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OFHEO Fannie Mae Report of Examination, 2001

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REPORT OF EXAMINATION

**2001 Examination
Results and Conclusions**

**Prepared for
Fannie Mae's Board of Directors**



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Open Date: January 2, 2001
Close Date: December 31, 2001

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2001 Examination Results and Conclusions Overview Prepared for Fannie Mae's Board of Directors

Members of the Board:

I am writing to share the results and conclusions of OFHEO's 2001 annual risk-based examination of Fannie Mae. I am pleased to share the conclusion from our 2001 examination work that Fannie Mae is a well-run company in a financially safe and sound condition. Our judgments of Fannie Mae's condition, shared with you here, were formed during OFHEO's onsite examination and reflect OFHEO's assessment of Fannie Mae's current risk profile and risk management techniques and strategies. These judgments are also factored into OFHEO's process for determining Fannie Mae's capital adequacy.

OFHEO's examination program is committed to providing customized communications to ensure that each audience is provided with an appropriate level of information and detail. Accordingly, this Overview is intended to provide Fannie Mae's Board of Directors with the necessary information about the results and conclusions of OFHEO's 2001 examination. Additional supporting information Board members may wish to refer to is contained in the Summary Analysis portion of this report. Through the course of the 2001 examination process, OFHEO's examination staff and management had even more detailed communications with personnel across the company. The cooperation, professionalism, responsiveness and courtesies Fannie Mae management and employees extended to OFHEO's examination staff are appreciated.

This Overview and the supporting Summary Analysis should be considered in the context of OFHEO's annual risk-based examination program. The examination program is described in our Examination Handbook which has been provided to management. In brief, OFHEO's annual risk based examination program encompasses the major areas of financial risk confronting Fannie Mae, and the quality of governance exercised in managing both those risks and Fannie Mae's business. Within OFHEO's examination program there are discrete program areas that evaluate a wide-ranging series of qualitative and quantitative features of risk and risk management. While conducting work in the discrete program areas, examiners focus on: the quality of Fannie Mae's policies and the adherence to these policies; the quality of the tools used to select and manage risks and portfolios of risk; the expertise of personnel and management; the effectiveness of business processes; the quality of management reporting; and the effectiveness of, and adherence to, Fannie Mae's control framework. In both this Overview and the Summary Analysis, we report results and conclusions for the examination program areas: Credit Risk, Interest Rate Risk, Liquidity Management, Information Technology, Internal Controls, Business Process

Controls, Audit, Board Governance, Management Information and Management Process.

In accordance with our examination program, the results and conclusions for each program area are reported in relation to safety and soundness standards – whether they meet, exceed, or fail to meet safety and soundness standards. Throughout the annual examination cycle, OFHEO's examiners had ongoing dialogues with Fannie Mae's operating management about the company's operations and processes in the program areas covered by Credit Risk, Market Risk, Operational Risk and Corporate Governance. In these discussions, the examiners shared their views about discrete opportunities the company had to strengthen its operations and processes, including initiatives that if implemented, would enhance existing tools and processes and minimize the resulting exposure to financial risk. The goal of ensuring that Fannie Mae's operations meet or exceed financial safety and soundness standards at any given point in time is supported by this iterative process and netted results that find your organization to be well-managed and financially sound. At year-end 2001, Fannie Mae exceeds safety and soundness standards in all examination program areas.

Fannie Mae's credit risk management and credit risk management framework exceed safety and soundness standards. The portfolio is diversified and the profile of credit risk is in compliance with the internally prescribed limits. Policies, procedures, internal controls and management reporting for the credit function are effective. Fannie Mae is appropriately compensated for the credit risk it assumes. Management prudently manages counterparty exposure. New products and initiatives are well researched prior to implementation. The process for determining the reserve for losses and credit risk sharing strategies are effective, as are the tools used to manage credit risk. Fannie Mae effectively identifies, quantifies and tracks its credit risk exposures. Management has an effective means for following up on credit related issues. The technology and controls supporting the credit risk management function are effective. Management effectively reconciles differences between actual and expected credit portfolio performance.

Fannie Mae's interest rate risk management exceeds safety and soundness standards. The policies, procedures, internal controls and management reporting relating to interest rate risk are effective. Management has a meaningful methodology for quantifying and monitoring the level and nature of interest rate risk. Fannie Mae's management effectively follows up on issues related to interest rate risk. Fannie Mae appropriately researches and controls the extent to which new products and initiatives may impact the interest rate risk profile. The technology and controls supporting the interest rate risk management function are effective. The tools used to model interest rate risk, and the strategies to alter the exposures to interest rates are effective. Management effectively incorporates tactical and strategic issues into the management of interest rate risk. The responsibilities for strategy and analytics functions are appropriately separated from those for the execution functions.

Derivative instruments are used prudently and in accordance with the standards used by other large financial intermediaries.

Fannie Mae's liquidity management exceeds safety and soundness standards. The policies, procedures, internal controls and management reporting relating to liquidity management are effective. Management has an effective methodology for quantifying and monitoring liquidity, and management appropriately evaluates the impact of events and alternative environments when developing contingency plans. The planning process for liquidity management is effective. Fannie Mae appropriately considers the impact new products and initiatives may have on liquidity. Management effectively follows up on issues and initiatives that influence liquidity. Technology and controls for liquidity management are effective. The quality of tools Fannie Mae uses to manage and monitor liquidity, and the quality of tools used to perform scenario analyses are effective. An appropriate separation of duties exists between the strategy and analytics functions and the execution function. Fannie Mae effectively analyzes and is well positioned to respond to trends and anomalies in funding spreads. Liquidity management is appropriately integrated with other management and financial performance issues.

