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January 22, 2002

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Re: *FM Watch and Consumer Mortgage Coalition Comments on Proposed Corporate Governance Regulations, RIN 2550-AA20 – Reply Comment*

Dear Mr. Pollard:

Fannie Mae respectfully submits the following comments in response to comments on OFHEO's proposed corporate governance regulations filed on December 13, 2001 by representatives of FM Watch and the Consumer Mortgage Coalition ("CMC").[1] The purpose of this comment letter is to correct the record with regard to the issues raised by FM Watch/CMC, many of which are either (i) outside the scope of OFHEO's proposal and thus should be disregarded; or (ii) distort both the federal government's regulatory regime for Fannie Mae and Fannie Mae's status as a private company. In their substantially similar letters,[2] FM Watch and the CMC belittle OFHEO's regulatory authority and members of Fannie Mae's Board of Directors and urge OFHEO to adopt provisions that advance their member companies' financial agendas rather than good corporate governance principles.

The FM Watch and CMC letters make a series of recommendations that are founded on two false premises: (1) the assertion that Fannie Mae and Freddie Mac are not "private companies;" and (2) the claim that Fannie Mae and Freddie Mac are not subject to market discipline. These propositions crumble under even the most cursory of inspections and recommendations based on them thus have no merit. The remaining assertions and recommendations made by FM Watch and CMC, also discussed in detail below, run counter to law, Congressional intent and sound principles of corporate governance.

First, both the FM Watch and CMC comments assert that Fannie Mae and Freddie Mac are sufficiently different from "fully private companies" as to warrant corporate

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1 Letter from W. M. House to A. Pollard (December 13, 2001) ("FM Watch Letter") and Letter from A. Canfield to A. Pollard (December 13, 2001) ("CMC Letter").

2 The two letters make the same arguments, urge OFHEO to adopt the same recommendations and even cite the same law review articles.

governance treatment that diverges radically from that of other private financial firms.[3] There is no basis for such an assertion. To the contrary, Congress established Fannie Mae as a fully private company *in order to* achieve a private, self-sustaining secondary mortgage market subject to the discipline of private capital and private management.

As President Johnson stated in transmitting the Administration's housing proposals to Congress in 1968:

> *"I propose legislation to transfer the secondary market operation of the Federal National Mortgage Association on an orderly basis to completely private ownership. This new [Fannie Mae will be] concerned exclusively with providing an increasing and continuous flow of funds into residential financing."*[4]

It is worth reviewing the history of the legislation that ensued. Under the Housing and Urban Development Act of 1968 (the "1968 Act"), Fannie Mae as it existed on August 31, 1968 was divided into two separate corporations. One corporation, retaining the Fannie Mae name, was to become privately owned. The other, to be known as the Government National Mortgage Association ("Ginnie Mae"), was to remain in the Department of Housing and Urban Development ("HUD"). Importantly, the 1968 Act provided for a transitional period during which control of Fannie Mae's Board of Directors would pass from the federal government to stockholders. Congress required that Fannie Mae operate with private capital and that Fannie Mae's operations be "fully self-supporting."[5] Congress also authorized Fannie Mae's Board of Directors to appoint, employ, compensate, promote, and terminate officers, agents, and employees outside of the federal civil service system.[6]

Indeed, the Senate Report on the legislation that privatized Fannie Mae confirms Congress' intent in making Fannie Mae a privately owned and managed company. The Senate Banking Committee wrote that:

> *"The committee expects that the privately owned corporation, with its improved financing methods, will add a significant impetus to the flow of funds in the secondary market and the availability of credit in the home mortgage market."*[7]

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[3] FM Watch Letter at 1; *see also* CMC Letter at 2 ("The Enterprises . . . should not be treated as fundamentally similar to private corporations.").

[4] President's Message, Housing and Cities, H.R. Doc. No. 261, 90th Cong., 2d Sess. 13 (1968), emphasis in original.

[5] 12 U.S.C. § 1719(a)(1).

[6] 12 U.S.C. § 1723(b).

[7] Report of the Committee on Banking and Currency, United States Senate, on the Housing and Urban Development Act of 1968, S. Rep. No. 1123, at 79 (1968).

It is important to note that Fannie Mae receives no federal appropriations, and by law its obligations are explicitly not guaranteed by the U.S. government and do not constitute a debt or obligation of the United States: a fact which Fannie Mae and Freddie Mac are required by law to indicate clearly on each of their obligations.[8]

In contrast, other private financial institutions (including FM Watch and CMC members) take deposits from the public, which, in turn, are backed by federally guaranteed deposit insurance. As of September 30, 2001, 9,701 depositories held $3,179.8 billion in federally insured deposits. It is unclear why FM Watch and the CMC believe that their member firms that enjoy, among other federal benefits, the benefits of government-backed deposit insurance are "fully private," while Fannie Mae and Freddie Mac – that lack this express, direct public benefit – are not.

