2002

OFHEO Fannie Mae Report of Examination, 2002

United States: Office of Federal Housing Enterprise Oversight (OFHEO)

REPORT OF EXAMINATION

2002 Examination
Results and Conclusions

Prepared for
Fannie Mae's Board of Directors

Open Date: January 2, 2002
Close Date: December 31, 2002

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2002 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 2002 annual risk-based examination of Fannie Mae. I am pleased to share the conclusion from our 2002 examination work that Fannie Mae is a well-run company in 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 2002 examination. For more detail, Members of the Board may refer to the Appendix (Analysis Supporting the Overview).** Through the course of the 2002 examination process, OFHEO's examination staff and management had detailed communications with personnel across your company. The cooperation, professionalism, responsiveness and courtesies Fannie Mae management and employees extended to OFHEO's examination staff are appreciated.

This Overview and the Appendix 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 Appendix, 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 Processes.

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. The results of the 2002 examination show that in all of the program areas, Fannie Mae exceeds safety and soundness standards.

Credit & Counterparty Risk

Fannie Mae's credit risk management and the framework used to manage credit risk exceed safety and soundness standards. The portfolio is diversified and the credit risk profile is in compliance with the internally prescribed limits. Policies, procedures, internal controls and management reporting for the credit function are effective. Fannie Mae is adequately compensated for the credit risk it assumes and its credit risk models produce reliable results. Management prudently manages counterparty exposure. New products and initiatives are well-researched prior to implementation. The credit risk sharing strategies and the credit risk management tools are effective. 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.

Interest Rate Risk

Fannie Mae's interest rate risk management exceeds safety and soundness standards. During 2002, Fannie Mae's strategies and practices were effective in responding to the financial impacts associated with a volatile rate environment that resulted in sharp increases in mortgage prepayment speeds. 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 are reliable and continue to be enhanced. 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.

In the second-half of 2002, management demonstrated its effectiveness in rebalancing the portfolio's sensitivity position during a challenging environment.

Examiners and Fannie Mae representatives were in close communication while the sensitivity position was outside the company's preferred operating range. Examiners focused on management's compliance with its prescribed policies, the quality of management's action plans and the effectiveness of management's actions. In reflection, we note that management's behaviors conformed with the prescribed policies and practices, management's tactical plans were appropriate and responsive, and management prudently reduced the exposure without introducing new or other inappropriate risks.

Liquidity Management

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 considerations.

Information Technology

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. Business continuity planning reflects quality analysis and incorporates the most current thinking. 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 effective and efficient controls over end-user computing.

Internal Controls
The internal control framework and the management of that framework exceed safety and soundness standards. Management has a reliable process for identifying risks to business processes and implementing appropriate controls. Implemented controls properly address risks that have been identified. Management has a reliable process for ensuring the timely resolution of control related issues. Internal Audit identifies and communicates control deficiencies to management and the Board of Directors. Management effectively enforces compliance with established internal controls.

Business Process Controls
Business process controls exceed safety and soundness standards. The process used when considering new or substantially revised business initiatives is effective. The analysis and review of new or substantially revised business initiatives are effective. Pilot programs are effectively used and the analysis and review conducted after the launch of a new or substantially revised business initiative is appropriate. The communications associated with new or substantially revised business initiatives are effective. Fannie Mae appropriately balances risk management, internal controls and market pressure to deliver new or substantially revised initiatives to the marketplace.

Audit Activities
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.

Board Governance
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.

Management Information

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.

Management Processes

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. The company'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.

Conclusion

Our 2002 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. Had there been any supervisory or regulatory issues meriting your direct involvement or immediate attention, I would have apprised you of that fact earlier. If anything arises during the 2003 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 2002 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

Appendix

2002 Examination Results and Conclusions
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 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. Management provides interpretations and advice on a case-by-case basis to ensure that Fannie Mae's standards and guidelines are consistently applied. Internal controls for credit risk management are comprehensive, effective and evaluated at least annually. Management reporting for credit risk is comprehensive, timely, appropriately detailed, and tracks variances between actual and forecasted performance.

