



Federal Housing Finance Agency

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September 4, 2008

Mr. Daniel Mudd
President and Chief Executive Officer
Federal National Mortgage Association
3900 Wisconsin Avenue, NW
Washington, DC 20016

Dear Mr. Mudd:

Please find attached a draft of our mid-year letter for Fannie Mae. Please note that the composite rating is "Critical Concerns."

This draft is provided for your information and should be provided to your Board.

Please contact me if you have any questions.

Sincerely,

Christopher H. Dickerson
Acting Deputy Director
Division of Enterprise Regulation

cc: Bill Senhauser



Federal Housing Finance Agency

CONFIDENTIAL DRAFT – MID-YEAR LETTER

September [], 2008

Mr. Daniel Mudd
President and Chief Executive Officer
Federal National Mortgage Association
3900 Wisconsin Avenue
Washington, D.C. 20016

Dear Mr. Mudd:

Fannie Mae's composite rating is "Critical Concerns." This rating reflects critical safety and soundness concerns with the Enterprise. The financial condition of the Enterprise is vulnerable to continuing adverse business conditions, and it cannot raise additional capital to cover a potential significant increase in credit losses and related expenses. Moreover, the amount and quality of the Enterprise's capital is of critical concern and remains the subject of an ongoing examination. Given the unsafe or unsound practices and conditions that gave rise to the Enterprise's existing condition, the deterioration in overall asset quality and significant earnings losses experienced through June 2008, as well as forecasted future losses, likely require recapitalization of the Enterprise.

This rating reflects a downgrade from the previous quarter and stems from the continuing and significant deterioration in credit quality of mortgages and securities in the retained portfolio, as well as the guarantee business. Earnings, solvency, and liquidity are each negatively affected by current and forecasted credit losses, as well as the possibility of further impairments of private label securities and deferred tax assets. As described more fully below:

- Fannie Mae's own public filings have indicated accelerating credit losses in the most recent quarter;
- FHFA's current examination of the reserve process could have an additional negative impact on capital calculations;
- If unable to rebut the OTTI guidelines, the Enterprise may incur significant additional write-downs;

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- The Enterprise lacks sufficient reserves for exposures to mortgage insurers and financial guarantors;
- The Enterprise has failed to comply with FHFA's request to manage its net cash needs to ensure that it has cash or cash equivalents to last 30 calendar days without access to the discount note market;
- The Enterprise continues to rely on flawed modeling which has forced the Enterprise to repeatedly revise its own forecasts; and
- Fannie Mae's continues to rely almost exclusively on short term, discount note funding.

Given the seriousness of our concerns, this letter reflects our observations not only during the first and second quarters of this year, but through the year to-date.

The critical issues facing the Enterprise at this time include, but are not limited to:

- The amount and quality of capital is declining and, as the Enterprise has acknowledged in writing, there is limited potential to augment capital materially from external private sources. Moreover, there is a reasonable possibility that regulatory capital could fall below the minimum capital level, and perhaps further, based on the following assumption changes.
 - (a) The timing of losses: accelerated losses provide less time for revenues to cover losses.
 - (b) The magnitude of losses: higher defaults or severity of losses from those defaults.
 - (c) The duration of losses: losses could continue to increase or show less recovery in the future.
- Credit losses and related expenses are high and forecasts show significant and continuing accelerated deterioration.
- Earnings are poor and deteriorating and are not sufficient to generate adequate capital and reserves, particularly after considering the quality of the Enterprise's on and off balance sheet financial instruments. Continued declines in earnings could result in impairment of deferred tax assets, which would further impair capital.
- Liquidity risk is high and represents a critical risk to Fannie Mae. Capital Markets management's liquidity strategy is significantly strained in the current market. Deteriorating market confidence in Fannie Mae, and the other GSE, as well as worsening market liquidity for GSE bullet and callable debt increased pressure on Fannie Mae's discount note issuance program to a critical level. The Enterprise's

practice of relying on repo financing of its agency collateral to raise cash in the current credit and liquidity environment is an unsafe or unsound practice, given the unavailability of willing lenders to provide secured financing in significant size to reduce pressure on its discount notes borrowings.

- Persistent systems deficiencies prevent the securitization of the whole loan book in the retained portfolio, reducing Fannie Mae's asset liquidity. The inability to securitize its whole loan portfolio decreases assets available for liquidity by about one-third.
- Over the years, the Board and senior management failed to establish and maintain a sufficient infrastructure, i.e., systems, data, and risk management systems and controls to accommodate new products and properly manage their risks.
- The development and validation of several key models used to estimate prices and risk levels, and to determine economic capital are lagging due to long-standing deficiencies in staffing. Results from these key models are unreliable due to extraordinary external factors and the use of outdated assumptions and/or incomplete models.
- Interest rate risk exposures (IRR), the IRR strategies, and IRR limits are aggressive given the current earnings and capital situation and forecasted credit losses.
- Market risk oversight resources are not commensurate with the aggressive interest rate risk limits and positions and is an unsafe and unsound practice.
- Operations are inefficient and manually intensive. The operational risk framework is not fully built-out.

The decisions of the Board of Directors and senior management prior to and continuing into 2007 to engage in Alt-A loans and other higher risk loan products contributed significantly to Fannie Mae's current earnings losses and financial weakness. Members of the executive management team made imprudent decisions to increase market share and enter into higher risk products with outdated models, and without all the necessary information or reports to evaluate the risks of its decisions. In addition, the Board's and management's decisions to purchase or guarantee higher risk mortgage products contributed to the Enterprise's continuing deterioration of its financial condition. Senior management and the Board of Directors made these decisions to increase market share, raise revenue and meet housing goals, but many of these decisions were imprudent because they were based on a flawed lending strategy predicated on relaxed underwriting and eligibility standards (such as mortgages without full documentation) and failed to adequately price these loans for risk. When housing prices nationwide declined, the fundamental flaws of this strategy became manifest, particularly in areas such as California, where the combination of "alternative" mortgage products and severe house price declines have resulted in losses that are still rising.