Since 1968, when Fannie Mae became a private company, the company has increased its capital from $185 million to $25.2 billion. That $25.2 billion in private capital keeps liquidity flowing in the conventional mortgage market and keeps interest rates for homebuyers as low as possible. It is also the clearest evidence of the compact between the federal government and private investors – a compact in which private equity capital and private management play a critical role, allowing Fannie Mae to link more efficiently than ever the international capital markets with the U.S. housing finance market, and, at the same time, requiring the company to serve affordable housing and homeownership needs throughout the country.

Second, the FM Watch comment letter asserts that Fannie Mae and Freddie Mac "are not subject to effective market discipline."[9] In fact, Fannie Mae and Freddie Mac are subject to *more* effective market discipline than the vast majority (if not all) of the companies FM Watch represents. In October 2000, Fannie Mae and Freddie Mac adopted a series of initiatives designed to place the companies at the forefront of evolving world practices on safety and soundness. These initiatives give investors and policymakers more information about Fannie Mae's risk exposure – and confidence that Fannie Mae can manage that exposure – than they can get from any other financial institution. The following is a brief description of just two of these initiatives:

> *Subordinated debt issuance.* Fannie Mae and Freddie Mac are the two largest issuers of subordinated debt in the world. Federal Reserve Chairman Alan Greenspan has characterized subordinated debt as "the canary in the coal mine" with regard to alerting the public to deterioration in a company's credit position.[10] Fannie Mae and Freddie Mac have committed to issue subordinated debt in an amount such that core capital plus subordinated

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[8] 12 U.S.C. § 1719(e).

[9] FM Watch Letter at 1.

[10] When asked about his view on mandatory subordinated debt proposals at his re-nomination hearing in 2000, Chairman Greenspan responded: "The great advantage of having vehicles on the balance sheet such as subordinated debentures is that it is something in the nature … of a canary in a mine, that if … some of the credit capacity of these institutions seems to be eroding at the edges, it is very much more likely to show up in the prices of liabilities which are

debt and unallocated loss reserves will equal at least 4 percent of on-balance-sheet assets plus 0.45 percent of mortgage-backed securities ("MBS") outstanding. In 2001, Fannie Mae alone issued $5 billion of such debt, which made it the single largest issuer of subordinated debt.

Fannie Mae's subordinated debt contains features that make it particularly useful to investors and regulators as a market discipline tool. For example, interest payments on Fannie Mae's subordinated debt will be automatically suspended under defined conditions of economic stress and, should the company experience difficulties, holders of subordinated debt securities will stand in line behind senior debt creditors and mortgage-backed securities investors before they can recover their principal. Unlike other subordinated debt issues, the interest deferral cannot be delayed by Fannie Mae or by any other party if the defined conditions occur.

Fannie Mae's first two subordinated debt issuances received Aa2 ratings from Moody's Investor Services and AA- ratings from Standard and Poor's. The rating agencies rated the subordinated debt without regard to Fannie Mae's federal charter. Evidence that investors view Fannie Mae's subordinated debt as truly subordinated to the company's senior debt can be found in the differences between yields on the company's senior debt and subordinated debt. Over the course of 2001, Fannie Mae's subordinate debt traded at 25 basis points more in yield than the company's senior debt obligations.

Disclosures. Subordinated debt is most effective as a tool of market discipline if the issuer makes available to investors a quantum of information sufficient for investors to determine the financial position of the issuer. In this regard also, Fannie Mae and Freddie Mac meet or exceed best practices for disclosures by financial services firms and exceed the practices of nearly all of the firms represented by FM Watch and CMC.

- Fannie Mae issues an annual Information Statement and quarterly supplements to that Statement that provide information similar to what other companies make available in an SEC 10-K or 10Q. Fannie Mae also publishes a quarterly Investor/Analyst report that provides extensive additional statistical data and interim financial statements.

- On a monthly basis, the company discloses the sensitivity of Fannie Mae's projected net interest income to an immediate 50 basis point increase or decrease in interest rates and a 25 basis point increase or decrease in the slope of the yield curve over both a one- and four-year period. Fannie Mae supplements its net interest income at risk disclosure with monthly disclosure of the company's effective asset/liability duration

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not insured and have no collateral behind them." *See* Testimony of Alan Greenspan, Hearing of the Senate Banking, Housing and Urban Affairs Committee, January 26, 2000.

gap. Effective duration is a measure of the sensitivity of a security's value to changes in interest rates, and is commonly used in fixed-income portfolio management. Few other financial companies report interest rate risk information as frequently.

- On a quarterly basis, Fannie Mae discloses the sensitivity of expected credit losses from a five percent drop in property values.

- Also on a quarterly basis, Fannie Mae discloses the share of its on-balance-sheet assets held in a liquid, marketable portfolio of non-mortgage securities.