- Fannie Mae's reserve determination process is effective. The process which is supported by independent analysis includes the use of reasonable assumptions. The process provides management with reliable loss forecasts based on economic estimates, movements in house prices, projected

[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.

business volumes and composition, and the composition of the current book of business; considers historical performance and identifiable credit performance trends; and enables executive management to make well-informed determinations about the allowance.

- Fannie Mae has an effective methodology for identifying and quantifying its credit risk exposure. Management uses a variety of reliable tools and processes to quantify the company's credit exposure. Management thoroughly analyzes the 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, is effective.

- Fannie Mae has an effective system of tracking credit risk exposures. Management reports are appropriately detailed, and address key measures of credit exposure, including: portfolio performance, delinquency, foreclosures, credit losses, product composition, 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. Quality communications, powerful tools and extensive management reporting result in an effective and reliable system for tracking credit risk exposure.

- Fannie Mae routinely evaluates actual performance against expected performance, and addresses material variances. Management addresses deviations from expected performance in a timely manner. Evaluations of actual versus expected performance are incorporated into management reports.

- Fannie Mae is effective in following-up on credit issues. The management framework and reporting structure ensure that management receives appropriate information to follow-up on credit related issues. Personnel responsible for credit risk management communicate effectively across the company. Identified credit issues remain on tracking reports until they are appropriately addressed.

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

The changes in the level and quality of credit risk in 2002 have not adversely affected the portfolio. The credit portfolio continues to exceed safety and soundness standards.

- The products introduced in 2002 have not adversely altered the risk profile, and they do not compromise the credit quality of the book of business.

EXAMINATION OBJECTIVE: *Assess the overall adequacy and effectiveness of credit risk management. Determine how well the Enterprise manages 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 in compliance with prescribed limits and guidelines. The book of business is geographically diversified, and the portfolio 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 concern. The Multifamily portfolio is structured to avoid dominance in regional and local markets. The credit profile of the portfolio is consistent with corporate objectives, and is in compliance with prescribed limits and guidelines.

- Fannie Mae is appropriately compensated for the credit risk it assumes. The analytical tools, decision processes, and tracking mechanisms used to price credit risk were determined to be effective.

- Fannie Mae's credit models produce reliable results. Management routinely reviews the performance of credit models and evaluates their performance against actual results.

- Fannie Mae prudently manages counterparty exposure. Management uses effective guidelines, performance benchmarks and standards, and eligibility requirements for its seller/servicers. Prudent management of exposure to mortgage insurers is accomplished through eligibility requirements for financial strength and performance; by monitoring trends including claims payment; and by establishing exposure limits for mortgage insurance companies. Management uses effective policies, procedures, performance standards and collateral methodologies to manage its exposure to derivative counterparties.

- 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 exposures. Management employs effective tools across the credit spectrum, from master agreements, to tools that enforce credit quality standards, to tools that monitor credit trends within the book of business, to tools that evaluate mortgage insurers, to the structures applied in transactions.

- Fannie Mae's risk sharing strategies effectively reduce the company's credit exposure. Fannie Mae shares credit risk with financially responsible counterparties through the use of credit enhancements and other contractual arrangements.

- The technology and controls supporting Fannie Mae's management of credit risk are effective. Management 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 management of credit risk, 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 and tracked. 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 on 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. During the second-half of 2002, management took decisive action to rebalance the portfolio in response to market conditions. Management's strategy and actions were designed to prudently address the portfolio's sensitivity imbalance without harming the longer-term financial condition of the company.

- The impact of new products, programs and initiatives on the 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 tactical investment and funding decisions took advantage of favorable market conditions, and they were consistent with the 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 separate from personnel who execute transactions. Personnel performing transactions and performing analysis do not code software 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 2002, Fannie Mae made effective tactical investments and funding decisions while adhering to the overall 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. Management uses derivatives primarily for reducing interest rate risk, and our examination did not find a single instance where derivatives were used for speculative purposes. 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 and their use.

