quick rate given the underlying level of basic (non-housing) inflation. The data also revealed that price appreciation was beginning to accelerate in some states that had not yet experienced particularly impressive price increases. Appreciation rates in Mississippi, Texas, Oklahoma, and Utah, for example, saw significant increases relative to recent quarters.

In response to a number of recent inquiries, the latest HPI release also includes a short analysis of house price levels in California as revealed in the OFHEO data. The analysis indicates that, despite the fact that OFHEO's price data come from mortgages that fall below the conforming loan limit, the price trends shown in the index are computed using data from a large number of relatively expensive homes. The analysis thus allays some concerns about the relevance of the trends shown in the index, suggesting that consumers can rely on the OFHEO HPI as a valuable measure of price trends even in MSAs in high-priced states like California.

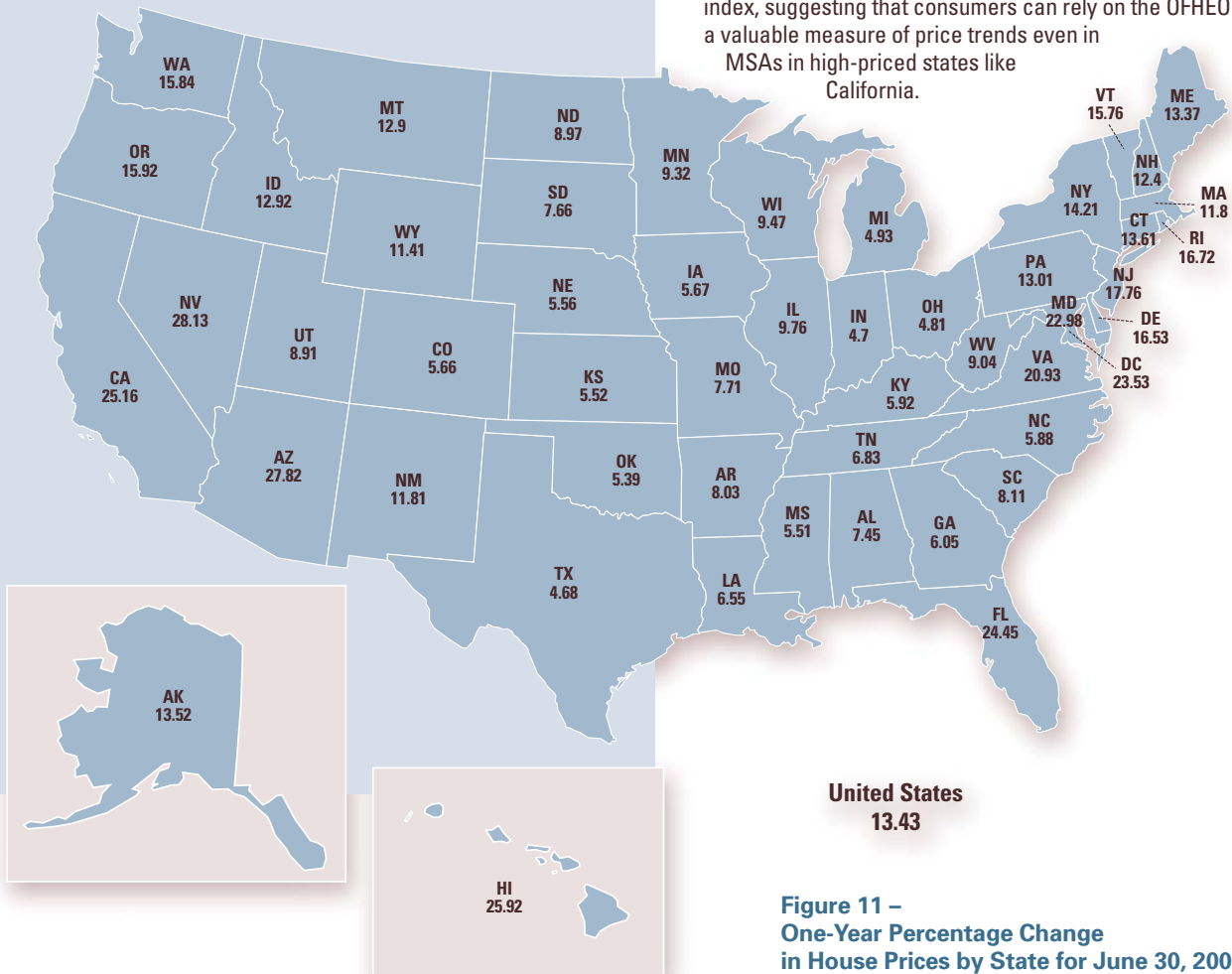


Figure 11 – One-Year Percentage Change in House Prices by State for June 30, 2005

MSAs, reported results from purchase-only transactions, and provided additional analysis of specific areas and trends. The HPI report for each quarter is on the OFHEO web site.

In November 2004 and May 2005, OFHEO also released public versions of the software used to run the risk-based capital stress test along with a stylized data set to use in the model. By running this “hypothetical firm” through the stress test model, members of the public can better understand the sensitivities and implications of the stress test.

While much of OFHEO’s research and analysis includes projects for internal purposes only, all OFHEO reports and staff working papers that can be made available to the public are posted on the OFHEO web site. In FY 2005, OFHEO published on its web site a research paper entitled “Single Family Mortgages Originated and Outstanding, 1990 - 2004.” This paper presents statistics for single family mortgages originated and outstanding by loan type for calendar years 1990 – 2004. Reports and working papers are authored by OFHEO economists and analysts. The views in OFHEO working 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.

GOAL 2.2 ■ Communicate effectively with all stakeholders on regulatory issues.

2005 Performance Results

MEASURE 2.2(1)	The majority of survey respondents attending OFHEO’s symposium find it valuable.	
MEASURE 2.2(2)	Report on OFHEO activities, examination results and conclusions, and the secondary mortgage market in the OFHEO annual Report to Congress.	
MEASURE 2.2(3)	Consider and respond appropriately to all Congressional inquiries within 14 days.	
MEASURE 2.2(4)	Consider and respond appropriately to all public inquiries within 21 days.	