The information technology infrastructure and surrounding risk management framework exceed safety and soundness standards. Operating processes are in place to ensure secure, effective and efficient data center processing and problem management. There are effective policies and processes in place to ensure that data, information and computing resources are secure and accessed only by authorized users. There are effective policies and processes in place to ensure the timely and appropriate resumption of business in the event of a disaster. Management has processes in place that ensure information technology plans effectively address business unit and corporate objectives. Effective processes are in place to ensure appropriate controls are implemented. Documentation for system development and maintenance is complete. Fannie Mae has implemented effective processes to ensure data and information are processed accurately and in a timely manner. Effective controls are in place to secure networks and/or firewalls from unauthorized or inappropriate actions. Fannie Mae has policies and procedures to ensure the conduct of E-commerce is secure. Fannie Mae has effective and efficient controls over end-user computing.

Fannie Mae's internal control framework and the management of that framework exceed safety and soundness standards. Management has an accurate and reliable process for identifying risks to business processes and implementing appropriate controls. Implemented controls properly address risks assessed by management. Management has a reliable process for ensuring the timely resolution of control related issues. Internal Audit appropriately identifies and communicates control deficiencies to management and the Board of Directors. There are established policies and procedures that delineate internal control

process and standards for the control environment. Management effectively ensures compliance with established internal controls.

The framework for business process controls and the management of that framework exceeds safety and soundness standards. The processes and control environment used when Fannie Mae considers and/or develops new or substantially revised business initiatives are effective. The use of pilot programs and the communication flows surrounding new or substantially revised business initiatives are effective. The balance between risk management, internal controls and the pressure to develop new or substantially revised business initiatives is appropriate. Fannie Mae's corporate environment promotes and supports the introduction of new ideas and intellectual capital. Both the analysis and review conducted for potential, new or substantially revised business initiatives, and the analysis conducted after a new or substantially revised business initiative is launched, are effective.

The audit functions exceed safety and soundness standards. The Internal and External Audit functions have the appropriate independence. Auditors performing the work possess appropriate professional proficiency. The scope of audit work performed is appropriate, and the audit work is complete. The management of the Internal Audit department is effective. Executive management and the Board of Directors are appropriately involved with and follow up on identified audit issues. The auditor's risk assessment process is effective. Internal Audit is appropriately involved in new products and new initiatives.

The Board discharges its duties and responsibilities in a manner that exceeds safety and soundness standards. We consider the Board to be appropriately engaged in the development of a strategic direction for the company. From our point of view, the Board ensures that management appropriately defines the operating parameters and risk tolerances of the Enterprise in a manner consistent with the strategic direction; legal standards; and ethical standards. Our examination activities find that the Board has an effective process for hiring and maintaining a quality executive management team, and that the Board effectively holds the executive management team accountable for achieving the defined goals and objectives. We consider the Board to be appropriately informed of the condition, activities and operations of the Enterprise. From our perspective, the Board has sufficient, well-organized time to carry out its responsibilities.

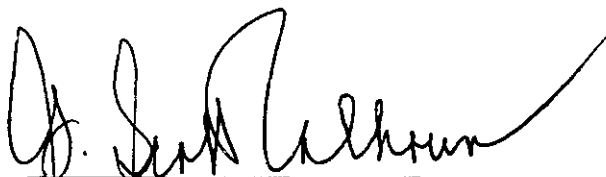
The framework used to produce timely, accurate and reliable reports exceeds safety and soundness standards. Management and the Board of Directors receive necessary reports on Fannie Mae's performance relative to established goals and objectives. Management reporting provides the levels of management with the necessary information to carry out their responsibilities efficiently and effectively. Management reporting permits management to gauge the quality of

their decisions. Information systems are linked to Fannie Mae's overall strategy, and are developed and refined pursuant to a strategic plan. The reports management uses for decision making are accurate. Enterprise strategy, roles and responsibility are effectively communicated. Employees have effective channels of communication to provide feedback, report suspected improprieties and suggest enhancements. Communications across the company are effective.

Key management processes that influence company-wide talent and behaviors exceed safety and soundness standards. The strategic planning process is comprehensive. Business unit goals, implementation plans and programs designed to achieve the corporate plan are effective. Management is able to monitor and manage change. Key performance measures are appropriate, effective and align with strategy. The behavior management programs are effectively designed to achieve corporate goals and objectives. Fannie Mae has effective programs for career and management development, and for recruiting competent personnel. Fannie Mae's proprietary risk management programs and systems are effective. Management effectively conveys an appropriate message of integrity and ethical values. Management's philosophy and operating style have a pervasive effect on the company. The organizational structure and the assignment of responsibility provide for accountability and controls.

Our 2001 examination work did not identify any matters requiring the direct involvement of the Board of Directors. Operating management has been responsive and effective in addressing issues raised for their attention and action. Had there been any issues meriting your direct involvement or immediate attention, I would have apprised you of that fact earlier. If anything arises during the 2002 examination that you should be aware of or involved with, consistent with our communication standards, I will share that information with you in a timely fashion. In addition, I will continue to provide periodic updates to ensure the Board and executive management are appropriately apprised of our examination judgments about the financial safety and soundness of Fannie Mae.

This Report of the 2001 Examination Results and Conclusions contains both examination-related information gained by OFHEO through its examination process and examiner judgments. We ask that you accord this document appropriate confidential treatment.



G. Scott Calhoun
Chief Examiner
Office of Examination and Oversight

2001 Examination Results and Conclusions Summary Analysis Supporting the Overview Prepared for Fannie Mae's Board of Directors

This section of the Report provides summary analysis supporting results and conclusions for the Credit Risk, Interest Rate Risk, Liquidity Management, Information Technology, Internal Controls, Business Process Controls, Audit, Board Governance, Management Information and Management Process examination program areas. The Summary Analysis is presented by the examination objectives that are unique to each program area.¹ This section provides an assessment of, and support for, the examination objectives and rates each examination objective on a scale of "meets", "exceeds" or "fails to meet" safety and soundness standards.

CREDIT RISK PROGRAM

EXAMINATION OBJECTIVE: *Evaluate the risk management framework surrounding credit risk.*

Fannie Mae's risk management framework surrounding credit risk exceeds safety and soundness standards.

