



2006 Performance and Accountability Report



OFHEO FY 2006 Performance and Accountability Report

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Message from the Director



The Fiscal Year 2006 Performance and Accountability Report for the Office of Federal Housing Enterprise Oversight is my first and only OFHEO's second. On behalf of OFHEO's dedicated employees, it is a pleasure to submit this report which reviews our 2006 progress. OFHEO received an unqualified opinion of our audited accounts for the ninth straight year and substantially achieved our performance goals.

Mission

OFHEO's primary mission is ensuring the safety and soundness of the government-sponsored enterprises (GSEs or the Enterprises), Fannie Mae and Freddie Mac, and to promote housing and a strong national housing finance system. On a combined basis they have guaranteed or own mortgages totaling \$4.0 trillion, representing 40 percent of the total mortgages outstanding in the United States. Over the years, the Enterprises have been an important element in the growth of the mortgage market. However, the rapid growth of the Enterprises; their ongoing accounting, systems, internal control and risk management problems; and OFHEO's relatively weak regulatory framework means that the Enterprises present serious risks. Although it will take several years and legislation to reduce these risks, during 2006 progress was made by the Enterprises in better assessing the magnitude of the problems and beginning to fix them.

Fannie Mae Special Examination

During 2006, OFHEO completed its special examination of Fannie Mae's accounting and internal controls practices, first begun in 2004. OFHEO's Report of the Special Examination of Fannie Mae detailed accounting scandals, earnings manipulation, and management failures. The examination found that the Board of Directors contributed to these problems by failing to act independently of management. As a result of the special examination, OFHEO and the Securities and Exchange Commission on May 23, 2006, jointly announced a settlement and consent order in which Fannie Mae agreed to pay a penalty of \$400 million dollars and to implement corrective measures in 81 areas.

Enterprises Remediation

OFHEO is focused on requiring Fannie Mae to fix these problems and Freddie Mac to fix similar ones found in OFHEO's earlier special examination. When OFHEO completed its special examinations at the

Enterprises, each company was directed to address accounting, internal controls, and financial reporting problems. While progress has been made, significant difficulties remain at each company. Although timely financial reporting, which they project to occur in 2007, will be a major step forward for both Enterprises, it will take several years to achieve full remediation of their problems.

Portfolio growth limits were established at both Fannie Mae and Freddie Mac because neither Enterprise has demonstrated adequate risk controls. These limits constrain the overall growth of the Enterprises, but do not prevent them from continuing to support the housing markets by securitizing mortgages and meeting affordable housing goals.

Improved Supervision

During the year OFHEO made significant efforts to enhance its supervision of the Enterprises. We established an Office of Supervision to oversee and coordinate the examinations, accounting, compliance, and capital supervisory functions. Other initiatives to improve OFHEO's supervisory oversight programs include: updating the Supervision Handbook, establishing a policy development and quality assurance function within the supervision program, improving the financial analysis of the Enterprises, enhancing measurement of operational risk, developing alternative methodologies for assessing capital adequacy, and initiating a records retention regulation.

Legislation

The agency has worked actively to support legislation currently under consideration in Congress to strengthen the regulatory oversight of Fannie Mae and Freddie Mac. We have worked with the Administration, Congress, and interested parties to support the enactment of legislative reform that will provide bank-like powers to a new GSE regulator that will oversee Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. Among the key authorities provided for in the legislation are: combining mission and new product approval authority, flexibility in setting capital requirements, authority to limit Enterprise portfolios, and independence from the congressional appropriations process. It is my hope that the Congress will complete its work on this important legislation before the end of 2006.

President's Management Agenda

As OFHEO is forcing Fannie Mae and Freddie Mac to implement better management practices, it is important that we also adopt best practices. As such, OFHEO has emphasized the President's Management Agenda. In 2006

OFHEO made progress in four of the five areas: Strategic Management of Human Capital, Improved Financial Performance, Expanded Electronic Government, and Budget and Performance Integration. We also used the Office of Management and Budget's Performance Assessment Rating Tool to rate OFHEO's program for the first time.

Program Data and Financial Performance

OFHEO's FY 2006 Performance and Accountability Report contains performance and financial data that is complete and reliable, with the exceptions noted in the section on Completeness and Reliability of Capital Performance Measures. The Compliance with Laws and Regulations section contains the details of management assurances and describes the creation this year of an Executive Internal Controls Committee to oversee OFHEO's internal control structure.

Conclusion

I am pleased to serve as the Director of OFHEO and to report on our significant accomplishments in 2006. Since my appointment by President Bush in April 2006, I have been impressed with the hard work and expertise of the employees of OFHEO. I am also pleased that as OFHEO grows we have been able to attract very qualified individuals, including Ed DeMarco, who just joined OFHEO as Deputy Director.

Fiscal Year 2007 will also be a year of challenges as the housing market softens and Fannie Mae and Freddie Mac continue their remediation programs. Importantly, an enhanced supervision and regulatory regime as proposed by Congress and the Administration will benefit the nation's housing finance system and all of the stakeholders of Fannie Mae and Freddie Mac.



James B. Lockhart III
Director

Management's Discussion & Analysis

Overview

The Office of Federal Housing Enterprise Oversight (OFHEO) issues a Performance and Accountability Report (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 2006:

Chapter One: Management's Discussion and Analysis

- ▲ *Explains OFHEO's purpose and structure*
- ▲ *Provides highlights of the year's accomplishments*
- ▲ *Describes the agency's management challenges*
- ▲ *Summarizes OFHEO's performance*
- ▲ *Presents a financial summary for 2006*

Chapter Two: Performance Section

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

Chapter Three: Financial Section

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



OFHEO's Mission Statement ¹

To promote housing and a strong national housing finance system by ensuring the safety and soundness of Fannie Mae and Freddie Mac.

About OFHEO

OFHEO was established as an independent entity 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 agency is headed by a Director appointed by the President for a five-year term. James B. Lockhart III was nominated by President George W. Bush to become the Director of OFHEO and was confirmed by the U.S. Senate. Mr. Lockhart served as Acting Director from April 28, 2006, until he was sworn in as OFHEO's third Director on June 26, 2006. Prior to joining OFHEO, he served as Deputy Commissioner and Chief Operating Officer of the Social Security Administration for over four years.

OFHEO's primary mission is ensuring the capital adequacy and financial safety and soundness of two government-sponsored enterprises, 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 \$4.2 trillion at year-end 2005, which represents over 40 percent of mortgages outstanding.

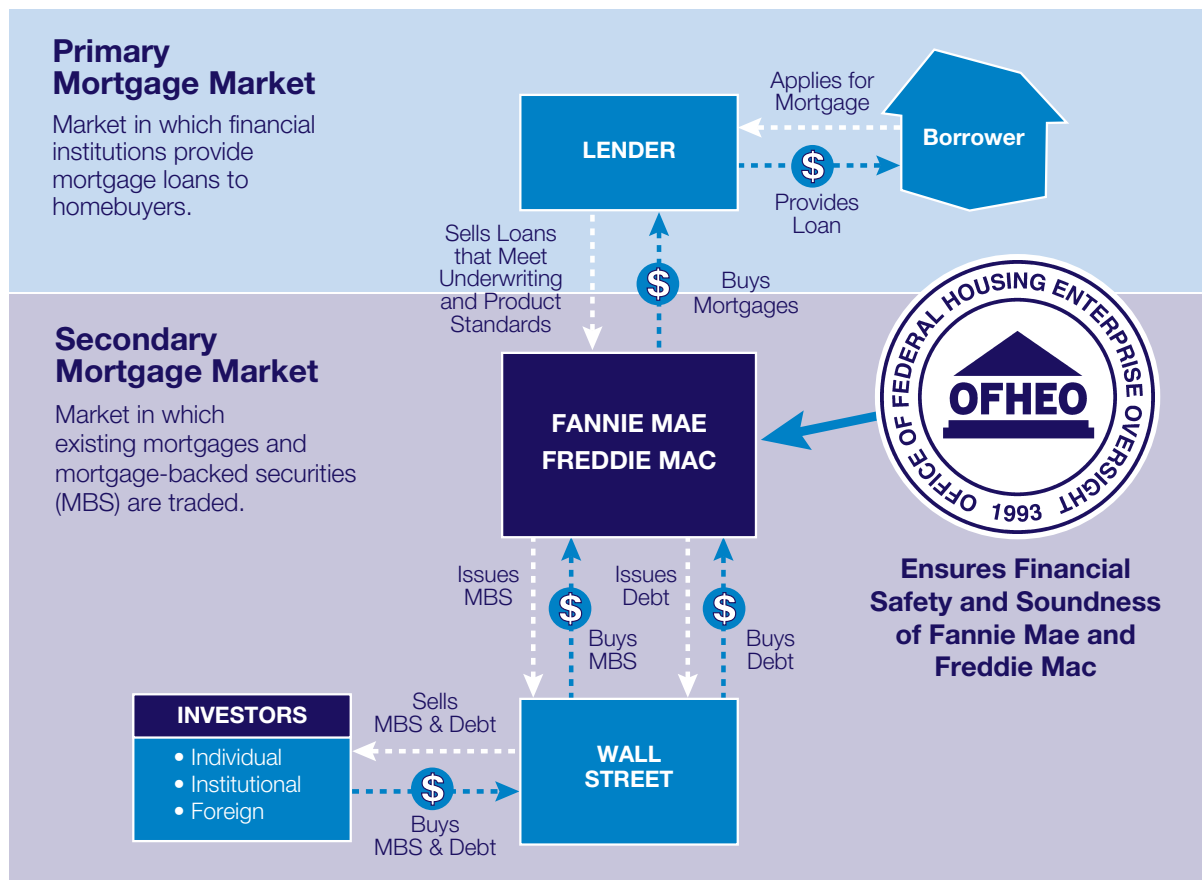
¹ This is OFHEO's current mission statement, consistent with the recently released FY 2006-2011 Strategic Plan. OFHEO operated under a similar mission statement until the end of FY 2006.

OFHEO's oversight responsibilities include the following:

- ▲ *Conducting broad-based and targeted examinations of Fannie Mae and Freddie Mac*
- ▲ *Making quarterly findings of capital adequacy based on a minimum capital standard and a risk-based capital standard*
- ▲ *Administering a risk-based capital standard, using a "stress test" that simulates interest rate and credit risk scenarios*
- ▲ *Prohibiting excessive executive compensation*
- ▲ *Issuing regulations concerning capital and enforcement standards*
- ▲ *Taking necessary enforcement actions*
- ▲ *Issuing an annual Report to Congress on the financial and operational condition of the Enterprises*

OFHEO is funded through assessments on Fannie Mae and Freddie Mac. OFHEO's operations represent no direct cost to the taxpayer.

OFHEO's Role

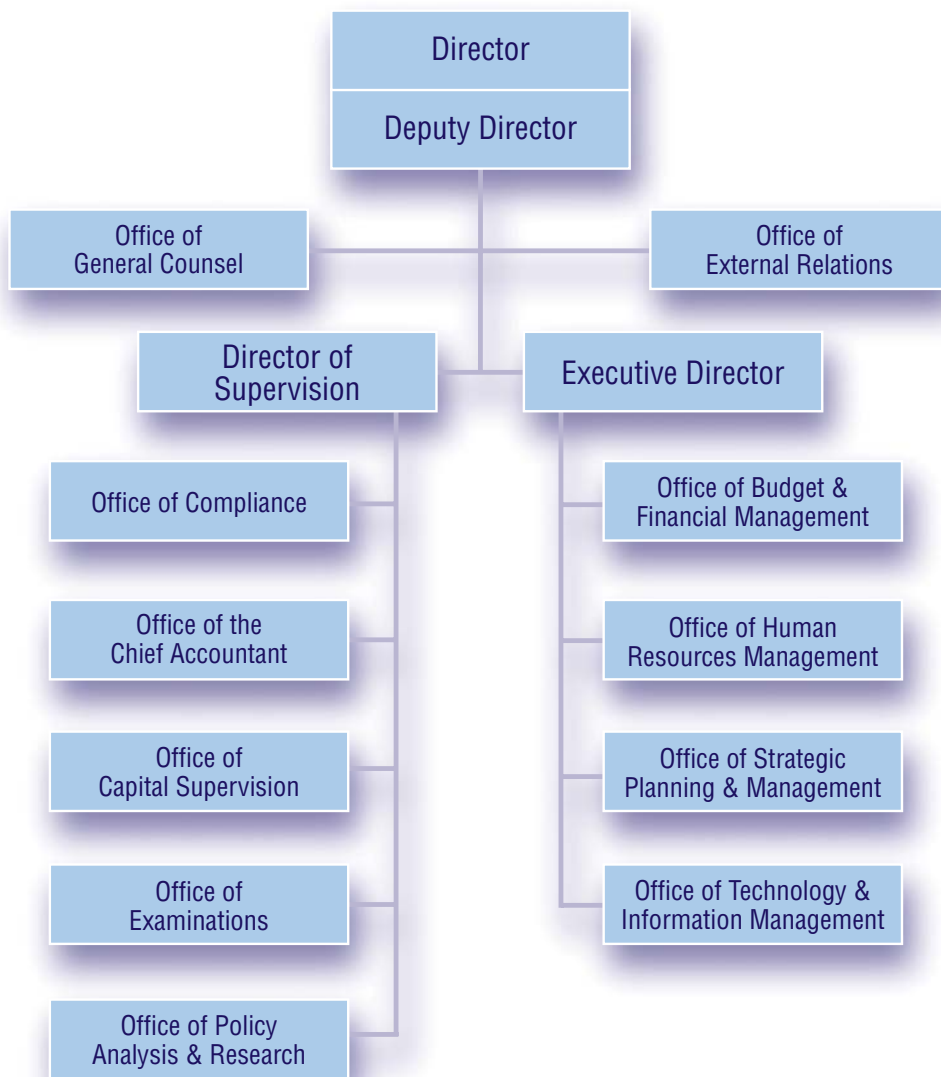


OFHEO's Organizational Structure

OFHEO is led by the Director, who sets the direction for OFHEO to achieve its mission of ensuring the safety and soundness of Fannie Mae and Freddie Mac. At the end of the fiscal year, OFHEO had a staff of 225 employees. OFHEO's operations are structured efficiently to accomplish its mission with a relatively small staff. Its component offices have specific responsibilities and work together to ensure effective oversight of Fannie Mae and Freddie Mac.

In 2006, OFHEO established an Office of Supervision to coordinate and oversee a wide range of supervision activities. The Office of Supervision is responsible for ensuring that the agency's examinations of the Enterprises, identification of matters requiring enforcement, compliance efforts, capital adequacy determinations, and policy and research functions are integrated

Figure 1 –
OFHEO Organizational Chart



and managed effectively. The Director of Supervision accomplishes this through the efforts of five component offices (see organization chart).

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, specifically providing support for supervision functions and enforcement actions.

The Office of External Relations works with OFHEO's external stakeholders to ensure effective communication by responding to public and congressional inquiries and releasing pertinent information.

The Office of the Executive Director is responsible 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 all offices.

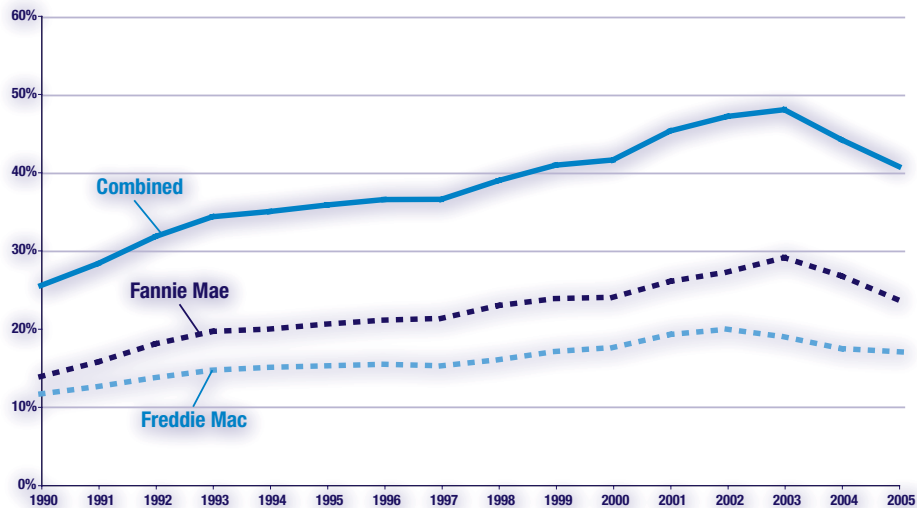
OFHEO is located at 1700 G Street NW in the District of Columbia.

Fannie Mae and Freddie Mac Mortgage Assets and MBS as a Share of Residential Mortgage Debt Outstanding, 1990-2005

Role of the Enterprises

Fannie Mae and Freddie Mac were created by Congress to perform an important role in the nation's housing finance system – to provide liquidity, stability and affordability to the mortgage market. The Enterprises provide liquidity (ready access to funds on reasonable terms) to the thousands of banks, savings and loans, and mortgage companies that make loans to finance housing. Fannie Mae and Freddie Mac buy mortgages from lenders and either hold these mortgages in their portfolios or package the loans into mortgage-backed securities (MBS) that are sold to the public. Lenders use the cash raised by selling mortgages to the Enterprises to engage in further lending. The Enterprises' purchases help ensure that individuals and families that buy homes and investors that purchase apartment buildings and other multifamily dwellings have a continuous, stable supply of mortgage money. The chart at the right shows the Enterprises' share of the market.