Performance Results Key:
Goal Fulfillment

Fully Achieved



Substantially Achieved



Not Achieved






Prior Year Performance

YEAR	COMMENTS	RESULTS
2005	Annual Report sent to Congress on June 15, 2005. Issued secondary mortgage market report for both 2003 and 2004	
	Responded to all inquiries from Congress within 14 days and responded to all public inquiries within 21 days.	

Performance Results Key:
Goal Fulfillment

Fully Achieved	
Substantially Achieved	
Not Achieved	

2004	Annual Report sent to Congress on June 15, 2004. No report issued in FY2004 on the secondary mortgage market.	
	Responded to all inquiries from Congress within 14 days and responded to all public inquiries within 21 days.	
2003	Annual Report sent to Congress June 4, 2003. No report issued in FY2003 on the secondary mortgage market.	
	Responded to nearly all inquiries from Congress and the public within 7 days.	
2002	Annual Report sent to Congress June 15, 2002. Secondary mortgage market report published in September 2002, one quarter later than scheduled.	
	Responded to all inquiries from Congress and the public within 7 days.	

2005 Performance Discussion

OFHEO published the annual Report to Congress on June 15th, describing the results and conclusions of the OFHEO CY 2004 examinations of the Enterprises and some of the regulatory activities of the Office. The report explained the results of the examinations through the CAMELS framework traditionally used by other financial regulators, through which risks are described through **C**apital adequacy, **A**sset quality, **M**anagement, **E**arnings, **L**iquidity, and **S**ensitivity. 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.

While OFHEO originally planned a symposium open to those in the housing finance community during FY 2005, the Office instead devoted those resources to enhanced monitoring and examination of Fannie Mae and the litigation efforts related to Freddie Mac’s special examination. However, OFHEO continued to respond effectively to inquiries from the Congress and the public, resolving all inquiries within the target time frames despite the continued high volume due to regulatory events and enhancements to OFHEO’s House Price Index. 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 2005, OFHEO issued public statements on an agreement with both Enterprises regarding

subordinated debt, the Freddie Mac consent order, the maximum conforming loan limit, directives to the Enterprises and quarterly capital classifications throughout the year. In addition, the General Counsel testified before the House Subcommittee on Oversight and Investigations and the Director of OFHEO testified before the House Financial Services Capital Markets Subcommittee and the Senate Banking Committee.

STRATEGIC GOAL 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 works 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.


GOAL 3.1 ■ Cooperate with other Federal financial agencies on regulatory issues.


2005 Performance Results

MEASURE 3.1(1)	Participate in on-going task forces and forums with other regulatory agencies.	
MEASURE 3.1(2)	Respond within 30 days to requests from other Federal agencies for information about housing finance markets and the Enterprises.	

Performance Results Key:
Goal Fulfillment

Fully Achieved 

Substantially Achieved 

Not Achieved 

Performance Results Key:
Goal Fulfillment

Fully Achieved 

Substantially Achieved 

Not Achieved 

Prior Year Performance		
YEAR	COMMENTS	RESULTS
2005	Worked with other Federal agencies on various issues, participated in interagency task forces and responded to Federal agencies' requests for information within the timeframe.	
2004	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.	

2005 Performance Discussion

OFHEO continued to work with other Federal agencies by responding to their requests for information and participating in task forces and other interagency efforts on regulatory issues. During FY 2005, OFHEO worked with:

- ▲ *the Federal Reserve Board,*
- ▲ *other Federal bank regulators,*
- ▲ *the Securities and Exchange Commission,*
- ▲ *the Department of the Treasury,*
- ▲ *the Public Company Accounting Oversight Board,*
- ▲ *the Internal Revenue Service,*
- ▲ *the Department of State,*
- ▲ *the Farm Credit Administration,*
- ▲ *the Office of Management and Budget,*
- ▲ *the Department of Justice,*
- ▲ *the Government Accountability Office,*
- ▲ *the Congressional Research Service, and*
- ▲ *the Department of Housing and Urban Development*

OFHEO worked with these Federal agencies on a variety of issues including: the Fannie Mae restatement and issues related to the Freddie Mac and Fannie Mae special examinations; OFHEO's House Price Index; accounting policy; executive compensation; fair lending; Enterprise market share; corporate and mortgage-backed securities disclosure; 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 Working Group on Financial Markets. OFHEO is also a member of the President's Task Force on Corporate Fraud and the Interagency Task Force on Fair Lending.

RESOURCE MANAGEMENT STRATEGY:

Manage OFHEO resources effectively to enable the Office to fulfill its mission.

The success of OFHEO in achieving the strategic goals 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 ensures 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. A lean organization, OFHEO has grown considerably over the last two years, but still relies on private sector services and products wherever practicable. The OFHEO procurement processes are increasingly electronic and reliant on performance-based contracting. OFHEO continues to automate manual processes – in FY 2005, OFHEO enhanced the electronic recruitment tool currently in use and began developing a time and attendance system within the integrated financial management system.

GOAL 4.1 ■ Ensure the staff have the knowledge and skills to fulfill the goals of the agency.




Performance Results Key:
Goal Fulfillment

Fully Achieved	
Substantially Achieved	
Not Achieved	

2005 Performance Results

MEASURE 4.1 **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.** 

Prior Year Performance

YEAR	COMMENTS	RESULTS
2005	Completed annual revision of individual development plans for all staff members. Training and development ongoing.	
2004	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. (No related performance goal.)	

2005 Performance Discussion

During the year, OFHEO shifted its resources to achieve its goals, including reorganizing staff when necessary and hiring additional staff in critical areas. OFHEO began to develop a Human Capital Strategic Plan that provides a vision and structure for future workforce planning.