- Fannie Mae has comprehensive quality policies, procedures, internal controls and management reporting for the credit risk management functions. Policies and procedures for managing credit risk are thorough, comprehensive, well-documented, appropriately distributed and updated. As evidenced in the aftermath of September 11, management appropriately provides interpretations and advice on a case-by-case basis to ensure that Fannie Mae's standards and guidelines are consistently applied as intended. Internal controls for credit risk management are comprehensive, effectively developed and applied by management, and formally evaluated annually through the SAQ process. Management reporting for credit risk is comprehensive, timely, appropriately detailed, and tracks variances between actual and forecasted performance. The management reports address appropriate components of credit risk management.

¹ The examination objectives common to all program areas are not included in this report. The common examination objectives which are set forth in the *Examination Handbook* do not reflect the financial safety and soundness of Fannie Mae, but instead relate to OFHEO's examination process.

- Fannie Mae's reserve determination process is effective. The process which is supported by independent analysis includes the use of reasonable assumptions of future economic environments and business profiles. The process provides management with reliable loss forecasts based on economic estimates, movements in house prices, projected business volumes and composition, and the composition of the current book of business; takes historical performance and identifiable credit performance trends into account; and enables executive management to make well informed determinations about the amount of the allowance.
- Fannie Mae has an extensive, effective methodology for identifying and quantifying its credit risk exposure. Fannie Mae uses a variety of reliable, effective tools and processes to identify and quantify the company's credit exposure. Management thoroughly analyzes the Enterprise's book of business, including factors such as product type, borrower credit profile, LTV, origination year, and geographic region. Technology tools and the loan performance data allow management to evaluate credit risk exposures in terms of the performance and profitability of each segment of Fannie Mae's book of business. Regular analysis including "early warning" assessments are effectively used to evaluate the book of business through several hypothetical scenarios.
- Fannie Mae has an effective system of tracking credit risk exposures, and the system provides appropriate credit risk related information to the different levels of management. Management reports are appropriately detailed, and address key measures of credit risk exposure, including: portfolio performance, delinquency, foreclosures, credit losses, product composition, geographic and market concentrations, quality control findings, REO management, loan repurchase trends, seller/servicer performance, loan loss forecasts, mortgage insurer performance and expected economic, finance and housing market trends. Management meetings and communications, powerful technology tools and extensive management reporting result in an effective and reliable system for tracking credit risk exposure.
- Fannie Mae regularly evaluates actual credit portfolio performance against expected performance, and identifies and addresses material variances between the two. Management addresses deviations from expected performance in a timely manner through a variety of effective communication channels. Evaluations of actual versus expected credit portfolio performance are appropriately incorporated into Fannie Mae's management reports.
- Fannie Mae's management effectively follows up on credit related issues. The company's management framework and reporting structure ensure that Fannie Mae's management receives appropriate information to effectively follow up on credit related issues. Fannie Mae personnel responsible for

credit risk management have frequent contact with each other. Credit related issues remain on tracking reports until they are resolved.

EXAMINATION OBJECTIVE: *Identify and evaluate any changes occurring in the level and quality of credit risk as well as the potential impact on the Enterprise.*

Although there were changes in the level and quality of credit risk in 2001, the portfolio still exceeds safety and soundness standards.

- The products introduced in 2001 do not present a risk profile significantly different from Fannie Mae's core business, and do not threaten to compromise the credit quality of the Enterprise's book of business.
- The manufactured housing pilot was developed pursuant to the new product development framework, and is consistent with Fannie Mae's credit risk profile.
- The initiative to guarantee or wrap REMIC securities funded by loan pools that include subprime mortgages did introduce additional risk to the portfolio. However, the initiative was subject to appropriate review and the resulting credit risk exposure was effectively limited by structuring mechanisms and credit enhancements.

EXAMINATION OBJECTIVE: *Assess the overall adequacy and effectiveness of credit risk management. Determine how well the Enterprise manages and/or hedges credit risk.*

Credit risk management at Fannie Mae exceeds safety and soundness standards.

- Fannie Mae's retained and guaranteed credit portfolios are appropriately diversified and are in compliance with management's prescribed limits and guidelines. Fannie Mae's book of business is geographically diversified, and the company is not unduly exposed to credit losses attributable to regional economic fluctuations. While there are concentrations in highly populated states and in metropolitan areas, these are not excessive relative to the market area, and as a consequence, do not raise undue safety and soundness concerns. The Multifamily portfolio is constructed to avoid dominance in regional and local markets. The credit risk profile of the

portfolio is consistent with corporate objectives, and is in compliance with Fannie Mae's prescribed limits and guidelines.

- Fannie Mae is appropriately compensated for the credit risk it assumes. Fannie Mae effectively uses a variety of analytical tools, decision processes, and tracking mechanisms to ensure that the company is compensated at or above a level commensurate with the credit risk to which it is exposed.
- Fannie Mae's credit models produce reliable results. Fannie Mae's various credit-related models provide reliable predictions of future mortgage performance; identify delinquent loans likely to result in default and foreclosure; generate dependable quality ratings of seller/servicers; recommend methods of property valuation; evaluate repair/increased market value scenarios for REO; and analyze mortgage pools to identify the highest grade pieces. Management routinely reviews the performance of credit models and evaluates their performance against actual experience.
- Fannie Mae prudently manages counterparty exposure. Fannie Mae has effective guidelines, performance benchmarks and standards, and eligibility requirements for its seller/servicers. Fannie Mae prudently manages its exposure to mortgage insurers through eligibility requirements for financial strength and performance; by monitoring trends including claims payment; and by establishing exposure limits for mortgage insurance companies.
- Fannie Mae's credit risk tools are proven, reliable, cover key components of credit risk management and enable management to effectively assess and manage credit risk exposures. Fannie Mae uses effective tools across the credit risk management spectrum, from master agreements, to tools that establish credit quality standards, to tools that monitor credit related trends within the book of business, to tools that evaluate mortgage insurers, to the structures applied in REMIC transactions.
- Fannie Mae's risk sharing strategies effectively reduce the company's exposure to credit risk. Fannie Mae shares credit risk with financially stable counterparties through the effective use of credit enhancements and other contractual arrangements.
- The technology and controls supporting Fannie Mae's credit risk management function are effective. Management has an effective practice that ensures business unit personnel receive appropriate technology support and that technology support and tools are appropriately integrated with business needs.
- There is a strong and effective control environment supporting Fannie Mae's credit risk management function, including annual attestations of the effectiveness of controls.