- Management governs its use of derivatives in accordance with the standards used by other large financial intermediaries. Fannie Mae appropriately quantifies the credit risk and market risk of its derivatives portfolio. Fannie Mae has a sound method for determining mark to market exposure for collateral. Counterparty risk is prudently managed and the credit quality of counterparties is regularly monitored and evaluated.

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. In addition to duration, 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. There is an appropriate dedication to enhancing the tools used to manage interest rate risk. Controls are in place to ensure the integrity of data used in interest rate risk and portfolio management tools.

- The tools used to model interest rate risk and the strategies to alter the exposures to interest rates are effective. There are effective tools used to evaluate the effect of changing interest rates on all areas of the balance sheet. The prepayment models are well documented and incorporate the appropriate factors. 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.

- Policies, procedures, internal controls, and management reporting that relate to liquidity management are effective. The policies and procedures detail the nature of liquidity risk and how it is managed. Risk limits and lines of authority are clearly identified. The types of investments in the Liquidity Investment Portfolio are consistent with the stated goals and the strategy for managing liquidity. The internal controls covering liquidity management are appropriate. 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 self-assessments of risk, and management appropriately follows-up on issues identified through these processes that require attention.

- Technology and controls for 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 technology systems and tools 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 are appropriately separate. The transactors and portfolio analysts do not code software used. Regular analysis of the underlying markets is performed independently from the transactors.

- Management 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 integrated into other management and financial performance considerations. Liquidity risks are incorporated into Fannie Mae's corporate and business unit plans. Fannie Mae's corporate plans and strategic initiatives fully appreciate the need to maintain adequate liquidity. Liquidity considerations are reflected in the management of derivatives. The Treasurer's Office considers the ability to get out of positions quickly and cost effectively when evaluating 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 continued to enjoy quality access to liquidity and a solid reputation in the markets during 2002. Management of liquidity exceeds safety and soundness standards.

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 across all processing platforms are effective, including the procedures and controls for the management and security of the mainframe operating system. CIS uses effective tools to monitor and manage system capacity. Physical security over IT assets is effective, appropriately monitored, and controlled.

- 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 effective. There is 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 tests are performed periodically to determine whether all critical business units can resume operations effectively. Management planning for business recovery is effective and timely.

- Fannie Mae's processes ensure information technology plans effectively address business unit and corporate objectives. Business units develop focused IT plans which are driven by major business initiatives. The oversight for strategic IT decisions and issues is appropriate.

- There are effective processes in place to ensure appropriate controls are implemented and documentation maintained for system development. The established change management procedures are effective, and testing is performed to ensure that business requirements are achieved.

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 2002 strengthened the technology framework and controls.

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

The risk management framework and controls exceed safety and soundness standards.

- Fannie Mae has effective processes that result in accurate and timely data and information. The system development methodology provides effective controls for software.
- Effective controls are in place to secure networks and/or firewalls from inappropriate or unauthorized actions.
- Management has implemented effective and efficient 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.

- There is a meaningful process used to identify risks to business processes and the appropriate controls that are needed. Business units annually assess their controls using a mechanism based on the COSO framework. Internal Audit verifies the results of the business self-assessments.
- Management was effective in requiring the timely resolution of control related issues.
- 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. Management has enforced 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 changes in 2002 adversely affecting the quality 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 provide the appropriate safeguards against risks. The effectiveness of controls is demonstrated by, among other things, measures of credit performance, the quality of liquidity, management of the interest rate exposure, as well as by the findings and follow-up from the audit activities.

- Management enforces compliance with established internal controls and monitors performance against those controls. There are effective processes that support the timely resolution of deviations from prescribed limits and controls.

BUSINESS PROCESS CONTROLS PROGRAM

EXAMINATION OBJECTIVE: ***Evaluate the framework for implementing controls around revised or new initiatives.***

The quality of updates to the control framework where there are revised or new initiatives exceeds safety and soundness standards.

- The process used to update the control framework when there are new or revised business initiatives is effective.

- Communications associated with new or revised business initiatives are effective. The communications among the affected business and control units are timely, appropriate and accurate.