OFHEO maintains a strong commitment to recruiting and retaining a high-caliber workforce and ensuring that the staff have 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 178 staff on board as of September 2004 to 215 as of September 2005, an increase of 21 percent. During FY 2005, 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.

GOAL 4.2 ■ Provide effective information resources management services to OFHEO managers and staff.

2005 Performance Results

MEASURE 4.2 **Implement the fiscal year 2005 component of the OFHEO 5-Year IT Strategic Plan.** ▲

Prior Year Performance		
YEAR	COMMENTS	RESULTS
2005	Implemented all three projects outlined in the FY 2005 Component of 5-Year IT Strategic Plan.	▲
2004	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. (No related performance goal.)	

Performance Results Key: Goal Fulfillment

Fully Achieved ▲

Substantially Achieved ▲

Not Achieved ▲

2005 Performance Discussion

OFHEO maintains a five-year Information Technology Strategic Plan. This plan allows the Office to stage and upgrade the information technology that is appropriate for the work planned each year. The OFHEO five-year strategic plan for information technology outlines specific improvements or activities for each year of the plan that will be completed. In the FY 2005 component of the plan, three elements were planned and all three were completed before the end of the fiscal year, including specific milestones on the development of an examiner workstation.

GOAL 4.3 ■ Maintain a strong internal control and risk management program.


2005 Performance Results

Performance Results Key:
Goal Fulfillment

Fully Achieved 

Substantially Achieved 

Not Achieved 

MEASURE	RESULTS
4.3	No material weakness identified by OFHEO's external auditor or external review. 
Prior Year Performance	
YEAR	COMMENTS
RESULTS	
2005	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 found OFHEO's allocation of resources, staffing and compensation was comparable to other regulators.
2004	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 found OFHEO exceeded the requirements of the 2004 Appropriations Act to use no less than 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. (No related performance goal.)

2005 Performance Discussion

During FY 2005, external auditors conducted a complete financial audit and issued a clean audit opinion finding no material weaknesses for OFHEO for FY 2004. OFHEO also received a clean audit opinion for FY 2005. OFHEO received a clean opinion from an independent review of the information security program with no significant weaknesses.

In FY 2005, OFHEO addressed the recommendations made by the HUD Inspector General in its FY 2004 review for compliance with a provision of the 2004 VA/HUD Appropriations Act. While the HUD IG concluded that OFHEO was in compliance with the provision, it recommended that OFHEO validate its estimates of actual expenses by strategic goal. During FY 2005, OFHEO implemented a quarterly time study that surveys every employee about the time they spent working on projects and activities to achieve each strategic goal. OFHEO developed specific guidance to match activities, projects, work products and expenses directly to the appropriate strategic goal. The time study, in conjunction with the new guidance and its implementation in OFHEO's integrated financial management system, allows OFHEO to produce more accurate reports of actual obligations and expenses by goal.

The HUD IG also issued a report in March 2005 that found that OFHEO's allocation of resources and staffing are comparable to other regulatory agencies. The IG also found that OFHEO staff's education and expertise, and their compensation, was reasonably comparable to other regulators.

The Office of Personnel Management (OPM) issued its final report in FY 2005 of an audit conducted in FY 2004 of the OFHEO delegated examining unit, which grants OFHEO authority to hire non-status employees. OPM found that the OFHEO delegated examining staff adhered to the requirements of the delegation from OPM and provided a high quality work product that supports mission accomplishment.

FINANCIAL SECTION

MESSAGE FROM THE CHIEF FINANCIAL OFFICER



I am pleased to report that OFHEO has received an unqualified audit opinion on its financial statements for FY 2005. This marks the eighth straight year OFHEO has received a clean audit opinion, dating back to FY 1998, when OFHEO first chose to have its financial statements audited by external auditors. This record of financial management accomplishments puts OFHEO among the best in the Federal Government at managing its resources and complying with Federal regulations and GAAP accounting standards.

This year's accomplishment is especially meaningful, as it is the first year OFHEO has operated with its own accounting system. In FY 2004, OFHEO integrated its administrative processes with the development of its new core accounting system to take a giant step forward in meeting Federal requirements. Prior to conversion to the new system in October 2005, OFHEO used a variety of administrative systems including financial systems of other Federal agencies. None of these systems were linked, requiring duplicative data entry and making tracking and control time-consuming and labor intensive. OFHEO met its goal of implementing the new system at the start of FY 2005.

I am also delighted to report that OFHEO has no open audit findings, and no material internal control weaknesses have been identified. During FY 2005, OFHEO resolved an audit recommendation of the HUD OIG pertaining to the validation of our estimated resource distribution among strategic objectives. OFHEO conducted a time usage study which showed that actual personnel costs closely tracked our estimates and the HUD OIG closed its audit recommendation.

These impressive results could not have been achieved without the dedication and hard work of OFHEO's financial management staff and the collaborative efforts of staff throughout the agency in adhering to OFHEO policies and controls. OFHEO management are especially cognizant of the importance of maintaining effective programs of internal control and the need to validate the effectiveness of these controls, including financial system controls, at least annually.

I am confident that OFHEO has established an infrastructure and supporting environment to efficiently and effectively manage its resources for years to come.

Sincerely,

A handwritten signature in blue ink that reads "Mark Kinsey". The signature is stylized and fluid, with the first and last names clearly legible.

Mark Kinsey
Chief Financial Officer



Dembo, Jones, Healy, Pennington & Marshall, P.C.

