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## Fannie Mae Report Is Long, but It's Not the Whole Story



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It took 17 months to prepare, cost more than \$60 million in professional fees and runs 2,652 pages. And yet, as the definitive word on what went wrong at Fannie Mae, the report submitted by former senator Warren Rudman and his colleagues at Paul, Weiss, Rifkind, Wharton & Garrison is surprisingly unsatisfying. You get the whos, whats, wheres and whens. But it's annoyingly short of the whys.

That's not Rudman's fault exactly. As he explained yesterday, he and his crew took a lawyerly approach, laying out what they found out from hundreds of interviews and millions of documents, and the logical conclusions that could be drawn from them.

What you don't get, however, is much of the context in which it all occurred -- the frenzy on Wall Street, the ridiculous escalation in executive pay, the widespread deterioration of accounting standards, the relentless political assault against the company by its competitors and ideological foes.

And even after wading through hundreds of pages, you still can't figure out why so many smart, hardworking and basically decent people could get it so wrong.

Too many trees, too little forest.

The basic story line of the Rudman report is that Fannie's chief financial officer, Tim Howard, and a few of his loyal lieutenants cleverly and systematically twisted accounting rules in an effort to smooth earnings and meet bonus targets. For a while, they were able to hide it all from the chief executives and a vigilant board of directors while convincing outside auditors and lawyers that, even if they were wrong about a few things, it didn't amount to a hill of beans. When the truth finally emerged, however, Fannie's directors moved aggressively to clean house and put new policies in place.

That, of course, just happens to be the story Fannie would want to put before a jury if, for example, it were to be sued by the Securities and Exchange Commission or by unhappy shareholders. Call me cynical, but I somehow doubt that's the whole story.

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For me, the most telling chapter comes near the end of the Rudman report. Freddie Mac has already been brought low by an accounting scandal, prompting federal regulators to order a thorough review of the books at its fraternal twin, Fannie Mae. Fannie directors have hired the blue-chip law firm Wilmer Cutler to ensure full cooperation with the regulators and conduct their own "substantive review" of Fannie's accounting policies. Wilmer, in turn, has hired a second audit firm, Ernst & Young, to bring fresh eyes to the accounting issues and the work of Fannie's longtime auditor, KPMG. At a crucial meeting in July 2004, Fannie's board gathers to hear the "second opinion" from its expensive new experts.

As directors and top executives remember it, Wilmer Cutler and E&Y essentially gave Fannie a clean bill of health. No evidence of earnings management. Full compliance with generally accepted accounting principles. Total cooperation with the federal probe. It was not surprising, then, that directors went away relieved and reassured.

But the reality, Rudman concluded, may have been quite different.

Unbeknownst to the board, for example, regulators were furious over the resistance they encountered from Fannie Mae and its outside lawyers against producing all the documents that had been requested. Rudman's associates found several key documents that were withheld from regulators based on what he concluded was a pugnaciously narrow reading by Wilmer attorneys of the original request.

In addition, E&Y would later tell Rudman that it had never been asked by Wilmer Cutler to give a "second opinion" about Fannie's accounting policies, agreeing only to a more limited role. Moreover, E&Y now claims that its accountants never concluded that Fannie's accounting policies were justifiable and reasonable but in fact had raised several red flags that might lead regulators to demand a restatement.

Now I don't know about you, but I suspect there's a wee bit of fanny-covering going on here.

Let's start with the directors. If, after Enron and WorldCom, any director who actually believed that there had been no earnings management at Fannie Mae -- or any other major company, for that matter -- ought to immediately check into the Betty Ford Gullibility Clinic. And it would have taken only a five-minute call to the Office of Federal Housing Enterprise Oversight for a vigilant director to determine how little cooperation regulators were getting from Fannie's legal pit bulls.

At the same time, if E&Y and Wilmer Cutler had raised concerns about Fannie's accounting policies, I doubt they would have sat by silently in 2004 and 2005 as Fannie officials repeatedly invoked their good names in fending off criticism. In fact, they gave



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the answer they thought management and the board wanted to hear, collected their fees and are now scrambling to defend their reputations.

As I was reading through that and other chapters of the Rudman report, I had a nagging feeling that I had read the story before. And then I realized where: in a management book about blowups of other once-successful corporations, written by Sydney Finkelstein, a professor at Dartmouth's Tuck School of Business.

Finkelstein's insight is that big corporate mistakes aren't caused by stupidity, or venality, or by an unexpected bit of bad luck. Nor are they the result of flawed strategy or inability to execute, although those may sometimes appear to be the cause.

Rather, Finkelstein says, the most spectacular corporate failures occur in companies that are so blinded by their own competence and past success that they instinctively tune out legitimate outside criticism. Inside, a positive can-do culture tends to snuff out criticism, dissent or negative feedback. Executives at these companies tend to be obsessed with the company's image, underestimate major obstacles, assume they have all the answers and stubbornly rely on what worked for them before.

The reasons behind most corporate collapses, according to Finkelstein, entail the deep-seated psychological need people have at all levels of a company to belong and get along, to rationalize what has already been done or decided, and to put off loss or failure.

"From what I know about Fannie Mae, it certainly fits the pattern," Finkelstein told me yesterday.

So if you want to know *how* Fannie Mae misstated its earnings and ran itself off the rails, Warren Rudman's 2,652-page report is probably as good a guide as you're going to get. If you want to know *why* it happened, save yourself some time by reading Sydney Finkelstein's 290-page "Why Smart Executives Fail."

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