Until recently, models used to guide credit decisions were, and had been for a number of years, deficient and were developed based on the characteristics of borrowers who were much more creditworthy and did not fully account for Alt-A and other nontraditional loans that had new product features and layering of risk, as there was little data available to estimate their behavior in stressed economic conditions. In addition, these models assumed a much healthier economic environment than the current severe environment in which we have been operating since these models were developed. Moreover, management has not been sufficiently proactive in modifying liquidity and interest rate risk strategies, its interest rate risk limits, or the quality of its independent market risk oversight, all of which are essential to keeping the aggregate levels of risk at reasonable levels. These unsafe or unsound practices have caused and are likely to continue to cause a substantial dissipation of assets and earnings and cause the Enterprise to presently be in an unsafe or unsound condition. Moreover, while management completed a capital raising effort in the second quarter, it has allowed its capital to deteriorate substantially in the past months, dangerously reducing the capital resources available to the Enterprise to absorb losses embedded in its existing portfolio and guarantee obligations. The Enterprise is therefore vulnerable to further deterioration given the current conditions in the mortgage market.

Management has made progress in such areas as the development of accounting policies and the production of financial statements. Evidence of sustainable processes in these areas led to the removal of the Consent Order earlier this year. Management also devoted effort to better strengthen limits, policies, and several risk management practices across the Enterprise in order to stem the tide of surging credit losses. However, further declines in house prices, especially in geographic locales where borrowers are most highly leveraged, such as California and Florida, are likely to result in additional significant credit losses. Fannie Mae does not have appropriate levels of capital resources to absorb those losses. Fannie Mae also remains significantly exposed to the health of key counterparties, especially mortgage insurers, bond guarantors and key seller/servicers.

Overall risk remains a critical concern. Recent adverse changes in the overall economic environment have magnified the impact of the Enterprise's weaknesses to the point where they pose serious risks to its continued operation. In particular, FHFA is concerned that the Enterprise's conduct has resulted, or is likely to result in:

- A substantial dissipation of earnings and assets due to unsafe or unsound practices.
- The Enterprise being in an unsafe or unsound condition to transact business.
- The Enterprise facing an inability to meet its obligations in the normal course of its business.
- A weakening of the condition of the Enterprise due to unsafe or unsound practices or conditions.

As described more fully below, these critical issues have been identified in each category of the “GSEER” risk classification system.

Governance

Governance is rated “Significant Concerns.” Governance comprises accounting, compensation, compliance, enterprise wide risk management, external audit, internal audit, management, model process, reputation and strategy. This rating reflects FHFA’s determination that more than moderate weaknesses and unsafe or unsound practices or conditions exist.

Board and Executive Management Practices

The Board and senior management failed to develop or complete many corporate management practices for credit until late 2007. In recent years, the plans to meet market share targets have resulted in strategies to increase purchases of higher risk products, creating a conflict between prudent credit risk management and corporate business objectives. Since 2005, Fannie Mae has rapidly grown Alt-A and grown some other higher risk products without adequate controls in place, such as those to ensure pricing and post-purchase quality control of higher risk products commensurate with the additional risk. Further, increasing and rapidly deteriorating performance indicators of the Alt-A portfolio demonstrate Fannie Mae management’s failure to adequately assess the credit performance of the higher risk products with unknown, uncertain performance. Additionally, management’s decisions to tighten Alt-A eligibility and underwriting standards as late as mid-2007 reveals a belated response to a deteriorating market environment.

Despite signs in the latter half of 2006 and 2007 of emerging problems, management continued activity in risky programs, and maintained its higher eligibility program for Alt-A loans without establishing limits on the Enterprise’s total Alt-A position. In the latter half of 2007, Fannie Mae tightened underwriting and eligibility standards; however, by that time the earlier unsafe or unsound practices caused the unsafe or unsound condition in which Fannie Mae now finds itself.

Until recently, many credit decisions were driven by market share, distorting some credit decisions, and allowed for an infrastructure that did not properly control or fully take into account pricing and risk. Management viewed their mortgage business as low risk, and many controls they implemented in the past did not meet industry standards, some of which remain outstanding today.

(a) Early warning reports that showed poor performance of new mortgage products such as Alt-A mortgages were ignored. This is part of a larger issue of limited performance tracking for credit models.

(b) During 2006 and 2007, modeled loan fees were higher than actual fees charged. Focus was improperly placed on market share and competing with Wall Street and the other GSE.

(c) Quality control (QC) over loans meeting documentation and other standards, and actions to collect on loan repurchases were lax, resulting in a massive backlog of loan repurchases with Countrywide. Management only recently improved the loan QC process and efforts to make servicers buy back noncompliant loans. The backlog was largely cleared out in mid-2008. Different servicers received different treatment regarding repurchases. For example, Countrywide's repurchases were allowed to backlog for years.

(d) Fannie Mae executives purchased private label securities backed by Alt-A or subprime loans during a time that credit quality in the sector was deteriorating.

While a number of past control deficiencies have been corrected, a number of other key areas remain seriously deficient. In particular, FHFA has significant supervisory concerns over management's failure to implement an effective market risk oversight (MRO) function under the authority of the Chief Risk Officer. MRO resources are not commensurate with the aggressive interest rate risk limits and positions, due to protracted vacancies in senior positions. Moreover, the failure to maintain an effective MRO function during this period of tumult in the housing finance and capital markets sectors not only exposes the company to increased governance risk, it also constitutes an unsafe and unsound practice.