These disclosures are world-class and are consistent with the recommendations of the Basel Committee on Banking Supervision, the Federal Reserve's Working Group on Public Disclosure, and other basic statements of regulatory principles. In summarizing the value of the package of disclosures to which Fannie Mae committed itself, Moody's Investor Services, in a Special Comment, stated:

> *"These financial disclosure commitments by Fannie Mae and Freddie Mac set new standards not only for them, but for the global financial market.*
>
> *The provision by Fannie Mae and Freddie Mac of periodic, detailed risk information to the broad market will permit better independent reviews and monitoring of their risk profiles and should substantially reduce the uncertainty about their actual financial health as well as dampen any systemic risks they present.*
>
> *The regular disclosures of their interest and credit risk exposure, combined with stress testing their capital base, should significantly increase market comfort with their risk management disciplines and capital adequacy."*[11]

Third, FM Watch asserts that Fannie Mae and Freddie Mac "are not subject to comprehensive examination by a regulator with the resources and authority to ensure both safety and soundness and fulfillment of their public mission."[12] This vote of no-confidence in HUD and OFHEO is not supported by the facts. The 1992 Act reaffirmed and strengthened HUD's role as Fannie Mae's and Freddie Mac's mission regulator and established OFHEO to ensure the capital adequacy and safe operation of the companies.

OFHEO has been conducting a comprehensive, continuous, on-site examination program since 1994, the scope and rigor of which equals or exceeds that to which any other regulated financial institution is subject. OFHEO devotes more resources to its examination program of Fannie Mae

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[11] Moody's Invester Services, Special Comment: *New Fannie Mae and Freddie Mac "Open Book" Policy: A Positive Credit Development*, March 2001, at 4.

[12] FM Watch Letter at 2.

and Freddie Mac than the Office of the Comptroller of the Currency ("OCC") and the FDIC devote to large and far more complex banking institutions.[13] In addition, Congress required that the results of OFHEO's examinations be made public in OFHEO's Annual Report to Congress. Other financial regulators issue annual reports to Congress, but only OFHEO reports on individual companies' exam results.

The 1992 Act also includes a forward-looking capital standard for Fannie Mae and Freddie Mac. The risk-based capital standard requires the two companies to be able to withstand severe economic conditions that are far more catastrophic and persist far longer than those of the thrift crisis in the 1980s. As stated in the statute, the standard requires each company to hold enough capital to withstand a 10-year stress period characterized by unprecedented interest rate movements and credit losses occurring simultaneously, with an additional capital requirement to cover management and operations risk. The standard is truly extraordinary, and Fannie Mae has operated under its version of the standard since 1993, as OFHEO has developed and is now nearing implementation of its rule. This is a risk-based capital standard that none of the members of FM Watch or CMC could meet.

With regard to mission regulation, HUD is responsible under the 1992 Act for ensuring that Fannie Mae and Freddie Mac carry out their housing missions and comply with their charters. By statute, HUD sets the annual percent-of-business housing goals for the companies' service to low- and moderate-income borrowers, to residents of central cities and other underserved areas, and to very low-income borrowers. Regulations promulgated by HUD for 2001-2003 raised all three goals substantially. HUD also regulates the companies with regard to the fair lending laws, and must give its prior approval to new conventional mortgage programs that are significantly different from those in place before 1992 or previously approved.

Fourth, FM Watch asserts, "there is no formal mechanism corresponding to the Community Reinvestment Act examination of insured depository institutions to ensure that the Enterprises meet their public responsibilities."[14] In fact, the 1992 Act established precisely such a formal mechanism in the form of annual affordable housing goals set by HUD. The goals – which Fannie Mae has exceeded every year since 1994 – impose on Fannie Mae and Freddie Mac tougher affordable housing targets, a greater degree of reporting and monitoring, and stronger penalties than the Community Reinvestment Act ("CRA") requirements imposed on insured depository institutions.

Under the housing goals, HUD sets specific quantitative goals that are measured as a percentage of Fannie Mae's business each year, including a subgoal for targeted multifamily housing business. If Fannie Mae does not meet one of the housing goals or if HUD believes that Fannie Mae will not

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[13] The size of OFHEO's examination staff relative to the number of regulated entities demonstrates the resources that OFHEO is able to devote to its examination responsibilities. OFHEO has 29 examiners for two regulated institutions in a monoline business: a ratio of more than 14 to 1. In 2000, for example, the OCC had an examiner to bank ratio of 0.75 (with regulated entities in a wide range of financial businesses) and the FDIC had a ratio of 0.30.

[14] FM Watch Letter at 2.

meet a goal in a specific year, HUD can compel Fannie Mae to produce a plan for achieving compliance. Failure to provide the plan in a timely fashion or to implement the plan in good faith could lead HUD to exercise its cease and desist powers or impose civil money penalties.

In contrast, the CRA does not impose quantifiable goals but instead relies on the evaluations of examiners, who look at a variety of quantitative and qualitative factors, including relative performance of the banks and thrifts in their service areas. CRA exams occur in a two-year cycle for larger depositories and over a five-year cycle for smaller institutions. A less-than-satisfactory CRA record may be the basis for disapproval of bank activities (including domestic branches or mergers, acquisitions, or consolidations), but the CRA does not authorize civil money penalties. Insurance companies and mortgage banks are not subject to CRA or any affordable housing business requirement.

