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CONFIDENTIAL

MEMORANDUM

TO: James B. Lockhart III
Director, Federal Housing Finance Agency

FROM: Christopher Dickerson
Acting Deputy Director, Division of Enterprise Regulation

DATE: September 6, 2008

RE: Proposed Appointment of the Federal Housing Finance Agency as Conservator for the Federal National Mortgage Association

I. Introduction and Summary of Conclusions

The Federal Housing Finance Agency ("FHFA" or the "Agency") was established by the Federal Housing Finance Regulatory Reform Act of 2008, replacing the Office of Federal Housing Enterprise Oversight ("OFHEO") and the Federal Housing Finance Board as the regulator vested with the authority of supervising and regulating two government sponsored entities ("GSEs"), the Federal Home Loan Banks, the the Federal National Mortgage Association ("Fannie Mae" or the "Enterprise") and the Federal Home Loan Mortgage Corporation ("Freddie Mac").[1] [2] The Agency's examination program assesses the financial safety and soundness and overall risk management practices of Fannie Mae and Freddie Mac.

The GSEs are the nation's largest housing finance institutions. They buy mortgages from commercial banks, thrift institutions, mortgage banks, and other primary lenders, and either hold these mortgages in their own portfolios or package them into mortgage-backed securities for resale to investors. These secondary mortgage market operations play a major role in creating a ready supply of mortgage funds for American homebuyers.

[1] *See,* Housing and Economic Recovery Act of 2008, Pub. L. 110-289, 122 Stat. 2654 (the "2008 Act").

[2] For purposes of this Memorandum, the term "FHFA" or "Agency" will refer either to FHFA or its predecessor, OFHEO, as appropriate.

The financial condition of the Enterprise is vulnerable to continuing adverse business conditions, and management has been unable to implement effective corrective actions. Earnings, solvency, and liquidity are each negatively affected by current and forecasted credit losses, as well as by the possibility of further impairments of private label securities and deferred tax assets. The critical unsafe or unsound practices and conditions that gave rise to the Enterprise's current condition, and the deterioration in overall asset quality and significant impairment in earnings throughout 2008 calls into question the ongoing viability of the Enterprise absent immediate financial assistance. In light of the inability of the current Board of Directors ("Board") and the current management to address adequately these concerns, we recommend that a conservator be appointed for the Enterprise before further deterioration in its condition can occur.

Based on FHFA's examination and supervision of the Enterprise, we believe that the Enterprise is experiencing the following severe problems, all of which contribute to the unsafe or unsound condition of the Enterprise:

(1) Capital is declining, and as the Enterprise has acknowledged in writing, there is very limited potential to augment capital materially from external private sources. Moreover, there is a reasonable possibility that regulatory capital will fall well below the minimum capital level if any one of several assumed variables were to occur.

(2) The Enterprise's capital is inadequate and the quality of the capital base in the current environment runs contrary to generally accepted standards of prudent operation and, if continued, could result in abnormal loss or damage to the Enterprise. The Enterprise has acknowledged that it is unable to raise capital from private sources in the current market.

(3) Undue reliance upon Deferred Tax Assets ("DTA") and other comprehensive income ("AOCI") to meet regulatory minimum capital requirements results in the Enterprise's reported capital base being inadequate because such assets cannot be monetized and do not provide protection against substantial, embedded credit losses not yet realized. The Enterprise's core capital, when adjusted to remove intangible capital, is insufficient to absorb the reasonable, expected losses in the current book of business and ensure the repayment of its obligations.

(4) Credit losses and related expenses are high and forecasts show significant and continuing accelerated deterioration.

(5) Earnings are poor and are not sufficient to generate adequate capital and reserves, particularly after considering the state of the Enterprise's balance sheet. Continued declines in earnings could result in impairment of deferred tax assets which would further impair capital.

(6) Liquidity represents a critical risk to Fannie Mae. The Enterprise's liquidity strategy is significantly constrained by the current market. The Enterprise cannot use its mortgage backed securities ("MBS") in repurchase agreements in any significant amount, nor can it sell significant amounts of its Liquidity Investment Portfolio

("LIP") rapidly because the market does not have the capacity to absorb them. Even if rapid significant sales were possible, such large transactions would send a negative signal to the markets. In addition, additional funds cannot be generated through the issuance of capital.

(7) Systems deficiencies and imprudent management priorities 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 significantly decreases assets available for liquidity.

(8) Over the years, the Board and senior management failed to establish and maintain a sufficient infrastructure, *i.e.*, operations, data, and risk management systems and controls, to support new products and properly manage their risks.

(9) Interest rate risk exposures, strategies, and limits are too aggressive given the current capital situation and forecasted credit losses.

(10) Market risk oversight resources are not commensurate with the aggressive interest rate risk limits and positions, and is an unsafe or unsound practice.

(11) Operations are inefficient and manually intensive. The operational risk framework is not fully built-out.