The company's practice of relying on repo financing of its agency collateral to raise cash in a systemic liquidity event is an unsafe or unsound practice given the unavailability of willing lenders to provide secured financing in significant size. Management failed to ensure that the company could convert unencumbered agency MBS to cash through secured lines of credit, sales of MBS, or an active repo funding program. Examples include:

- Fannie Mae's 90-day liquidity report was designed to show management that under extreme duress, i.e., no access to the discount note market, Fannie Mae would be able to borrow using its agency collateral to raise more than \$100 billion to cover 90 days of net cash needs. Today, given stressed credit and liquidity conditions, market lenders are not willing to issue term-repos or to commit secured lines to Fannie Mae in that size.
- In addition, management is not complying with FHFA's request to manage its net cash needs to ensure that it has cash or cash equivalents to last 30 calendar days without access to the discount note market.

In addition, some recent corporate decisions have the potential to further adversely impact Fannie Mae.

(a) Senior management has placed people with insufficient skill sets into key management positions. For example, the head of Human Resources was moved to SVP of business relations in Fannie Mae's Central region, without the requisite background, experience or skills to perform the new responsibilities.

(b) Administrative costs have been cut several times in the last couple of years, with many cuts coming from voluntary retirement programs. Many experienced people with knowledge or skills of proprietary systems were lost. Model development was significantly adversely impacted by the retirement of several long time employees:

Model Development and Validation

Model risk is rated “Significant Concerns.” The level of model risk for credit pricing remains high as uncertainty surrounding credit conditions and future home prices continues. The inability of market risk models to capture the liquidity-based disruptions in MBS increases the uncertainty surrounding market risk limits and corresponding hedging strategies. Projections of negative earnings mean that model results have immediate impact on increasingly constrained capital. This model risk has resulted in increased uncertainty in the pricing of acquisitions in both the credit guarantee business lines, as well as in estimates of portfolio credit and market risks. As such, the long-term risk to earnings has increased, thereby expanding the need for risk-based capital to cover the additional model risk.

Models are less dependable and require adjustment when the economic environment is outside of historical experience. Models are estimated using selected historical experience as a guide. When circumstances are such that no historical experience can provide insight for model builders, models are very unlikely to produce accurate projections. Such circumstances put a premium on the Enterprise’s ability to rapidly and accurately devise models based on more realistic assumptions about the future. Failure to have done so earlier is an unsafe or unsound practice that has caused an unsafe or unsound condition.

Management for credit and interest rate risks has been too reliant on outdated models in making major decisions, which has resulted in questionable decisions and significant safety and soundness concerns. For example, the Loss Forecast Model contributed to management not raising enough capital soon enough. The version of the CreditWorks model used in 2006 and 2007 suggested g-fees that subsequent versions of the model showed were inadequate. In addition, several critical models have not been independently validated, such as the loss forecasting, and several models used in back-end credit loss management, such as the property disposition model. Fannie Mae has failed to provide adequate resources to validate the bulge in models that need validation now given the current condition of the market and the Enterprise. This failure constitutes an unsafe or unsound practice likely to cause substantial dissipation of assets or earnings or further weaken the condition of the Enterprise.

BA&D and CRO and have improved model development, risk management and oversight in the past year. The BA&D model development group continues to provide project management, model controls and documentation, CMP compliance efforts, and strategic planning for the function. However, the model performance tracking function in this group has still not fully been addressed. Though VP Sykes has led a sound model validation function, the level of model risk exposure, coupled with a backlog in models to be validated, has increased significantly, so that the need for additional resources in this area is critical. In addition, BA&D currently has approximately 17 open positions, of which 14 are currently

being actively recruited. The recruitment process for these positions has been intensified so that it involves more senior management involvement and monitoring. Nevertheless, the failure to adequately staff this function that is critically important to the Enterprise in today's environment is an unsafe or unsound practice and has resulted in the Enterprise being in an unsafe or unsound condition.

Credit Risk Models

BA&D has lost critical staff members due to the early retirement program. New hires for various positions have less experience in key roles than the staff they may replace. BA&D's Strategic Initiative has been approved, providing more staff resources for modeling efforts. The most critical result of resource constraints is the delay in updating the Single Family CreditWorks (SFCW) models, although much progress has been made. Many of the models in the CreditWorks application have been updated this year, and the incorporation of current market data has become timelier. But key issues remain with respect to modeling capital requirements and house price projections for this application.

Challenging credit conditions make it vital that credit losses can be adequately estimated and controlled. The current version of the Single Family Loss Forecast Models have not been independently validated, and their structures have not been updated for several years. Algorithms used for decision making at the back end of the credit life cycle, such as Loss Mitigation models, short sale models, and REO pricing models, have begun to be updated. But until just recently their development seriously lagged that of front end models, such as those used for underwriting.

The version of Desktop Underwriter used for most of this year was calibrated with data from cohorts of loans originated before 1996 and a substantial volume of higher risk product was underwritten using this model in 2006 and 2007. The deployment of a new DU model in June 2008, with much more current data is an important accomplishment, but the substantial dissipation of assets and earnings that the Enterprise is realizing today is the result of the earlier unsafe or unsound practices or condition, of failing to establish appropriate models.