INTEREST RATE RISK PROGRAM

EXAMINATION OBJECTIVE: *Evaluate the risk management framework surrounding interest rate risk.*

Fannie Mae's framework for managing interest rate risk exceeds safety and soundness standards.

- Fannie Mae's policies, procedures, internal controls and management reporting relating to interest rate risk are effective. Portfolio Management, Portfolio Strategy and the Treasurer's Office all have appropriate, comprehensive and current policies and procedures in place. The personnel involved with interest rate risk know and comply with these policies and procedures. The risk limits and appetites are clearly communicated through the monthly KPI reports and through the Office of the Chairman and the Portfolio Investment Committee. The control framework includes the appropriate separation of interest rate risk analysis functions from the transaction functions. Management reports for interest rate risk, including the weekly package for the Portfolio Investment Committee present the balance sheet and projected earnings in sufficient detail to allow decision makers to effectively identify the sources of interest rate risk.
- Management effectively follows up interest rate risk issues. Management continuously monitors its interest rate risk profile and takes appropriate and timely action whenever risk limits are approached or breached, as demonstrated by management's response to rapidly declining rates and high price volatility experienced in 2001. In both formal and informal settings, Fannie Mae's senior management involved with managing interest rate risk thoroughly discuss and analyze the risk/reward relationships affecting the balance sheet.
- The impact of new products, programs and initiatives on the company's interest rate risk profile is well researched and receives appropriate senior management and Board review prior to implementation. Management and the Board establish appropriate limits on new products and programs.
- Management's effective tactical investment and funding decisions took advantage of favorable market conditions were consistent with Fannie Mae's portfolio management strategy.
- The appropriate separation of responsibilities exists between the strategy and analytics function and the execution function. Personnel who craft strategy and analyze the balance sheet are appropriately separated from personnel who execute transactions. Traders and portfolio analysts do not code software that is used for portfolio management.

EXAMINATION OBJECTIVE: *Identify and evaluate any changes occurring in the level and quality of interest rate risk as well as the potential impact on the Enterprise.*

In 2001, Fannie Mae made effective tactical investments and funding decisions that took advantage of favorable market conditions while remaining within the boundaries of its portfolio management strategy.

EXAMINATION OBJECTIVE: *Identify and evaluate the use of derivative instruments.*

The framework for managing the use of derivative instruments at Fannie Mae exceeds safety and soundness standards.

- **Fannie Mae uses derivative instruments in a prudent manner. Derivatives are used in a manner that is consistent with the corporate risk management policies. Fannie Mae uses derivatives primarily for reducing interest rate risk, and our examination did not find a single instance of the company's using derivatives as a speculative vehicle. The use of Master Agreements to document existing and future derivative transactions is sound. Derivatives are marked to market daily using the DEBTS system, and the effect of derivative instruments are considered when Fannie Mae assesses the sensitivity of market values and earnings to changes in interest rates. Systems for data capture, processing, settlement and management reporting are effective. Management reports for derivatives are comprehensive and identify important attributes of the instruments.**
- **Management governs the use of derivatives in accordance with the standards used by other large financial intermediaries. Fannie Mae measures the credit risk and market risk of its derivatives portfolio independently of the portfolio management function. Fannie Mae has a sound method for determining mark to market exposure for collateral obligations. Counterparty risk is appropriately diversified, and the credit quality of counterparties is regularly monitored.**

EXAMINATION OBJECTIVE: *Assess the overall adequacy and effectiveness of interest rate risk management. Determine how well the Enterprise manages and/or hedges interest rate risk.*

Fannie Mae's management of interest rate risk exceeded safety and soundness standards.

- Management has established a meaningful methodology for quantifying and monitoring the level and nature of interest rate risk. Fannie Mae's primary measures of sensitivity to changing interest rates are Duration Gap and Duration Gap Sensitivity. Management uses a wide range of measures to quantify and monitor interest rate risk, including estimating the sensitivity of the Enterprise's market value to parallel shifts in the yield curve, and changes in the shape of the yield curve and prepayment speeds. Management also uses stochastic tools to generate multiple interest rate paths and probabilistic estimates of earnings sensitivity. The methodologies are sound and provide a meaningful basis for managing interest rate risk.
- Technology and controls supporting the interest rate risk management function are effective. Fannie Mae has specialists dedicated to developing new tools for managing interest rate risk. Fannie Mae also has functions that support hardware and networks used to manage interest rate risk. Controls are in place to ensure the integrity of data used in interest rate risk and portfolio management models.
- The tools used to model interest rate risk and the strategies to alter the exposures to interest rates are effective. Fannie Mae has tools that evaluate the effect of changing interest rates on all areas of its balance sheet. The prepayment models are well documented and incorporate a wide range of appropriate factors. The prepayment models are tailored to specific asset types including 30 year fixed, 15 year fixed and adjustable rate mortgages. Interest rate generation models incorporate appropriate parameters. The assumptions and parameters are continuously reviewed for reasonableness by both the developers and users of the models.

LIQUIDITY MANAGEMENT PROGRAM

EXAMINATION OBJECTIVE: Evaluate the liquidity positions and surrounding management framework.

Fannie Mae's management of its liquidity exceeds safety and soundness standards.