Recent adverse changes in the overall economic environment magnified the impact of the Enterprise's weaknesses to the point where they pose serious risks to its continued operation. Based upon our findings in the mid-year review and the supervisory history of the Enterprise, I recommend that the Director immediately appoint the FHFA as conservator of the Enterprise for the following reasons:

- The Enterprise's unsafe or unsound practice or condition is likely to — (i) cause insolvency or substantial dissipation of assets or earnings and (ii) weaken the Enterprise's condition.
- The Enterprise is in an unsafe or unsound condition to transact business.
- The Enterprise has experienced substantial dissipation of the assets or earnings due to unsafe or unsound practices.
- The Enterprise is likely to be unable to pay its obligations or meet the demands of its creditors in the normal course of business.

II. Background

A. Historical Overview

The Enterprise was established as a government agency in 1938 to create a secondary market for residential loans jointly guaranteed by the FHA and the Department of Veterans Affairs. Its purpose was to improve capital availability for these loans across regions and over real estate cycles. Fannie Mae was quasi-privatized into a government-sponsored entity in 1968, and its charter was expanded to include all types of residential loans. Fannie Mae's activities remain confined to the secondary mortgage market, and its current financial position and prospects for financial recovery have been adversely impacted by recent conditions in the national housing market.

B. Current Market Conditions

The overall conditions in the mortgage and housing markets remain challenging for many mortgage market participants. The Enterprise is exposed to both of these markets directly through its guarantees of mortgage-backed securities ("MBS") and the mortgage-backed securities in their portfolio, and indirectly through its exposure to counterparty credit risk.

From the end of 2001 through early 2007, the annual growth in house prices averaged 7% based on the OFHEO house-price index. This rapid increase in house prices was fueled by a number of factors on the demand side, which included strong economic fundamentals, relaxed lending standards, and some degree of speculation on future house price appreciation. On the supply side, the rapid increase in house prices resulted in increased new housing construction, with housing starts increasing from 1.6 million per year in 2001 to a peak annualized rate of 2.3 million in early 2006.

As now has become clear, relaxed lending standards, primarily in the subprime and Alt-A mortgage markets, led to a significant deterioration in credit quality that manifested itself through higher delinquencies and foreclosures. The focus of the subprime mortgage market is on borrowers who have had some prior credit problems. As of the end of 2007, the foreclosure rate on subprime mortgages originated between 2004 and 2006 was about 4% for fixed-rate mortgages and nearly 10% for ARMs. Mortgages originated in 2005 performed worse than mortgages originated in 2004; mortgages issued in 2006 performed slightly better, but it is projected that their performance will worsen with time as ARMs originated in 2006 reset. In the first quarter of 2008, 6.4% of outstanding subprime ARMs and 2% of outstanding subprime fixed rate mortgages began the foreclosure process.

The Alt-A mortgage market focused on borrowers with better credit history than the subprime market, but often included mortgages with little or no documentation of key factors such as income. The default rate on Alt-A mortgages originated between 2004 and 2006 was 2% for fixed-rate mortgages and 3% for ARMs. As in the subprime market, performance is worse in later vintages.

As conditions deteriorated in the subprime, and subsequently the Alt-A, markets, the rising inventory of foreclosed homes, along with a general tightening of credit, put considerable downward pressure on house prices. These factors, along with a general slowing of the economy, eventually resulted in the deterioration spreading to the prime mortgage market. In the first quarter of 2008, 1.5% of outstanding prime ARMs and 0.3% of outstanding prime fixed-rate mortgages started foreclosure. In the preceding 5 years, the average foreclosure start rates for prime ARMs and fixed-rate loans were 0.30% and 0.15%, respectively.

It is difficult to predict with any certainty when the current housing correction will end. New housing construction has fallen dramatically from a peak annualized rate of 2.3 million in January 2006 to 965,000 in July 2008. But the remaining new home inventories and increased foreclosures have led to large increases in housing inventory. As of the first quarter of 2008, the current housing inventory stands at about 10 months' supply at current sales rates, which is up significantly from the historical average of about 6 months' supply. Measures of the decline in house prices vary widely, from 5% using the OFHEO index, to 17% using the Residential Property Index ("RPX"), to 19% using the Case Shiller Index. The RPX index, which is based on 25 Metropolitan Statistical Areas, is the most actively traded property derivative. Current forward prices on the RPX index imply that we are only half way through the correction in housing prices. Further declines in house prices are likely to place additional pressure on overall mortgage credit quality as the incentive for homeowners to walk away from their mortgages payment increases. Indeed, in a presentation to the U.S. Department of the Treasury, on August 25, 2008, Fannie Mae acknowledged in writing that this is the "[m]ost difficult and uncertain housing market in over 30 years, with rising delinquencies and defaults."