- The balance between risk management, internal controls and the pressure to implement new or revised initiatives is appropriate. Management has quality information about the effectiveness of risk management and internal controls at critical decision points in the process.

- Management effectively uses pilot programs.

- The analyses Fannie Mae conducts to determine whether new initiatives are successful is effective. There is comprehensive analysis and review conducted after the roll-out. Post-implementation reviews are conducted against established standards, and modifications are made when appropriate.

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 conducted 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 reports. Management's disagreements with audit findings are appropriately documented. The controls surrounding Internal Audit's advisory services and participation on corporate committees and projects effectively preserve the independence of internal audits. 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. Four Board resolutions passed in 2002 reflect best practices and formalized key standards of independence for the internal and external audit functions. The expanded due diligence related to the reappointment of the company's external auditor for 2002 focused appropriately on the independence of KPMG.

- The auditors performing the audit work possess appropriate professional proficiency. A significant percentage of the internal audit staff have advanced degrees and/or professional certifications. The individuals working on the engagement for the external auditor have appropriate professional expertise and experience in auditing complex financial institutions. Moreover, the auditors' proficiency is evident in their audit reports, workpapers and communications with management and the Board's Audit Committee.

- The scope of the audit work is appropriate. The joint audit plan meets industry standards and includes all activities necessary to certify the company's financial statements and attest to the effectiveness of controls, including controls over risks posed by third parties. All internal audits reviewed by OFHEO included fraud analysis, and Internal Audit performed appropriate work on predatory lending related issues. Internal Audit has 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. Communications from both the Internal and External Audit functions adhere to professional standards. The External Auditor completed all of its activities listed in the 2001 Joint Audit Plan in a timely manner. Internal Audit completed all activities identified in the 2001 Joint Audit Plan in a timely manner, and reasonably decided to postpone a certain percentage of other audit activities until 2002. Internal Audit reasonably deferred, cancelled or combined certain audit activities (none of which were in the Joint Audit Plan) originally planned to be completed in 2002.

- The management of the Internal Audit department is effective. Appropriate risk assessments are developed and maintained, the internal audit portions of the Joint Audit Plan are met, programs are carried out, and results of audits are promptly communicated to managers and directors. Internal Audit plans are ambitious and the decisions to revise Internal Audit plans are reasonable. Internal Audit management has effective means of tracking audit issues and communicating progress to management and the Board. Internal Audit management ensures that there are effective controls in place to ensure the integrity and independence of internal audits on processes or products for which Internal Audit staff provided expert guidance.

- Executive management and the Board are appropriately involved with audit issues, and each group follows up on audit issues in an appropriate manner. Both executive management and the Board are appropriately informed of the auditors' risk assessment, the scope of the Joint Audit Plan, adherence to the Joint Audit Plan, and audit findings. Both executive management and the Board foster forthright communications and critical examinations of issues identified through the audit processes. Both executive management and the Board are regularly provided with the monthly Audit Tracking List and the status of efforts to address identified audit issues.

- The auditors' risk assessment processes are effective. The Joint Audit Plan is premised on a risk assessment that appropriately reflects the organizational objectives; assesses strategic and inherent business risks; and evaluates management practices. Internal Audit's risk assessment model developed in 2001 and used for the 2002 audit planning process is an appropriate risk analysis tool that takes into account each of the 40 business areas, their inherent risks, mitigating controls and previous audit results.

- Internal Audit is appropriately involved with new products and initiatives. New products and new initiatives are included in the audit planning process. Internal Audit staff provide expert guidance on new products and initiatives, but there are effective controls in place to ensure Internal Audit's ability to perform unbiased audits is maintained.

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 material changes in the audit functions or roles in 2002.**

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.