Market Risk Models

While model risk remains high, there has been significant progress in improving model risk management processes. This progress is expected to continue in four respects. Progress has been made to assess, independently validate and enhance models, and in the formulation and funding of a Strategic Initiative for 2008 to significantly enhance BA&D's capabilities that may lead to improved turnaround time for model development. However, certain factors may cause progress to slow, thus causing market model risk to increase over the next year. Fannie Mae does face greater mortgage credit risk, which may continue to increase the demands on credit modeling. This is occurring at a time when key modeling staff are leaving and may be very difficult to replace, so staffing to meet the challenges may be difficult. In addition to these challenges in credit risk modeling, market risk models have been challenged by the unprecedented behavior of spreads in capital markets, and the absence of earnings creates the

likelihood that inherent errors in model results lead to immediate adverse effects on Fannie Mae's capital.

Mortgage market turmoil has resulted in a significant increase in the model risk within market risk models. Prepay models are challenged by the sudden deterioration in mortgage credit markets and falling home prices. After several recent updates, Fannie Mae's 30-year fixed-rate mortgage prepayments are now closer to actuals than most dealer estimates. Capital Markets Strategy has indicated that the move to the new 30-year prepay model added roughly \$13- to \$14 billion in 5-year swap equivalents to the portfolio risk position (\$63 billion in duration dollars).

Economic Capital Model

Fannie Mae does not have an effective economic capital model including market, credit, and operational risk. The development has been subject to delays. Such a model could have informed management that they needed more capital to face current market conditions.

Accounting

FHFA has limited but continuous concerns relating to accounting policy at the Enterprise, based upon our analysis, findings, and observations so far this year. This concern is exacerbated by the fact that the economic environment in which the Enterprise operates has continued to deteriorate precipitously. The incidence of mortgage loan-related delinquencies and foreclosures has increased, and the Enterprise's large investments in mortgage-related securities have continued their decline in value.

The amount by which the lifetime expected losses related to credit exposures exceeds the GAAP credit loss reserves has increased appreciably. In response to increasing questions and concerns in this area of accounting, FHFA has begun an examination of the reserving process, focusing on critical areas such as high risk products; the setting of the loss emergence period; establishment of appropriate risk "buckets" for the expected default rate calculation; the basis of collateral values used in the calculations of loss severity; and comparability between the Enterprises. We are also focused on the appropriate recognition of losses through "other than temporary impairment" (OTTI) of investment securities. In this regard, we have concerns regarding the relaxation by the Enterprise of previously stated policies. FHFA drafted a supervisory position on the assessment and recognition of OTTI, which would establish a baseline set of assumptions for OTTI assessment with respect to subprime and Alt-A private label securities. We believe that the implementation of this guidance would likely result in a material increase in OTTI recognized by the Enterprise.

Solvency

Solvency is rated "Critical Concerns." Solvency evaluates the quantitative measurement of available capital in relation to the risks facing the Enterprise, the sufficiency of capital planning, and other capital management tools in light of the risks and future capital

requirements. The rating of “critical concerns” reflects FHFA’s assessment that immediate, material fundamental changes are necessary to address the issues evaluated.

FHFA expects the Enterprise to maintain capital commensurate with the nature and extent of risk. Accordingly, the types and quantity of risk inherent in the Enterprise’s activities, as well as its ability to manage these risks, will determine the extent to which it is necessary to maintain capital above the statutory minimums to properly reflect the potential adverse consequences that these risks may have on the Enterprise. Fannie Mae was classified as “adequately capitalized” for the first quarter 2008. However, the capital raise of \$7.4 billion in May 2008 and the effect of lowering the FHFA-directed requirement in both March and May 2008 have been significantly offset by the continued high credit loss provisions. Accordingly, capital adequacy, even in the near term, is a serious concern in light of the inherent risks and the acknowledged questionable ability of the Enterprise to raise a material amount of capital from private sources in a deteriorating economic environment.

FHFA is seriously concerned that the failure to properly estimate loan loss reserves, losses through the “other than temporary impairment” and potential loss of tax benefits from use of DTA and LIHTC could result in capital that is materially overstated. FHFA’s current examination of the reserve process could have an additional negative impact on capital calculations.

Earnings will likely be further decreased by the fact that the Enterprise will probably not be able to avail itself of certain tax-advantaged assets. Greater losses will further adversely impact capital levels. Sustained earnings losses could reduce or eliminate the tax benefits of the following:

- (a) DTA have increased from about \$9 billion in 1Q07 to about \$21 billion in 2Q08 (an amount equaling almost 45% of the Enterprise’s capital), and continues to increase primarily due to the increasing loan loss reserve and PLS losses. This increase coupled with the uncertain market has heightened our concern around the quality and recoverability of this \$21 billion tax benefit, calling into question the amount of core capital.
- (b) OTTI will likely increase earnings losses, further depleting capital. Available for Sale (AFS) securities, primarily private-label securities (PLS), currently have about \$8 billion in unrealized losses. About \$2 billion may be a recognized loss in 3Q08 earnings.
- (c) LIHTC, at about \$7 billion, may not be used to offset taxes should earnings losses continue. Management recognizes this, has stopped purchasing LIHTC, and is currently working to sell all or part of its LIHTC portfolio to third parties such as energy companies. However, LIHTC is slow to sell in meaningful amounts: Fannie Mae was able to sell only \$1 billion YTD 2008, and is likely to be less successful in future sales.