Put another way: Fannie Mae and Freddie Mac are subject to more rigorous regulation of their achievement of their public responsibilities than are the FM Watch and CMC member companies – and at risk of more serious enforcement consequences should they fail to meet these responsibilities.

Fifth, FM Watch asserts that Fannie Mae and Freddie Mac "are not required to file registration statements and reports with the Securities and Exchange Commission ("SEC") and they are exempt from most class action securities lawsuits and SEC enforcement actions."[15] As described above, Fannie Mae provides more information to investors than required by the relevant SEC regulations. Moreover, Fannie Mae is not exempt from antifraud provisions of the federal securities laws and regulations and thus has every incentive to provide full and fair disclosure to investors.

Sixth, FM Watch asserts that Fannie Mae and Freddie Mac have a "government-granted duopoly position."[16] Again, this is a flat misstatement of the facts. Contrary to the FM Watch assertion of a "government granted duopoly," Fannie Mae competes vigorously with Freddie Mac as well as with many other entities, including members of FM Watch and CMC. In the interest rate risk and credit guarantee markets, Fannie Mae held in its portfolio only 11 percent, and guaranteed an additional 12 percent, of the $6.1 trillion in total residential mortgage debt outstanding as of Q3 2001. Fannie Mae faces competition in these arenas from Freddie Mac, commercial banks and thrifts, the Federal Home Loan Bank (FHLB) System, Ginnie Mae, private investors, insurance companies, state and local credit agencies, credit unions, finance companies, and other investors and managers of mortgage risk. In the broad and liquid fixed income market, Fannie Mae competes with all other issuers of debt, including other agency and MBS issuers, U.S. Treasury debt, corporate bonds, asset-based securities, commercial MBS, municipal bonds, and other bonds. Moreover, Fannie Mae and Freddie Mac are two separate companies pursuing separate business strategies, and they compete vigorously in all dimensions of their businesses. The benefits of this competition among

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15 FM Watch Letter at 1-2.

16 *Id.*

many players flow directly to American consumers in the form of observably lower mortgage interest rates.

In short, try as they may, FM Watch and the CMC are unable to paint a convincing portrait of Fannie Mae and Freddie Mac as either quasi-public government-subsidized entities (on the one hand) or free-wheeling corporations that are unaccountable to financial regulators or to the markets (on the other) – and the absurdity of the FM Watch/CMC position is driven home by the mutually contradictory nature of these two characterizations. The reality is that Fannie Mae and Freddie Mac are private entities subject to constant and unyielding market discipline that is at least as strict as (if not stricter than) the discipline brought to bear on other financial institutions – as well as an even greater degree of regulatory and supervisory oversight than that brought to bear on FM Watch and CMC member companies.

FM Watch/CMC Recommendations

Given the stringent regulatory regime that governs Fannie Mae and Freddie Mac and the fact that the companies are subject to market discipline and public accountability, the nearly identical FM Watch/CMC recommendations are unnecessary and inappropriate. As explained below, not only do the recommendations diverge radically from well-established corporate governance principles and from express provisions of law, they would actually weaken corporate governance and safe operation of the two companies.

I. The FM Watch/CMC recommendation that OFHEO not apply one particular body of corporate governance law to Fannie Mae and Freddie Mac misconstrues the relationship between state and federal law.

The most curious recommendation in the FM Watch/CMC letters is that OFHEO not apply any particular body of law to the two companies because the application of a uniform body of corporate law might somehow enable the companies to evade the restrictions in their Congressional charters.[17]

Clearly, the stated reason for this concern is illogical. OFHEO's proposal would simply apply the corporate governance law of one jurisdiction to the corporate governance practices and procedures of a company; obviously, it would not – and could not – supersede the provisions set forth in the Congressional charters for the two companies. (Indeed, under FM Watch's skewed logic, other companies would be able to argue that they need not comply with federal laws – such as environmental or labor laws – on the ground that they are subject to the corporate law of their state of incorporation. It should go without saying that any court would reject such an argument out of hand.) Moreover, FM Watch fails to note that the OCC has a similar provision in its corporate governance regulations for national banks; of course, no national bank has suggested that this exempts it from federal banking laws and other federal statutes that limit its activities.

[17] FM Watch Letter at 10; CMC letter at 2-3.

II. The FM Watch/CMC recommendation that Presidentially appointed directors have different responsibilities and powers from the shareholder-elected directors would undermine the intent of Congress and diminish – rather than increase – the Board's focus on mission-related issues.