- The Board of Directors remains appropriately informed of the condition, activities and operations of the Enterprise. Board orientation and on-going Director education position the Directors to effectively assess the information provided to them and to take appropriate action based on that information. There are effective controls in place to ensure the integrity and reliability of information provided to the Board, and the information provided to the Board is consistent with that provided to and relied up on by management. The Board and its committees receive the appropriate standard and special reports. Special reports to the Board, such as that on Fannie Mae's corporate governance practices, are timely and comprehensive. Reports and discussions about evolving policy matters provide the Directors with the proper context within which to consider and assess information provided to them. 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. Director orientation and on-going Director education contribute to the efficiency of Board and Committee meetings, and to the ability of the Board to carry out its responsibilities in a timely manner. Effective Director succession planning ensured that there was a full complement of Directors at all times in 2002. The Board and its committees completed all time-sensitive actions in 2002 in a timely manner. The Board appropriately prioritizes issues and reasonably deferred a standard report on the Fannie Mae Foundation for one meeting. Because Board members receive information sufficiently in advance of meetings, and because members know that certain issues will be covered at specific meetings, Board and committee meetings are conducted in an efficient manner.

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.

- Effective Board succession planning was evident in the timely nomination of Mr. Malek to assume the Board vacancy created by Mr. Mai's retirement.

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.

- The Board of Directors remains appropriately engaged in charting the strategic direction for the company. Board orientation positions new members to be engaged in charting the strategic direction of the company. The Board addressed and considered the strategic goals for 2002 and beyond in a timely manner. Throughout the year, the Board and its Committees receive informative reports on strategic initiatives and issues. At its annual strategic retreat, the Board reasonably focused on public policy issues and their impact on Fannie Mae's strategic direction.

- The 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; financial standards; and ethical standards. Effective Director orientation and on-going training programs provide Directors with the necessary tools to assess the quality and effectiveness of operations and risk positions. Special reports to the Directors, such as those on Fannie Mae's risk appetite and on new legal standards provide Directors with key information with which to assess the effectiveness of Fannie Mae's control environment. Standard Board reports are effectively designed to alert the Board to trends and to highlight indicators that are approaching risk tolerances. The Board is regularly briefed on the activities of the company's Business Conduct Committee and about matters related to the Code of Business Conduct.

- The Board of Directors has an effective process for hiring and maintaining a quality executive management team. In 2002, after reviewing appropriate information, the Board approved the appointment of one new Executive Vice President and four new Senior Vice Presidents. The Compensation Committee directed the Chief Executive Officer and Chief Operating Officer to review succession planning for each key position in the company.

- The Board of Directors holds the executive management team accountable for achieving the defined goals and objectives. In executive session, the Chairman of the Compensation Committee discussed with the Board the results of the formal evaluation of the CEO's performance. The Board plays an appropriate role in reviewing the evaluations of the COO's direct reports. Long-term and other compensation for the executive management team tie directly to the achievement of corporate goals and objectives. The Cororate Performance Assessments provide the Board with updates on a variety of metrics against which they can assess the management team's progress and effectiveness.

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. The Core Infrastructure Project reflects a comprehensive approach to enhance and strengthen information systems for both internal and external customers' use. The Critical to Quality process demonstrated Fannie Mae's ability to identify emerging information needs and commitment by senior executives with broad responsibilities to determine information needs and priorities. Fannie Mae's ability to post on its web site timely and accurate information about insider securities transactions demonstrates the effectiveness of strategic planning for information systems.

- Fannie Mae's strategy, roles and responsibility are effectively communicated. Senior management from across the company have effective venues in which to discuss strategy, roles and responsibilities, including the weekly Senior Leadership Team meetings which appropriately focus on key issues, and the Quarterly Business Reviews whose agendas include time to discuss "key strategic issues". The staff responsibilities and Steering Committee role for the Core Infrastructure Project are explicit and appropriate. Roles for key corporate relationships are clear and appropriate. The Code of Business Conduct effectively communicates roles and responsibilities for all employees.

- Channels of communication available to Fannie Mae employees to provide feedback, report irregularities, and suggest enhancements are effective. Feedback and enhancement recommendation features are built into the new Financial Dashboard and into many HomeSite applications. Processes are built into the Core Infrastructure Project allowing employees the opportunity to provide feedback and suggest enhancements. An appropriately wide cross-section of Fannie Mae employees and officers were interviewed as part of the strategic planning benchmark exercise.