Certified Public Accountants and Consultants

**Independent Auditors' Opinion
on the Financial Statements**

Mr. Stephen A. Blumenthal
Acting Director
Office of Federal Housing Enterprise Oversight

We have audited the accompanying balance sheets of the Office of Federal Housing Enterprise Oversight (OFHEO) as of September 30, 2005 and 2004, and the related statements of net cost, changes in net position, budgetary resources, financing, and custodial activity for the fiscal years then ended. These financial statements are the responsibility of OFHEO's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 01-02, "Audit Requirements for Federal Financial Statements." These standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Office of Federal Housing Enterprise Oversight as of September 30, 2005 and 2004, and its net costs; changes in net position; budgetary resources; financing; and custodial activities for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The Management Discussion and Analysis (MD&A) and the Required Supplemental Information (RSI) sections are not required parts of the basic financial statements of the Office of Federal Housing Enterprise Oversight but are supplementary information required by the Federal Accounting Standards Advisory Board and OMB Circular A-136, "Financial Reporting Requirements". We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the MD&A and the RSI. However, we did not audit the information and, accordingly, express no opinion on it.

In accordance with *Governmental Auditing Standards*, we have also issued a report dated October 28, 2005, on our consideration of the Office of Federal Housing Enterprise Oversight's internal control over financial reporting and a report dated October 28, 2005 on its compliance with certain provisions of laws and regulations. These reports are an integral part of an audit performed in accordance with *Government Auditing Standards*, and, in considering the results of the audits, these reports should be read in conjunction with this report.

While this report is intended solely for the information and use of the management of the Office of Federal Housing Enterprise Oversight, OMB and Congress, it is also a matter of public record, and its distribution is, therefore, not restricted.

Dembo, Jones, Healy, Pennington & Marshall, P.C.

October 28, 2005

6010 Executive Boulevard • Suite 900 • Rockville, Maryland 20852
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MEMBER: AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS



Dembo, Jones, Healy, Pennington & Marshall, P.C.

Certified Public Accountants and Consultants

**Report of Independent Auditors
on Internal Control**

Mr. Stephen A. Blumenthal
Acting Director
Office of Federal Housing Enterprise Oversight

We have audited the accompanying balance sheets of the Office of Federal Housing Enterprise Oversight (OFHEO) as of September 30, 2005 and 2004, and the related statements of net cost, changes in net position, budgetary resources, financing, and custodial activity for the fiscal years then ended, and have issued our report thereon dated October 28, 2005. We conducted our audits in accordance with: auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 01-02, "Audit Requirements for Federal Financial Statements."

In planning and performing our audits, we considered the Office of Federal Housing Enterprise Oversight's internal control over financial reporting by obtaining an understanding of OFHEO's internal control, determined whether internal controls had been placed in operation, assessed control risk, and performed tests of controls in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements. We limited our internal control testing to those controls necessary to achieve the objectives described in OMB Bulletin No. 01-02. We did not test all internal controls relevant to operating objectives as broadly defined by the Federal Managers' Financial Integrity Act of 1982, such as those controls relevant to ensuring efficient operations. The objective of our audits was not to provide assurance on internal control. Consequently, we do not provide an opinion on internal control.

Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be reportable conditions. Under standards issued by the American Institute of Certified Public Accountants, reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of the internal control that, in our judgment, could adversely affect the OFHEO's ability to record, process, summarize, and report financial data consistent with the assertions by management in the financial statements. Material weaknesses are reportable conditions in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Because of inherent limitations in internal controls, misstatements, losses, or noncompliance may nevertheless occur and not be detected. However, we noted no matters involving the internal control and its operation that we considered to be material weaknesses as defined above. However, we noted other matters involving the internal control over financial reporting, which we have reported to management of the Office of Federal Housing Enterprise Oversight in a separate letter by October 28, 2005.

Finally, with respect to internal control related to performance measures reported in the annual performance plan, we obtained an understanding of the design of significant internal controls relating to the existence and completeness assertions, as required by OMB Bulletin No. 01-02. Our procedures were not designed to provide assurance on internal control over reported performance measures, and, accordingly, we do not provide an opinion on such controls.

While this report is intended solely for the information and use of the management of the Office of Federal Housing Enterprise Oversight, OMB and Congress, it is also a matter of public record, and its distribution is, therefore, not restricted.

Dembo, Jones, Healy, Pennington & Marshall, P.C.

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**Report of Independent Auditors
on Compliance with Laws and Regulations**

Mr. Stephen A. Blumenthal
Acting Director
Office of Federal Housing Enterprise Oversight

We have audited the accompanying balance sheets of the Office of Federal Housing Enterprise Oversight (OFHEO) as of September 30, 2005 and 2004, and the related statements of net cost, changes in net position, budgetary resources, financing, and custodial activity for the fiscal years then ended, and have issued our report thereon dated October 28, 2005. We conducted our audits in accordance with: auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and, Office of Management and Budget (OMB) Bulletin No. 01-02, "Audit Requirements for Federal Financial Statements."

The management of the Office of Federal Housing Enterprise Oversight is responsible for complying with laws and regulations applicable to OFHEO. As part of obtaining reasonable assurance about whether OFHEO's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts and certain other laws and regulations specified in OMB Bulletin No. 01-02, including the requirements referred to in the Federal Financial Management Improvement Act (FFMIA) of 1996. We limited our tests of compliance to these provisions and we did not test compliance with all laws and regulations applicable to the Office of Federal Housing Enterprise Oversight.

The results of our tests of compliance with the laws and regulations described in the preceding paragraph exclusive of FFMIA disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards* or OMB Bulletin No. 01-02.

Under FFMIA, we are required to report whether OFHEO's financial management systems substantially comply with the Federal financial management systems requirements, applicable Federal accounting standards, and the United States Government Standard General Ledger at the transaction level. To meet this requirement, we performed tests of compliance with FFMIA section 803(a) requirements.

The results of our tests disclosed no instances in which OFHEO's financial management systems did not substantially comply with the three requirements discussed in the preceding paragraph.

Providing an opinion on compliance with certain provisions of laws and regulations was not an objective of our audits and, accordingly, we do not express such an opinion.

While this report is intended solely for the information and use of the management of the Office of Federal Housing Enterprise Oversight, OMB and Congress, it is also a matter of public record, and its distribution is, therefore, not restricted.