Factors impacting the Solvency rating also include, but are not limited to:

- Fannie Mae's written acknowledgement to the Department of the Treasury on August 25, 2008, and repeated comments to the FHFA, that it is infeasible for the Enterprise to raise capital from the private sector in the current environment.
- The continued high exposure from credit-related risks place pressure on the capital base of Fannie Mae, further eroding capital as losses continue.
- Current and projected earnings capacity remains insufficient to grow the capital base through normal operations.
- Capital projections, while continuing to reflect surpluses, have been repeatedly recast downward, raising concerns over the reasonableness of Fannie Mae's projections and ability to withstand losses it does not currently anticipate, using its existing models. Thus, capital adequacy in the near term under a continuingly difficult market environment is highly questionable.
- Recent auctions indicate that the "agency" debt markets, particularly for long-term issues, are fragile.
- Fannie Mae's success in raising \$7.4 billion in new equity during May 2008 reflected positively on its ability to access the markets at that time. However, given the current uncertainty in the markets, regulatory changes, the Enterprise's current condition (and by the Enterprise's own written admission) the capacity to raise additional capital in the future is extremely questionable.
- Capital planning efforts have continued to evolve somewhat, including improvements in credit risk modeling. The importance of continued planning and stressing of projections is critical given the uncertainty of forecasted income and credit losses.
- According to the June 30, 2008 10-Q, the fair value of shareholder's equity was only \$12.5 billion, which was \$28.8 billion less than the GAAP carrying value. The fair value of stockholder's equity decreased by \$23.3 billion during the first six months of 2008, and in light of the need to take additional provisions and the continued decline in PLS and MBS prices, the fair value of shareholders' equity is expected to decline further in the near term.

Projected capital levels are based on uncertain forecasts in credit loss trends. Current forecasts show capital falling below regulatory minimum capital but remaining above critical capital levels in 3Q09 based on the assumption that trends in credit losses begin to improve during 3Q09. There is a reasonable possibility that regulatory capital could fall below the minimum capital level, and perhaps further, based on the following assumption changes.

- (a) The timing of losses: accelerated losses provide less time for revenues to cover losses.

- (b) The magnitude of losses: higher defaults or severity of losses from those defaults.
- (c) The duration of losses: losses could continue to increase or show less recovery beyond 3Q09.

Earnings

Earnings are rated “Critical Concerns.” This rating comprises all aspects of earnings and financial analysis including the soundness of the business model, adequacy of earnings and the ability to build and maintain capital. The rating of “critical concerns” reflects FHFA’s assessment that immediate, material and fundamental changes are necessary to address the issues evaluated and concern that the Enterprise is unable to implement corrective actions in the current environment.

Earnings have declined steadily over the past 5 years, including 2007, most recently due primarily to increasing credit related losses. FHFA has issued supervisory letters over the past three quarters identifying concerns related to earnings. Thus, the unsafe or unsound practices that led to this significant dissipation of earnings places the Enterprise in a position that it cannot generate adequate capital and reserves, particularly after considering the deteriorating quality of the Enterprise’s on and off balance sheet assets.

Earnings in the first half of 2008 have been adversely affected by escalating credit-related expenses, substantial fair value losses on the trading portfolio and derivatives, and security impairments, which together have caused substantial net losses, negative returns to shareholders and substantial erosion of retained earnings.

Forecasts of future earnings and capital continue to be revised downward as forecasts of credit-related expenses continue to rise substantially. The speed with which earnings forecasts have changed and the severity of downward revisions of the forecasts over relatively short periods highlights the uncertainty surrounding these forecasts, as well as the vulnerability of earnings and capital to credit exposure.

Notwithstanding the dominance of credit-related expenses in earnings forecasts, future earnings are also exposed to fair value losses from spread widening of private-label securities in the trading portfolio, as well as security impairments in the available-for-sale portfolio. Our critical concerns relating to earnings include the following:

- Fannie Mae accumulated net losses to common shareholders in the first half of 2008 of \$5.1 billion.
- Retained earnings shrank by \$5.6 billion in the first half of 2008.

- The pre-tax loss of \$7.9 billion in the first half of 2008 exceeds the full year 2007 pre-tax loss of \$5.1 billion.
- The provision for credit losses (excluding repurchases on delinquent loans out of trusts) at \$6.9 billion for the first half of 2008 is more than double the full year 2007 amount of \$3.2 billion.
- The Enterprise's base-case earnings forecast indicates substantial pressure on solvency and on capital, which will likely fall below regulatory requirements especially if the economic environment does not improve dramatically in the near-term. Indeed, the Enterprise's own forecasted earnings in a more stressful scenario indicate that its capital resources will continue to decline in the short term given the prolonged continuing deterioration in house prices.
- Further losses will likely result in impairments to deferred tax assets that will cause a further impairment to the adequacy of capital.

Enterprise Risk

Credit Risk Management

Credit risk is rated "Critical Concerns." This component is comprised of an evaluation of accounting, counterparty, credit models, multifamily, portfolio credit, and single family and incorporates both the quantity of risk in the Enterprise and the quality of risk management in these areas. The rating of "critical concerns" reflects FHFA's assessment that immediate fundamental changes are necessary to address the issues evaluated and concern that the Enterprise's corrective actions, many implemented since mid-2007, may not be adequate to address the problems arising from loans acquired in 2007 and earlier, given increasing volumes of foreclosures and the current environment. Data, systems, and risk management practices do not fully accommodate the current levels of complex and higher risk products, which is an unsafe or unsound practice.

The "Critical Concerns" rating reflects a downgrade from Significant Concerns in the first quarter of 2008, and is due to continued and significant deteriorating single-family performance indicators, rapidly growing credit losses, declining financial capacity of mortgage insurers and financial guarantors, financial weakness of significant servicers, and market pressures that are expected to stress the Enterprise's performance, including earnings and capital, through 2008 and thereafter. Moreover, the level of model uncertainty has grown because of the current unprecedented credit conditions and declining house prices. Significant concerns also remain regarding deteriorating performance of collateral underlying private-label securities owned by Fannie Mae, coupled with the stress on bond guarantors.

