



OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

1700 G STREET NW WASHINGTON DC 20552 (202) 414-3800

Office of the Director

September 20, 2004

Board of Directors
Fannie Mae
3900 Wisconsin Avenue
Washington DC 20016-2892

Dear Board Member:

As you are aware, the Office of Federal Housing Enterprise Oversight is conducting a special examination of Fannie Mae's accounting policies, internal controls, and financial reporting processes. I am transmitting to you a report I have received on our findings to date. The findings raise such serious safety and soundness concerns that immediate action is warranted, rather than waiting until the completion of the full special examination.

The report concludes that "the matters detailed in this report are serious and raise doubts concerning the validity of previously reported financial results, the adequacy of regulatory capital, the quality of management supervision, and the overall safety and soundness of the Enterprise."

More specifically, the report documents how Fannie Mae 1) applied accounting methods and practices that do not comply with GAAP in accounting for the enterprise's derivatives transactions and hedging activities, 2) employed an improper "cookie jar" reserve in accounting for amortization of deferred price adjustments under GAAP, 3) tolerated related internal control deficiencies, 4) in at least one instance deferred expenses apparently to achieve bonus compensation targets, and 5) maintained a corporate culture that emphasized stable earnings at the expense of accurate financial disclosures.

These findings cannot be explained as mere differences in interpretation of accounting principles, but clear instances in which management sought to misapply and ignore accounting principles for the purposes of meeting investment analyst expectations; reducing volatility in reported earnings; and enabling fragmented processes and systems, and an ineffective controls environment to exist.

As I stated earlier, these findings warrant immediate remedial action. I have enclosed an agreement for your review and consent that includes the minimum steps that need to be taken to address the safety and soundness problems we have identified to date. Included are corrective actions related to accounting policies and practices, capital adequacy, internal controls, segregation of duties, and further reviews. In addition, we must consider the accountability of management and whether we have sufficient confidence in management to fully implement these corrective measures and bring about broad cultural and operational changes in the areas of concern. The analysis and findings of this report make it difficult to assert such confidence.

We will be available to answer any questions you may have following today's briefing on the report. I am prepared to work with you to resolve this matter in an orderly manner. However, you must realize I am prepared to act if the Board does not.

Sincerely,

A handwritten signature in black ink, appearing to read 'Armando Falcon, Jr.', with a stylized, cursive script.

Armando Falcon, Jr.

Enclosure