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OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

Balance Sheets as of September 30, 2005 and 2004

	2005	2004
ASSETS		
Intragovernmental Assets		
Fund Balance with Treasury - Note 2	\$ 24,336,970	\$ 8,340,510
Accounts Receivable	30	24,714
Total Intragovernmental Assets	24,337,000	8,365,224
Accounts Receivable	106,475	443
Property, Plant and Equipment, Net - Note 3	9,397,224	11,215,567
Other	14,765	-
Total Assets	\$ 33,855,464	\$ 19,581,234
LIABILITIES		
Intragovernmental Liabilities – Note 4		
Other	\$ 50,103	\$ 17,763
Total Intragovernmental Liabilities	50,103	17,763
Liabilities with the Public – Note 4		
Accounts Payable	219,095	1,724,919
Accrued Liabilities	2,571,667	1,109,587
Accrued Payroll	1,248,342	922,680
Accrued Annual Leave	1,749,483	1,327,603
Other	2,161	-
Total Other Liabilities	5,571,653	3,359,870
Total Liabilities with the Public	5,790,748	5,084,789
Total Liabilities	\$ 5,840,851	\$ 5,102,552
NET POSITION		
Unexpended Appropriations – Note 1.I	\$ 20,246,579	\$ 4,414,972
Cumulative Results of Operations	7,768,034	10,063,710
Total Net Position	28,014,613	14,478,682
Total Liabilities and Net Position	\$ 33,855,464	\$ 19,581,234

The accompanying notes are an integral part of these statements.

OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

Statements of Net Cost for the Fiscal Periods Ended September 30, 2005 and 2004

	2005	2004
Program Costs		
Intragovernmental Costs	\$ 10,754,086	\$ 7,118,163
With the Public Costs	41,189,786	37,967,018
Total Program Costs - Note 6	\$ 51,943,872	\$ 45,085,181
Net Cost of Operations	\$ 51,943,872	\$ 45,085,181

The accompanying notes are an integral part of these statements.

OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

Statements of Changes in Net Position for the Fiscal Periods Ended September 30, 2005 and 2004

	2005 Cumulative Results of Operations	2005 Unexpended Appropriations	2004 Cumulative Results of Operations	2004 Unexpended Appropriations
Beginning Balance	\$ 10,063,710	\$ 4,414,972	\$ 14,065,618	\$ 4,710,466
Prior Period Adjustment – Note 10	(151,056)	151,056	-	-
Beginning Balance, As Adjusted	\$ 9,912,654	\$ 4,566,028	\$ 14,065,618	\$ 4,710,466
Budgetary Financing Sources:				
Appropriations Received	\$ -	\$ 64,209,000	\$ -	\$ 39,915,000
Other Adjustments	-	-	-	(1,815)
Appropriations Used	48,528,449	(48,528,449)	40,208,679	(40,208,679)
Other Financing Sources:				
Imputed Financing	1,270,803	-	874,594	-
Total Financing Sources	\$ 49,799,252	\$ 15,680,551	\$ 41,083,273	\$ (295,494)
Net Cost of Operation	(51,943,872)	-	(45,085,181)	-
Net Change	\$ (2,144,620)	\$ 15,680,551	\$ (4,001,908)	\$ (295,494)
Ending Balance - Net Position	\$ 7,768,034	\$ 20,246,579	\$ 10,063,710	\$ 4,414,972

The accompanying notes are an integral part of these statements.

OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

Statements of Budgetary Resources for the Fiscal Periods Ended September 30, 2005 and 2004

	2005	2004
Budgetary Resources		
Appropriations Received	\$ 64,209,000	\$ 39,915,000
Unobligated Balance, Beginning of Period	-	1,815
Recoveries of Prior Year Obligations - Note 8	152,723	181,110
Permanently not available Pursuant to Public Law 102-550	-	(1,815)
Total Budgetary Resources	\$ 64,361,723	\$ 40,096,110

Status of Budgetary Resources		
Obligations Incurred - Note 7	\$ 64,341,553	\$ 40,096,110
Unobligated Balance Not Available	20,170	-
Total Status of Budgetary Resources	\$ 64,361,723	\$ 40,096,110

Relationship of Obligations to Outlays:

Obligated Balance, Net - Beginning of Period	8,340,510	7,267,548
Obligated Balance, Net - End of Period		
Undelivered Orders	20,226,409	4,566,028
Accounts Payable	4,088,740	3,774,482
Total Obligated Balance, Net - End of Period	24,315,149	8,340,510

Outlays

Disbursements	\$ 48,214,191	\$ 38,842,537
Net Outlays	\$ 48,214,191	\$ 38,842,537

The accompanying notes are an integral part of these statements.

OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

Statements of Financing for the Fiscal Periods Ended September 30, 2005 and 2004

	2005	2004
Budgetary Resources Obligated		
Obligations Incurred	\$ 64,341,553	\$ 40,096,110
Recoveries of Prior Year Obligations - Note 8	(152,723)	(181,110)
Net Obligations	\$ 64,188,830	\$ 39,915,000
Other Resources		
Imputed Financing from Costs Absorbed by Others	1,270,803	874,594
Net Other Resources Used to Finance Activities	1,270,803	874,594
Total Resources Used to Finance Activities	\$ 65,459,633	\$ 40,789,594
Resources Used to Finance Items Not Part of the Net Cost of Operations		
(Increase) Decrease in Goods/Services/Benefits Ordered but Not Provided	(15,660,381)	293,678
Resources That Fund Expenses Recognized in Prior Periods	24,684	(12,746)
Net Resources That Finance the Acquisition of Assets	(5,919,227)	(3,180,737)
Total Resources Used to Finance Items Not Part of the Net Cost of Operations	(21,554,924)	(2,899,805)
Total Resources Used to Finance the Net Cost of Operations	\$ 43,904,709	\$ 37,889,789
Components of the Net Cost of Operations that will Require or Generate Resources in Future Periods		
Increase in Annual Leave Liability	421,880	237,796
Other	-	467
Total Components of Net Cost of Operations that will Require or Generate Resources in Future Periods	421,880	238,263
Components Not Requiring or Generating Resources:		
Depreciation and Amortization	7,617,283	6,957,129
Total Components Not Requiring or Generating Resources	7,617,283	6,957,129
Total Components of Net Cost of Operations that will Not Require or Generate Resources in the Current Period	8,039,163	7,195,392
Net Cost of Operations	\$ 51,943,872	\$ 45,085,181

The accompanying notes are an integral part of these statements.

OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

Statements of Custodial Activity for the Fiscal Periods Ended September 30, 2005 and 2004

	2005	2004
	<hr/>	<hr/>
Revenue Activity:		
Sources of Cash Collections:		
Fines Assessed - Note 9	\$ -	\$ 125,125,000
	<hr/>	<hr/>
Total Cash Collections	-	125,125,000
Accrual Adjustments	-	-
	<hr/>	<hr/>
Total Custodial Revenue	\$ -	\$ 125,125,000
 Disposition of Collections:		
Transferred to Others:		
US Treasury	-	125,125,000
	<hr/>	<hr/>
Net Custodial Activity	\$ -	\$ -

The accompanying notes are an integral part of these statements.

NOTES TO FINANCIAL STATEMENTS

Note 1 – Summary of Significant Accounting Policies

A. Reporting Entity

The Office of Federal Housing Enterprise Oversight (OFHEO) was established as an independent office within the Department of Housing and Urban Development (HUD) by the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (Title XIII of P.L. 102-550). OFHEO is responsible for examination of Fannie Mae and Freddie Mac, and determining whether the Enterprises are operating in a financially safe and sound manner and are adequately capitalized.

The accompanying financial statements reflect the activities of OFHEO. OFHEO has primarily entity activities, which include the appropriation received to conduct operations. The only non-entity activities are immaterial amounts charged for Freedom of Information Act (FOIA) requests and two specific penalties that were charged and collected in FY 2004 as discussed in Note 9.

B. Basis of Presentation

OFHEO is not covered by the requirements of the Chief Financial Officer's (CFO) Act nor the Accountability of Tax Dollars of 2002 to prepare audited financial statements. The principal statements were prepared from the official financial records and general ledger of OFHEO in accordance with Generally Accepted Accounting Principles (GAAP) as established through the Federal Accounting Standards Advisory Board (FASAB) standards and follow the presentation guidance established by the Office of Management and Budget (OMB) Circular A-136.

C. Basis of Accounting

Transactions are recorded on both an accrual accounting basis and on a budgetary basis. Under the accrual method, revenues are recognized when earned and expenses are recognized when a liability is incurred, without regard to receipt or payment of cash. Budgetary accounting facilitates compliance with legal requirements and controls over the use of Federal funds. OFHEO complies with the U.S. Standard General Ledger and conforms to the hierarchy of the American Institute of Certified Public Accountants (AICPA) through Statement on Auditing Standards (SAS) No. 69, as amended by SAS No. 91, Federal GAAP Hierarchy, of accounting principles for the Federal Government:

Federal Accounting Standards Advisory Board (FASAB) Statements and Interpretations plus AICPA and Financial Accounting Standards Board (FASB) pronouncements if made applicable to the Federal governmental entities by a FASAB Statement or Interpretation;

FASAB Technical Bulletins and the following pronouncements if specifically made applicable to Federal governmental entities by the AICPA and cleared by the FASAB: AICPA Industry Audit and Accounting Guides and AICPA Statements of Position;

AICPA Accounting Standards Executive Committee (ACSEC) Practice Bulletins if specifically made applicable to Federal governmental entities and cleared by the FASAB and Technical Releases of the Accounting and Auditing Policy Committee of the FASAB;

Implementation guides published by the FASAB staff and practices that are widely recognized and prevalent in the Federal government; and Accounting policy and procedures established by OFHEO to enhance consistency or to provide guidance in the absence of government-wide standards.

D. Funds with the U.S. Treasury

Each year Congress enacts a "no-year" appropriation to fund OFHEO's operating costs. The appropriation is paid by an annual assessment from Fannie Mae

and Freddie Mac and not with taxpayer funds. OFHEO receives an appropriation warrant from the U.S. Treasury (Treasury) General Fund each year, and fully offsets the General Fund warrant with money collected from the Enterprises.

Law requires that OFHEO return to the Enterprises unobligated funds as of the end of the fiscal year by crediting the next year's assessment. It is important to understand how the crediting provision functions with the "no year" fund designation. "No year" funds are available for obligation without fiscal year limitation. Rules for "no year" funds essentially remove all statutory limits as to when the funds may be obligated and expensed, and funds remain available for their original purpose until expended. When OFHEO closes its books each fiscal year, it accounts for funds not obligated as of the end of that fiscal year (September 30). OFHEO reduces the current year's (October 1) assessment by the amount of the unobligated balance from the previous year. Consequently, the amount of the annual assessment due from the Enterprises is reduced by the credit awarded to the Enterprises for unobligated funds from the prior year. For this reason, the amount of unobligated balance included in the fund balance with Treasury at fiscal year-end is classified as unavailable.

OFHEO collects fees for processing Freedom of Information Act (FOIA) requests. These fees are not available for OFHEO's use, but are transferred after year-end to the U.S. Treasury General Fund. The amount of collected fees included in the fund balance with Treasury at fiscal year-end are classified as non-entity, meaning the collections do not belong to OFHEO.

OFHEO cash receipts and disbursements are processed by Treasury. With the exception of the unobligated balance and the collected amount for FOIA requests, the fund balance with Treasury represents assessment money available to pay current liabilities and to finance authorized purchase commitments.

OFHEO does not: 1) have monetary assets held outside OFHEO's fund balance at Treasury or 2) hold any marketable or non-marketable securities, or operate a direct loan or loan guarantee program.