FM Watch questions the "role and effectiveness of presidential appointees…"[18] and FM Watch and the CMC recommend that OFHEO establish separate tiers of directors – by imposing additional responsibilities on Presidentially appointed directors that would give them "a special responsibility to serve the public interest and to ensure that the Enterprise fulfills its public mission in a manner consistent with safety and soundness."[19] FM Watch's comment belittles the value and experience these individuals bring to the Board. Congress required the appointment of knowledgeable and effective housing, industry, and consumer advocates to the Fannie Mae Board. Section 308 of the company's charter requires that:

> *"The board shall at all times have as members appointed by the President at least one person from the homebuilding industry, at least one person from the mortgage lending industry, at least one person from the real estate industry, and at least one person from an organization that has represented consumer or community interests for not less than two years or one person who has demonstrated a career commitment to the provision of housing for low-income households."*[20]

The charter further states the responsibilities of *all* of the members of the Fannie Mae Board:

> *"Within the limits of law and regulation, the board shall determine the general powers which shall govern the operations of the corporation, and shall have the power to adopt, amend, and repeal bylaws governing the performance of the powers and duties granted to or imposed upon it by law."*[21]

This provision gives the *full* Board, and not some subset thereof, the responsibility to adopt and oversee policies that implement the statutory affordable housing mission imposed on Fannie Mae by section 301 of the charter.[22] This section also requires the Board to adopt policies that comply with *all* of the provisions in Fannie Mae's charter -- not just the ones that Fannie Mae's competitors may

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[18] FM Watch Letter at 4.

[19] FM Watch Letter at 7; *see also* CMC Letter at 4.

[20] 12 U.S.C. § 1723(b).

[21] *Id.* (emphasis added)

[22] 12 U.S.C. § 1716 (in part requiring Fannie Mae to (1) provide stability in the secondary market for residential mortgages; (2) respond appropriately to private capital markets; (3) increase liquidity of mortgage investment (including activities related to mortgages on housing for low- and moderate-income families); and (4) promote access to mortgage credit throughout the Nation (including central cities, rural areas and underserved areas)).

choose to emphasize at any given time. Any change in this structure would require a legislative change to the company's charter.

By creating two classes of directors, the commenters' proposal would contravene the intent of Congress and could damage the cohesion and collegiality necessary for an effective board. Just as importantly, however, this proposal would likely diminish – rather than increase – the Board's focus on those issues for which Presidential appointees have "a special responsibility," by implying that only Presidentially appointed directors need to focus on mission and safety-and-soundness issues. Inevitably, any time one group of individuals is told that a specific matter is its particular bailiwick, the non-stated implication is that others are less responsible for those matters. That is not how the Fannie Mae Board operates – it is the responsibility of all directors to promote the company's public mission and financial health.[23]

In any event, the implication of the FM Watch proposal – that Fannie Mae's directors are not sufficiently focused on promoting the company's mission – is simply false. To the contrary, the company continues to demonstrate its strong commitment to expanding homeownership – and helping moderate-income families become first-time homeowners. In March 2000, Fannie Mae launched the "American Dream Commitment," a $2 trillion targeted lending program designed to increase homeownership by breaking down the barriers between underserved families and mainstream mortgage finance. The project will help 18 million American families by the end of the decade. During the first year alone, Fannie Mae financed over $190 billion of home mortgages for nearly two million American families in need through its lender partners. Fannie Mae has also committed to contribute at least $420 billion in mortgage investments to serve more than three million minority households by 2010. In 2000, Fannie Mae purchased minority loans totaling nearly $35 billion and served more than 316,000 minority households.

Today, the nation's rate of homeownership is at its highest level in history – approaching 68 percent overall, with record high rates reported among minority groups. Studies show that Fannie Mae deserves substantial credit for these achievements – and that the company's involvement in the mortgage business lowers interests rates for homebuyers by 25 to 50 basis points. Fannie Mae's mortgage-backed securities business is thriving, demonstrating that Fannie Mae is succeeding at attracting billions of investment dollars to the mortgage sector that otherwise might not be there at all. And Fannie Mae's technological innovations have reduced the costs and inefficiencies of mortgage origination. (Of course, the member companies of FM Watch and CMC do not have

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[23] Notably, the example cited by FM Watch to support the supposed need for a two-tiered board is the experience of the Union Pacific Railroad in the 19th century. FM Watch Letter at 6. Leaving aside the obvious question of whether FM Watch can muster any support for its position in corporate governance developments of the past century, it is not even clear that the antiquated example that FM Watch cites proves the point for which it is offered. Nowhere does FM Watch allege that Presidentially appointed Board members at Fannie Mae are being excluded from board meetings or treated like "spies," as was the case with the railroad board 150 years ago, according to the FM Watch letter. And in any event, the Union Pacific example only highlights the importance of treating all board members the same regardless of how they were appointed – the exact opposite of what FM Watch and CMC propose.

public missions – and unlike Fannie Mae, they are not required to take the "public interest" into consideration in their business planning.)

