



April 2006

Only Skin Deep: The Rudman Report Scratches the Surface

By Peter J. Wallison

Although the Rudman report on Fannie Mae did not contain any significant new information, it gave rise to some important issues for policymakers. First, despite doing everything required by the Sarbanes-Oxley Act, Fannie's board and audit committee were still deceived by the company's management, raising questions about the act's reliance on "gatekeepers" to prevent corporate fraud. Second, management pressure for specific earnings results at Fannie was strong and pervasive, raising questions about what else management might have done—in addition to manipulating the company's accounts—to achieve its earnings objectives. Finally, had the management shakeup at Freddie Mac—the event that caused the Office of Federal Housing Enterprise Oversight (OFHEO) to commission a forensic audit of Fannie—never occurred, it seems likely that the company's management would still be deceiving the board, its regulator, and investors on its way to a cataclysmic default. This suggests that it is faulty policy to rely on regulation alone for protecting taxpayers and the economy against the systemic risks associated with the mortgage portfolios of these huge, complex enterprises.

In late February 2006, a law firm retained by a special committee on Fannie Mae's board of directors delivered a long-awaited report on the issues raised in a September 2004 forensic audit of Fannie by its regulator, the Office of Federal Housing Enterprise Oversight (OFHEO). The investigation was headed by former senator Warren Rudman, and thus the law firm's report—running to 2,600 pages, including exhibits—became known as the Rudman report.¹ As a source of dramatic disclosures about what actually happened at Fannie Mae, the report was a disappointment; it turned out to be little more than a dilation on the earlier OFHEO audit.

Nevertheless, the report was not without significance. As detailed in this essay, it demonstrates that a board of directors is powerless to prevent a determined management from manipulating a company's financial reports, and thus casts doubt on the efficacy of the Sarbanes-Oxley Act,

which relies on audit committees and boards of directors to prevent just such financial deception. In addition, by revealing the lengths to which Fannie's management was willing to go in order to report favorable earnings results to Wall Street, the report should alert investors, lawmakers, and OFHEO to the possibility that Fannie's management might have manipulated more than merely its accounting in order to achieve its financial reporting objectives.

In its 2004 analysis, OFHEO alleged that Fannie falsified its accounting in several important respects. This allegation, shocking at the time it was made, was later supported by the chief accountant of the Securities and Exchange Commission (SEC), resulting in the resignation of Fannie's chairman, Franklin D. Raines, and chief financial and accounting officers. The Rudman report, in page after page of numbing detail, confirmed OFHEO's conclusions and attempted to assign responsibility for the violations of accounting rules, concluding that "management's accounting

Peter J. Wallison (pwallison@aei.org) is a resident fellow at AEI.

practices in virtually all the areas that we reviewed were not consistent with GAAP [Generally Accepted Accounting Principles].”²

As a result of the 2004 OFHEO report, Fannie has been required to restate its financial reports over many years. It has been unable to produce any financial statements since autumn 2004 and has said it will not be able to produce new ones until the end of this year. The fact that Fannie did not collapse as a result of its accounting disclosures is testimony—if any were needed at this point—to investors’ faith that the government will not allow a government sponsored enterprise to fail. Indeed, Fannie’s stock rose and both its senior and subordinated debt strengthened after the Rudman report was made public.

Implications for Sarbanes-Oxley

That Fannie Mae was still engaged in falsifying its accounts two years after the adoption of Sarbanes-Oxley and its much-vaunted reforms should tell us a great deal about whether the act is likely to be effective in preventing future Enrons and WorldComs. Fannie’s board of directors was made up almost entirely of independent directors. Its audit committee, as required by the act, was composed entirely of independent directors, one of whom—as also required—was a “financial expert.” Fannie’s chairman was the head of the Corporate Governance Committee of the prestigious Business Roundtable, and its independent auditor was one of the remaining “big four” auditing firms. A sister firm, Arthur Andersen, had collapsed after being charged by the Justice Department with criminal conduct in its audits of Enron. Yet the Rudman report made clear that despite this phalanx of qualified “gatekeepers,” and after all the hoopla associated with the adoption of the Sarbanes-Oxley Act—which its sponsors and the media called the most significant reform in corporate law and disclosure since 1933—Fannie’s management continued to mislead the board, investors, and its regulator with false accounting.