Many of these deficiencies arise from prior unsafe or unsound practices involving credit decisions and that have now caused and are likely to continue to cause a substantial dissipation of assets and earnings or further weaken the Enterprise's condition. In particular, many credit

decisions were driven by market share, distorting some credit decisions, and allowed for an infrastructure that did not properly control or take into account pricing and risk. Fannie Mae executives continued activity in Alt-A and other nontraditional product segments during a time when credit quality in the sector, as was being widely reported, was rapidly deteriorating. Moreover, the lack of data definitions has led to the misclassification or misunderstanding of risk. In the latter half of 2007, Fannie Mae tightened underwriting and eligibility standards; however, the Enterprise is now suffering from the unsafe or sound practices of earlier years, resulting in its unsafe or unsound condition.

Single Family

Fannie Mae did not have effective credit risk management and oversight during times when it set corporate goals to increase market share. The plans to meet market share targets resulted in strategies to increase the acquisition of Alt-A and other higher-risk products, creating a conflict between prudent credit risk management and corporate business objectives. These strategies are now resulting in credit problems evidenced by increasing delinquencies, defaults, foreclosed properties, and expected and actual loan losses.

Concerns with Alt-A Mortgages include:

Executive management for the business unit stated that Fannie Mae did not have sufficient analytical tools to assess the risks of this untested mortgage product. Specifically, it used outdated data and credit models to support its decision.

The growth in the Alt-A book contributed largely to meeting market share goals, despite management knowing that Alt-A lending was riskier than traditional mortgage loan products. The Alt-A strategy for 2007 was to achieve \$20-\$40 billion in incremental volume growth annually and achieve total market penetration of 25%. At the time, the Enterprise was aware that nearly 1% of all Alt-A deliveries defaulted and became real estate owned. The Single Family business unit claims it knew of the risks in Alt-A lending, yet it chose to expand its acquisition of this product while it reduced the base g-fee and risk based price adjustments. Additionally, Fannie Mae acknowledged that credit enhancement was more difficult to obtain and more expensive.

The reporting of the Alt-A book was altered in 2006 when Fannie Mae redefined Alt-A and moved an estimated \$10 billion (UPB) in mortgages into the prime book. Additionally, management has not included special lender programs in the Alt-A metrics despite the mortgages in these programs lacking full documentation. This issue results in inaccurate or incomplete reporting. This does not meet the requirements of FHFA's directive communicated letter dated April 10, 2007.

Housing and Community Development (Multifamily)

The Watchlist data for multi-family loans in Housing, Community, and Development (HCD) is not timely and delays the completion of the HCD book review, which is delivered the third

month after quarter end. In 2006, OFHEO shut down AD&C activity based on pervasive deficiencies in data, reports, controls, and risk ratings. The Enterprise addressed most issues, but issues regarding risk ratings and post-acquisition review remain. An effective and accurate risk rating system for multi-family loans is not in place for debt and equity investments in HCD.

Concerns with Whole Loan Portfolio

Fannie Mae has a large, illiquid whole mortgage loan portfolio. This book is starting to show higher delinquencies, but credit reserves seem small in light of the portfolio size and increasing delinquencies.

Other

- (a) Pilots and new initiatives are often not accompanied by benchmarks, defined measurements, or exit strategies.
- (b) There are persistent problems in the accuracy of reporting. A recent instance involves reporting on borrower assistance in that information initially reported by the servicers was incorrect and there was not a consistent cutoff date. Previous instances of inaccurate reporting were noted in the examination of Manufactured Housing and the Acquisition, Development, and Construction Lending program.

Counterparty Exposure

Counterparty exposure is growing rapidly at a time when the counterparty financial institutions are under growing stress. The deteriorating financial strength in counterparties increases their inability to meet payment obligations, presenting serious safety and soundness issues for the Enterprise.

- (a) Mortgage insurers, particularly mono-line MIs, continue to deteriorate: four out of seven major MIs are now rated below AA-. Should they be unable to pay, this could significantly increase Fannie Mae's losses. Fannie Mae cannot easily mitigate exposure to past MI obligations. Fannie Mae's estimated stress losses for the MI industry are \$30 billion, which is beyond the MIs' \$15.5 billion in capital. MI revenues may or may not make up the difference. Of Fannie Mae's \$111 billion of risk-in-force coverage from MIs, Fannie Mae's stress tests show potential exposure to MIs at about \$23 billion.
- (b) Seller/servicer exposure is controlled and has been significantly reduced in most areas by deposits of daily P&I payments at third parties in Fannie Mae's name, and an \$8 billion reduction of ASAP credit to Countrywide. Exposure remains in the servicers' capacity to continue repurchases of nonconforming loans. Exposure also exists when servicing from a failed servicer must be transferred to another servicer.
- (c) Derivatives counterparties are comprised of large, multinational financial institutions. Several of these financial institutions have exhibited some deterioration in overall financial performance.

- (d) In the recent past, the National Underwriting Center and the account teams poorly managed loan repurchases with Countrywide. By 2006 the repurchase backlog was substantial and required executive management to intervene and negotiate with Countrywide on the repurchases. It took almost two years to bring the account current. Countrywide represented 23% of the serviced book and was by far the largest seller/servicer, and is also the largest seller of Alt-A to Fannie Mae.
- (e) When Fannie Mae recognized that the Land Economics mortgages were fraudulent, it did not immediately require repurchase by Countrywide as required by the seller servicer guide.
- (f) RiskNet does not completely and consistently measure counterparty exposure. Until recently, RiskNet did not capture several important elements such as servicing exposure, separately from P&I. Additionally, there is inconsistency in reporting as some exposures are measured using notational amount, such as principal and interest, and some are measured using PFE-potential future exposure, such as derivative exposure.