By packaging mortgages into MBS and guaranteeing the timely payment of principle and interest on the underlying mortgages, Fannie Mae and Freddie Mac attract to the secondary mortgage market investors who might not otherwise invest in mortgages, thereby expanding the pool of funds available for housing. That makes the secondary mortgage market more liquid and helps



lower the interest rates paid by homeowners and other mortgage borrowers.

Fannie Mae and Freddie Mac also can help stabilize mortgage markets and protect housing during extraordinary periods when stress or turmoil in the broader financial system threaten the economy. Further, a majority of the mortgages purchased by Fannie Mae and Freddie Mac finance dwelling units that are affordable to low- and moderate-income households, or are located in geographic areas that the Department of Housing and Urban Development believes are underserved. The Enterprises' support for mortgage lending that finances affordable housing reduces the cost of such borrowing.

Performance Highlights

OFHEO Completes Fannie Mae Special Exam

During 2006, OFHEO completed its special examination of Fannie Mae's accounting and internal controls practices, begun in 2004. On May 23, 2006, OFHEO released the Report of the Special Examination of Fannie Mae, which detailed numerous accounting and corporate governance problems at the Enterprise, including deliberate and intentional manipulation of earnings by management to meet bonus targets from 1998 through 2004. The examination found that the Board of Directors contributed to these problems by failing to act independently of management and cited inadequate investments in staffing and systems that contributed to these problems. As a result of the special examination, OFHEO and the SEC jointly announced a settlement and consent order in which Fannie Mae agreed to implement corrective measures and pay a collective penalty of \$400 million dollars. OFHEO and Fannie Mae entered into a consent order containing 81 remedial actions. OFHEO has since focused its attention on ensuring that Fannie Mae makes the improvements required by the consent order.

OFHEO Sets Portfolio Limits for Both Enterprises

Portfolio growth limits were established at both Fannie Mae and Freddie Mac because neither Enterprise demonstrated adequate controls for risk. These portfolio limits constrain the overall growth of the Enterprises, but do not prevent them from continuing to securitize mortgages and meet their affordable housing goals. The limits allow each Enterprise to focus on fixing its operational, accounting, and internal controls issues. In May 2006, OFHEO and Fannie Mae, addressing the special examination findings, agreed to limit Fannie Mae's mortgage portfolio assets to the December 31, 2005, level. In July 2006, Freddie Mac voluntarily agreed with OFHEO to limit its mortgage portfolio growth to no more than two percent annually from the level of June 30, 2006, until the Enterprise resumes production and timely public release of quarterly financial statements. These agreements limit Fannie Mae to a \$727.7 billion mortgage portfolio and restrict Freddie Mac to two percent annual growth over its \$710.3 billion mortgage portfolio from June 2006.

Freddie Mac And Fannie Mae Need to Make More Progress on Remediation Plans

When OFHEO completed special examinations at the Enterprises, each company was required to develop a remediation plan to address accounting, internal controls, and financial reporting problems. Freddie Mac

entered into an agreement with OFHEO in December 2003 requiring 29 specific improvements. Freddie Mac has made slow and inconsistent progress improving its internal controls and is working to restate its financial results for prior years and achieve timely financial reporting. To date, Freddie Mac has restated financial results for 2000 and 2001, revised 2002 results, and released its financial results for 2003, 2004, and 2005 late. Quarterly financial statements for 2006 are not being published. Due to continued operational risk, OFHEO requires Freddie Mac to maintain a 30 percent capital surplus over its minimum capital requirement. Freddie Mac plans to begin timely financial reporting in 2007.

Fannie Mae also has adopted remediation plans and consent agreements with OFHEO to correct accounting and internal control problems identified through OFHEO's special examination. Fannie Mae began the intensive process of restating financial results and improving internal controls last year and continued its efforts through 2006. By December 2006, Fannie Mae plans to restate financial results for 2002 and 2003 and revise financial results for 2004, including quarterly data for two quarters that were previously published. The Enterprise is working towards issuing 2005 financial results and returning to timely financial statements in 2007. Fannie Mae also has had a capital restoration plan in effect beginning in 2005 to ensure that it meets the OFHEO capital standards and holds an additional 30 percent capital surplus because of its increased operational risk. Fannie Mae achieved the 30 percent capital surplus requirement over minimum capital levels as of September 30, 2005, and continued to maintain this surplus through 2006.

Timely financial reporting will be a major step forward for both Enterprises. However, it may take several years beyond that to achieve full remediation.



Wanda DeLeo, OFHEO Chief Accountant, provides details of accounting manipulation at Fannie Mae at a news conference about OFHEO's special examination, on May 23, 2006. Listening to DeLeo are OFHEO Director James Lockhart and Chief Compliance Examiner Christopher Dickerson.

Problems at Freddie Mac Identified by OFHEO

- Freddie Mac disregarded accounting rules, internal controls, and disclosure standards in the pursuit of steady earnings growth.
- The incentive compensation plans of senior executives contributed to the improper accounting and management practices.
- The Enterprise had significant failures in its accounting, auditing, and internal controls.
- Freddie Mac did not follow some public disclosure standards, which misled investors about specific capital market and accounting transactions.
- The Board of Directors was complacent and failed to exercise adequate oversight.
- Freddie Mac was required to restate prior year financial statements for 2000, 2001, and 2002 to correct errors. This restatement effort, along with other required corrective actions, has delayed the timely publishing of Freddie Mac's audited financial results.
- Freddie Mac does not have proper internal controls or accounting policies in place and the Enterprise's Chief Financial Officer failed to exercise adequate oversight.
- Freddie Mac did not report December 31, 2005, financial results until May 30, 2006. Quarterly financial results have not been released for the first three quarters of 2006.
- Freddie Mac has not yet implemented its comprehensive plan to correct accounting and internal control deficiencies, despite extensive planning efforts.
- Freddie Mac has not fully implemented a comprehensive Enterprise-wide risk management function that will enable the Enterprise to better understand and manage all risks.
- Freddie Mac continues to experience high employee turnover rates. Reducing turnover, establishing a culture of accountability, and ensuring responsibilities are met continue to be top priorities.

Problems at Fannie Mae Identified by OFHEO

- Fannie Mae's senior management promoted a false image of the Enterprise as one of the lowest-risk financial institutions in the world.
- Fannie Mae had serious problems in internal controls due to deficiencies in data and systems coupled with cultural issues that led to poor accountability and insufficient funding of support functions and needed updates to information technology.

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OFHEO Enhances Supervision Program

During the year, OFHEO established an Office of Supervision and appointed Len Reid as Director of Supervision to oversee and coordinate the various supervision functions within the agency. This central coordination will provide better communication and collaboration among supervision staff, leading to more comprehensive and effective supervision of the Enterprises. In conjunction with a review based on the Office of Management and Budget's (OMB) Program Assessment Rating Tool, OFHEO established new outcome-oriented measures to assess its performance in future years.

OFHEO made significant efforts to enhance its supervision of the Enterprises. Besides completing annual, risk-based examinations of Fannie Mae and Freddie Mac, OFHEO made quarterly determinations of their capital adequacy, reviewed their compliance with laws, regulations, and directives, and monitored their progress in remediation. OFHEO has also taken specific steps to strengthen the standards against which the Enterprises are measured. OFHEO began a data validation review and proposed a records retention regulation for the Enterprises to ensure that OFHEO has access to records that are maintained in line with best practices and receives complete and accurate information.

The agency also updated its Supervision Handbook, which will be published on OFHEO's web site during FY 2007, and proposed technical amendments to its risk-based capital regulation. OFHEO began to disclose quarterly the Enterprises' subordinated-debt positions, as part of the September 2005 agreements with Fannie Mae and Freddie Mac. OFHEO also initiated a project to develop a uniform Call Report for the Enterprises, to be fully implemented in 2008. Other initiatives to improve OFHEO's supervisory and oversight programs include establishing a policy development and quality-assurance function within the supervision program, improving financial analysis of the Enterprises, enhancing the measurement of the Enterprises' operational risk, and developing alternative measures and methodologies for assessing capital adequacy.

Demand for OFHEO's Quarterly House Price Index Grows

OFHEO ensured that its house price index (HPI) continued to provide useful information and analysis to the public. The HPI is a quarterly measure of house price trends within and across all fifty states and the District of Columbia. It provides individual citizens, businesses, and government agencies with a reliable, timely indicator of home price movements. The extremely large increases in home prices in recent years spurred growing demand for market information from government researchers, industry practitioners, and consumers. In 2006, OFHEO supplemented its HPI release materials throughout the year with satellite television feeds highlighting regional trends and citing relevant causes of appreciation patterns. OFHEO also continued to research improvements to the HPI, and published a working paper reviewing the effects of appraisal bias on measured house price trends and describing an alternative indexing methodology aimed at removing the effects of any appraisal bias from the index. OFHEO continued to release purchase-only and seasonally-adjusted variations on the HPI and provided additional analysis in the report itself, including



Patrick Lawler, OFHEO Chief Economist, answers a question at a Senate Committee on Banking, Housing and Urban Affairs hearing on "The Housing Bubble and its implications for the Economy", September 13, 2006. Listening to Lawler from left to right are Richard Brown, Chief Economist, Federal Deposit Insurance Corporation, Dave Seiders, Chief Economist, National Association of Homebuilders and Tom Stevens, President, National Association of Realtors.

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- Fannie Mae's deficiencies in data, systems, controls, policies, processes, practices, risk metrics, and reports prevented or impeded many aspects of performance and risk management.
- Fannie Mae had developed an organizational structure that impeded or prevented internal controls in several business units, and did not provide sufficient independent oversight over controls and several aspects of risk management.
- Fannie Mae employed too few personnel who emphasized or understood industry standards for internal controls or risk management. Fannie Mae must now rely on a large number of contractors to correct accounting and internal controls errors.
- Fannie Mae's Board of Directors failed to be sufficiently informed, to act independently of its Chairman and other senior executives, and to exercise the requisite oversight over the Enterprise's operations.
- The combination of significant problems in culture, corporate governance, internal controls, organizational structure, and data and systems contributed to deficiencies in accounting and financial reporting and resulted in Fannie Mae's overstatement of reported income and capital by an estimated \$10.6 billion.
- A large number of Fannie Mae's accounting policies and practices did not comply with Generally Accepted Accounting Principles (GAAP). One example of this is the creation of "cookie jar" reserves to help smooth earnings.
- Between 1998 and 2004, Fannie Mae's senior management deliberately and intentionally manipulated accounting methodologies to hit earnings targets and help executives maximize their bonuses.
- Because of the manipulation of earnings with accounting practices that did not comply with GAAP, Fannie Mae is required to correct the errors by restating prior year financial statements for 2002 and 2003, and revising 2004 financial statements so that they comply with GAAP.
- This restatement effort, along with other required corrective actions, has delayed the timely publishing of Fannie Mae's audited financial results.
- Restatement work has strained resources and significantly delayed important model and systems projects until the restatement work is completed.

studying the effects of Hurricane Katrina on home prices in the Gulf States. OFHEO originally developed and still uses the HPI in establishing quarterly capital standards for the Enterprises.

OFHEO Supports Legislation to Strengthen Enterprise Oversight

After completing the special examination, the agency has actively worked to support legislation under consideration in Congress that would strengthen the regulatory regime of the government-sponsored enterprises. Support for statutory reforms to strengthen regulatory powers was one recommendation of OFHEO's special examination of Fannie Mae. The current legislation combines OFHEO with the Federal Housing Finance Board to create a new GSE regulator with bank regulator-like powers, combined mission and new product approval authority, flexibility in setting capital requirements, authority to limit portfolios due to their market, credit, operational and systemic risks, and greater independence including removal from the appropriations process. OFHEO has worked with the Administration, Congress, and interested stakeholders to support legislative reform. OFHEO worked with congressional members and staff on issues related to reform proposals. The Director testified before the Senate Banking Committee and the House Financial Services Committee on the agency's oversight of Fannie Mae and Freddie Mac and the need for statutory changes. He also addressed various groups with interests in the housing and mortgage finance industry to explain the need for statutory changes and possible effects and to gather their input. The Director and senior staff also met with trade association and housing advocacy groups to discuss specifics of the pending legislation from OFHEO's and their groups' perspectives. OFHEO conducted media outreach and television interviews and responded to questions about the legislation.

OFHEO Issues New FY 2006-2011 Strategic Plan

OFHEO issued a new Strategic Plan for FY 2006-2011 that sets out the agency's mission and goals for the next five years. OFHEO's revised strategic goals are: 1) Enhance supervision to ensure the Enterprises operate in a safe and sound manner, are adequately capitalized and comply with legal requirements, 2) Provide support for statutory reforms to strengthen our regulatory powers, and 3) Continue to support the national policy of an efficient secondary mortgage market which promotes homeownership and affordable housing. The plan also includes a resource management strategy: Manage effectively OFHEO's human capital and other resources to support our mission. The plan, issued at the end of FY 2006, highlights some of the

initiatives that OFHEO will take to meet its goals and describes how OFHEO will measure its performance annually. To achieve its mission, OFHEO focuses on achieving results through teamwork and mutual respect. The agency embraces the values of Integrity, Independence, Professionalism, and Accountability to guide its operations. OFHEO's Strategic Plan can be found on its web site at www.ofheo.gov.

Management Challenges

Maintaining Effective Regulatory Oversight

Currently, Fannie Mae and Freddie Mac are working to improve their internal controls, compliance with accounting standards, risk management, financial reporting data quality and systems, executive leadership, and governance, although slower than expected. The Enterprises are making improvements while still facing the demands of the dynamic markets in which they operate, filling critical management and staff positions, and working to change the cultures of their organizations. OFHEO will continue to be challenged to ensure that the Enterprises meet the commitments made in their agreements with OFHEO. OFHEO must proactively work with the Enterprises to ensure that they make corrections and improvements and must take appropriate action to effect change. OFHEO believes both Enterprises still have years of work before their critical problems are corrected.

Maintaining Capacity to Strengthen Supervision and Address Emerging Risks

OFHEO continues to strengthen its supervisory standards and operations and reviews the Enterprises' risks and risk management on a continuous basis, despite limitations presented by OFHEO's current statutory framework for regulation. Through continuous monitoring, research and analysis, and risk-based examinations, OFHEO identifies issues that warrant additional attention and explores them further through targeted examinations. OFHEO is strengthening its oversight with lessons learned from prior examinations by proactively issuing additional guidances and standards and establishing a quality-assurance function. This ongoing supervision should place OFHEO in a good position to identify and address emerging problems in a timely fashion. However, the size and complexity of the Enterprises' business activity, the dynamics of their markets, and the status of their internal

Figure 2 — Fannie Mae Minimum vs. Risk-Based Capital Requirements for 2005-2006

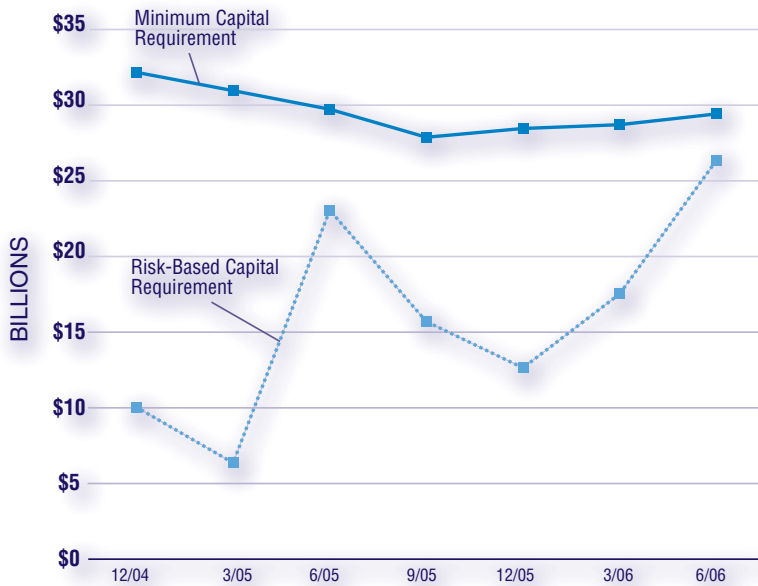
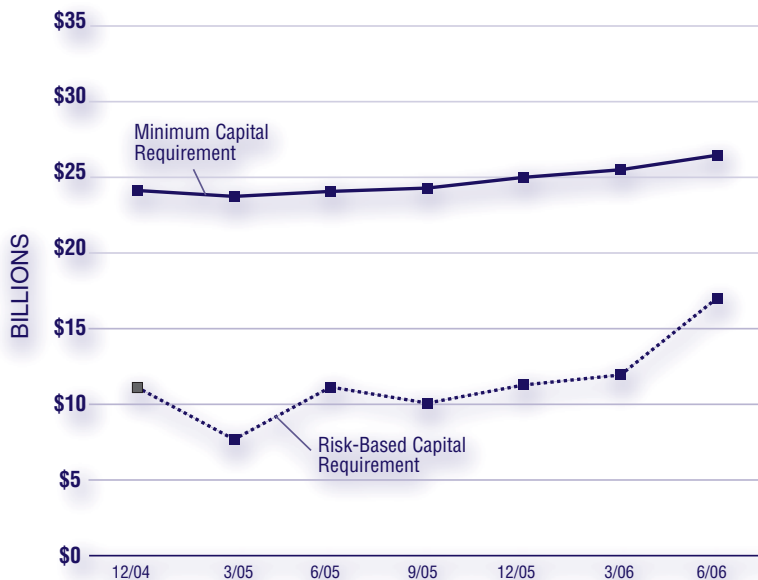


Figure 3 — Freddie Mac Minimum vs. Risk-Based Capital Requirements for 2005-2006



controls and financial reporting continue to present challenges for their regulator. While OFHEO’s resources and talented staff have increased over time, the competition for highly skilled and experienced staff in technical fields continues to challenge OFHEO in recruiting staff with the quality and expertise necessary to oversee the Enterprises. OFHEO also still faces challenges in expanding the depth of its expertise in model and accounting oversight. OFHEO must invest in its staff so they can stay abreast of the changes in their fields and reinforce the agency’s knowledge base.