E. Property and Equipment

OFHEO's property and equipment is recorded at cost and is depreciated using the straight-line method over the estimated service lives of the assets. Service lives have been established as three years for most computer-related systems and up to 15 years for other equipment. Leasehold improvements are depreciated over the remaining term of the lease agreement. OFHEO has an established capitalization threshold of \$5,000 to conform to the materiality approach for the accounting that supports OFHEO's independent financial statements. Other property items, normal repairs, and maintenance are charged to expense as incurred.

OFHEO has no capitalized leases, no real property holdings, and no heritage assets.

F. Accounts Receivable

OFHEO's accounts receivable consists of amounts due from Federal agencies, employees and its sublessor for a leasehold improvement allowance. No portion of any account receivable is deemed uncollectible.

G. Liabilities

Liabilities represent the amount of funds that are likely to be paid by OFHEO as the result of a transaction or event that has already occurred.

OFHEO reports its liabilities under two categories: Intragovernmental and With the Public. Intragovernmental liabilities represent funds owed to another Federal agency. Liabilities with the public represent funds owed to any entity or person that is not a Federal agency, including private sector firms and Federal employee accrued payroll. Each of these categories can comprise liabilities that are covered by budgetary resources and liabilities not covered by budgetary resources.

Liabilities covered by budgetary resources are liabilities that are funded by a current appropriation or other funding source. These consist of accounts payable and accrued liabilities. Accounts payable reflect invoices processed for payment during the fiscal year which are unpaid as of the end of the fiscal year due to scheduling of payments to reflect prompt payment guidelines. Accrued liabilities consist of

estimates of amounts owed for the value of goods and services received during the fiscal year for which OFHEO had not been billed (invoiced) as of the end of the fiscal year and payroll accruals reflecting payroll costs earned by employees during the fiscal year which are not paid until the next fiscal year.

Liabilities not covered by budgetary resources are liabilities that are not funded by any current appropriation or other funding source. These liabilities consist of accrued annual leave and compensatory time and accrued FECA. Annual leave and compensatory time are earned throughout the fiscal year and are paid when leave is taken; the accrued liability for annual leave and compensatory time represent the balance earned, but not yet taken. The Department of Labor (DOL) is the central paying agent for all worker's compensation claims filed under the Federal Employees Compensation Act. The accrued FECA liability represents the amount OFHEO is to reimburse DOL for claims paid to OFHEO employees. No liability is recorded for future worker's compensation for fiscal years 2005 and 2004 as OFHEO's methodology for estimating this future worker's compensation as prescribed by DOL determined that the liability would be negligible.

H. Retirement Plans

OFHEO participates in the retirement plans offered by the Office of Personnel Management (OPM) and does not maintain any private retirement plans. All full time, permanent employees participate in either the Civil Service Retirement System (CSRS) or the Federal Employees Retirement System (FERS).

OFHEO expenses its contributions to the retirement plans of covered employees as the expenses are incurred. OFHEO is reporting imputed costs with respect to retirement plans, health benefits and life insurance pursuant to guidance received from OPM. These costs are paid by OPM and not by OFHEO. Disclosure is intended to provide information regarding the full cost of OFHEO's program in accordance with GAAP.

I. Net Position

OFHEO's net position is comprised of the following components:

- 1) Unexpended Appropriations, consisting of undelivered orders and unobligated balances of OFHEO's funds.
- 2) Cumulative Results of Operations, consisting of:
 - a. Invested capital, which represents OFHEO's investment in property and equipment, net of accumulated depreciation. Increases to invested capital are recorded when assets are acquired with direct appropriations, and decreases are recorded as a result of depreciation and disposition of capital assets.
 - b. Future funding requirements, which represent funds required to pay for accrued annual leave and compensatory time and accrued FECA. The expense for these accruals is not funded from current assessments, but will be funded from future assessments as the expenses are incurred.
 - c. Equity in accounts receivable and prepaid expenses.

J. Comparative Data

Certain 2004 line items in the Balance Sheet and the Statement of Net Cost have been reclassified to conform to the current year's presentation.

Note 2 – Fund Balance with Treasury

Fund Balance with Treasury consists of the following as of September 30, 2005 and 2004:

	Obligated	Unobligated		Non-entity	2005	2004
		Available	Unavailable			
General Funds	\$24,315,149	\$ -	\$ 20,170	\$ 1,651	\$24,336,970	\$8,340,510

Note 3 – Property, Plant and Equipment

OFHEO's major asset is the risk-based capital software and associated equipment. The risk-based capital software is used to decide on a quarterly basis the amount of risk-based capital determined by the Director to be required for each Enterprise's adequate capitalization. The final risk-based capital rule, which includes a description of the stress test software, was published in September 2001 and became enforceable in September 2002. The software was put into use for its intended purpose effective October 1, 2002. Therefore, depreciation began as of that date of implementation.

Property, Plant and Equipment balances as of September 30, 2005 and 2004 are as follows:

Asset Type	Acquisition Cost	Accumulated Depreciation	2005 Net Book Value	2004 Net Book Value
Equipment	\$ 7,642,043	\$ 5,173,849	\$ 2,468,194	\$ 1,184,968
Leasehold Improvements	5,357,057	2,084,161	3,272,896	2,708,108
Internal Use Software	17,612,540	15,850,234	1,762,306	5,020,760
Internal Software in Development	1,893,828	-	1,893,828	2,301,731
Total	\$32,505,468	\$ 23,108,244	\$9,397,224	\$11,215,567

Note 4 – Liabilities Covered and Not Covered By Budgetary Resources

Description	2005			2004		
	Covered	Not Covered	Total	Covered	Not Covered	Total
Intragovernmental						
Accrued Liability	\$ 49,636	\$ -	\$ 49,636	\$ 17,296	\$ -	\$ 17,296
Accrued FECA	-	467	467	-	467	467
Total Intragovernmental	\$ 49,636	\$ 467	\$ 50,103	\$ 17,296	\$ 467	\$ 17,763
With the Public						
Accounts Payable	\$ 219,095	\$ -	\$ 219,095	\$1,724,919	\$ -	\$1,724,919
<u>Other</u>						
Accrued Liabilities	2,571,667	-	2,571,667	1,109,587	-	1,109,587
Accrued Payroll	1,248,342	-	1,248,342	922,680	-	922,680
Annual Leave	-	1,749,483	1,749,483	-	1,327,603	1,327,603
Other Liabilities	-	2,161	2,161	-	-	-
Total With the Public	\$4,039,104	\$1,751,644	\$5,790,748	\$3,757,186	\$1,327,603	\$5,084,789

All liabilities are classified as current. OFHEO has no liabilities that are considered to be non-current.