Market Risk Management

Market risk is rated “Critical Concerns,” and is driven by the liquidity rating. This component is comprised of an evaluation of accounting, interest rate, liquidity and market models and incorporates both the quantity of risk in the Enterprise and the quality of risk management in these areas. The subordinate risk rating for funding and liquidity is “Critical Concern” while the subordinate ratings for interest rate risk and portfolio management are “Significant Concern.” Accordingly, the rating reflects more than moderate weakness as a whole, and as to funding and liquidity, FHFA’s assessment that immediate fundamental changes are necessary to address the issues evaluated and concern that the Enterprise is unable to implement many corrective actions in the current environment.

Liquidity

Liquidity risk is high, and represents a critical risk to Fannie Mae and places the Enterprise in an unsafe or unsound condition. Capital Markets management’s liquidity strategy is significantly strained in the current market.

Liquidity-related Safety and Soundness Conditions

Deteriorating market confidence in Fannie Mae, and the other GSEs, as well as worsening market liquidity for GSE bullet and callable debt increased pressure on Fannie Mae’s discount note issuance program to a critical level. Fannie Mae’s almost exclusive reliance on discount note funding is a critical concern.

Weekly auction pricing of discount notes are at historically wide levels versus Treasury bills (though less historically wide when compared to LIBOR). Continued deterioration in market confidence could lead to failure of a weekly auction that would trigger an increase in headline

risk and a further erosion of investor confidence in GSE debt.

Similarly, deterioration of scheduled monthly pricing of long-term Benchmark Notes could lead to a failure of a monthly Benchmark Note issuance that also results in headline risk and a further erosion of investor confidence in GSE debt. This further lack of confidence could trigger significant sales of GSE debt, push down prices on GSE debt and effectively cut-off Fannie's ability to issue longer-term debt.

Callable issuance of medium-term debt has also decreased significantly. This lack of investor interest impacts both liquidity and also interest rate risk (IRR) management as callable issuance is a key component to the IRR management practices of Fannie Mae, specifically the repurchase of options to offset the mortgage portfolio's short option position.

Mortgage market conditions are so weak that significant MBS sales from the Fannie Mae retained portfolio to raise cash would likely trigger significant decreases in MBS prices and increase mortgage rates offered to consumers. The magnitude of this consumer impact is significant as option adjusted spreads on TBA MBS are already at historically high levels and incremental sales could widen mortgage rates 25-50 basis points or more.

Liquidity-related Safety and Soundness Practices

Fannie Mae's liquidity management practices are critically inadequate and unsafe and unsound because management failed to ensure that the company could, in the current environment, convert unencumbered agency MBS to cash through secured lines of credit, carry out an active repo funding or MBS sales program and/or securitize its \$245 billion single-family mortgage portfolio in an automated, controlled manner. Areas of concern include:

- Fannie Mae's 90-day liquidity policy was designed to make sure that under extreme stress, with no access to the discount note market, Fannie would be able to rely significantly on lenders' willingness to lend against agency collateral in significant size, up to \$140-\$150 billion. However, in the current market, lenders are not willing to issue term-repos or to commit secured lines to Fannie Mae in that amount.
- Fannie Mae owns approximately \$245 billion of single family whole loans which it cannot securitize in a well-controlled, automated manner which impedes its ability to use these assets for liquidity purposes. Though not all \$245 billion of single family whole loans would be eligible for securitization, most of it would be eligible for MBS pooling.

Other areas of concern include:

- Management is not complying with FHFA's request to manage its net cash needs to ensure that it has cash or cash equivalents to last 30 calendar days without access to the discount note market.
- During the 2Q08, Fannie Mae acknowledged that it did not have adequate procedures to accurately report its exposure to its variable-rate demand bonds. Lack of procedures/reporting for variable rate demand bonds. The existence of inadequate procedures and reporting resulted in management significantly underestimating its day to day liquidity needs, including contingency demands arising from these multi-family liquidity facilities.
- Fannie Mae has relied, and continues to rely, on a manually-intensive process to move agency collateral to secure repo transactions. Spot checks of this process have failed because staff were not properly trained. However, Fannie Mae has sought to mitigate this deficiency by holding \$20B in agency collateral at BoNY/Chase to effectively buy time for any operational issues that arise during an emergency.

Interest Rate Risk

Significant interest rate risk sensitivity and aggressive risk limits make the quantity of risk at Fannie Mae a significant concern. Capital Markets and executive management maintained an aggressive strategy and limits for interest rate risk despite earnings losses and forecasts of declining earnings and capital. Management was not proactive in lowering interest rate risk when forecasts showed adverse earnings and capital trends. Significantly, it does not even expect to finalize this issue until October 2008.

Confidence in the quality of interest rate risk metrics suffers when current market information is not included in interest rate risk estimates on a timely basis. Model risk issues have also reduced the reliability of interest rate risk management metrics at the Enterprise as prepayment models estimates have differed significantly from actual, slower prepayments. Finally, governance issues relating to the Office of the Chief Risk Officer, particularly relating to Market Risk Oversight (MRO), further reduce the quality of interest rate risk management processes, because MRO resources are not commensurate with the aggressive interest rate risk limits. The Market Risk Oversight SVP position remained open for many months after the incumbent was asked to leave. The eventual replacement lacked the necessary experience, but the explanation was given that the CRO had extensive IRR management experience. He is now leaving. These unsafe or unsound practices or condition has weakened, and is likely to continue to weaken, the Enterprise's condition.