Strengthening Capital Standards and Capital Oversight

OFHEO continues to review and strengthen its capital oversight. OFHEO monitors the Enterprises’ capital weekly, makes capital classifications quarterly, and conducts an ongoing review to verify and validate the data used in capital calculations. OFHEO has placed a 30 percent capital surcharge on the minimum capital requirement for each Enterprise to account for serious deficiencies in their operations that were identified through OFHEO’s special examinations. In addition, OFHEO is embarking on a significant review of the risk-based and minimum capital standards and will identify proposed changes that would strengthen the standards to better account for risk. Some improvements OFHEO could identify to better capture risk might require changes in law. The current law requires the Enterprises to maintain low

regulatory minimum capital levels at about half of what large banks must maintain in order to be classified as well capitalized. As shown in Figures 2 and 3, the risk-based capital standard has been constrained by the 1992 law and is much lower and more volatile than the minimum capital requirements because the current law limits how these risks can be measured. OFHEO is challenged to update and strengthen these capital standards to better account for risk without the flexibility to do so.

Enhancing Authorities

OFHEO's ability to ensure the safety and soundness of the Enterprises will be limited unless Congress acts to reform the regulatory structure for overseeing the Enterprises. Without additional authorities, OFHEO will have to rely on consent orders and other voluntary agreements with the Enterprises or slow and cumbersome enforcement proceedings to affect change and may not be able to act quickly enough to help prevent future problems. The authorities that need to be created are wide-ranging: independent litigation authority, receivership authority, better enforcement powers (including employee and director malfeasance penalties), independent funding authority, capital authority, and explicit authority to set portfolio growth limits. These authorities would provide OFHEO with the tools and resources necessary to keep up with the growth and complexity of the Enterprises, address systemic risk posed by the Enterprises to financial markets and other financial institutions, and provide growth constraints in lieu of market discipline. This comprehensive approach to strengthen the regulator in turn strengthens the Enterprises' credibility and lessens the uncertainties they and their shareholders face.

Creating a New Regulatory Agency if Legislation is Enacted

Legislation is under active consideration by both houses of Congress to combine the two agencies regulating housing 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. The FHFB is responsible for the oversight of the Federal Home Loan Banks across the nation. GSE mission oversight functions of the Department of Housing and Urban Development also would be transferred to the new entity. OFHEO supports these changes, which would provide integrated oversight. If this legislation is enacted, OFHEO will face policy-related, people-related, and systems-related challenges similar to those that confront private companies in mergers. These challenges include increased

attention to the similar and different approaches and standards used to supervise Fannie Mae and Freddie Mac on the one hand, and the Federal Home Loan Banks on the other. Administratively, the new agency will need to merge information technologies and systems, administrative and human resources functions, and agency cultures to meet the needs of the new entity.

Maintaining OFHEO's Information Technology Infrastructure, Security, and Preparedness

OFHEO uses technology to leverage its small staff to accomplish its supervision mission for two large and complex financial institutions. At OFHEO, technology is used to support the regulation of capital adequacy at the Enterprises and to enhance regulatory oversight with efficient systems and tools. OFHEO also relies on technology to ensure an efficient infrastructure to support supervision (including examinations, capital classification, modeling, research, and analysis) and the underlying administrative functions. The technological sophistication of the Enterprises' operations and products requires equivalent sophistication at OFHEO. OFHEO will continue to be challenged to maintain the robustness and versatility of its information technology infrastructure while ensuring appropriate security for the data and information OFHEO needs to do its job. OFHEO is also challenged to ensure the continuity of its operations to be prepared for a possible disruption from external systems or events and to integrate its emergency preparedness plans with those of each Enterprise.

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 2006 performance goals.

OFHEO had these three strategic goals and one resource management strategy in FY 2006:

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

Resource Management Strategy: Manage OFHEO resources effectively to enable the Office to fulfill its mission.

OFHEO set six annual performance goals to reach its strategic goals and three annual performance goals to support its resource management strategy. OFHEO's 2006 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 agency 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 Substantially Achieved Its Performance Goals

OFHEO substantially achieved all of its performance goals in 2006. During the year, OFHEO strengthened its supervisory program while addressing the issues identified at both Enterprises through special examinations and monitoring progress on remediation plans and agreements at both Enterprises. 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 the performance goals for each strategic goal. A complete discussion of OFHEO's annual performance goals can be found in the Performance Section of this report.





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

Figure 4 – Performance Goals for FY 2006

Performance Goals for FY 2006

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.

- Completed annual examinations at both Fannie Mae and Freddie Mac.
- Completed special examination at Fannie Mae.
- Entered into settlement agreement with Fannie Mae requiring the Enterprise to correct deficiencies identified in the special examination, make improvements, and pay a \$400 million civil money penalty to OFHEO and the SEC.
- Monitored the remediation efforts of the Enterprises. Both Fannie Mae and Freddie Mac have considerable work to do to correct their internal controls and accounting problems.



GOAL 1.2

Ensure the Enterprises are adequately capitalized.*

- Ensured Freddie Mac was adequately capitalized for the first three quarters of the year and maintained a mandatory capital surplus 30% over the regulatory minimum capital levels.
- Ensured Fannie Mae was adequately capitalized for the first three quarters of the year and maintained a mandatory capital surplus 30% over regulatory minimum capital levels.



GOAL 1.3

Ensure the Enterprises comply with applicable laws, regulations and directives, including executive compensation, corporate responsibility and disclosure.

- Implemented a mortgage fraud reporting system with the Financial Crimes Enforcement Network.
- Proposed technical amendments to OFHEO's risk-based capital regulation.
- Pursued administrative charges against Freddie Mac's former CEO and CFO.

STRATEGIC GOAL 2 ■ Enhance public understanding of the nation's housing finance system.



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.

- Published quarterly House Price Index (HPI) report.
- Published the "Report of the Special Examination of Fannie Mae."
- Published a research paper on "Mortgage Markets and the Enterprises in 2005."
- Provided public information about the need for legislation to strengthen the regulation of Fannie Mae and Freddie Mac, including testimony, speeches, public forums, and media interviews.



GOAL 2.2

Communicate effectively with all stakeholders on regulatory issues.

- Issued OFHEO's annual Report to Congress describing the findings of the calendar year 2005 examinations of both Enterprises. OFHEO is unique among regulators, as it is required by law to make public its examination findings.
- Surveyed users of OFHEO's web site; over 90% found the information on it valuable.

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.

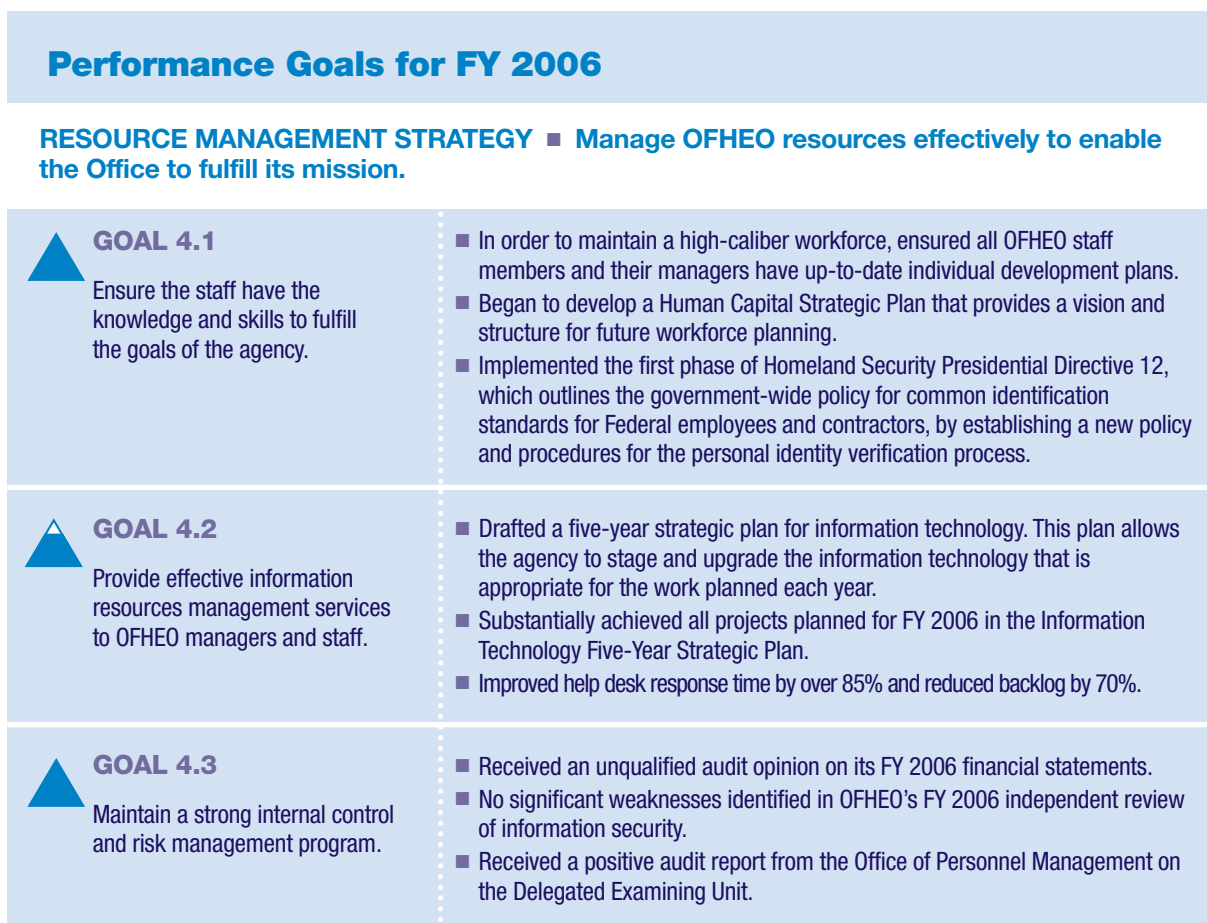
- Worked with other Federal agencies by responding to their requests for information and participating in task forces and other interagency efforts on regulatory issues.

* Data for the quarter ending September 30, 2006, will be available by December 29, 2006.

Managing OFHEO's Resources

OFHEO's management philosophy reflects the government-wide management goals outlined in the President's Management Agenda. 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 indicative of an effective support infrastructure.

Figure 5 – Resource Management Goals for FY 2006



President's Management Agenda

The President's Management Agenda (PMA) contains five government-wide initiatives that focus on making government more citizen-centered, results-oriented, and market-based. During 2006, OFHEO made strides in addressing these five initiatives:

- **Strategic Management of Human Capital.** OFHEO's most valuable resources are its employees and recruitment, retention, and development of employees are critical to ensuring that OFHEO meets its goals. OFHEO has begun developing a Human Capital Strategic Plan that provides a vision and structure for future workforce planning. The plan will help OFHEO effectively manage these goals by focusing on five areas: strategic alignment, leadership knowledge, results-oriented performance culture, talent management, and accountability. OFHEO also has a merit-based performance rating system and merit-based pay, another element identified in the PMA. OFHEO staff receive pay increases based on merit ratings that link to agency mission and goals. 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.
- **Competitive Sourcing.** In fulfilling the staffing and resource needs of the agency, OFHEO reviews whether commercial activities performed by the government can be more efficiently obtained and executed by private sector service providers or Federal employees. As a result, the agency contracts for many services. For example, instead of hiring permanent personnel, significant computer systems support and litigation services are obtained through contracts. OFHEO also uses the services of other Federal agencies for payroll services, background security adjudication, relocation services, and independent review of computer security. However, OFHEO has not undertaken any formal competitions. OFHEO completes the annual Fair Act report, which is posted on the agency's website www.ofheo.gov.
- **Improved Financial Performance.** OFHEO continued its focus on strong financial management practices in FY 2006. OFHEO's integrated financial information management system was implemented last year. OFHEO received an unqualified audit opinion on its FY 2005 and 2006 financial statements from its external auditor with no material weaknesses reported.
- **Expanded Electronic Government.** OFHEO relies heavily on information technology. During FY 2006, OFHEO drafted a new five-year Information Technology Strategic Plan. The plan outlines the goals and deliverables needed to support the mission and functions of OFHEO and carries out the E-Gov goals of the President's Management Agenda. During the year, OFHEO also began the process of certifying and accrediting all of its information systems. OFHEO continued to automate manual processes by beginning the implementation of a time and attendance system that is integrated with the National Finance Center and automated reporting on training with OPM's e-Training initiative. OFHEO also worked with other agencies to develop an electronic Official Personnel Folder and began automating the performance evaluation

process. OFHEO implemented an Investment Review Board to institutionalize the process of establishing business cases for major systems investments and to make efficient information technology decisions. An independent contractor identified no significant or material weaknesses in OFHEO's compliance with the Federal Information Security Management Act (FISMA).

- **Budget and Performance Integration.** Understanding the connection between the budget and achieving agency performance goals is key to making informed decisions. OFHEO management meets quarterly to review agency performance and uses the information exchanged to improve OFHEO's ability to meet its mission and achieve its goals. OFHEO also tracks the cost of achieving its strategic goals throughout the year through the financial management system and a quarterly time study and reports those results in the Performance and Accountability Report (see Figure 7). In FY 2006, OFHEO issued a new strategic plan that outlines a limited number of outcome-oriented goals and measures, including those reviewed through OMB's Performance Assessment Rating Tool (PART) process (see next section).

Performance Assessment Rating Tool

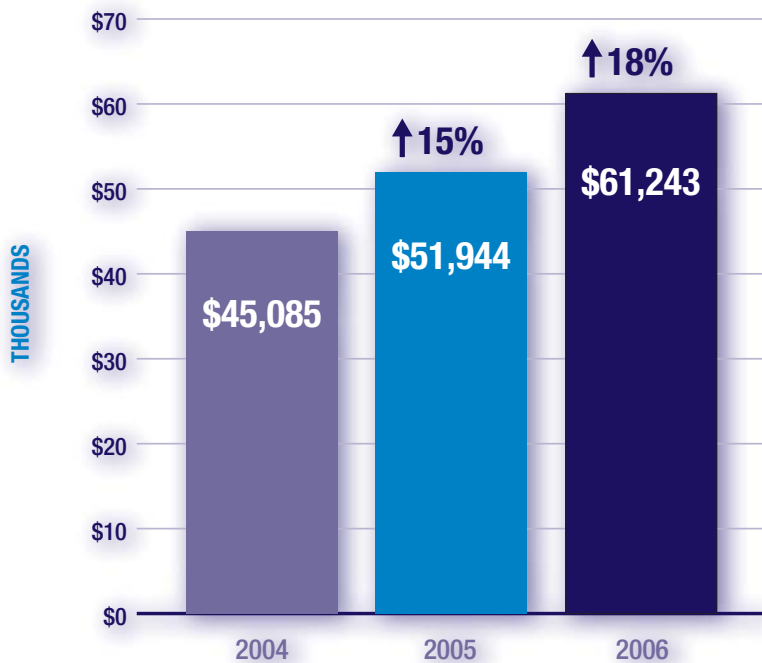
OFHEO was reviewed by its management and OMB using the Performance Assessment Rating Tool in FY 2006. The results of this assessment, including OFHEO's rating, will be publicly released with the President's 2008 Budget in February 2007.

Financial Summary

Fiscal Year 2006 Financial Results

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. The funding appropriated to OFHEO is collected from Fannie Mae and Freddie Mac and deposited in the U.S. Treasury for paying OFHEO expenses.

Figure 6 – OFHEO Net Cost in Thousands, 2004 – 2006



In FY 2006, OFHEO’s appropriation was for \$60.0 million in budget authority. During FY 2006, OFHEO recovered prior year unspent obligations of \$0.6 million, bringing its total budgetary resources to \$60.6 million. The agency obligated all but \$53,000 of that amount. Budgetary resources decreased \$3.8 million between FY 2005 and FY 2006. The total budgetary resources for FY 2005 included the original appropriation of \$59.2 million, \$5 million supplemental appropriation for special examination related expenses and \$0.2 million prior year recovery of unspent obligations.