- Fannie Mae's policies, procedures, internal controls, and management reporting relating to liquidity management are effective. The Treasurer's Office policies and procedures detail the nature of liquidity risk and how it is managed. Risk limits and lines of authority are clearly identified in policies and procedures. The types of investments in the Liquidity Investment Portfolio are consistent with Fannie Mae's goals and strategies. The internal controls for liquidity management are adequate and operate as intended. Management reports are timely, accurate and provide meaningful information on liquidity. The various daily, weekly and monthly reports are appropriately distributed and support management's ability to make tactical and strategic decisions.
- Management has established an effective methodology for quantifying and monitoring liquidity. Management routinely evaluates the impact of events and alternative environments, and develops appropriate contingency plans. Management reviews short-term cash requirements, purchase commitments and funding costs daily. Fannie Mae assesses the adequacy of its liquidity in simulated interest rate environments through various effective models such as the Stochastic Income Model and the Portfolio Valuation Model. In addition, portfolio managers in the Treasurer's Office monitor the Liquid Investment Portfolio continuously to ensure the securities can be readily converted to cash if necessary.
- The planning process for liquidity management, including tactical, strategic and contingency planning is effective. Fannie Mae's planning appropriately takes short-term cash needs, access to capital markets, cost of capital and the ability to liquidate market positions into consideration. Capital allocation strategies – including limits on the amount of capital dedicated to liquid investments – are set at the business unit level and reflect the Board's capital allocation decisions.
- Fannie Mae's management is effective in following up on issues and initiatives that influence liquidity. Liquidity issues are effectively communicated across business units, and the Treasurer's Office maintains consistent contact with the various business units that can impact cash

forecasts. Liquidity issues are covered by the audit functions and by the corporate self-assessment of risk process, and management appropriately follows-up on issues identified through these processes that require attention.

- Technology and controls for Fannie Mae's liquidity management are effective. There are specialists who support the liquidity management functions by developing new tools, maintaining systems and ensuring the reliability of hardware and networks. The information technology systems provide timely and accurate liquidity management information and reports.
- The quality of tools used to manage and monitor liquidity and the quality of tools used to perform scenario analyses are effective. Fannie Mae uses a variety of tools to assess the effect of changing interest rates on its liquidity position. Management assesses the effect of liquid investments in its interest rate risk modeling.
- The duties of the strategy and analytics functions and the execution functions at Fannie Mae are appropriately separated. The traders and portfolio analysts do not code software used for liquidity management. Regular analysis of the underlying markets is performed independently from the traders.
- Fannie Mae effectively analyzes and is well positioned to respond to, trends and anomalies in funding spreads. Management regularly reviews and assesses spreads for Discount notes, Medium-term notes, Benchmark Bills, Benchmark Notes and Bonds, Callable Benchmark Notes, Interest rate swaps and mortgages and non-mortgage investments relative to funding benchmarks. Fannie Mae uses information about trends and anomalies in funding spreads to make appropriate decisions regarding liquidity.
- Liquidity management is appropriately integrated into other management and financial performance issues. Liquidity risks are incorporated into Fannie Mae's corporate and business unit plans. Fannie Mae's corporate plans and strategic initiatives fully account for the need to maintain adequate liquidity. Liquidity risk is reflected in the management of derivatives. The Treasurer's Office fully considers the ability to get out of positions quickly and cost effectively when contemplating derivative transactions.

EXAMINATION OBJECTIVE: *Identify and evaluate any changes occurring in the quality of liquidity and the Enterprise's position in the credit markets.*

Fannie Mae's actions in 2001 strengthened its liquidity position. The Enterprise's access to liquidity and reputation in the credit markets exceeds safety and soundness standards.

- Fannie Mae's liquidity was enhanced by the introduction in 2001 of the Investment Notes program. Extensive research and analysis supported the conclusion that the Investment Notes would provide Fannie Mae with a lower cost funding supplement to the institutional Medium-term Notes.
- The Subordinated Benchmark Notes initiated in 2001 pursuant to the Voluntary Initiatives, incorporate features of the successful Benchmark Notes program.
- The Callable Benchmark Notes program was reintroduced in 2001 to provide investors with liquid callable structures brought to the market in a regular and transparent manner.

INFORMATION TECHNOLOGY PROGRAM

EXAMINATION OBJECTIVE: *Evaluate the information technology infrastructure and the surrounding risk management framework.*

Fannie Mae's information technology infrastructure and surrounding risk management framework exceed safety and soundness standards.

- Fannie Mae has operating processes in place to ensure secure, effective and efficient data center processing and problem management. Policies and procedures for operations management and monitoring across all processing platforms are effective, including the procedures and controls for the management and security of the mainframe operating system and for tape management. CIS uses various effective tools to monitor and manage system capacity. Physical security over IT resources is effective, appropriately monitored and restricted.
- There are effective policies and processes in place to ensure that data, information and computing resources are secure and accessed only by authorized users. Security administration is facilitated by an effective automated security request system, and user profiles are appropriately established on the basis of current business roles and job assignments. Fannie Mae has a comprehensive information security plan that includes monitoring capabilities, virus detection and application controls.
- Fannie Mae has effective policies and processes in place to ensure the timely and appropriate resumption of business in the event of a disaster. Integrated business recovery test are performed periodically to determine whether all critical business units can resume operations effectively. Fannie Mae successfully demonstrated its ability to resume business when, due to an air conditioning system outage, it seamlessly transferred affected functions to a previously designated back up site.
- Fannie Mae's processes ensure information technology plans effectively address business unit and corporate objectives. Fannie Mae's business units develop focused IT plans which are driven by major business initiatives. The progress of the IT plans is reported in the Corporate Objectives Progress Report, and the Technology Committee provides effective corporate wide oversight for strategic IT issues. By centralizing IT functions in the reorganized Enterprise Systems and Operations Division, Fannie Mae focuses and concentrates knowledge of corporate IT functions.

- Fannie Mae has effective processes in place to ensure appropriate controls are implemented and documentation for system development and maintenance is complete. The system development methodology is documented and provides guidance on key development tasks. The established change management procedures are effective, and testing is performed to ensure that business requirements are satisfied.

EXAMINATION OBJECTIVE: *Identify and evaluate changes that may influence the risks associated with information technology as well as the potential impact on the Enterprise.*

Changes introduced in 2001 strengthen Fannie Mae's Information Technology framework and controls.