Note 5 – Operating Lease

OFHEO has an occupancy lease with the Office of Thrift Supervision (OTS) at 1700 G Street NW, Washington, DC that covers office space and building services which include utilities, security guards, janitorial services, mail delivery, use of the loading dock, garage parking and building operation and maintenance. The initial term of the lease was for five years beginning in 1993, with the option to renew for three 5-year terms. OFHEO has exercised the second of the three option terms.

OFHEO may terminate the lease agreement with OTS in whole or in part. In the event of a termination at OFHEO's discretion, OFHEO would be required to pay two months rent. If either party ceases to exist or

merge with another entity by operation of law, either party may terminate the rental agreement. In the event of termination under this provision, neither party is liable for further costs, fees, damages or other monies due to the termination, except for payments through the date of termination.

In FY 2005, OFHEO obtained additional rental space at 1750 Pennsylvania Avenue NW, Washington, DC through a private sector sublessor. The expiration date of the lease is March 30, 2011. If the primary lease would terminate earlier than the expiration date, the sublease would then also terminate.

Total rent expense for the years ended September 30, 2005 and 2004 was approximately \$4.4 million and \$3.4 million, respectively. The following table summarizes the minimum future lease payments for the two properties:

	2005		2004	
	1700 G St NW	1750 Penn Ave NW	1700 G St NW	1750 Penn Ave NW
Future Minimum Lease Payments				
Year 1	\$ 4,110,786	\$ 827,395	\$ 3,912,854	\$ 576,692
Year 2	4,234,309	872,293	4,114,512	827,395
Year 3	4,357,831	907,184	4,238,035	872,293
Year 4	4,481,354	943,472	4,361,557	907,184
Year 5	4,604,876	981,211	4,485,080	943,472
After 5 Years	14,970,381 ¹	498,671 ²	19,590,469	1,479,882
Total Minimum Lease Payments	\$36,759,537	\$ 5,030,226	\$ 40,702,507	\$5,606,918

¹ Lease runs through November, 2013 when including option years

² Lease runs through March, 2011.

Note 6 – Program Costs

OFHEO does not have stewardship responsibilities for Federal lands. Program costs represent assessment collections, from Fannie Mae and Freddie Mac, that have been expensed for salaries and operating expenses to support OFHEO during the fiscal years ended September 30, 2005 and 2004. Program costs are distributed into two categories: Intragovernmental and With the Public. Intragovernmental costs are a result of OFHEO contracting with other Federal agencies for goods and/or services, such as rent paid to OTS and payroll processing services received from the Department of Agriculture. With the Public costs include expenditures for contracts with the private sector for goods or services, payments for employee salaries and non-cash expenses such as depreciation.

Note 7 – Apportionment Categories of Obligations Incurred

All obligations incurred are characterized as OMB Category B obligations (i.e., not apportioned by fiscal quarter) as reported on the Statements of Budgetary Resources for the years ended September 30, 2005 and 2004 and consisted of the following:

	2005	2004
Direct Obligations (Category B)	\$64,341,553	\$40,096,110

Note 8 – Recoveries of Prior Year Obligations

Recoveries of prior year obligations consist of the reapportionment of prior year funds by OMB. OFHEO requested and received the authority to re-obligate these prior year funds in fiscal years 2005 and 2004.

Note 9 – Custodial Activities

During fiscal year 2004, OFHEO collected \$125,000,000 for payment of a penalty assessed against Freddie Mac as a result of a special investigation conducted into Freddie Mac's accounting and internal controls. OFHEO also collected \$125,000 for payment of a penalty assessed against a former employee of Freddie Mac as a result of the same special investigation. These funds were deposited directly to the General Fund of the Treasury and were not available for use by OFHEO. There were no similar penalty assessments made in fiscal year 2005.

Charges for services provided in response to FOIA requests were immaterial for FY 2005 and FY 2004 and therefore not reported on the Statements of Custodial Activity.

Note 10 – Prior Period Adjustment

A prior period adjustment for \$151,056 was made to properly reflect the balances in unexpended appropriations and cumulative results in operations. This corrects the effect of how reimbursement activity was posted in certain prior fiscal years with respect to the classification of unexpended appropriations and cumulative results of operations. The budgetary accounting and budget authority were processed properly.

OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

Required Supplementary Information Intragovernmental Trading Partners September 30, 2005 and 2004

Intragovernmental Assets Trading Partner Agency

	2005	2004
Department of Treasury ¹	\$ 24,336,970	\$ 8,340,510
Department of Housing and Urban Development ²	-	24,684
Other	30	30
	<u>\$ 24,337,000</u>	<u>\$ 8,365,224</u>

¹ Fund balance with Treasury consists of assessment funds that are available to pay current liabilities and to finance authorized purchase commitments.

² This receivable represents funds owed by HUD for HUD employees incorrectly coded for payroll processing and charged against OFHEO funds.

Intragovernmental Liabilities Trading Partner Agency

	2005	2004
Department of Veteran's Affairs	49,636	-
Federal Deposit Insurance Corporation	-	17,296
Department of Labor	467	467
	<u>\$ 50,103</u>	<u>\$ 17,763</u>

OFHEO's Intragovernmental liabilities consist of accounts payable for the value of services received for which OFHEO had not been billed as of the end of the fiscal year.

The accompanying notes are an integral part of these statements.



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