While budget authority is the maximum amount that OFHEO can obligate in the year, net cost represents a calculation of program costs. Net cost includes expenses paid and depreciation expense for the year, but excludes money paid for capitalized assets. It also includes year-end accruals and

unfunded expenses for retirement plans, health benefits, and life insurance paid by the Office of Personnel Management for OFHEO. The net cost of OFHEO operations increased in FY 2006 over FY 2005 by \$9.3 million or 17.9 percent, as reflected in the Statements of Net Cost for the Years Ended September 30, 2006, and 2005. Figure 6 reflects the net change in cost of operations from FY 2004 to FY 2006. The increase in net cost from FY 2005 to FY 2006 is primarily due to expenses associated with strengthening supervisory activities, the special examination of Fannie Mae, and litigation costs associated with enforcement actions arising from the Freddie Mac special examination. Some of these expenses were obligated in the prior year but were paid in FY 2006 as goods and services were received.

Human Capital Cost Increase Strengthens Supervision Program.

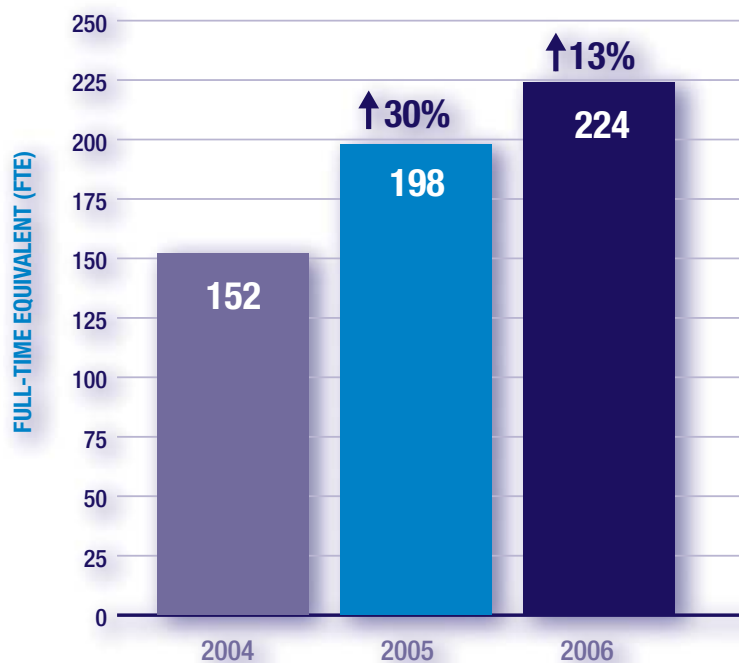
Payroll expenses rose about \$5.2 million during FY 2006, primarily associated with an increase in staffing of 26 Full-Time Equivalents (FTE). Nearly \$4 million or 76 percent of the human capital cost increase supported direct supervisory activities, of which 75 percent is associated with staffing increases in examination functions. An additional 8 percent of the total was for legal activities associated with litigation pertaining to the special examination. The balance is associated with administrative support such as human resources, administrative accounting, facilities, records, and information technology. Payroll benefits contributed to about \$1 million of the rise for the greater number of participants, higher OPM benefits costs, and the addition of vision benefits.

Special Examination Costs. Net cost rose more than \$4.5 million for contract legal and document management services supporting the Fannie Mae special examination.

Other Factors. A number of expenses, such as rent, administrative support systems, and information technology purchases, increased by smaller amounts in 2006. Depreciation expense was \$3.3 million lower in FY 2006 because the last \$5 million depreciation expense for the RBC software took place in 2005.

Figure 7 reflects OFHEO's change in Full-Time Equivalents (FTE) from 2004 to 2006. During FY 2006, OFHEO continued to focus on hiring and retaining staff to ensure effective oversight of the Enterprises. FTE rose from 198 in FY 2005 to 224 at the end of FY 2006, an increase of 13 percent. The increase is primarily attributed to direct regulation of the Enterprises, with 22 of the 26 additional FTE dedicated to direct regulatory activities. Additional staff to strengthen the supervision program resulted in an increase of 17 percent, from 114 FTE in FY 2005 to 134 in FY 2006. Additional legal staff to support litigation associated with the special examination of Freddie Mac rose by nearly 9 percent, from 24 FTE in FY 2005 to 26 in FY 2006.

Figure 7 – OFHEO Full-Time Equivalents, 2004 – 2006



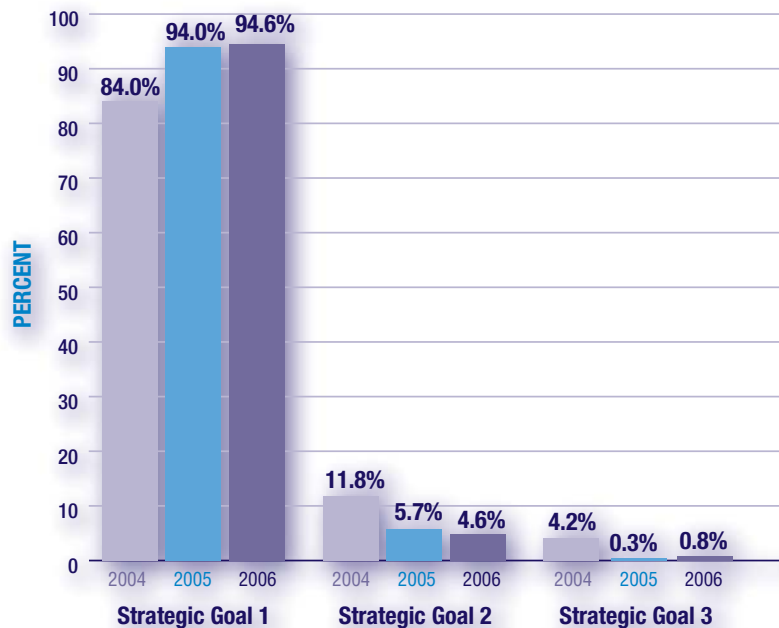
Unqualified Audit Opinion for Fiscal Year 2006

For FY 2006, 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 FY 1998. No material weaknesses were noted in internal controls nor any non-compliance with laws and regulations.

Compliance with Appropriation Mandate

OFHEO is in compliance with language in OFHEO’s FY 2006 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, verified by quarterly staff time studies and financial management system data recorded at the transaction level by

Figure 8 – OFHEO Obligations by Strategic Goal, 2004 – 2006



* FY 2004 data are estimates. FY 2005 and FY 2006 data are based on actual obligations, using the data captured in the time study and financial management system.

strategic goal. Figure 8 demonstrates that OFHEO used 94.6 percent of its available resources toward the examination, supervision and oversight of Fannie Mae and Freddie Mac during FY 2006. OFHEO had a similar appropriations requirement for the last two years, which it also met having devoted 94.0 percent of its resources to the first strategic goal in FY 2005, up from 84 percent in FY 2004.

Compliance with Other Laws and Regulations

Management Assurances.

Pursuant to OMB Circular A-123, Appendix A, effective for FY 2006 activities, OFHEO strengthened its internal control structure by creating an Executive Internal Controls Committee (EICC) charged with the responsibility to oversee internal controls and provide recommendations to the Director

pertaining to management assurances on the effectiveness of OFHEO’s internal controls. The EICC is composed of the Executive Director who serves as the Chair, the Director of Supervision, the General Counsel, and the Deputy Director. The EICC advises the Director on all internal control matters. The EICC is supported by a Senior Assessment Team chaired by the Chief Financial Officer. The Chief Information Officer is a permanent member of the Senior Assessment Team and other members are appointed as appropriate to review specific internal control issues.

During FY 2006, OFHEO continued to require managers to monitor internal controls and report on the effectiveness of controls to the Director. The EICC and the Director reviewed documentation from program managers as well as documentation on financial system and accounting processes. In compliance with the new OMB requirements, the Director was able to determine with reasonable assurance that as of June 30, 2006, the agency’s internal controls were sufficient to support materially accurate financial reporting and he issued an unqualified opinion on internal controls over financial reporting as of June 30, 2006. Between June 30 and September 30, OFHEO continued to review internal controls matters and the Director re-confirmed his June 30,

2006, unqualified opinion on internal controls as of September 30, 2006. This assurance can be found in the third chapter of this report and meets the reporting requirement for internal controls in the Federal Managers' Financial Integrity Act (FMFIA).

The Federal Financial Managers Improvement Act (FFMIA) 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." OFHEO's Financial Information Management System (FIMS), the core accounting and financial system to which OFHEO converted in FY 2005, meets the 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. During FY 2006, OFHEO streamlined accounting processes by completing an electronic interface between the NFC payroll accounting system and FIMS. The new interface is effective for the first pay period in FY 2007.

Federal Information Security Management Act. 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 agency's information security program through an independent contractor and reports the results to OMB. The independent review found no significant or material weaknesses for FY 2006. OFHEO's report showed that the agency improved its overall security posture with respect to safeguarding its information assets and systems. Specific recommendations in the report included organization issues pertaining to the Chief Information Officer and Chief Information Security Officer, operational controls, separation of duties among the technical staff, and addressing specific technical deficiencies for OFHEO's information systems that were noted during the review. The FY 2006 review reflected continued progress in certifying and accrediting major systems, targeted for completion in 2007. During FY 2006, OFHEO continued to take steps to strengthen its information systems. OFHEO initiated a comprehensive monitoring program and a comprehensive review of its network and the automated supervisory tool, with the goal of certification and accreditation of these systems. In addition, OFHEO also contracted for a risk assessment of FIMS. These reviews will be completed in FY 2007. OFHEO is committed to continuing improvement of management and security of its information systems.

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. The agency has implemented and maintains 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. There were zero erroneous payments issued by OFHEO in FY 2006.

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 2006, the dollar amount subject to prompt payment was \$22.7 million, an increase of 60 percent over \$14.2 million in FY 2005. The amount of interest penalty paid in FY 2006 was \$13,702 or 0.06 percent of the total dollars disbursed. This compares to the \$4,149 interest penalty paid in FY 2005 at 0.03 percent of total dollars disbursed. Of the total interest paid in FY 2006, over 99 percent, or \$13,609, was paid during the first one-half of the year. OFHEO made personnel and management changes that substantially improved accounts payable processing resulting in improved performance relative to Prompt Payment Interest payments.

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 Statement ²

To promote housing and a strong national housing finance system by ensuring the safety and soundness of Fannie Mae and Freddie Mac.

OFHEO's three strategic goals in effect in FY 2006 support the clear and important mission of the agency. 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

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

Each year, OFHEO develops outcome-based 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 level of 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.

² This is OFHEO's current mission statement, consistent with the recently released FY 2006-2011 Strategic Plan. OFHEO operated under a similar mission statement until the end of FY 2006.

Figure 9 –
OFHEO's Goal Hierarchy



Managing and Measuring Performance

OFHEO accomplishes its mission primarily by conducting examinations of the Enterprises, assessing their capital adequacy, and conducting research and analysis about the Enterprises and the markets in which they operate. OFHEO's regulatory framework supports these functions. The OFHEO Annual Performance Budget describes how OFHEO achieves its goals. But 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, OFHEO managers reported their progress in achieving the 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. The Director was able to use real-time budget information throughout the year to redirect resources in a timely manner to facilitate the achievement of OFHEO's goals and to address emerging issues, such as the special examination of Fannie Mae and litigation related to the special examination of Freddie Mac.

Most of OFHEO's performance indicators reflect data and milestones internal to the agency, with the 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 2006. However, the agency participated in OMB's Performance Assessment Rating Tool review during the year and the results will be published with the President's Budget in February 2007. OFHEO also received an unqualified audit opinion from an independent, external financial auditor and a clean review on the OFHEO information security program for FY 2006.

Figure 10 –
OFHEO 2006 Obligations by
Strategic Goal



Performance Budget

OFHEO dedicates the majority of its resources to achieving its first strategic goal focusing on examinations, supervision, and capital oversight. In FY 2006, OFHEO had an appropriation of \$60 million and a recovery of \$0.6 million of prior year unspent obligations. OFHEO met the requirement, part of the 2006 Appropriations Act, to use at least 80 percent of its resources on examination, supervision, and capital oversight (Strategic Goal 1). Figure 10 shows the allocation of OFHEO's fiscal resources 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 the Enterprises operate in a safe and sound manner in order to fulfill their important role in the nation’s housing finance system. 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 fundamental to the ability of OFHEO to ensure their safe and sound operation.

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

A key part of the oversight program is ensuring capital adequacy. 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, and that is when it could be most needed to support the nation’s housing finance system. Regulatory capital standards may require an Enterprise to hold more capital than it might otherwise choose to hold, thereby providing greater protection for the nation’s housing markets.

OFHEO seeks to identify and resolve 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 rapid changes in the environment and the evolution of products and services provided by the Enterprises.

Performance Results Key:
Goal Fulfillment

.....

Fully Achieved	
Substantially Achieved	
Partially Achieved	
Not Achieved	

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

MEASURE 1.1(1)

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



2006 PERFORMANCE

Both Enterprises continue to pose supervisory concern including internal controls and accounting problems. Both Enterprises have remedial plans in place to address special examination findings and OFHEO continues to identify other issues requiring attention. Although both Enterprises are responding to OFHEO’s concerns, they have considerable work to do to correct their accounting and internal controls problems.

Prior Year Performance

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.

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.

2006 Performance Discussion for Goal 1.1

Overall

OFHEO completed its calendar year 2005 annual examination and began its calendar year 2006 examination of both Enterprises during fiscal year 2006. OFHEO found both Enterprises financially sound for calendar year 2005, but warranting supervisory concern. OFHEO continued to identify issues that needed attention and monitored resolution of the concerns raised through special examinations and targeted reviews of both Enterprises in 2005 and prior years. As issues were identified during the year, OFHEO worked with the Enterprises to begin corrective action, though in many cases, that will take a multiyear effort. The OFHEO annual Report to Congress in June 2006 noted that Fannie Mae and Freddie Mac had made progress in 2005, but that much more work and several years are needed to fully achieve safe and sound practices.

As part of its future examinations, OFHEO will continue to monitor progress that each Enterprise is making in resolving weaknesses and returning to timely reporting through frequent meetings with executives and with the Enterprises' external auditors. OFHEO will continue to use its available enforcement authorities as necessary. The calendar year 2005 examinations included continuous review of the Enterprises' accounting practices, credit portfolio management, interest rate exposure management and controls, and model development activities.

Results and conclusions from the calendar year 2005 examination of Fannie Mae and Freddie Mac were detailed in the Report to Congress OFHEO published in June 2006. The report explained the results of the examinations through the CAMELS framework traditionally used by financial regulators to assess key areas of risk: Capital adequacy, Asset quality, Management, Earnings, Liquidity, and Sensitivity to interest rate risk. Results of the calendar year 2006 examinations will be detailed in the 2007 Report to Congress.

Fannie Mae

At Fannie Mae, OFHEO found a large number of deficiencies that management must prioritize and address to improve data, systems, controls, communication, risk measurement, and management, as well as process efficiency and systems flexibility to remain competitive in the future business environment.

Portfolio Limits and Systemic Risk

In recent years, because of their rapid growth, concern has increased about the systemic risk of Fannie Mae and Freddie Mac—the risk the Enterprises pose to the stability and smooth functioning of the financial system. If either Enterprise unexpectedly got into severe financial trouble, there could be adverse consequences for banks, other financial institutions, and financial markets. In the extreme, the functioning of the financial system could be disrupted, mortgage rates could spike, and a drop in economic output could occur.

Indicators of systemic risk include an institution's risk profile and its quality of risk management. Some key areas of concern for the Enterprises are their high leverage, their continued inability to produce financial statements, their weak internal control environment, their huge mortgage asset portfolios that contain substantial interest rate and operational risks, the very limited market discipline they face, the importance of their obligations to other institutions and markets, and the degree of reliance placed on them by many mortgage lenders.

There are several major reasons that Fannie Mae and Freddie Mac pose increased systemic risk. In the 1990s and early in this decade, the Enterprises acquired huge portfolios of mortgages and mortgage-backed securities (MBS). Those portfolios grew from less than \$200 billion at the end of 1992 to more than \$1.6 trillion at year-end 2003 and 2004, before dropping to \$1.4 trillion in 2005 and this year. To fund the portfolios, Fannie Mae and Freddie Mac issued huge amounts of debt. Many banks hold large amounts of that debt relative to their capital, and the debt is widely held by foreign investors, including foreign central banks. To lower the cost of funding and manage the risks of the portfolios, the Enterprises also extensively used financial derivatives.

One of the reasons for this rapid growth is that the debt markets did not apply normal market discipline because of the GSE status and the assumption of an "implicit" government guarantee. Also because of their GSE status, unlike other major financial institutions, by law the Enterprises cannot diversify their assets.