- Fannie Mae is implementing a Public Key Infrastructure (PKI), a set of policies, processes, server platforms, software, workstations used for administering digital certificates and public-private key pairs. When fully implemented, PKI will further enhance security and efficiency.

EXAMINATION OBJECTIVE: *Assess the overall adequacy and effectiveness of risk management and controls for information technology.*

The risk management and controls for information technology at Fannie Mae exceeds safety and soundness standards.

- Fannie Mae has implemented effective processes for the processing of data and information to ensure accuracy and timeliness. The company's system development methodology provides guidance for controls to be implemented in software applications to ensure the integrity and accuracy of data processed by the applications.
- Effective controls are in place to secure networks and/or firewalls from inappropriate or unauthorized actions. The PKI initiative, as well as work with the MBAA and ABA will further strengthen the security of networks and firewalls.
- Management has implemented policies and procedures to ensure that the conduct of E-commerce is secure. The PKI initiative, as well as work with the MBAA and ABA will further strengthen the security of E-commerce

- Management has implemented effective and efficient controls over end-user computing. The revisions to WHEELS that resulted in SLCM (Systems Life Cycle Methodology) strengthened controls over end-user computing.

INTERNAL CONTROLS PROGRAM

EXAMINATION OBJECTIVE: *Evaluate the framework for internal controls and the management of this framework.*

The internal control framework and the management of the framework exceed safety and soundness standards.

- Fannie Mae has accurate and reliable processes for identifying risks to business processes and implementing appropriate controls. Business units annually assess their controls using a mechanism based on the COSO framework. Internal Audit verifies the results of the business self-assessments. Every month management measures and reports key indicators of risk.
- Fannie Mae's management has reliable processes for ensuring the timely resolution of control related issues. The testing and implementation of the Business Continuity Plan demonstrates Fannie Mae's ability to ensure timely resolution of control related issues. The Audit Tracking List shared with management across the company provides relevant information about the status of control issues identified by Internal Audit.
- Fannie Mae's Internal Audit unit appropriately identifies and communicates internal control deficiencies to management and the Board of Directors.
- Fannie Mae has appropriate policies and procedures that delineate internal control processes and standards for the control environment. Management control standards for business units are documented and provide guidance on how to apply those control standards.

EXAMINATION OBJECTIVE: *Identify and evaluate any changes that may influence the quality of internal controls and the potential impact on the Enterprise.*

There were no adverse changes in 2001 influencing the effectiveness of internal controls.

EXAMINATION OBJECTIVE: *Determine the adequacy and effectiveness of the Enterprise's system of internal controls.*

Fannie Mae's system of internal controls and the effectiveness of that system exceeds safety and soundness standards.

- The controls Fannie Mae has implemented properly address risks. The effectiveness of Fannie Mae's controls is demonstrated by, among other things, measures of credit performance, liquidity, interest rate exposure, as well as by the results of audit activities.
- Fannie Mae's management enforces compliance with established internal controls. Management actively monitors compliance with internal controls and has effective processes in place to support the timely and effective resolution of deviations from prescribed controls.

BUSINESS PROCESS CONTROLS PROGRAM

EXAMINATION OBJECTIVE: *Evaluate the framework for building the control environment surrounding revisions to the business proposition or new initiatives.*

The framework for building the control environment surrounding revisions to the business proposition or new initiatives exceeds safety and soundness standards.

- The processes and control environment Fannie Mae uses when considering or developing new or substantially revised business initiatives are effective.
- The communications associated with new or substantially revised business initiatives are effective. The communications among the affected business and control units throughout the business initiative process are timely, appropriate and accurate.
- The balance between risk management, internal controls and the pressure to develop new or substantially revised business initiatives is appropriate. Management has appropriate and timely information about the effectiveness of risk management and internal controls surrounding business initiatives at critical decision points in the business initiative process. Management appropriately requires that adequate controls be in place before a business initiative is introduced.
- Fannie Mae effectively uses pilot programs in connection with its new and substantially revised business initiatives. For example, each phase of the PKI initiative is tested and the results are evaluated before full implementation.
- The analyses Fannie Mae conducts to determine whether new initiatives are successful or warrant reconsideration/modification are effective. The analysis and review that occurs after roll-out is meticulous and deliberate. Post-implementation reviews are conducted against established standards, and modifications are made when appropriate.
- Fannie Mae's corporate culture promotes and supports the introduction of new ideas. Fannie Mae rewards ideas from sources across the company. The effective communication of corporate goals and strategies to all employees provide Fannie Mae with an informed and interested group who can and do provide suggestions and new ideas.

EXAMINATION OBJECTIVE: *Determine the adequacy and effectiveness of the due diligence process for new or revised business initiatives.*

The due diligence process for new or revised business initiatives exceeds safety and soundness standards.

- Fannie Mae uses appropriate criteria to determine whether a business initiative will be subject to review as "new" or "substantially revised."
- The analysis and review Fannie Mae conducts for new or substantially revised business initiatives are appropriate.

AUDIT PROGRAM

EXAMINATION OBJECTIVE: *Assess the overall adequacy and effectiveness of both internal and external audit functions and the management of the audit program.*

The effectiveness of the internal and external audit functions and the management of the audit program exceed safety and soundness standards.

- The internal and external audit functions have appropriate independence to carry out their responsibilities. The independence of the audit functions is evident in the audit workpapers and in the reports that document management's disagreements with audit findings. The independence of the audit functions is supported by the Board and its Audit Committee which meets regularly in executive session with appropriate representatives from the internal and external auditors. The independence is further supported by the regular briefings of the Chairman of the Audit Committee in anticipation of Audit Committee meetings and the processes the Board uses to hire the external auditor.
- The auditors performing the audit work possess appropriate professional proficiency. The auditors' proficiency is evident in their work. Fannie Mae expanded and enhanced the training programs for its internal audit staff. The external auditors were selected in part because the company and individuals working on the engagement have appropriate professional expertise and backgrounds.
- The scope of the audit work is appropriate and includes assessments of the controls over risks posed by third parties. . Both internal and external audit have responsibility to ensure the entire scope of necessary audit work is completed. In addition to its traditional audit function, Internal Audit plays an appropriate role in ensuring the integrity and reliability of key management reports.
- The performance of the audit work has been complete. Audit workpapers document audit objectives, controls, evaluations, results and follow-up. Fannie Mae actively manages its internal audit activities to ensure compliance with Institute of Internal Auditor (IIA) standards, including those related to completeness of audit activities.
- The management of the Internal Audit department is strong. Planned and implemented changes demonstrate management's willingness and ability to expand the expertise and efficiency of the internal audit function.