The Rudman report goes into substantial detail to make clear that the board and the audit committee were diligent in following—and indeed going beyond—the requirements of the Sarbanes-Oxley Act. Among other things, the board benchmarked its corporate-governance policies—including its ethics and compliance functions—to what were considered best practices for public companies, and it

solicited and obtained analyses of its corporate-governance practices by outside corporate-governance rating agencies. After the accounting problems at Freddie Mac were revealed in 2003, the board, according to the report, was diligent in attempting to assure themselves that the same issues were not present at Fannie. The report concludes:

Overall, we find that Fannie Mae’s Board sought in good faith to respond to evolving legal and other standards in the area of corporate governance; that it sought appropriate internal and external support and advice in meeting these standards; and that its aim was to establish governance policies and practices at least in line with those of leading U.S. corporations and peer institutions. The Corporate Governance Benchmarking Project, conducted with the assistance of an outside law firm, reflects the Board’s intent that the Board remain up-to-date in the area of governance, consistent with its obligations and responsibilities.³

The Rudman report, in page after page of numbing detail, confirmed OFHEO’s conclusions and attempted to assign responsibility for the violations of accounting rules.

From all of this it seems unlikely that Sarbanes-Oxley’s effort to use corporate governance, internal controls, restrictions on the non-audit functions of accountants, and other similar measures to prevent corporate fraud and accounting manipulation will achieve the results its sponsors sought. Fannie’s board, as the Rudman report made clear, appears to have done everything possible as a matter of corporate governance to assure itself that it had control of events at the company. And yet, the company’s management did as it pleased in order to achieve the financial results it wanted to report, and in the process manipulated both the

board and the audit committee. This is a story not substantially different from Enron, WorldCom, and the other corporate scandals that gave rise to the act. Accordingly, it would not be excessive to suggest that the considerable costs imposed by the act are likely to be a deadweight loss to the economy—a conclusion investors promptly drew in 2002, when the Dow index declined precipitously upon investors’ recognition that the act would be adopted by Congress.⁴

Recent academic studies also confirm this assessment. In particular, an event study published in December 2005 analyzed the effect on European companies cross-listed in

the United States as the scope of the act's extraterritorial effect was considered in Congress. As events occurred in the United States casting doubt on the act's applicability to foreign issuers, the value of these companies rose, and as events indicated that they would be covered by the act, their value declined.⁵ If the act were expected to produce any benefits to shareholders, the reactions would have been the opposite.

Implications of the Rudman Report for Legislation and Ongoing Investigations

The report also has significant implications for ongoing investigations and the current legislation in Congress that would control Fannie's and Freddie's growth. Despite its \$70-million cost, the report only scratched the surface of what actually occurred inside the company. Accounting is only a version of reality, and a limited and artificial one at that. Reality is what the company did at the operating level in order to achieve the earnings results it wanted—the risks it took and the corners it cut. A thorough OFHEO report, expected in April or May, should cover these operational matters.

The sheer number of accounting failures certainly reflects a serious problem at Fannie. In all, the report noted that Fannie had failed to comply with accounting requirements in eighteen separate areas, singling out two—Financial Accounting Standards (FAS) 91 and 133—for especially detailed treatment. FAS 91 requires that companies that hold prepayable assets revise their financial reports to take account of actual prepayment experience. Fannie ignored this requirement until 1998, when the necessary adjustment had grown so large it could no longer be ignored. In that year, however, recognition of the full extent of the correction would have caused the company to miss the earnings threshold necessary to pay management's bonuses. So it appears, according to the report, that management simply picked a cost number that would not jeopardize its bonuses. None of this was disclosed to the board or the audit committee, including the fact that the company's independent auditor took exception to the treatment the company adopted.

The report also concluded that Fannie's management manipulated the accounting for hedging transactions so as to avoid reporting the earnings volatility or the losses that

would have resulted from a proper application of FAS 133. This standard requires companies to recognize increases or decreases in the value of derivatives used for hedging purposes, and if applied correctly by Fannie would have resulted in significant earnings volatility or losses on hedges it had closed out, undermining the company's effort to show Wall Street a steady upward trend in earnings. So, according to the report, the company embarked on a program of misconstruing or misinterpreting the requirements of FAS 133. Fannie's independent auditor apparently did not object and did not inform the audit committee or the board that there was a significant issue involving the company's implementation of the rule. However, reviewing the matter later, both OFHEO and

the SEC's chief accountant found the company's treatment to be materially incorrect, precipitating the resignation of Fannie's chairman and other top officers.

There is no point in reviewing all the areas where Fannie's accounting was deficient. As the report noted, it failed to comply with GAAP in virtually every important area. Thus, the report criticized Fannie's accounting treatment for (i) loan losses, (ii) financing through short-term borrowings known as "dollar rolls," (iii)

forward commitments, (iv) classification of securities held in portfolio as either held to maturity or available for sale, (v) recognition of interest expense and income, (vi) other-than-temporary impairment of manufactured housing bonds and other asset-backed securities, (vii) investments in interest-only mortgage-backed securities (MBS), (viii) securitization of wholly owned MBS, (ix) income tax reserves and tax-advantaged transactions, (x) insurance products, (xi) out-of-portfolio securitization, (xii) debt repurchase, (xiii) amortization of callable debt expenses, (xiv) minority lending, (xv) realignment of amortization and securities databases, and (xvi) investment in affordable housing partnerships.