Continued on next page

As described more fully under Performance Goal 1.3, during FY 2006, OFHEO completed a special examination of the accounting practices and financial reporting control issues at Fannie Mae. Prior to 2006, based on earlier findings from the special examination, Fannie Mae had entered into agreements with OFHEO to improve the Enterprise's accounting procedures. The Enterprise also agreed to develop a 30 percent capital surplus over the minimum capital requirement, providing additional protection for operational risk, and to make organizational changes to improve internal controls, corporate governance, and accounting systems.

In May 2006, these agreements were consolidated within a new agreement that addressed all the findings of the special examination and required a new remediation plan. OFHEO closely monitored Fannie Mae's progress in completing these corrections and improvements, including Fannie Mae's progress toward restating its financial results from 2001 through 2003, revising 2004 results and its efforts to publish financial statements for 2005 and 2006. OFHEO monitored changes to accounting policy and process, internal controls, and information technology and reviewed the work of the Enterprise's external auditor. OFHEO is watching Fannie Mae closely to ensure that it makes organizational changes that clarify accountability and responsibility among management and staff. In addition, OFHEO monitored Fannie Mae's new business initiatives to ensure they do not detract from Fannie Mae's corrective actions and that they are appropriate and have proper controls.

Freddie Mac

While Freddie Mac had made progress by developing plans called for in the 2003 Consent Order that followed OFHEO's special examination, the volume and complexity of issues became more apparent during remediation efforts in 2005 and slowed management's ability to carry them out. After reviewing progress in 2005, OFHEO called several matters to the Board's attention that required strong Board oversight. In the human resources area these issues include monitoring staff turnover and other key human resources metrics to

ensure that ongoing activities are appropriately staffed and effectively managed, implementing key cultural initiatives related to building a strong executive team, strengthening management depth and expertise, and ensuring staffing levels are consistent with the Enterprise's priorities. OFHEO is overseeing management's progress toward remediating widespread internal control weaknesses to enable the release of accurate and timely financial statements, permit a return to auditing that can be based on controls, and effectively managing the pace of introducing new products and services with necessary internal controls. Enterprise risk management program issues include overseeing management's progress in establishing the program; ensuring clear definitions of authorities, roles, and responsibilities, and identifying, aggregating and reporting Enterprise-level risks promptly.

During 2006, Freddie Mac developed comprehensive multiyear plans to address all known internal control weaknesses and return to timely financial reporting. These include key automation initiatives and reviews of business processes from end to end. Management is holding executives accountable for making these corrections. Throughout 2006, OFHEO continued to monitor Freddie Mac as it developed these corporate-wide plans and began to carry them out. The agency worked to assess the status of internal controls, safety and soundness controls, and progress toward timely financial statements, placing emphasis on comprehensive and sustainable solutions.

OFHEO Supervision Program

During the year, OFHEO significantly strengthened its supervisory program by establishing an Office of Supervision to coordinate the oversight of the Enterprises. OFHEO has increased its on-site presence at the Enterprises and hired additional experienced examiners to provide more in-depth analysis of Enterprise performance, risks, processes, and controls. OFHEO also worked to improve examiner efficiency through the ongoing development of an automated supervisory tool.

Continued from previous page

Another reason for the risk is that there is not a full range of regulatory processes for addressing the claims of creditors if Fannie Mae or Freddie Mac ever become insolvent. If an Enterprise suddenly experienced severe financial difficulties, the resulting uncertainty could contribute to illiquidity in the market for its debt and losses to its derivatives counterparties. Each Enterprise has so much debt outstanding and is so involved in derivatives markets, that such developments could disrupt broader financial markets and harm the economy.

The retained mortgage portfolios of Fannie Mae and Freddie Mac can benefit homebuyers by enabling the Enterprises to buy unusual loans that finance affordable housing and to purchase mortgages when there is turmoil in financial markets, other investors want to sell mortgages, and mortgage rates are rising. But those benefits of providing liquidity, stability, and affordability to the nation's housing market could be gained with smaller portfolios that would not pose as significant systemic risk.

The housing finance system would be stronger, and the financial safety and soundness of Fannie Mae and Freddie Mac would be enhanced, if steps were taken to limit the systemic risk of the Enterprises. One step would be to give the regulator the authority to appoint a receiver for an insolvent Enterprise. Such action would reduce uncertainty about the status of claimants and the likelihood that severe financial difficulties at an Enterprise would harm the rest of the financial sector. A second step would be to authorize the regulator to limit the size of each Enterprise's retained mortgage portfolio to the amount necessary for the Enterprise to perform its mission of supporting the liquidity and stability of the secondary mortgage market and supporting lending that finances affordable housing. A third step would be to authorize the regulator to strengthen capital requirements. The Enterprises' capital requirements are currently set in a law that was designed 15 years ago and sets minimum capital at levels well below well-capitalized levels for large banks, and risk-based capital levels without including the full array of risks. Enhancing capital requirements would reduce the risk of failure of an Enterprise. A fourth step would be to ensure that the regulator has the full range of powers that a bank regulator has.

GOAL 1.2 ■ Ensure the Enterprises are adequately capitalized.

MEASURE 1.2(1)

Each Enterprise meets OFHEO's determination of capital adequacy or OFHEO receives an acceptable capital plan.¹



2006 PERFORMANCE

Both Enterprises are adequately capitalized, and both maintained a surplus over the OFHEO-directed capital requirement.^{2,3}

MEASURE 1.2(2)

Initiate development of a formal program to systematically review and revise (as necessary) all capital adequacy regulations, models and measures.



2006 PERFORMANCE

OFHEO initiated a systematic re-evaluation of the capital standards, regulations, models, and measures to better account for the full range of Enterprise risk.

MEASURE 1.2(3)

Develop additional measures of Enterprise capital adequacy.



2006 PERFORMANCE

OFHEO began developing additional measures this year.

Prior Year Performance

2005



Freddie Mac: classified as adequately capitalized each quarter.⁴
Fannie Mae: classified as adequately capitalized for two quarters and classified as significantly undercapitalized for the quarter ending December 31, 2004.²

2004



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, 2004.²

2003



Freddie Mac: classified as adequately capitalized each quarter.
Fannie Mae: classified as adequately capitalized each quarter.²

¹ The data for the quarter ending September 30, 2006 will be available by December 29, 2006.

² Fannie Mae's capital classification is based on Fannie Mae's best estimates of its financial condition, as certified and represented as true and correct to the best of Fannie Mae management's belief and knowledge. The classification remains subject to revision during Fannie Mae's re-audit and accounting restatement process.

³ Freddie Mac's capital classification is based on Freddie Mac's best estimate of its financial condition, as certified and represented as true and correct by Freddie Mac's management. The capital classification remains subject to revision based upon results from Freddie Mac's ongoing audit.

⁴ On May 30, 2006, Freddie Mac submitted amended Minimum Capital Reports for all quarters of 2005 in conjunction with the issuance of financial statements for 2005. OFHEO has determined that Freddie Mac remained adequately capitalized during all periods in 2005.

2006 Performance Discussion for Goal 1.2

For the first three quarters of FY 2006, both Fannie Mae and Freddie Mac were adequately capitalized and both maintained a 30 percent minimum capital surplus as required by OFHEO. OFHEO is statutorily required to determine capital adequacy of the Enterprises on the basis of both minimum and risk-based capital standards.

Fannie Mae is required to maintain the 30 percent surplus over its minimum capital requirement due to uncertainties in its financial statements and operational weaknesses identified through OFHEO's special examination (see Performance Goal 1.3 for more information). The requirement was established in Fannie Mae's capital restoration plan, approved in February 2005. OFHEO continues to hold weekly capital assessment meetings with Fannie Mae to closely monitor its capital position as the Enterprise restates financial results for years 2002 through 2004 and works to produce financial results for 2005 and 2006.

OFHEO has also required Freddie Mac to maintain a 30 percent capital surplus over its minimum capital requirement due to inadequate controls and improper accounting. The requirement was established in January 2004. During FY 2006, Freddie Mac resubmitted its financial results for 2005 and OFHEO reviewed the capital classifications and determined that Freddie Mac remained adequately capitalized. OFHEO also monitors Freddie Mac's capital on a weekly basis.

OFHEO publishes the OFHEO-directed, minimum, and risk-based capital requirements for each Enterprise on its web site, www.ofheo.gov. Data on the Enterprises' capital for the quarter ending September 30, 2006, will be disclosed by December 29, 2006.

Figure 11 – Fannie Mae Minimum and OFHEO-Directed Capital, 2005-2006ⁱ



ⁱ In accordance with its approved capital restoration plan, Fannie Mae was required to meet the 30 percent surplus requirement beginning with the quarter ending September 30, 2005.

Figure 12 – Freddie Mac Minimum and OFHEO-Directed Capital, 2005-2006

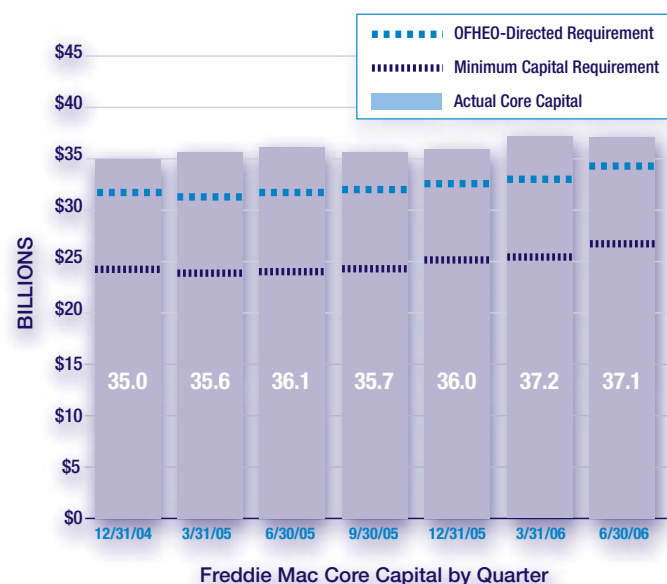
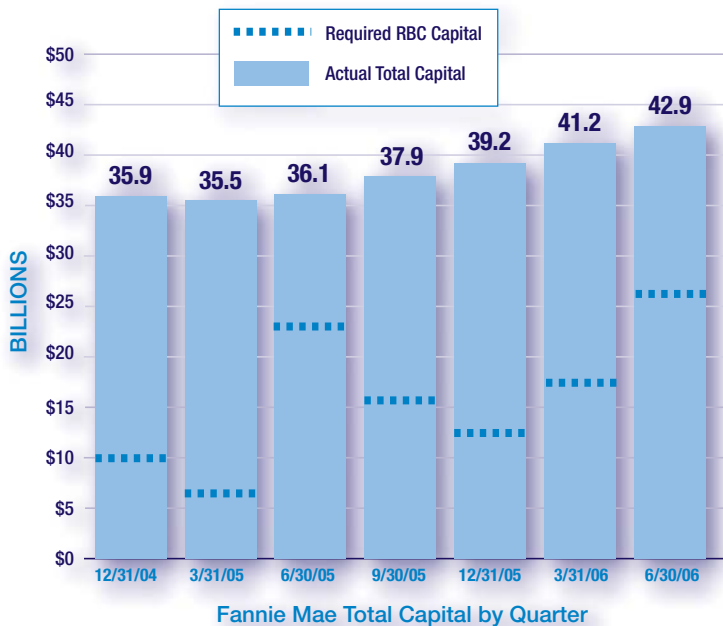
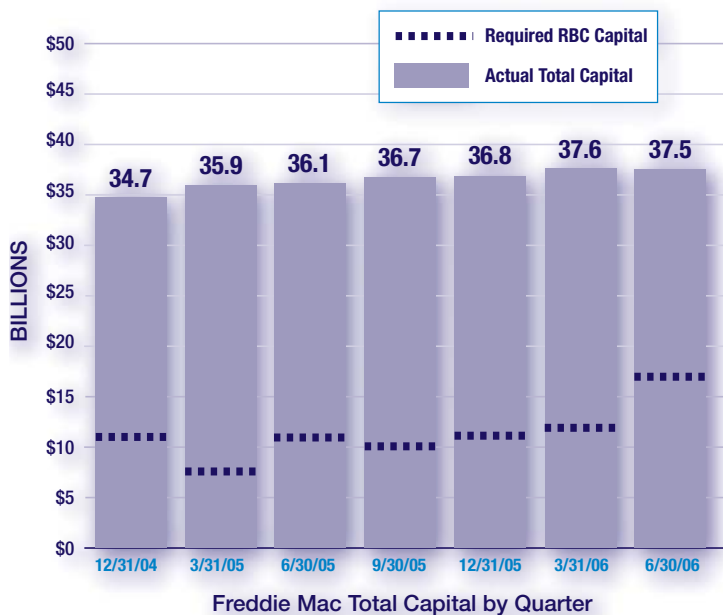


Figure 13 – Fannie Mae Risk-Based Capital (RBC) Requirements, 2005-2006



In FY 2006, OFHEO initiated a systematic review of its capital standards for the Enterprises. This top-to-bottom review includes a re-evaluation of the current approaches, measurements, and methodologies in both the minimum and risk-based capital standards and may include changes to the capital regulations in the future. OFHEO will focus on strengthening the standards to better account for the full range of Enterprise risks, including better measurement of operational risk and usage of market value approaches. OFHEO also began developing additional measures of capital adequacy during the year. This work will continue into FY 2007. In October 2005 and again in April 2006, OFHEO published on its web site new versions of the software for the risk-based capital stress test and related stylized data, which the public can use to run the model.

Figure 14 – Freddie Mac Risk-Based Capital (RBC) Requirements, 2005-2006



Completeness and Reliability of Capital Performance Measures

OFHEO relies on data from the Enterprises to determine their capital adequacy. Because of the timing of this report, data for the quarter ending September 30, 2006, are not yet available. OFHEO expects to release this information publicly in FY 2007 and include it with the other performance information in the OFHEO Performance Budget that accompanies the President’s FY 2008 budget.

For the minimum and risk-based capital calculations, senior officers of each Enterprise transmit their data and attest to its completeness and accuracy. Under normal circumstances, OFHEO is able to validate the minimum capital data through comparison with audited Enterprise data with a high level

of integrity. For the risk-based capital standard, OFHEO uses data validation protocols to ensure the consistency and integrity of the data received. This allows for ready identification of data issues, which OFHEO resolves with the Enterprises. In 2006, OFHEO began a data validation review of the Enterprises' data submitted for capital classification purposes. 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.

Freddie Mac's serious accounting errors forced it to restate its financial results for the years 2000 through 2003 and published delayed results for 2004 and 2005. In May 2006, OFHEO reassessed Freddie Mac's capital levels based on resubmitted data for 2005, reaffirmed the Enterprise's capital classification, and revised minimum capital results for those quarters on the OFHEO web site. OFHEO determined that Freddie Mac's accounting errors did not substantially affect the risk-based capital outcomes for the Enterprise for the quarters affected. Freddie Mac's 2006 capital classification results are still subject to revision pending published financial results.

Fannie Mae is also in the process of restating prior year financial results as a result of accounting and internal control errors identified by OFHEO through its special examination. Both minimum and risk-based capital data for Fannie Mae for 2002 through 2006, including the quarters reported in this report, are subject to change based on 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.

OFHEO's Capital Requirements

Capital represents the ability of a firm to absorb losses and pay off creditors without assistance and is thus an important measure of a firm's soundness.

The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 requires the OFHEO Director to determine the capital level and capital classification of the Enterprises not less than quarterly, and to report the results to Congress. OFHEO classifies the Enterprises as adequately capitalized, undercapitalized, significantly undercapitalized, or critically undercapitalized. The Enterprises are required by Federal statute to meet the higher of the minimum and risk-based capital standards to be classified as adequately capitalized.

Under current law, the minimum capital requirement for the Enterprises is set at 2.5 percent of an Enterprise's assets, plus 0.45 percent of their off-balance sheet obligations. Enterprise assets largely consist of mortgage-backed securities (MBS) and whole mortgage loans. Off-balance sheet obligations include credit-guaranteed MBS sold to investors and derivatives held by the Enterprises. For purposes of regulatory minimum capital, an Enterprise is considered adequately capitalized if core capital—common stock, perpetual noncumulative preferred stock, paid-in capital, and retained earnings—equals or exceeds minimum capital. OFHEO has also directed both Enterprises to hold an additional 30 percent capital surplus above their minimum capital levels. This represents the amount of capital the Enterprise currently needs to maintain to compensate for increased operational, accounting, and control risks. The OFHEO-directed requirement is calculated by multiplying the minimum capital requirement by 1.3. 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 adverse interest rate and credit risk conditions, plus 30 percent to cover management and operational risk. Current law specifies that the risk-based requirement be calculated to withstand two hypothetical but prescribed stress tests.

Before making the determination that an Enterprise is adequately capitalized, OFHEO calculates the OFHEO-directed, minimum and risk-based capital requirements and then considers other factors which may affect capital adequacy. These factors provide context and additional information to form a more comprehensive picture of the Enterprises' capital positions and trends. OFHEO considers the level of capital and financial condition of the Enterprise, prospects and plans for capital growth, credit risk exposure, portfolio composition and market risk exposure, earnings projections and access to capital markets, and the sufficiency of capital management practices. In addition, OFHEO performs sensitivity analysis and reviews alternative interest rate scenarios in the risk-based capital stress test.