- Fannie Mae's level of interest rate risk exposure remains significant. As of July 1, 2008, the 10-day value at risk for duration, convexity and volatility was \$800 million.

In addition, a 10 basis point volatility shock results in a \$710 million change in the portfolio's pre-tax market value of equity.

- Significant interest rate risk measurement errors were evident in the March 2008 monthly summary, which disclosed an initial loss estimate of \$1.1 billion for a 50 basis point shock. However, the subsequent estimate for the March 31, 2008 10-Q was a \$2.2 billion loss for the same 50 basis point shock. The primary reasons for the measurement error were widening spreads on PLS and whole loans, as well as higher callable debt prices. Management should ensure that interest rate risk metrics are based upon more timely and accurate prices and that pricing methodologies are applied on a reasonable and consistent basis. Failure to do so is as unsafe or unsound practice that is likely to continue to weaken the Enterprise's condition.
- Fannie Mae expects to update its conventional fixed rate prepayment models in the third quarter of 2008 with an estimated increase in duration of about \$15 billion in 5-year equivalents. Additionally, Fannie Mae has not yet decided to remove the spread duration component of its PLS portfolio from its net duration position. Effectively, this extends Fannie Mae's duration, yet this spread duration cannot be hedged with swaps.

Retained Mortgage Portfolios

During the second quarter of 2008, Fannie Mae's retained portfolio grew \$27 billion in mortgage-related assets due to attractive option adjusted spreads. Management's decision to undertake this growth was within reported regulatory constraints.

- Fannie Mae continues to experience a large credit and liquidity exposure in non-agency securities, which is comprised of about \$117.3 billion of Alt-A and subprime private-label securities (PLS), including a portion of subprime securities wrapped by a Fannie Mae guarantee. Fannie Mae has improved certain credit risk management processes. However, this non-agency book continues to experience spread widening, credit downgrades and impairments that could impact earnings and capital through higher levels of OTTI. At June 30, 2008, the sub-prime and Alt-A non-agency portfolio had an outstanding balance of about \$48.8 billion categorized as 'available-for-sale' (not including subprime PLS wrapped by Fannie Mae of about \$13 billion) with an estimated fair value loss of about \$7.9 billion. During the second quarter Fannie Mae impaired about \$500 million of these securities (all subprime). If unable to rebut the OTTI guidelines, an additional write-down of approximately \$2 billion will be required based on prices on July 31, 2008.
- Fannie Mae's subprime PLS portfolio had \$21.1 billion of rating agency downgrades. About \$4.6 billion of the PLS portfolio is currently rated below investment grade. As of June 30, 2008, none of the Alt-A PLS had been downgraded, nor had any of the downgraded bonds been sold.

Operational Risk

Operational risk is rated “Significant Concerns.” This component evaluates accounting, financial reporting, information technology, internal controls, and operational models. This rating reflects FHFA’s determination that more than moderate weaknesses exist.

Information Technology

The risks associated with completing IT strategic planning and governance improvements, while also meeting critical IT project timelines including planned disaster recovery and business resilience enhancements, are being managed effectively. Technology continues to successfully manage a number of high profile and critical single family and capital markets application development projects. However, the risk associated with Summit Debt and Derivatives and Servicer and Investor Reporting (SIR) project delays coupled with the operational risk associated with the de-commissioning of the Restatement Operations Center (ROC) and complexity of the Urbana disaster recovery implementation highlight the challenges facing Technology in successfully completing critical projects within existing time, budget, and resource constraints given the current business environment.

The Risk Transformation Facility (RTF) strategic initiative included project plans to implement the securitization of whole loans in the retained portfolio by April 2009. The inability to securitize these whole loans over month end due to system limitations and intensive manual accounting corrections has been a longstanding issue. The Enterprise noted RTF project changes would be made to accelerate the delivery of systems development and implementation is not expected until the first quarter of 2009. In the interim, FHFA is requesting the Enterprise to develop a manual process to securitize whole loans in the event additional liquidity is required quickly due to market conditions.

Data Quality

Leveraging the data quality initiatives supporting timely financial reporting and improved portfolio management analytics, Fannie Mae has developed a data strategy tightly integrating data architecture and data management objectives with the goal of reducing the number and complexity of data warehouses. In addition, Enterprise Technology is establishing enterprise-wide business data practices, tools, and data quality performance metrics consistent with emerging technology standards. An enterprise-wide data governance forum has been implemented to drive best practices in data management and data. The data strategy is part of a multi-year plan to reduce cost and technical complexity by re-engineering or replacing legacy applications and re-designing business processes end-to-end.

Internal Controls

Fannie Mae’s internal controls for processes and information technology are manually intensive and inefficient, but adequately control substantially all systems and processes. Business

processes and internal controls are manually intensive and key person dependencies remain an area of concern, which has been a long-standing criticism.

However, Enterprise Operations, the ORO and the business units continue to improve the internal control environment through a myriad of projects and programs that are completed or currently in progress. In the second quarter of 2008, through the enhanced processes, there were no material weaknesses in their internal controls over financial reporting. The significant deficiency that materialized in the preparation of the 2007 10-K filing has been remediated, but validation is pending. The SOX error rate remains less than 5%, which is consistent with SOX compliant firms. Current processes have proven effective in assisting Fannie Mae in its third consecutive timely filing of financial statements.

For the foregoing reasons, Fannie Mae's composite rating is "Critical Concerns."

Sincerely,

Christopher H. Dickerson
Acting Deputy Director
Division of Enterprise Regulation

cc: Bill Senhauser