- Executive management and the Board are appropriately involved with audit issues, and each group follows up on audit issues in an appropriate manner. The decision to build the Significant Discussion Item function into the Audit Information Manager (AIM) enhanced management's ability to follow up on audit issues. The Board is regularly informed of the status of efforts to address critical audit findings reported on the Audit Tracking List.
- The risk assessment process used by Internal Audit for the 2001 audit plan was effective and continued the "top ten" risk approach.
- Internal Audit is appropriately involved with new products and initiatives. New products and new initiatives are appropriately included in the audit planning process. Internal Audit assesses whether existing systems have the ability to capture accurate and timely data for new products and initiatives. Advisory projects are designed in part to ensure early Internal Audit involvement.

EXAMINATION OBJECTIVE: *Identify and evaluate any changes occurring in internal and external audit functions or roles as well as the potential impact on the Enterprise.*

There were no changes in the audit functions or roles that adversely impacted the work, timeliness or results of audits. Changes introduced in 2001 strengthened Internal Audit operations.

- In 2001, Internal Audit implemented AIM, (Audit Information Manager) an automated workpaper system. This tool was several years in development and enhances management's ability to ensure consistency and completeness of audit workpapers and activities.
- In 2001, Internal Audit developed a new risk assessment model that will result in more sophisticated risk analysis than the "top ten" approach used in recent years, and will enhance the audit planning process. The new model will take into account each of the 40 business areas, inherent risks, mitigating controls and previous audit results.

BOARD GOVERNANCE PROGRAM

EXAMINATION OBJECTIVE: *Evaluate the framework for board governance and the management of this framework.*

The framework for board governance and the management of the framework exceed safety and soundness standards.

- Fannie Mae's Board of Directors remains appropriately informed of the condition, activities and operations of the Enterprise. Reports, presentations and discussion topics all ensure that the Board remains appropriately informed. There are effective controls in place to ensure the integrity and reliability of information provided to the Board. Information provided to the Board is appropriately consistent with that provided to and relied up on by management. The process management uses to identify materials that should be provided to the Board of Directors is comprehensive, and provides Board members with appropriate and necessary, but not overwhelming, information. The committee structure and meeting frequency provide an effective framework for an informed Board of Directors.
- Fannie Mae's Board of Directors has sufficient well organized time to carry out its responsibilities. Because Board members receive information sufficiently in advance of meetings, meetings can be conducted in an efficient manner. This efficiency is enhanced by the practice of having certain topics covered at designated Board meetings. Minutes reflect that the full Board and its committees appropriately prioritize issues, dedicating time to matters in direct relation to their significance to the company.

EXAMINATION OBJECTIVE: *Identify and evaluate any changes occurring in the structure and composition of the Board of Directors as well as the potential impact on the Enterprise.*

Changes in the composition of the Board ensured the Board was able to continue its effective oversight of the company.

- Processes were in place that ensured shareholders were always represented by qualified individuals. When, in keeping with Fannie Mae's Board term limits Mr. Birk did not stand for re-election, Mr. Marron was elected to the Board by the shareholders.
- President Bush appointed five qualified individuals – Mr. Ashe, Ms. Bordonaro, Mr. Harvey, Mr. Justiz and Mr. Segue – to the Board in 2001.

- **EXAMINATION OBJECTIVE: *Determine whether the Board effectively discharges its duties and responsibilities.***

The manner in which Fannie Mae's Board of Directors discharges its duties and responsibilities exceeds safety and soundness standards.

- Fannie Mae's Board of Directors remains appropriately engaged in charting the strategic direction for the company. The Board is formally involved throughout the year in the development and refinement of the company's strategic direction. Throughout the year, the Board and its Committees receive informative reports on strategic initiatives and issues. The Board appropriately considers strategic direction when identifying potential new Board members.
- Fannie Mae's Board of Directors ensures that executive management appropriately defines the operating parameters and risk tolerances of the company consistent with the strategic direction; legal standards; and ethical standards. The Board is appropriately apprised of progress toward meeting corporate objectives, including the status of operating parameters and risk tolerances, and is appropriately apprised of the effectiveness of Fannie Mae's control environment. Reports to the Board are effectively designed to alert the Board to trends and appropriately highlight indicators that are approaching risk tolerances. The Board is regularly briefed by the Chair of the Business Conduct Committee about matters under that Committee's jurisdiction.
- Fannie Mae's Board of Directors has an effective process for hiring and maintaining a quality executive management team. The frequent and substantive interaction of the Board with its executive management team provides the Board with a sound basis for evaluating its team.
- Fannie Mae's Board of Directors holds the executive management team accountable for achieving the defined goals and objectives. Long-term and other compensation for the executive management team tie directly to the achievement of corporate goals and objectives. The Board conducts a formal assessment of the CEO and plays an active role in reviewing the evaluations of the COO's direct reports.

MANAGEMENT INFORMATION PROGRAM

EXAMINATION OBJECTIVE: *Evaluate the framework employed to produce reliable management information.*

Fannie Mae's framework for producing reliable management information exceeds safety and soundness standards.