GOAL 1.3 ■ Ensure the Enterprises comply with applicable laws, regulations and directives, including executive compensation, corporate responsibility and disclosure.

MEASURE 1.3(1)

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



2006 PERFORMANCE

Reviewed Enterprise compliance with applicable laws, regulations, and directives, including corporate responsibility, executive compensation, and disclosure requirements. Each Enterprise responded appropriately to address issues identified by OFHEO.

Prior Year Performance

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.

2003



Reviewed Enterprise compliance with applicable laws, regulations, and directives. Each Enterprise responded appropriately to issues identified by OFHEO.

2006 Performance Discussion for Goal 1.3

Monitoring each Enterprise's compliance with laws, regulations, directives, and agreements has been a major focus for OFHEO throughout the year. Both Fannie Mae and Freddie Mac are under agreements to make corrections and improvements to address internal controls, operations, and accounting issues.

Fannie Mae

OFHEO completed the multiyear special examination of Fannie Mae and issued a report describing OFHEO's findings and recommendations in May 2006. OFHEO found the following:

- ▲ Fannie Mae senior management promoted a false image of the Enterprise as one of the lowest-risk financial institutions in the world.
- ▲ A large number of Fannie Mae's accounting policies and practices did not comply with Generally Accepted Accounting Principles (GAAP).
- ▲ Fannie Mae had serious problems of internal control, financial reporting, and corporate governance, resulting in Fannie Mae's overstating reported income and capital.
- ▲ Between 1998 and 2004, Fannie Mae senior management deliberately and intentionally manipulated accounting to hit earnings targets, so that senior management maximized the bonuses and other executive compensation they received.
- ▲ Fannie Mae's Board of Directors failed to be sufficiently informed, to act independently of its chairman, Franklin Raines, and other senior executives, and to exercise the requisite oversight over the Enterprise's operations.
- ▲ Despite rapid growth and changing accounting and legal requirements, Fannie Mae senior management did not make investments in accounting systems, computer systems, other infrastructure, and staffing needed to support a sound internal control system, proper accounting, and GAAP-consistent financial reporting.

At the conclusion of the special examination, Fannie Mae was already under agreement with OFHEO to correct some of the deficiencies that OFHEO identified earlier. This included a requirement to maintain a 30 percent capital surplus over the minimum capital requirement. These

agreements were consolidated within a new agreement between OFHEO and Fannie Mae in May 2006 that called for the Enterprise to make additional improvements and take further corrective actions. Fannie Mae also agreed to pay a collective penalty of \$400 million as part of a settlement with OFHEO and the Securities and Exchange Commission (SEC). The new OFHEO agreement has 81 requirements. Key provisions of the agreement call for Fannie Mae to do the following:

- ▲ Complete a comprehensive remediation plan to correct deficiencies and make improvements to its internal controls, accounting policies and procedures, and other aspects of its operations.
- ▲ Continue to maintain a 30 percent capital surplus over the minimum capital requirement.
- ▲ Strengthen its Board of Directors' procedures to enhance Board oversight of Fannie Mae's management.
- ▲ Undertake a review of individuals currently with the Enterprise that are mentioned in OFHEO's report.
- ▲ Cooperate with OFHEO in any enforcement actions against former Fannie Mae employees.
- ▲ Limit growth of its portfolio mortgage assets to the level of December 31, 2005, i.e., \$727.7 billion.

Freddie Mac

During the special examination of Freddie Mac in FY 2003, OFHEO took specific actions regarding several former executives of Freddie Mac, including imposing civil money penalties and initiating the process to sanction the former CEO and CFO. OFHEO continued to pursue these administrative charges in FY 2006.

Also as a result of the special examination findings, OFHEO directed Freddie Mac to complete a remediation plan and maintain a 30 percent capital surplus over its minimum capital requirement until certified

financial statements could be produced on a timely basis and operational issues were addressed. During 2006 OFHEO continued to closely monitor Freddie Mac's progress on its remediation plan and its capital position. To date, Freddie Mac has restated financial results for 2000 through 2003 and issued delayed financial statements for 2004 and 2005.

Throughout the year, OFHEO reviewed termination agreements, employment agreements, and revisions to these agreements at both Enterprises. OFHEO proposed a regulation to require the Enterprises to establish record retention programs, as well as technical amendments to the risk-based capital regulation. OFHEO is also monitoring Freddie Mac's compliance with a HUD ruling that certain mixed-pool commercial mortgage-backed securities are not compliant with Freddie Mac's charter.

OFHEO issued the maximum 2006 conforming loan limit for single-family mortgage purchases by Fannie Mae and Freddie Mac, \$417,000, in November 2005. The conforming loan limit establishes a ceiling on the size of loans an Enterprise may purchase or guarantee. In 2004, 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.

Conforming Loan Limit

Fannie Mae and Freddie Mac are restricted by law to purchasing single-family mortgages with unpaid balances below specific amounts, known as the "conforming loan limits." The conforming loan limits are set to maintain a substantial margin relative to the average price of homes purchased. Loans above these limits are known as jumbo loans. Conforming loans carry a slightly lower interest rate than jumbo mortgages, partly because Fannie Mae and Freddie Mac participate in this part of the secondary mortgage market. Seeking these interest rates, many home buyers of higher-priced homes and borrowers who want to refinance existing mortgages typically prefer to take out loans with balances below those limits, and are willing to make larger down payments to do so.

The conforming loan limit for mortgages that finance single-family one-unit properties has increased from \$33,000 in the early 1970s to \$417,000 in 2006. Higher limits apply to loans for properties that finance two to four units. The limits are adjusted each year to reflect the change in the national average single-family home price, using the Federal Housing Finance Board's Monthly Interest Rate Survey. The limits are 50 percent higher for four statutorily-designated high cost areas: Alaska, Hawaii, Guam, and the U.S. Virgin Islands. As the loan limit is the same for all states in the continental U.S. and the price of housing varies in local and regional markets, the conforming loan limit has a different effect in lower cost and higher cost housing markets.

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



Partially Achieved



Not Achieved



MEASURE 2.1(1)

Report about house price trends quarterly through the House Price Index (HPI) report.



2006 PERFORMANCE
HPI Report issued quarterly.

MEASURE 2.1(2)

Publish special reports on topical issues as appropriate.



2006 PERFORMANCE
Report of the Special Examination of Fannie Mae issued in May 2006.

One research paper and one working paper published.

Prior Year Performance

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.

2006 Performance Discussion for Goal 2.1

OFHEO provides valuable information to the public about the financial performance and condition of the Enterprises and their secondary mortgage market activities. OFHEO also informs the public about developments in the housing sector and the primary mortgage market through the publication of reports, papers, and other information. One key report this fiscal year was the Report of the Special Examination of Fannie Mae issued in May 2006. This report outlines the findings and recommendations of OFHEO's special examination (see Performance Goal 1.3 for more information).

OFHEO publishes the House Price Index (HPI) quarterly, two months after the quarter end. The HPI documents changes in the home prices for the nation, each state, many 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 2006 OFHEO continued to report on seasonally-adjusted results from a second index composed of purchase-only transactions and additional analyses of specific geographic areas and house price trends. The HPI report for each quarter is on the OFHEO web site.

OFHEO also released a public version of the software used to run the risk-based capital stress test along with a stylized data set to use in the model in April 2006. By running a "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, research papers, and staff working papers that can be made available to the public are posted on the OFHEO web site. In FY 2006, OFHEO updated the data series related to an OFHEO research paper from 2005 entitled "Single-Family Mortgages Originated and Outstanding, 1990 - 2004." In September 2006, OFHEO published a research paper on the secondary mortgage market, "Mortgage Markets and the Enterprises in 2005." OFHEO also issued a working paper entitled "Removing Appraisal Bias from a Repeat-Transactions House Price Index: A Basic Approach." This paper presents a "bias-neutral" approach to house price indices and demonstrates the different results. Reports, research papers, and working papers are authored by OFHEO economists and analysts. OFHEO staff also presented papers at professional and industry conferences.

House Price Index

OFHEO uses its House Price Index (HPI) to assess the capital adequacy of Fannie Mae and Freddie Mac. The index aids in the evaluation of the Enterprises' exposure to credit risk by allowing OFHEO to calculate how much equity borrowers have in the homes financed with mortgages purchased by the Enterprises. Changes in house prices affect the value of the equity of a home, and contribute to borrowers' incentives to default or pre-pay loans, key factors affecting credit risk.

The HPI also provides a service to the public by informing industry participants and consumers about recent house price trends. For example, OFHEO's last two HPI releases, which included data for the first and second quarters of 2006, revealed a number of interesting housing market trends. Figure 15, which uses data from OFHEO's latest release, shows the annualized growth rates in the second quarter of 2006 for each state.

The most striking development is that, in most of the country, house price increases have slowed dramatically relative to 2005. The cooling has been particularly dramatic in parts of the country that previously experienced the most rapid rise in house prices.

Appreciation has declined very sharply in Arizona, Hawaii, and Florida where annualized appreciation rates exceeded 20 percent until recently. Rates in the New England region, which was one of the fastest appreciating areas in the early part of the decade, continued their sharp slide.

In the states with modest house price growth in 2005 the slowdown is more moderate, yet still clearly observable. Quarterly growth rates in the East North Central Census Division (including Michigan, Wisconsin, Illinois, Indiana, and Ohio) exceeded 1.3 percent in each of the last two quarters of 2005, compared to price growth of a mere 0.2 percent during the second quarter of 2006. Quarterly growth was actually negative in the second quarter in Michigan, Ohio and Indiana.

House price growth remained firm or accelerated in only a handful of areas. Growth rates were at historically high levels in areas affected by Hurricane Katrina. In Louisiana as a whole, the annualized rate of increase was nearly 11 percent in the second quarter. Price growth also remained quite strong in the Pacific Northwest, as well as in some oil-rich areas in the state of Texas.

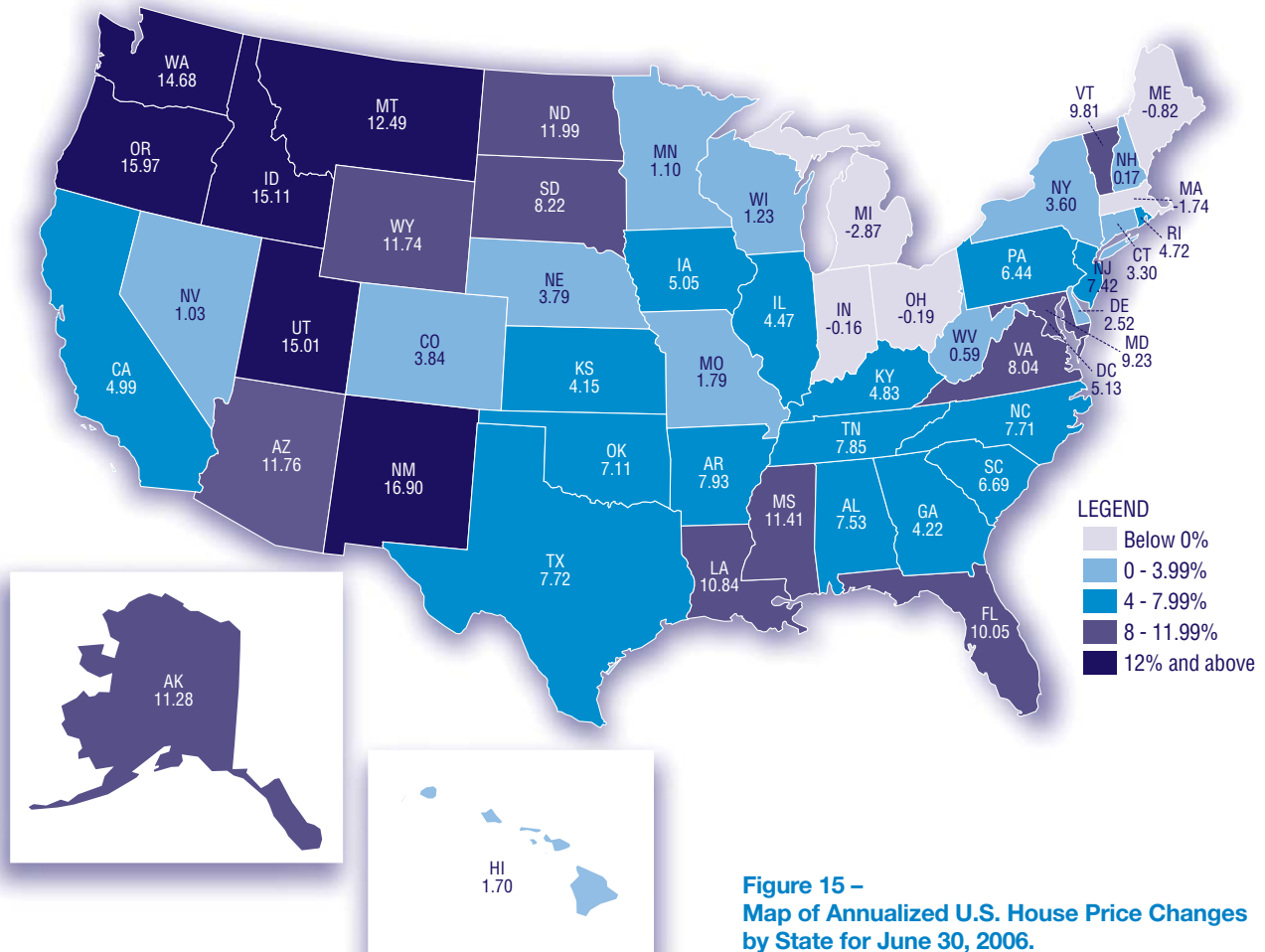


Figure 15 –
Map of Annualized U.S. House Price Changes
by State for June 30, 2006.

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

MEASURE 2.2(1)



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

2006 PERFORMANCE

Annual Report sent to Congress on June 15, 2006.

MEASURE 2.2(2)



The majority of survey respondents visiting OFHEO's web site find it a useful resource.

2006 PERFORMANCE

Over 93% of respondents indicated they found OFHEO's web site a valuable resource.

MEASURE 2.2(3)



Consider and respond appropriately to all congressional inquiries within 10 business days.

2006 PERFORMANCE

Responded to all inquiries within the time frame.

MEASURE 2.2(4)



Consider and respond appropriately to all public inquiries within 15 business days.

2006 PERFORMANCE

Responded to all inquiries within the time frame.

Prior Year Performance

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.

2004



Annual Report sent to Congress on June 15, 2004. No report issued in FY 2004 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 on June 4, 2003. No report issued in FY 2003 on the secondary mortgage market.

Responded to nearly all inquiries from Congress and the public within 7 days.

2005 Performance Discussion for Goal 2.2

OFHEO published the annual Report to Congress on June 15, 2006, describing the results and conclusions of the OFHEO calendar year 2005 examinations of the Enterprises and some of the regulatory activities of the agency. The report explained the results of the examinations through the CAMELS framework traditionally used by other financial regulators, through which risks are described through Capital adequacy, Asset quality, Management, Earnings, Liquidity, and Sensitivity to interest rate risk. OFHEO is unique among financial regulators as it is required by law to make public its examination findings. This report is available on the OFHEO web site.

In FY 2006, OFHEO developed and implemented a web site survey to obtain public feedback on the agency's public products and materials. Over 93 percent of respondents indicated that OFHEO's web site provided them valuable information. OFHEO collected feedback on web site usage, comments, and suggestions for improvements. Based on this feedback, OFHEO initiated a project to revamp the web site. The new and improved OFHEO web site is expected to be launched in the first quarter of FY 2007.

OFHEO also continued to respond effectively to inquiries from Congress and the public. The agency resolved all inquiries within the target time frames despite the continued high volume due to regulatory events and analyses released quarterly with OFHEO's House Price Index. OFHEO continued to post proposed and final regulations, reports, guidelines, speeches, testimony, and other pertinent information on its web site as soon as it was available. In FY 2006, OFHEO issued public statements on Freddie Mac's voluntary agreement to limit its portfolio growth, OFHEO's calculation of the maximum conforming loan limits, directives issued to the Enterprises, and quarterly capital classifications.

OFHEO continued briefings with congressional committee members and staff on issues related to ongoing oversight of the Enterprises, the special examinations of Freddie Mac and Fannie Mae, and the need for statutory changes to reform the regulation of the housing GSEs. In addition, the OFHEO Acting Director testified before both the Capital Markets Subcommittee of the House Financial Services Committee and the Senate Banking Committee on the Report of the Special Examination of Fannie Mae in June 2006. Also in June, the Senate Banking Committee held a confirmation hearing on the nomination of Acting Director Lockhart to be Director of OFHEO. Director Lockhart was confirmed by the Senate on June 15, 2006.

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.

Performance Results Key:
Goal Fulfillment

.....