- Communications across the company are effective. Centralized communications for major projects, and consistent messages advance the effectiveness of corporate messages and actions. Management reporting across the company is effective and subject to appropriate controls.

Communications related to the Core Infrastructure Project demonstrate the effectiveness of communications that cross organizational lines.

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.***

Efforts in 2002 such as the Core Infrastructure Project, the Critical to Quality process and the Senior Leadership Team meetings all further enhanced communications across the company and further demonstrated senior management's commitment to promoting communications and resolution of corporate issues that cross organizational lines.

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.

- Executive management and the Board of Directors are appropriately informed of performance against established goals and objectives. Independent parties, including the Contoller'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 remains appropriately apprised about performance 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 management for decision-making are accurate. Management uses centralized reporting which promotes the integrity and reliability of reports. Reports are generated from reliable 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.

- The planning process is comprehensive. Corporate planning includes an assessment of the implications of strategic initiatives. The benchmarking exercise further strengthened already effective strategic planning and budget processes. Strategic planning appropriately considers public policy issues and key strategic relationships. The Quarterly Business Review process ties directly to the strategic planning process. As demonstrated by the Core Infrastructure Project, planning efforts include gathering input and points of view from across the company.

- The key performance measures are appropriate and align with strategy. Corporate goals have identified metrics that are reported and monitored. The Key Drivers Report and process focuses on measures that are relevant, meaningful and appropriately balanced. The measures in the Quarterly Business Review process and in the monthly Key Performance Indicators reports align directly with both corporate and business unit strategies and goals.

- The company's behavior management programs are designed to achieve the corporate goals and objectives. Individual employee goals and performance assessment criteria tie directly to, and cascade down from the six corporate goals. The Board appropriately ties the compensation for executive management to corporate objectives.

- Management has effectively conveyed an appropriate message of integrity and ethics. The Code of Business Conduct includes many best practices. The securities transactions reports on the company's web site are timely, complete and exceed requirements.

- Decision-making roles and the assignment of responsibilities provide for accountability and control. In 2002 Fannie Mae refined several aspects of the major corporate reorganization implemented in 2000. Both primary responsibility and key dependencies are identified for each corporate objective.

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

The refinement of the 2000 corporate restructuring, the strategic planning benchmarking exercise, the Core Infrastructure Project, the introduction of the Critical to Quality process, and the creation of the Senior Leadership Team all strengthened and enhanced 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 on a company-wide basis exceed safety and soundness standards.

- The business unit goals, implementing plans and programs designed to achieve the strategic plan are effective. Business units define and refine their plans and programs to support corporate goals and objectives. More than 95% of the metrics related to Corporate Objectives were completed or strongly on track by the end of the third quarter. The six corporate goals drive alignment across the company and are evident in the business unit plans and programs. Designating a "strategy leader" for each business area further strengthens the link between the corporate strategic plan and business unit goals, plans and programs.

- Management has demonstrated its ability to lead change effectively. As evidenced by the strategic planning benchmark process, the company seeks continuous improvement and readily adopts changes that enhance its ability to achieve corporate goals. The Core Infrastructure Project is designed to address changes that have occurred in the mortgage market and to position the company to respond to changes in the future.

- There is an effective program for career and management development.

- There are effective programs for recruiting competent people. Management has demonstrated its response to observations identified through the 2001 Employee Perspectives Survey. In 2002, management streamlined the recruiting process, hired a campus recruiting manager and selected recruiting managers. Fannie Mae effectively uses outside resources, technology and its own employees when recruiting.

- The proprietary risk management systems and programs are effective.

- Management's philosophy and operating style have a pervasive impact throughout the company. Corporate communications reinforce management's philosophy and operating style. The Senior Leadership Team supports and advances the philosophy and operating style. The Chief Executive Officer's vision of strategic planning is clearly evident in the focus on clarity, resolution and execution. The management philosophy and operating style are evident in the Code of Business Conduct, and they effectively reinforced through the Business Conduct Committee.