Thus, not only is the FM Watch/CMC recommendation regarding Presidential appointees inappropriate and unnecessary as a matter of law, but Fannie Mae's continued focus on – and success at – expanding homeownership opportunities belies the public policy need for any such proposal. The sincerity of the interest of FM Watch and CMC members in their proposal for designated directors to oversee affordable housing would be demonstrated if they endorsed such a rule for their organizations. We doubt they would support the appointment of CRA oversight directors to their boards.

III. The FM Watch/CMC recommendation that OFHEO promulgate a stricter definition of "independent" director than the one required by the New York Stock Exchange ("NYSE") audit committee rules is based on a misunderstanding of established corporate governance principles.

In urging a stricter definition of "independent" director, FM Watch incorrectly states that the NYSE Audit Committee Rules allow a board of directors to appoint a director to the audit committee who is not "independent."[24] The NYSE Audit Committee Rules were revised in 1999 to, among other things, define "independence" more rigorously than in the past, require audit committees to consist entirely of independent directors who are financially literate, and require audit committees to adopt written charters that specify the committees' responsibilities. The revised NYSE Audit Committee Rules state that, "[e]ach audit committee shall consist of at least three directors, all of whom have no relationship to the company that may interfere with the exercise of their independence from management and the company."[25] The purpose of the NYSE Audit Committee Rules is to ensure that the audit committee is sufficiently independent from the management of the company to enable it to be critical of the company and its management.

What FM Watch cites as an exception to the "independence" requirement is actually a narrow exception to the presumption created by NYSE that if a director has any "business relationship" with the company, such relationship will be considered to interfere with the exercise of a director's independent judgment.[26] A board of directors can, nevertheless, overcome the presumption and appoint a director to the audit committee who has a "business relationship" with the company if the board "determines in its business judgment that the relationship does not interfere with the director's exercise of independent judgment."[27] FM Watch incorrectly posits that the NYSE audit committee rules permit the board of directors to waive the independence requirement. On the

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24 FM Watch Letter at 7; *see also* CMC Letter at 5.

25 NYSE Listed Company Manual § 303.01(B)(2)(a)).

26 *Id.* § 303.01(B)(3)(b)).

27 *Id.*

contrary, the board of directors is prohibited from allowing a director who has a "business relationship" with the company to serve on the audit committee unless it specifically determines that the relationship does not interfere with the exercise of such director's independent judgment.

In suggesting that OFHEO adopt a *per se* rule banning any director who has a "business relationship" or "political relationship" from serving on the audit committee of the Enterprises, FM Watch ignores the logic underlying the NYSE Audit Committee Rules, state law, and corporate scholarship. The purpose of such rules is not to ensure that a member of an audit committee has no relationship with the company but to ensure that any relationship such member may have with the company does not interfere with his or her exercise of independent judgment. Again, FM Watch fails to adequately explain why this common-sense approach is good enough for *its* member corporations but is not adequate to ensure independence on Fannie Mae's Board.

IV. The FM Watch/CMC proposal that the OFHEO regulations enumerate additional areas for which the Board of Directors be directly responsible would only exacerbate the problems that Fannie Mae identified in OFHEO's original proposal.

The FM Watch/CMC proposal incorrectly states that OFHEO's proposal to list responsibilities and standards of conduct for the Board in a regulation is consistent with state law and the Model Act. To the contrary, both Delaware and the Model Act adopt a flexible approach, recognizing that a key component of successful corporate governance is the exercise of informed business judgment in overseeing the management of a corporation. The standards of care, loyalty, and good faith – along with the business judgment rule –as articulated in Delaware law, the Model Act and state case law hold directors to very high standards, but also encourage thoughtful innovation and intelligent risk-taking.[28]

Moreover, the examples FM Watch cites from the banking context are inapposite because they involve guidelines and policy statements – not enforceable regulations. As a result, rather than expanding the enumerated responsibilities as suggested by FM Watch and CMC, OFHEO should dispose of such an approach altogether in order to align itself with the approach taken by other

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[28] *See* Fannie Mae Comment Letter, December 13, 2001, at pp. 6-11. *See also* comment of John Olson, Chairman, American Bar Association, Committee on Corporate Governance, December 13, 2001. Mr. Olson writes that, "the responsibilities and standards" proposed by OFHEO are "inconsistent with both state corporate law and the Model Act," and would "impose new burdens on directors without recognizing established protections and presumptions of due care." Donald G. Langevoort, professor of law at Georgetown University, similarly notes that the enforceable standards proposed by OFHEO are "a dramatic departure from prevailing law"; by way of example, Langevoort references the SEC's recent rejection of a proposal that would have set out detailed standards for the operation of audit committees because, among other things, it feared that adopting such standards may make it difficult for companies to attract talented audit committee members. Letter from D. Langevoort to A. Pollard (December 13, 2001), at 2-3.

financial institution regulators, state laws, the Model Act, and decades of legal and academic scholarship in this field.