Fully Achieved 

Substantially Achieved 

Partially Achieved 

Not Achieved 

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

MEASURE 3.1(1)	Participate in ongoing task forces and forums with other regulatory agencies.
	2006 PERFORMANCE Worked on various issues, such as accounting policy and mortgage fraud, and participated in interagency task forces, such as the Financial and Banking Information Infrastructure Committee.
MEASURE 3.1(2)	Respond within 30 days to requests from other Federal agencies for information about housing finance markets and the Enterprises.
	2006 PERFORMANCE Responded to all requests within the time frame.

Prior Year Performance

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.

2006 Performance Discussion for Goal 3.1

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 2006, OFHEO worked with the following Federal agencies and departments:

- ▲ *Department of Housing and Urban Development*
- ▲ *Federal Reserve Board*
- ▲ *Federal Deposit Insurance Corporation*
- ▲ *Office of Thrift Supervision*
- ▲ *Office of the Comptroller of the Currency*
- ▲ *National Credit Union Administration*
- ▲ *Federal Housing Finance Board*
- ▲ *Securities and Exchange Commission*
- ▲ *Department of the Treasury*
- ▲ *Public Company Accounting Oversight Board*
- ▲ *National Economic Council*
- ▲ *Council of Economic Advisors*
- ▲ *Internal Revenue Service*
- ▲ *Department of Labor*
- ▲ *Department of Commerce*
- ▲ *Office of Management and Budget*
- ▲ *Department of Justice*
- ▲ *Federal Bureau of Investigation*
- ▲ *Office of Personnel Management*
- ▲ *Government Accountability Office*

James Lockhart, OFHEO Director, with Securities and Exchange Commission (SEC) Chairman Christopher Cox, announces the findings of OFHEO's special examination of Fannie Mae, and settlements between the company and OFHEO and the SEC at a news conference on May 23, 2006.



OFHEO worked with these agencies on a variety of issues including: findings from the special examination of Fannie Mae; legal and regulatory issues related to the special examinations of Fannie Mae and Freddie Mac; OFHEO's House Price Index; house price volatility; accounting policy and practices; the Enterprises' derivative holdings; alternative mortgage products; the effects of the hurricanes in the Gulf Coast; the development of an electronic Official Personnel Folder (e-OPF); and planning, performance management, and performance measurement.

During the special examination of Fannie Mae, OFHEO coordinated with the Securities and Exchange Commission (SEC) on findings and recommendations relevant to both regulators. In May 2006, OFHEO announced with the SEC a collective penalty of \$400 million and a settlement agreement between OFHEO and Fannie Mae to make corrections and improvements. After issuing the special examination report, OFHEO continued to work with the SEC and the Public Company Accounting Oversight Board (PCAOB) regarding findings related to Fannie Mae's accounting practices.

In 2006, OFHEO entered into a memorandum of understanding with the Treasury Department's Financial Crimes Enforcement Network (FinCEN) on mortgage fraud. OFHEO forwards any information indicating mortgage fraud to FinCEN's reporting center so that the appropriate law enforcement authorities can access the data.

OFHEO continues to participate in 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.

OFHEO's Role in Preventing Mortgage Fraud

Mortgage fraud, the intentional misrepresentation or falsification of information to secure a mortgage, continues as a growing criminal activity both by individuals and institutions. Now criminal gangs and money launderers have been involved and identity theft has become standard practice in these crimes. Losses to individuals and to institutions represent a potential loss of public confidence in financial and legal structures.





OFHEO has acted to address actual or potential mortgage fraud. By regulation and examination guidance, OFHEO requires the Enterprises to have systems in place to detect mortgage fraud and to report known and possible mortgage fraud to OFHEO. The OFHEO requirements also focus on examiner oversight for the establishment of comprehensive anti-fraud programs, including Enterprise employee training.

OFHEO supports legislative efforts to enhance fraudulent transaction reporting by the Enterprises. Proposed legislation on GSE regulatory reforms would, by statute, direct reporting to OFHEO and would provide a safe harbor from liability for the Enterprises in their reporting of suspected fraudulent activities.

OFHEO has entered into a memorandum of understanding with the Treasury Department's Financial Crimes Enforcement Network (FinCEN) to share mortgage fraud information developed by OFHEO as part of FinCEN's law enforcement database. OFHEO is an active member of the President's inter-agency Corporate Fraud Task Force and continues to cooperate with other federal agencies in the effort to combat mortgage fraud, while working to ensure the safety and soundness of the Enterprises.

Resource Management Strategy:

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

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

The success of OFHEO in achieving its 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 internal coordination.

The OFHEO management philosophy reflects the government-wide management goals of the President’s Management Agenda. 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 and make other strides in improving efficiency.

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

MEASURE 4.1(1)

Maintain current Individual Development Plans for each staff member to ensure OFHEO staff maintains and enhances their expertise and skills.



2006 PERFORMANCE

Completed annual revision of individual development plans (IDPs) for all staff members. Training and development ongoing.

Prior Year Performance

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



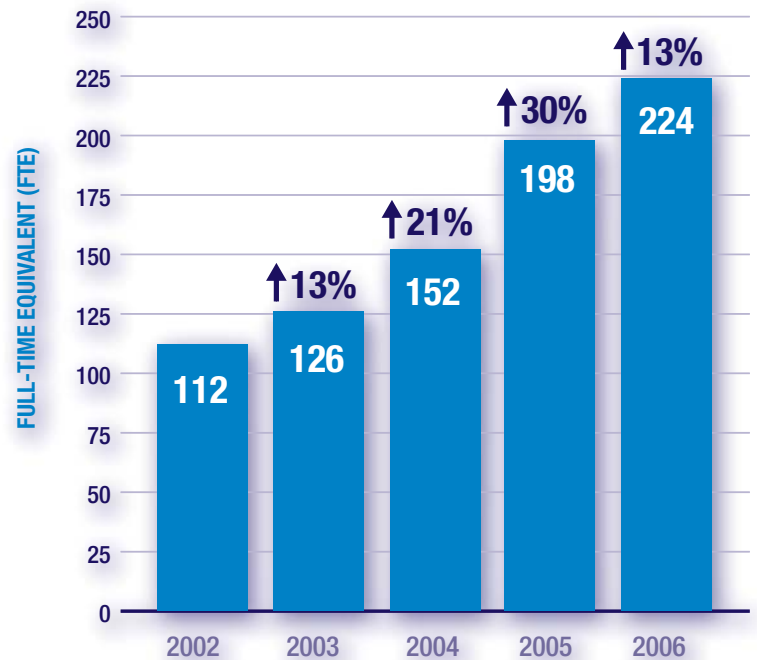
Completed annual revision of individual development plans for 95% of staff members. Training and development ongoing.

2006 Performance Discussion for Goal 4.1

During FY 2006, OFHEO began to develop a Human Capital Strategic Plan that will provide a vision and structure for addressing current and future workforce needs. In the past five years, OFHEO staff has doubled, from 112 Full-Time Equivalent (FTE) work years in 2002 to 224 in 2006. During the year, OFHEO shifted resources to achieve its goals, including reorganizing or detailing staff when necessary and hiring additional staff in critical areas.

OFHEO maintains a strong commitment to recruiting and retaining a high-caliber workforce and ensuring that the employees have the skills and expertise necessary to meet the important goals and mission of the agency. In FY 2006, OFHEO staff and management ensured that each staff member had an up-to-date Individual Development Plan (IDP), even as overall staffing levels increased. Over the course of the fiscal year, OFHEO hired over 30 new employees and, net of departures, grew from 215 staff on board as of September 2005 to 225 as of September 2006, an increase of five percent. As new staff came on board, OFHEO managers worked to ensure that new staff had IDPs in place within 60 days.

Figure 16 – OFHEO’s Growth in Full-Time Equivalents, 2002 – 2006



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

MEASURE 4.2(1)




Implement the fiscal year 2006 component of the OFHEO five-year IT Strategic Plan.



2006 PERFORMANCE

Successfully implemented four of six projects outlined in the FY 2006 component of the five-year IT Strategic Plan. Substantially completed the remaining two projects and expect to have them completed in the first and second quarter of 2007.

Prior Year Performance

2005 	Implemented all three projects outlined in the FY 2005 Component of Five-Year IT Strategic Plan.
2004 	Implemented all three projects outlined in the FY 2004 Component Five-Year IT Strategic Plan.
2003 	Implemented four projects from the FY 2003 Component of Five-Year IT Strategic Plan, made substantial progress on two others, and suspended one project.

2006 Performance Discussion for Goal 4.2

Since 2002, OFHEO has maintained a five-year Information Technology (IT) Strategic Plan. This plan allows the agency 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 that will be completed for each year of the plan. For the FY 2006 component of the plan, OFHEO set an ambitious agenda, taking on more complex and resource-intensive efforts than in prior years. In total, six elements were planned and four were completed before the end of the fiscal year. Two others were substantially achieved during the year and close to completion before year-end, including specific milestones on the second stage of development for X-Works, OFHEO's automated supervisory tool, and the development of a new information technology strategic plan. OFHEO expects to complete the X-Works certification and accreditation in the first half of FY 2007 and issue the new agency-wide IT strategic plan in the first quarter.

Key IT accomplishments include maintaining effective support for the risk-based capital stress test, maintaining and testing back-up systems for mission critical functions, improving help-desk response time to enable OFHEO system users to remain effective, and implementing an Investment Review Board process to ensure that IT resources are appropriately directed toward achieving the mission of the agency.

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

MEASURE 4.3(1)

No material weakness identified by OFHEO’s external auditor or external review.



2006 PERFORMANCE

Received an unqualified audit opinion on 2006 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.

Prior Year Performance

2005	Received an unqualified audit opinion on 2005 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 2003 and 2004 financial statements, internal controls, and compliance with laws and regulations from an independent, external auditor. No material weaknesses were reported during the independent review of the OFHEO information security program. The HUD Inspector General (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.

2006 Performance Discussion for Goal 4.3

During FY 2006, external auditors conducted a complete financial audit and issued a clean audit opinion finding no material weaknesses for OFHEO for FY 2006. Throughout the year, OFHEO continued its quarterly time studies, begun in 2005, to more accurately estimate expenses by strategic goal. These time studies survey employees about the

time they spent working on projects and activities to achieve each strategic goal. Using OFHEO's integrated financial management system and specific guidance to match activities, projects, work products, and expenses directly to the appropriate strategic goal, OFHEO is able to better estimate the cost of achieving each goal.

In FY 2006, the Office of Personnel Management (OPM) conducted an audit of OFHEO's human resources operations and found that OFHEO is managing its human capital and recruiting talent in support of its mission, and its human capital policies and practices support merit system principles and other applicable laws and regulations. OPM required one action that OFHEO implemented. OFHEO also received an opinion from an independent review of the information security program, as required by the Federal Information Security Management Act, indicating no material or significant weaknesses.

3

Financial Section





Message from the Chief Financial Officer

I am pleased to report for fiscal year 2006 that OFHEO once again has received an unqualified audit opinion on its financial statements. No material weaknesses were noted in internal controls and no instances of non-compliance with laws and regulations were identified. OFHEO began having its financial statements audited by external auditors in fiscal year 1998 and has received a clean opinion every year since then. This outstanding record of accomplishment reflects the strong financial control environment established for the agency.

This record of accomplishment extended to other areas of the agency as well. During fiscal year 2006, the Office of Personnel Management conducted an audit of OFHEO's Delegated Examining Unit. The audit concluded that the manner in which OFHEO conducts its delegated examining supports the Merit System Principles and the Veteran's Preference Act of 1974, as amended. An independent annual FISMA review of the agency's information systems security program revealed no significant or material weaknesses in the program.

OFHEO managers reported no material internal control weaknesses in any of the agency's programs. To further strengthen the agency's internal control structure, and to be consistent with revised OMB Circular A-123, Appendix A, OFHEO created an Executive Internal Controls Committee (EICC) charged with the responsibility to oversee internal controls and provide recommendations to the Director pertaining to management assurances on the effectiveness of OFHEO's internal controls. The EICC ensured that the agency maintained a strong internal control environment during fiscal year 2006 and will continue that focus in the years to come.

As always, these impressive results could not have been achieved without the dedication and hard work of OFHEO's staff in establishing and adhering to OFHEO policies and controls.

Sincerely,



Mark Kinsey
Chief Financial Officer



OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT
1700 G STREET NW WASHINGTON DC 20552 (202) 414-3800

Statement of Assurance

As of September 30, 2006

The management of the Office of Federal Housing Enterprise Oversight (OFHEO) is responsible for establishing and maintaining effective internal control and financial management systems that meet the objectives of the Federal Managers' Financial Integrity Act (FMFIA). OFHEO conducted its assessment of the effectiveness of internal control over its operations and compliance with applicable laws and regulations in accordance with OMB Circular A-123, *Management's Responsibility for Internal Control*. Based on the results of this evaluation and on-going management oversight of operations, OFHEO identified no material weaknesses in the design or operations of its internal controls. OFHEO can affirm that its internal controls provide reasonable assurance over the effectiveness and efficiency of operations and compliance with applicable laws and regulations as of September 30, 2006.

In addition, OFHEO conducted an assessment of internal control over financial reporting, which includes safeguarding of assets and compliance with applicable laws and regulations, in accordance with the requirements of Appendix A of the OMB Circular A-123. Based on the results of this evaluation and on the standard of reasonable assurance, OFHEO found that its internal control over financial reporting, as of June 30, 2006, was operating effectively without material weakness. In addition, external audit had not identified any material weakness in the design or operation of the internal controls over financial reporting. OFHEO re-confirmed this finding as of September 30, 2006.


James B. Lockhart III
Director


Date



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

Certified Public Accountants and Consultants

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

Mr. James B. Lockhart III
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, 2006 and 2005, 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. 06-03, "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, 2006 and 2005, 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) section is not a required part of the basic financial statements of the Office of Federal Housing Enterprise Oversight but is 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. 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 31, 2006, on our consideration of the Office of Federal Housing Enterprise Oversight's internal control over financial reporting and a report dated October 31, 2006 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 31, 2006

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

Certified Public Accountants and Consultants

**Report of Independent Auditors
on Internal Control**

Mr. James B. Lockhart III
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, 2006 and 2005, 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 31, 2006. 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. 06-03, "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. 06-03. 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 31, 2006.

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. 06-03. 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.

October 31, 2006

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

Certified Public Accountants and Consultants

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

Mr. James B. Lockhart III
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, 2006 and 2005, 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 31, 2006. 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. 06-03, "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. 06-03, 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. 06-03.

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.

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

October 31, 2006

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OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

Balance Sheets

As of September 30, 2006 and 2005

(Amounts Shown in Thousands)

	2006	2005
Assets		
Intragovernmental		
Fund Balance with Treasury - Note 3	\$ 72,256	\$ 24,337
Total Intragovernmental	72,256	24,337
Accounts Receivable	-	107
Property, Plant and Equipment, Net - Note 4	11,234	9,397
Other	-	15
Total Assets	83,490	33,856
Liabilities		
Intragovernmental		
Accounts Payable	-	50
Other Liabilities Due to Treasury	50,016	2
Total Other Liabilities	50,016	2
Total Intragovernmental - Note 5	50,016	52
With the Public		
Accounts Payable	1,386	2,791
Other Liabilities		
Accrued Payroll	1,378	1,248
Annual Leave	2,304	1,750
Deferred Rent	171	-
Total Other Liabilities	3,853	2,998
Total With the Public - Note 5	5,239	5,789
Total Liabilities	55,255	5,841
Net Position		
Unexpended Appropriations - Note 1.K	19,475	20,247
Cumulative Results of Operations - Note 1.K	8,760	7,768
Total Net Position	28,235	28,015
Total Liabilities and Net Position	\$ 83,490	\$ 33,856

The accompanying notes are an integral part of these statements.

OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

Statements of Net Cost

for the Years Ended

September 30, 2006 and 2005

(Amounts Shown in Thousands)

	<u>2006</u>	<u>2005</u>
Program Costs		
Program Costs - Note 7	<u>\$ 61,243</u>	<u>\$ 51,944</u>
Net Cost of Operations	\$ 61,243	\$ 51,944

The accompanying notes are an integral part of these statements.

OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

Statements of Changes in Net Position

for the Years Ended

September 30, 2006 and 2005

(Amounts Shown in Thousands)

	2006	2005
Cumulative Results of Operations		
Beginning Balance	\$ 7,768	\$ 10,064
Prior Period Adjustment	-	(151)
Beginning Balance, As Adjusted	7,768	9,913
Budgetary Financing Sources:		
Appropriations Used	60,752	48,528
Other Financing Sources:		
Imputed Financing	1,483	1,271
Total Financing Sources	62,235	49,799
Net Cost of Operations	(61,243)	(51,944)
Net Change	992	(2,145)
Cumulative Results of Operations	8,760	7,768
Unexpended Appropriations		
Beginning Balance	20,247	4,415
Prior Period Adjustment	-	151
Beginning Balance, As Adjusted	20,247	4,566
Budgetary Financing Sources:		
Appropriations Received	60,000	64,209
Other Adjustments	(20)	-
Appropriations Used	(60,752)	(48,528)
Total Budgetary Financing Sources	(772)	15,681
Unexpended Appropriations	19,475	20,247
Net Position	\$ 28,235	\$ 28,015

The accompanying notes are an integral part of these statements.

OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

Statements of Budgetary Resources

for the Years Ended

September 30, 2006 and 2005

(Amounts Shown in Thousands)

	<u>2006</u>	<u>2005</u>
Budgetary Resources		
Unobligated Balance, Beginning	\$ 20	\$ -
Recoveries of Prior Year Obligations - Note 9	612	153
Budgetary Authority:		
Appropriation	60,000	64,209
Permanently Not Available Pursuant to P.L. 102-550 - Note 10	(20)	-
Total Budgetary Resources	60,612	64,362
Status of Budgetary Resources		
Obligations Incurred - Note 8	60,559	64,342
Unobligated Balance Not Available	53	20
Total Status of Budgetary Resources	60,612	64,362
Change in Obligated Balances		
Obligated Balance, Beginning	24,315	8,340
Obligations Incurred	60,559	64,342
Gross Outlays	(62,075)	(48,214)
Recoveries	(612)	(153)
Obligated Balance, Ending	22,187	24,315
Net Outlays		
Disbursements	62,075	48,214
Net Outlays	\$ 62,075	\$ 48,214

The accompanying notes are an integral part of these statements.

OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

Statements of Financing

for the Years Ended

September 30, 2006 and 2005

(Amounts Shown in Thousands)

	2006	2005
Resources Used to Finance Activities		
Budgetary Resources Obligated		
Obligations Incurred	\$ 60,559	\$ 64,342
Recoveries of Prior Year Obligations - Note 9	(612)	(153)
Net Obligations	59,947	64,189
Other Resources		
Imputed Financing from Costs Absorbed by Others	1,483	1,271
Net Other Resources	1,483	1,271
Total Resources Used to Finance Activities	61,430	65,460
Resources Used to Finance Items Not Part of the Net Cost of Operations		
Decrease (increase) in Goods/Services/Benefits Ordered but Not Provided	804	(15,661)
Resources that Fund Expenses Recognized in Prior Periods	-	25
Resources that Finance the Acquisition of Assets	(6,232)	(5,919)
Total Resources Used to Finance Items Not Part of the Net Cost of Operations	(5,428)	(21,555)
Total Resources Used to Finance the Net Cost of Operations	56,002	43,905
Components of the Net Cost of Operations that will Not Require or Generate Resources in the Current Period		
Components Requiring or Generating Resources in Future Periods - Note 13		
Increase in Annual Leave	554	422
Other	171	-
Total Components of Net Cost of Operations that will Require or Generate Resources in Future Periods	725	422
Components Not Requiring or Generating Resources		
Depreciation	4,301	7,617
Revaluation of Assets or Liabilities	215	-
Total Components Not Requiring or Generating Resources	4,516	7,617
Total Components of Net Cost of Operations that will Not Require or Generate Resources in the Current Period	5,241	8,039
Net Cost of Operations	\$ 61,243	\$ 51,944

The accompanying notes are an integral part of these statements.

OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

Statements of Custodial Activity

for the Years Ended

September 30, 2006 and 2005

(Amounts Shown in Thousands)

	2006	2005
	<u> </u>	<u> </u>
Revenue Activity		
Sources of Cash - Note 14		
Fines Assessed	\$ 50,000	\$ -
FOIA Fees Collected	16	2
	<u> </u>	<u> </u>
Total Cash Collections	50,016	2
	<u> </u>	<u> </u>
Total Custodial Revenue	50,016	2
Disposition of Collections		
Due to Treasury - Note 14	50,016	2
	<u> </u>	<u> </u>
Total Disposition of Collections	50,016	2
	<u> </u>	<u> </u>
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 the regulatory oversight of Fannie Mae and Freddie Mac (Enterprises), including conducting annual and special examinations, determining whether the Enterprises are operating in a safe and sound manner and are adequately capitalized.

B. Basis of Presentation

OFHEO is not directly subject to the requirements of the Chief Financial Officer's (CFO) Act or the Accountability of Tax Dollars Act of 2002 to prepare audited financial statements. OFHEO is a component of the Department of Housing and Urban Development (HUD), and HUD is subject to both of these laws. OFHEO's principal statements were prepared from its official financial records and general ledger in accordance with generally accepted accounting principles (GAAP) and follow the presentation guidance established by the Office of Management and Budget (OMB) Circular A-136 "Financial Reporting Requirements." These financial statements are in addition to financial reports prepared by OFHEO, pursuant OMB directives, which are used to monitor and control budgetary resources.

C. Basis of Accounting

Transactions are recorded on both an accrual and budgetary basis of accounting. Under the accrual basis of accounting, 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 GAAP for Federal entities as prescribed by the standards set forth by the Federal Accounting Standards Advisory Board (FASAB). FASAB is recognized by the American Institute of Certified Public Accountants (AICPA) as the body designated to establish GAAP for Federal entities.

D. Use of Estimates

Estimates are used by OFHEO in determining the amounts to be reported for services provided by contractors that have not yet been billed to the agency at year-end. An accounts payable is recorded based on these estimates. In prior years, OFHEO separated the estimated payables from other accounts payables and designated them as accrued liabilities with the public. This segregation is not required. Estimates are also used in determining the amount of salaries and benefits earned but unpaid at year-end. An accrued payroll liability is recorded for this amount.

E. Earmarked Funds

FASAB's Statement of Federal Financial Accounting Standard (SFFAS) #27 "Identifying and Reporting Earmarked Funds" establishes certain disclosure requirements for funds defined as "earmarked." SFFAS #27 states that "(e)armarked funds are financed by specifically identified revenues, often supplemented by other financing sources, which remain available over time. These specifically identified revenues and other financing sources are required by statute to be used for designated activities, benefits or purposes, and must be accounted for separately from the Government's general revenues."

The standard also presents three required criteria for an earmarked fund. Based on the standard's criteria and in consultation with OMB, OFHEO determined that it has no earmarked funds.

F. 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. The mandated crediting provision for unobligated funds acts as a restriction to the "no-year" designation. Consequently, when OFHEO closes its books each fiscal year, it accounts for budgetary resources not obligated as of the end of that fiscal year (September 30). OFHEO reduces the following year's annual assessment by the amount of the unobligated balance from the prior year. The cash is retained in the OFHEO fund and it supplements the new assessment to fully cover the total amount appropriated for the new operating year.

Included in fund balance with Treasury at year-end are any civil penalties that have been levied against the Enterprises with OFHEO designated as the collecting agency. These penalty collections are not available for OFHEO's use, and they are designated as Treasury's money when collected by OFHEO. OFHEO also collects fees for processing Freedom of Information Act (FOIA) requests. Similar to the civil penalties, FOIA fees are not available for OFHEO's use. As part of Treasury's year-end closing process, the fund balance for these types of collections are swept into its General Fund.

The amounts collected for civil penalties and FOIA request fees are classified as non-budgetary fund balance and are considered non-entity assets.

OFHEO cash receipts and disbursements are processed by Treasury. With the exception of the amounts collected for civil penalties and FOIA requests, and the unavailable unobligated balance at year-end, the fund balance with Treasury represents assessment money available to pay current liabilities and to finance authorized purchase obligations.

G. 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, real property holdings, or stewardship or heritage assets.

H. Accounts Receivable

OFHEO's accounts receivable consist of amounts due from federal agencies, employees, individuals requesting FOIA services and its sublessor for a leasehold improvement allowance. No account receivable was estimated as uncollectible.

I. Liabilities

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

OFHEO reports its liabilities in the financial statements 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 employees. 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 payroll. Accounts payable represent amounts owed to another entity for goods ordered and received and for services rendered by other than employees. Accrued payroll represents 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, accrued Federal Employees Compensation Act (FECA) claims, deferred rent, and the amounts due Treasury for collections of civil penalties and FOIA request fees. Annual leave is earned throughout the fiscal year and is paid when leave is taken; the accrued liability for annual leave represents the balance earned, but not yet taken. The Department of Labor (DOL) is the central paying agent for all workers' compensation claims filed under FECA. Accrued FECA 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 2006 and 2005 as OFHEO's methodology for estimating this future worker's compensation as prescribed by DOL determined that the liability would be negligible. Deferred rent is the difference at year-end between the sum of monthly cash disbursements paid-to-date for rent and the sum of an average monthly rent calculated based on the term of the lease. This determination and recording of deferred rent is applicable only to the lease agreement on the property at 1750 Pennsylvania Ave that commenced in 2005 (see Note 6 – Operating Leases). A deferred rent liability of \$86 thousand and the related unfunded expense were not recorded in 2005 and were not material. These amounts have been reflected in the current year reporting for 2006.

J. 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 (unfunded) 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.

K. 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, accrued FECA and deferred rent. 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 other assets.

L. Comparative Data

In the 2005 financial statements, estimates for liability for services rendered but not invoiced and for goods received but not invoiced were separately classified on the Balance Sheet as accrued liabilities. These have been reclassified as accounts payable for the current financial statements. Also, the immaterial amounts for 2005 FOIA collections and accounts receivable were not presented on the Statement of Custodial Activity last year. They have been included in this year's presentation of the Statement of Custodial Activity along with the civil money penalty.

The form and content of the Statement of Budgetary Resources was changed significantly by OMB Circular A-136 "Financial Reporting Requirements" in 2006. The data for 2005 has been presented to conform to this change.

Note 2 – Non-Entity Assets

Assets that are classified as non-entity are the portion of fund balance with Treasury represented by collections of a civil penalty and FOIA request fees.

	<i>(Amounts Shown in Thousands)</i>	
	2006	2005
Intragovernmental Fund Balance	\$ 50,016	\$ 2

Note 3 – Fund Balance with Treasury

Fund Balance with Treasury consists of the following as of September 30, 2006, and 2005:

	<i>(Amounts Shown in Thousands)</i>	
	2006	2005
Fund Balances:		
Appropriated Funds	\$ 22,240	\$ 24,335
Other	50,016	2
Total	72,256	24,337
Status of Fund Balances:		
Unobligated Balance		
Unavailable	53	20
Obligated Balance	22,187	24,315
Non-Budgetary	50,016	2
Total	\$ 72,256	\$ 24,337

Note 4 – Property, Plant and Equipment

Property, Plant and Equipment balances as of September 30, 2006, are as follows:

(Amounts Shown in Thousands)

	Acquisition Cost	Accumulated Depreciation	Net Book Value
Equipment	\$ 10,695	\$ 6,855	\$ 3,840
Leasehold Improvements	6,296	3,022	3,274
Internal Use Software	21,652	17,532	4,120
Total	\$ 38,643	\$ 27,409	\$ 11,234

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

(Amounts Shown in Thousands)

	Acquisition Cost	Accumulated Depreciation	Net Book Value
Equipment	\$ 7,642	\$ 5,174	\$ 2,468
Leasehold Improvements	5,357	2,084	3,273
Internal Use Software	17,612	15,850	1,762
Internal Software in Development	1,894	-	1,894
Total	\$ 32,505	\$ 23,108	\$ 9,397

Internal use software applications included in the current net book value are OFHEO's Financial Information Management System (FIMS) and the automated supervisory tool (X-Works). The Risk-Based Capital (RBC) software was fully depreciated in FY 2005.

Note 5 - Liabilities Covered and Not Covered by Budgetary Resources

(Amounts Shown in Thousands)

	2006			2005		
	Covered	Not Covered	Total	Covered	Not Covered	Total
Intragovernmental						
Accounts Payable	\$ -	\$ -	\$ -	\$ 50	\$ -	\$ 50
Other Liabilities:						
Due to Treasury	-	50,016	50,016	-	2	2
Total Other Liabilities	-	50,016	50,016	-	2	2
Total Intragovernmental	-	50,016	50,016	50	2	52
With the Public						
Accounts Payable	1,386	-	1,386	2,791	-	2,791
Other Liabilities						
Accrued Payroll	1,378	-	1,378	1,248	-	1,248
Annual Leave	-	2,304	2,304	-	1,750	1,750
Deferred Rent	-	171	171	-	-	-
Total Other Liabilities	1,378	2,475	3,853	1,248	1,750	2,998
Total With the Public	\$ 2,764	\$ 2,475	\$ 5,239	\$ 4,039	\$ 1,750	\$ 5,789
Total Liabilities	\$ 2,764	\$ 52,491	\$ 55,255	\$ 4,089	\$ 1,752	\$ 5,841

All "Other Liabilities" are considered current, except for the deferred rent in FY 2006.

Note 6 – Operating Leases

1700 G Street NW

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 merges 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. Due to this termination clause, no deferred rent is established for this lease nor is disclosure of minimum future lease payments required under Financial Accounting Standard Board Statement #13. If OFHEO continues renting up to the expiration date of its current option term ending November 2008, lease payments for fiscal years 2007 and 2008 are estimated to be \$4.2 million and \$4.4 million, respectively.

1750 Pennsylvania Avenue NW

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. A deferred rent liability is established for this lease.

Under existing commitments, the future minimum lease payments through FY 2011 are as follows:

	<i>(Amounts Shown in Thousands)</i>
<u>Fiscal Year Ending September 30,</u>	<u>1750 Penn Ave NW</u>
2007	\$ 872
2008	907
2009	944
2010	981
2011	505 ¹
Total Future Minimum Lease Payments	<u><u>\$ 4,209</u></u>

¹ Lease runs through March 2011.

Total rent expense on the two leases for the years ended September 30, 2006, and 2005 was approximately \$4.9 million and \$4.4 million, respectively.

Note 7 – Program Costs

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, payroll processing services received from the Department of Agriculture, and imputed financing costs for post-retirement benefits with the Office of Personnel Management. With the Public costs include such costs as expenditures for contracts with the private sector for goods or services, payments for employee salaries, depreciation, annual leave, and deferred rent expenses.

(Amounts Shown in Thousands)

	<u>2006</u>	<u>2005</u>
Intragovernmental	\$12,016	\$10,754
With the Public	49,227	41,190
Total Program Costs	<u>\$ 61,243</u>	<u>\$ 51,944</u>

Note 8 – 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, 2006, and 2005 were:

(Amounts Shown in Thousands)

	<u>2006</u>	<u>2005</u>
Direct Obligations - Category B	<u>\$ 60,559</u>	<u>\$ 64,342</u>

Note 9 – Adjustments to Beginning Balance of Budgetary Resources

In addition to its appropriation, OFHEO received from OMB a reapportionment of prior year funds resulting from recoveries of prior year obligations. OFHEO requested and received the authority to re-obligate these prior year funds in fiscal years 2006 and 2005.

Note 10 – Legal Arrangements Affecting Use of Unobligated Balances

P.L. 102-550 states that any balance that remains unobligated at the end of the fiscal year must be returned to the Enterprises as a credit against the next year's assessment.

Note 11 – Explanation of Differences Between the Statement of Budgetary Resources (SBR) and the Budget of the U.S. Government (Budget)

The financial statements for FY 2006 are published before the 2006 U.S. Budget actual figures are available. Therefore, a reconciliation between the SBR and the Budget is prepared for FY 2005. OFHEO has no differences between the SBR and the U.S. Government Budget for FY 2005. OFHEO routinely reconciles financial data reported throughout the entire reporting process to ensure consistency.

(Amounts Shown in Millions)

	2005 SBR	2005 Budget
New Budget Authority	\$ 64	\$ 64
Change in Obligated Balance		
Obligated Balance, start of year	8	8
New Obligations	64	64
Outlays	-48	-48
Obligated Balance, end of year	24	24
Gross Outlays	48	48
Net Budget Authority and Outlays		
Budget Authority	64	64
Outlays	\$ 48	\$ 48

Note 12 – Undelivered Orders at the End of the Period

Undelivered orders are funds that have been obligated for goods or services yet to be received. The balances outstanding at September 30, 2006, and 2005 were:

(Amounts Shown in Thousands)

	<u>2006</u>	<u>2005</u>
Undelivered Orders	\$ 19,422	\$ 20,226

Note 13 – Relationship Between Liabilities Not Covered by Budgetary Resources and Components Requiring or Generating Resources in Future Periods

Liabilities not covered by budgetary resources reported on the Balance Sheet consist of collections of a civil penalty and FOIA fees due to Treasury, accrued FECA, accrued annual leave, and deferred rent. The changes between the year-end balances of accrued FECA, accrued annual leave, and deferred rent are reported in the Statements of Financing under the category "Components Requiring or Generating Resources in Future Periods." The change in these balances is commonly referred to as unfunded expense.

The liabilities established for the collections of the civil penalty and FOIA request fees do not impact the Statement of Financing, as they are considered custodial activities.

Note 14 – Custodial Activities

The \$50 million presented on the Statement of Custodial Activity represents a penalty paid by Fannie Mae as part of a settlement with OFHEO regarding Fannie Mae's accounting improprieties uncovered in a special examination. Fannie Mae paid a total penalty of \$400 million of which \$50 million was directed to OFHEO and \$350 million directed to the SEC. The \$50 million collected by OFHEO is not for OFHEO's use. A liability Due to Treasury is reported by OFHEO at year-end for the amount of the penalty collected.

OFHEO also collects fees for services provided in response to FOIA requests. These fees also are not available for OFHEO's use. A liability Due to Treasury is reported by OFHEO at year-end for the amount of fees collected.

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