What is most significant about the Rudman report, however, is what it left out or did not attempt to cover. For example, although it described accounting manipulations in detail, the report made no attempt to estimate the extent of the differences between what the company reported in its public statements and its actual earnings or financial condition. In particular, shortly after the company stopped filing financial statements in late 2004, it estimated that its unrecognized losses were in the range of \$9 billion,⁶ then later increased that figure to slightly

Despite its \$70-million cost, the [Rudman] report only scratched the surface of what actually occurred inside the company.

more than \$12 billion.⁷ Are these estimates still accurate? The report does not say, but it's hard to imagine, with all the errors that were described in the report, that Fannie could have accurately estimated these losses when it announced this result many months ago. Nor can one get a sense from the report of the significance of the failures to follow GAAP. Were the consequences in any sense material? Again, the report contains no hint. If they were material, the company's losses may be substantially greater than previously reported; if they were not material, what was the point of reporting them in such detail?

In contrast, the Baker Botts report on Freddie Mac, which resulted in the dismissal of the company's top management, went much further than the Rudman report, not only recounting the ways in which Freddie's management had manipulated the company's financial reports, but also in estimating the differences between the actual results of Freddie's operations and what was reported to the public.⁸

For those who believe that regulators and gatekeepers can save the economy from some future systemic disaster arising from a mistake or dishonesty on the part of either Fannie's or Freddie's management, the sequence of events here should be troubling. It begins with Freddie engaging a special counsel to review its accounting. The investigation was apparently unknown to OFHEO, although the regulator had been boasting at the time that it was fully engaged with both Fannie and Freddie and knew everything of significance that was happening in the two companies. Freddie's special counsel then reported that it had found financial manipulation—earnings management—and a coverup at the top of Freddie. This resulted in the dismissal of Freddie's top officers. Only then, it appears, did Freddie's problems come to the attention of OFHEO. Embarrassed by Freddie's disclosure, OFHEO began a forensic audit of Fannie, apparently believing that if Freddie had been engaging in financial deception that might also be true of Fannie, and in September 2004 published a highly critical report. Only then did the Fannie board request its own special counsel investigation, resulting in the Rudman report seventeen months later. Thus, there is good reason to believe that had Freddie not begun its own internal investigation and dismissed its top officers,

OFHEO would never have investigated either Fannie or Freddie, the Fannie board would never have been the wiser about the dishonesty of its own management, and the false accounting regime at Fannie would have continued—with untold results when it was finally revealed as a massive fraud many years later. This should be a sobering thought to lawmakers and other government officials who seem willing to place their faith in a “world class” regulator to protect the taxpayers and the economy from the systemic risks associated with Fannie's and Freddie's massive mortgage portfolios.

The Report's Conclusions about Motive

The Rudman report, for all its length and detail, leaves a great deal of ambiguity about why Fannie's accounting was so badly deranged. At times, the report suggests that it was simply incompetence or lack of sufficient personnel that allowed Fannie's accounts to fall into so much error. Thus, at one point the report notes, “With the exception of the 1998 accounting changes discussed previously . . . we see little evidence that any individual policy, or the policies in the aggregate, were designed or implemented to manipulate Fannie Mae's financial statements.”⁹ This statement, of course, is flatly untrue. The company's handling of accounting for derivatives was clearly intended—as detailed in the report—to avoid the earnings volatility and losses that would have resulted from a correct application of FAS 133. That is exactly what Freddie Mac had done in a different way, resulting in the dismissal of its top officers. Although it is true that the report cited only one instance in which Fannie's accounting was manipulated in order to permit the payment of bonuses that should not have been paid, it is certainly not correct to suggest that this was the only instance in which the company's financial reports were manipulated to achieve a particular result.