- Information systems are linked to Fannie Mae's overall strategy, and information systems are developed and refined pursuant to a strategic plan for information systems that considers information, data and reporting needs. Fannie Mae has a comprehensive strategic planning process and Technology and CIS are appropriately involved and provide expert guidance.
- Information systems that capture and produce the data that generate reports are subject to effective and appropriate controls. The quality of data and reports are monitored on a regular and ongoing basis.
- Fannie Mae's strategy, roles and responsibility are effectively communicated. Strategy, roles and responsibilities are consistently addressed and effectively reinforced through a variety of Homesite venues.
- Channels of communication available to Fannie Mae employees to provide feedback, report irregularities, and suggest enhancements are very effective. Almost 90% of employees responded to the biennial Employee Perspectives Survey conducted in 2001.
- Communications across Fannie Mae are effective. Centralized communications for major projects, including for example, Risk-Based Capital, advance the effectiveness and consistency of corporate messages and actions.

EXAMINATION OBJECTIVE: *Identify and evaluate any changes occurring that may substantially alter the production of management information as well as the potential impact on the Enterprise.*

In 2001 there were no changes to substantially alter the production of management information.

EXAMINATION OBJECTIVE: *Determine whether the Enterprise's management information produces timely, accurate and meaningful information and reports that are appropriately tailored for their audiences.*

Fannie Mae's management information exceeds safety and soundness standards and produces timely, accurate and meaningful information and reports that are appropriately tailored for their audiences.

- Fannie Mae's executive management and Board of Directors are appropriately and effectively informed of details relating to performance relative to established goals and objectives. Independent parties, including the Controller's office, make the qualitative judgments contained in reports about progress toward corporate and business unit goals and objectives. The Board is appropriately and effectively informed through standard and special reports, and through presentations by, and discussions with senior management. Executive management is appropriately and effectively apprised of the status of efforts to achieve established goals and objectives through a variety of reports and other communications.
- Management reporting provides the levels of management with the necessary information to carry out their responsibilities efficiently and effectively, and to gauge the quality of their decisions. Fannie Mae has a comprehensive reporting framework in place. Management reports are effective tools for identifying, monitoring and managing risks.
- Reports used by Fannie Mae's management for decision-making are accurate. All but two of the key management and Board reports are generated outside business units. This centralized reporting promotes the integrity and reliability of reports. Reports are generated from reliable and expected sources. Adjustments to data or information are reasonable and noted in reports. Reports used for decision-making are subject to appropriate verification and testing.

MANAGEMENT PROCESSES PROGRAM

EXAMINATION OBJECTIVE: *Evaluate the framework for management processes and the management of this framework*

The framework for management processes and the management of this framework exceed safety and soundness standards.

- Fannie Mae's planning process is appropriately comprehensive. The multiyear strategic business design and the budget process are key elements in the corporation's comprehensive planning process. Planning appropriately includes assessments of data implications raised by strategic initiatives. Planning related to the restructure was appropriately tied to the corporate vision for the future.
- Fannie Mae's key performance measures are appropriate, effective and align with strategy. Corporate goals have appropriate metrics that are effectively reported and monitored. The measures in the Quarterly Business Review process align directly with both corporate and business unit strategies and goals.
- Fannie Mae's behavior management programs are designed to achieve corporate goals and objectives. Corporate wide processes and practices focus on and tie into the six corporate goals. The Quarterly Business Review process focuses on opportunities and challenges to achieving the corporate goals, objectives and priorities. The Board appropriately ties the compensation for executive management to corporate objectives, and officer compensation reflects EPS goals.
- Fannie Mae's management effectively conveys an appropriate message of integrity and ethical values. The strong, clear and effectively communicated Code of Business Conduct includes many best practices. Management's commitment to corporate integrity and ethical values is reflected in Fannie Mae's national ranking by Business Ethics magazine.
- Decision making roles and the assignment of responsibilities effectively provide for accountability and controls. The organizational structures within the company are appropriate, effective and support accountability and controls. Both primary responsibility and key dependencies are identified for each corporate objective.

EXAMINATION OBJECTIVE: *Identify and evaluate any changes occurring that may influence the quality of management processes, as well as the potential impact on the Enterprise.*

The corporate restructuring that occurred in 2001 – including expanding the CFO's and EVP for Law and Policy's responsibilities – were effectively designed to streamline decision making and eliminate unnecessary overlap, enhance Fannie Mae's management processes.

EXAMINATION OBJECTIVE: *Determine the adequacy and effectiveness of management processes to manage the Enterprise on a company-wide basis.*

The adequacy and effectiveness of management processes to manage Fannie Mae on a company-wide basis exceed safety and soundness standards.

- Fannie Mae's business unit goals, implementing plans and programs to achieve the strategic plan are effective. Business units define and refine their plans and programs to support corporate goals and objectives. More than 90% of the metrics related to Corporate Objectives were completed or strongly on track by the end of the third quarter. The Voluntary Initiatives, including the associated public reporting, were successfully implemented in 2001.
- Fannie Mae is able to manage and monitor change effectively. Strong internal and external communications processes effectively support Fannie Mae's ability to monitor and manage change. Strong contingency planning that includes analysis of alternate scenarios and development of alternate action plans position Fannie Mae to effectively manage and respond to change.
- Fannie Mae has an effective program for career and management development. Executive management actively supports career and management development. Programs and courses designed and supported by Office of Corporate Learning OCL are appropriate, and support corporate objectives and career and management development. All officers have completed Fannie Mae's Leadership Institute.

- Fannie Mae has effective programs for recruiting competent people. Fannie Mae effectively uses outside resources, technology and its own employees when recruiting. Fannie Mae appropriately focuses on its diversity goals and objectives in its recruitment efforts.
- Fannie Mae's proprietary risk management systems and programs are effective. The results of operations, measures of credit performance and market risk indicators demonstrate the effectiveness of Fannie Mae's proprietary risk management systems and programs.
- Management's philosophy and operating style have a pervasive effect throughout Fannie Mae. Corporate communications continually reinforce management's philosophy and operating style. Management's philosophy and operating style are supported by, among others, an effective Code of Business Conduct and the Quarterly Business Review process. Results demonstrate the pervasive effect of management's philosophy and operating style.