We also note that the FM Watch comment is misleading because OFHEO already examines Fannie Mae's corporate governance practices to evaluate the Board's process for hiring and maintaining a high-quality executive management team and holding this team accountable for achieving the company's defined goals and objectives. OFHEO also determines whether the Board is appropriately informed on the condition, activities, and operations of the company. Such examinations cover *all* of FM Watch's suggestions for areas for the Board to review. Unlike most other large corporations, Fannie Mae is subject to examination of its corporate governance practices and a mechanism is already in place to address any potential issue. In addition, Fannie Mae has a listing agreement with the NYSE, which, among other things, requires Fannie Mae to comply with NYSE rules for establishment of audit committees of a corporate board.

V. In recommending that OFHEO prohibit Fannie Mae and Freddie Mac from targeting specific companies or groups for retaliation, FM Watch is simply re-airing its own baseless allegations.

The FM Watch recommendation that OFHEO prohibit Fannie Mae and Freddie Mac from targeting specific companies for retaliation has absolutely nothing to do with corporate governance, is nothing more than a continuation of FM Watch's political and public relations efforts and should be seen as such. The facts are, as Fannie Mae said publicly at the time FM Watch first leveled these allegations, the company does as much (or more) business today with the companies that support FM Watch as it did before FM Watch was formed.[29]

VI. FM Watch fails to explain why Fannie Mae should be subject to stricter employee disclosure recommendations than banks and other regulated institutions.

Like its other recommendations, the suggestion in the FM Watch letter that Fannie Mae and Freddie Mac should be subject to various disclosure requirements not applicable to other corporations[30] fails to explain convincingly why Fannie Mae and Freddie Mac should be singled out for rules different from those governing financial services entities (including the FM Watch member companies) – all of which are subject to federal law and regulation just like Fannie Mae and Freddie Mac, and many of which receive direct government subsidies – unlike Fannie Mae and Freddie Mac.

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[29] FM Watch makes this allegation in a section entitled "conflicts of interest" and notes its support for OFHEO's conflict of interest proposals. For all of the reasons cited in Fannie Mae's comment letter submitted to OFHEO on December 13, 2001, Fannie Mae respectfully objects to the OFHEO's proposal on conflicts of interest. *See* Fannie Mae Comment Letter at 22.

[30] FM Watch Letter at 9.

Financial firms (as well as most other sophisticated corporations) need to attract and retain well-qualified, skilled individuals with a range of experience in the private and government sectors. Fannie Mae and Freddie Mac are no different in this regard.

In arguing for the additional rules, FM Watch also fails to acknowledge that Executive and Legislative Branch employees are required to comply with ethics laws that address potential conflict-of-interest issues that arise when employees leave the government for the private sector. These requirements apply to all employees regardless of the specific firm with which they secure employment, reflecting the common-sense view that firms across the economy have business interests that intersect with the government.[31] By the same token, government officials who are subject to financial disclosure must disclose their spouse's employment on financial disclosure forms.[32]

Thus, Fannie Mae employees already comply with the same disclosure requirements as employees of the FM Watch member companies – and FM Watch fails to offer any reason why the rules governing Fannie Mae and Freddie Mac should be any different.[33] FM Watch also does not address the overwhelming intrusion on personal privacy that would result from its proposal and how public policy needs – in FM Watch's opinion – outweigh an invasion of financial privacy.

VII. The FM Watch/CMC recommendation regarding executive compensation would put OFHEO in the improper position of second-guessing employee compensation decisions based on vague standards.

The final recommendation in the FM Watch/CMC letter is that Fannie Mae and Freddie Mac consider "the extent to which an executive officer or employee contributed to the fulfillment of the Enterprise's public mission" in deciding compensation.[34] FM Watch also suggests that OFHEO prohibit Fannie Mae and Freddie Mac from considering "profits or revenues attributable to maintaining or increasing public subsidies" in making compensation decisions.[35] Again, such a provision would be contrary to law, unnecessary, and inappropriate.

The 1992 Act specifically authorizes OFHEO to prohibit Fannie Mae from providing compensation to any executive officer that is not reasonable and comparable with compensation for employment in other similar businesses (including other publicly-held financial services companies) involving

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31 18 U.S.C. § 207.

32 *See* Ethics In Government Act of 1978, 5 U.S.C. App. 4 § 102.

33 Notably, while FM Watch urges stricter conflict-of-interest requirements for Fannie Mae and Freddie Mac, it fails to list its members corporations in its comment letter or explain how its proposals – which are purportedly intended to promote the public interest – will benefit those corporations.

34 FM Watch Letter at 10; *see also* CMC Letter at 5.

35 FM Watch Letter at 10.

similar duties and responsibilities.[36] That is the full extent of authority granted by Congress after lengthy debate in 1992. The comments made by FM Watch and CMC ask OFHEO to adopt a regulation that would be outside the confines of the law and completely contrary to Congressional intent that a government regulator not interfere with the day-to-day management of a private company.