Indeed, by far the dominant theme of the report is the heavy pressure from top management at Fannie to avoid any accounting treatment that would add to the appearance of earnings volatility or interrupt the upward trend of the company's earnings. The importance that management attached to achieving particular earnings numbers was illustrated most dramatically in talking

By far the dominant theme of the report is the heavy pressure from top management at Fannie to avoid any accounting treatment that would add to the appearance of earnings volatility or interrupt the upward trend of the company's earnings.

points that Fannie's internal auditor used in communicating duties to his staff:

By now every one of you must have 6.46 [the earnings per share number desired by management] branded in your brains. You must be able to say it in your sleep, you must be able to recite it forwards and backwards, you must have a raging fire in your belly that burns away all doubts, you must live, breathe and dream 6.46. You must be obsessed on 6.46. . . . After all thanks to Frank [Raines] we all have a lot of money riding on it.¹⁰

It is noteworthy that this language was used by the head of internal audit, the group that has the ultimate responsibility for assuring that a company is complying with various rules and regulations, including accounting requirements. The head of internal audit in any well-run company is not a popular member of the staff and is seldom in a position to rise into top management; he will have stepped on too many toes in properly discharging the auditor's function. But this auditor had obviously gotten with the program at Fannie, and even sent his statement to Chairman Raines as proof of his complete acceptance of the company's perverted ethos. If Fannie had been properly run, he would have been shown the door that afternoon. In an environment like this, as the report should have noted, every member of the staff would be cutting corners and violating rules in order to meet management's earnings number.

The obvious importance attached to making the earnings numbers is what should worry lawmakers, regulators, and outside observers. What we know from the report is that a culture existed within the company that drove management to distort its accounting in order to achieve particular financial results. What we do not know from the report is what the company might or might not have done in its operations—as distinguished from its accounting—to achieve favorable earnings results. For example, if Fannie's officials were willing to falsify the accounting for certain transactions in order to cover up losses on real transactions, were they also willing to engage in real transactions that would have produced temporary earnings but resulted in losses over the longer term? This will probably be a key question in the investigation that is now being carried out by OFHEO and possibly the SEC.

Pressure from management for greater earnings or lower losses—coupled with the fact that Fannie seemed to

consider itself immune from scrutiny—might account for many of the issues that have been raised in the past about the company's operations. If its authors had chosen to go beyond the surface issue of the company's accounting, the Rudman report would have had to consider or address the following important questions:

- To what extent did the errors in Fannie's accounting identified by the report have a material effect on the company's reported earnings or its financial condition, beyond the amounts already estimated by the company?
- Was there a pattern in these errors that suggested they were induced by an effort to manage earnings rather than simply the result of mistakes?
- To what extent were the company's risk management procedures—including particularly its hedging activities—affected by the management's determination to achieve certain earnings goals? Did the company, in other words, incur unnecessary exposure in order to reduce the cost associated with its hedging activities?
- Did Fannie cherry-pick the portfolios it assembled, keeping those that were unlikely to prepay and selling to unsuspecting investors those that had a greater risk of prepayment?
- Did Fannie collude with Freddie Mac to maintain high guarantee fees on securitized portfolios?
- Did Fannie compromise its underwriting standards in order to reach for higher profits on its portfolios by taking greater risks—particularly by acquiring Alt A and lower-quality mortgages?
- Did Fannie set its underwriting standards so as to exclude borrowers in minority and low-income areas whose mortgages might have been thought to pose greater credit risk than borrowers of equivalent credit standing in other areas?

The Rudman report failed to address these questions; if the upcoming OFHEO examination report is thorough, it should provide some answers.

AEI staff assistant Daniel Geary and editorial assistant Nicole Passan worked with Mr. Wallison to edit and produce this Financial Services Outlook.

Notes

1. Paul, Weiss, Rifkin, Wharton & Garrison LLP, *A Report to the Special Review Committee of the Board of Directors of Fannie Mae* [Rudman report], February 23, 2006.
2. Rudman report, 416.
3. *Ibid.*
4. Peter Wallison, "Sarbanes-Oxley As an Inside-the-Beltway Phenomenon," *Financial Services Outlook*, June 2004, available at www.aei.org/publication20582/.
5. Kate Litvak, "The Effect of the Sarbanes-Oxley Act on Non-US Companies Cross-Listed in the US," *Law and Economics Research Paper 55*, University of Texas School of Law, December 22, 2005 (preliminary draft), available at <http://ssrn.com/abstract=876624>.
6. James R. Hagerty, "Fannie Warns of \$9 Billion Loss If Derivatives Ruling Is Adverse," *Wall Street Journal*, November 16, 2004, A3.
7. Jonathan Weil and James R. Hagerty, "Fannie Faces Billions in New Losses; Fresh Accounting Concerns for the Mortgage Company May Further Dent Capital," *Wall Street Journal*, March 3, 2005, A3.
8. Baker Botts LLP, "Report to the Board of Directors of the Federal Home Loan Mortgage Corporation: Internal Investigation of Certain Accounting Matters, December 10, 2002–July 21, 2003," available at www.freddiemac.com/news/board_report/.
9. Rudman report, 399.
10. *Ibid.*, 467.