Legal issues aside, as noted above, Fannie Mae has demonstrated an unparalleled commitment to its public mission and continues to exceed its ambitious goals in terms of expanded homeownership and affordable rental housing. Fannie Mae already considers mission issues in determining compensation; it also considers other critical issues such as how an executive has contributed to the overall financial health of the organization. Certainly, FM Watch, which has publicly questioned Fannie Mae's safety and soundness, should recognize the need to consider all of these factors in employee compensation. Moreover, this proposal would exacerbate the problems that Fannie Mae identified in OFHEO's proposal, *i.e.*, it suggests that OFHEO should further micromanage the companies' business practices by inserting itself into individual compensation decisions and second-guessing employees' commitment to the public mission.

Finally, it is worth noting that FM Watch again fails to draw a meaningful distinction between its member companies on the one hand and Fannie Mae and Freddie Mac on the other. To the extent that Fannie Mae receives any sort of "public subsidy," it (1) is at most implied and is far less than the express, direct subsidies FM Watch member companies receive in the form of federal deposit insurance and other government benefits for banks and thrifts;[37] and (2) results in a public benefit that far exceeds any benefits provided by FM Watch members (who, as noted above, do not have similar public interest/mission obligations).[38] Thus, it would be instructive to consider whether FM

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[36] 12 U.S.C. § 4518.

[37] As Chairman Alan Greenspan has testified: "Government guarantees of the banking system – deposit insurance and direct access to the Fed's discount window and payment system guarantees – provide banks with a lower average cost of capital than would otherwise be the case." Statement by Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, before the Subcommittee on Finance and Hazardous Materials of the Committee on Commerce, U.S. House of Representatives, April 28, 1999. Similarly, a study by Dr. James Pearce (a former Federal Reserve Bank and Federal Home Loan Bank economist) and Dr. James C. Miller III (former director of the United States Office of Management and Budget and chairman of the Federal Trade Commission) found that depositories (such as FM Watch member banks) "have access to insured deposits, which carry explicit federal guarantees, and low-cost advances from the Federal Home Loan Banks – institutions with federal sponsorship similar to that of Freddie Mac and Fannie Mae." James E. Pearce and James C. Miller III, *Freddie Mac and Fannie Mae: Their Funding Advantage and Benefits to Consumers*, Jan. 9, 2001 ("Pearce/Miller Study"), at 13-14. According to the Pearce/Miller study, Fannie Mae and Freddie Mac have no funding advantage relative to depositories; in fact, banks have an average cost of funds that is lower than Fannie Mae's and Freddie Mac's. *Id.* at 14.

[38] In fact, several economists have conducted studies that found that the public benefits provided by Fannie Mae and Freddie Mac substantially exceed their costs to the public. For example, a study conducted by the First Manhattan Consulting Group found that the gross benefit to Fannie Mae and Freddie Mac from government sponsorship was $1.9 billion, and the benefits Fannie Mae and Freddie Mac pass through to consumers were worth $6.6 billion, ***resulting in a net benefit to consumers of nearly $5 billion.*** Alden Toevs, *A Critique of the CBO's Sponsorship Benefit Analysis*, First Manhattan Consulting Group, at 3. The Pearce/Miller Study similarly found that "[b]enefits to consumers

Watch is urging that similar provisions be applied to banks, thrifts, and insurance companies. For example, CBO has asserted that only 10 percent of the benefits received by Federal Home Loan Bank System members is passed on to conforming mortgage borrowers. Should FM Watch and CMC members who retain benefits be subject to the special compensation rules proposed in their comment letters?

CONCLUSION

In their comment letters, FM Watch and the CMC have sought – in the guise of promoting strong corporate governance – to impose restrictions on Fannie Mae and Freddie Mac to further the political and competitive agendas of their own member companies. Fannie Mae is a mission-driven, private company with strong internal and external financial controls. The proposals made by FM Watch and the CMC would not in any way promote Fannie Mae's commitment to expanded homeownership or help ensure its safety and soundness. They are simply a red herring designed to promote the financial interests of a small number of companies – and should be recognized as such.

Even in the few comments made by FM Watch and CMC that relate to OFHEO's corporate governance proposal, Fannie Mae has demonstrated, on the merits, that these suggestions should not be adopted by OFHEO because they are contrary to well-established principles of corporate governance practice as embodied in state law, the Model Act, case law, and legal scholarship.

Thank you for consideration of our views.

Sincerely,

Ann M. Kappler

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provided by Freddie Mac and Fannie Mae far exceed the Freddie Mac and Fannie Mae funding advantage." Pearce/Miller Study at 23-30, 37. Also, a study by the Mercatus Center at George Mason University found that Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System passed more benefits to consumers in the form of lower mortgage rates than the three government-sponsored enterprises received in benefits through their Congressional charters. Jay Cochran, III and Catherine England, *Neither Fish Nor Fowl: An Overview of the Big Three Government-Sponsored Enterprises in the U.S. Housing Finance Markets*, Mercatus Center, November 2001, at 43.