As the assets underlying Fannie Mae's guaranty and investment portfolios have deteriorated, the cost of raising capital and providing liquidity for the Enterprise has risen. During the past two months, the deterioration in the Enterprise's borrowing conditions has accelerated, creating market conditions hostile to private-market capital-raising. The past two months have seen the option-adjusted spread ("OAS") on current coupons for Fannie Mae rise about 25bp and the Enterprise's preferred stock spreads rise about 600bp over long-term Treasuries. In the past year, the spread between the rate on GSE's subordinated debt and Treasuries has risen about 300bp, of which about 200bp occurred in the past 2 months. Fannie Mae equities have lost nearly two-thirds of this value since the end of June. In combination, these factors will make it difficult, if not impossible, for the Enterprise to raise significant quantities of capital from the private market, a fact Fannie Mae conceded during its presentation to the U.S. Department of the Treasury as recently as August 25, 2008.

C. OFHEO's Past Examination of the Enterprise

The Agency's examinations of Fannie Mae since 2005 have repeatedly identified deficiencies in many aspects of the Enterprise's operations, resulting in the Enterprise being deemed a "supervisory concern" in each of the past three years. While these deficiencies have been mitigated to differing degrees by the Enterprise in recent years, fundamental problems have remained uncorrected and have contributed to the current unsafe or unsound condition of Fannie Mae, which present management has been unable to rectify. In its current state, Fannie Mae has embedded in its portfolio a significant volume of severely underperforming assets, with no means of divesting itself of such assets without realizing sizeable losses. Although some steps have now been taken to begin to remedy the numerous failures that lead to the acquisition of these non-performing assets, the Enterprise has no means of correcting the past unsafe or unsound practices in time to avoid the losses that its current portfolio will produce over the next several years. Further, while a significant infusion of capital is needed, the Enterprise has acknowledged in writing that it has very limited ability to access the private markets for capital.

Set forth below are the acts and practices that have led to the current state of the Enterprise. As is evident, past examinations identified to the Enterprise's management the numerous deficiencies in key risk-modeling, price-setting, and portfolio and strategy management practices.

1. 2005 Condition

The 2005 examination of Fannie Mae found widespread deficiencies in numerous aspects of the Enterprise's operations. These deficiencies were attributed largely to previous management's emphasis on controlling costs at the expense of necessary and appropriate internal controls and risk management. It was also in 2005 that management began purchasing "Alt-A" loans in an effort to expand market share and pursue housing goals set by the United States Department of Housing and Urban Development ("HUD"). The examiners deemed the Enterprise to be a "supervisory concern" as a result of the concerns raised in the 2005 "ROE". While these concerns were partially addressed by management in subsequent years, they were not fully corrected and have contributed to the current unsafe or unsound condition of the Enterprise.

a. Management Supervision

The 2005 ROE found that past management had established an organization that provided insufficient monitoring, control, and coordination of its business units. This failure had lead to numerous structural weaknesses affecting operations controls, IT effectiveness and flexibility, and risk measurement, management, and communication throughout the Enterprise. Moreover, many controls were manually intensive, creating significant problems in numerous areas of Fannie Mae. These problems persist to this day. Additionally, the compliance program was deficient and lacked independence. Moreover, the Chief Risk Office ("CRO") was insufficiently staffed and not fully developed. Full correction of these issues was predicted to take several years, and is still ongoing.

b. Asset Quality and Credit Risk Management

The 2005 examination identified several areas of concern that have increasingly plagued the Enterprise as the credit environment has weakened. Poor data and systems were found to generate reports that impeded satisfactory management of many aspects of production and risk metrics. Historical risk metrics were not always available, which prevented the monitoring of some trends that became increasingly meaningful to the Enterprise's operations. A robust, risk-based pricing methodology had not been developed for the Housing and Community Development ("HCD") unit, which has been a recurring issue.

Significantly, it was in 2005 that management entered the "Alt-A" market in an effort to increase market share. The 2005 ROE noted that credit risk was increasing as a result of this decision, but it cited as mitigating factors the "credit enhancements" and "limited volume positions" of the product. However, the Enterprise did not take steps to limit adequately the volume or to account for the counterparty risk inherent in the credit enhancements. These shortcomings have now made themselves evident.

c. Liquidity

The 2005 ROE concluded that the Enterprise's liquidity position suffered from manually-intensive procedures for transferring securities for repurchase agreements, a failing that continues to affect Fannie Mae's liquidity today. The examiners observed that "the system used to transfer securities for use in repos is cumbersome, and the steps to complete a transfer are not intuitive. The systems' difficulties, coupled with infrequent use, increase the risk of transaction error during stress events." Nevertheless, liquidity was not then considered of paramount concern because of the fact that Fannie Mae's debt had historically been viewed by the market as a "flight to quality" product. Fannie Mae has now lost the benefit of this market perception, partially as a result of its imprudent Alt-A strategy.

d. Sensitivity to Market Risk

The 2005 examination found that manually-intensive processes and procedures increased the uncertainty of interest rate risk levels and contributed to two missed debt-call dates. The Enterprise acknowledged that 75 additional personnel would be needed for risk management, technology, and operations in the Capital Markets business unit, further compounding the difficulties created by the excessive reliance on manual processes. The ROE also found that additional actions would be necessary prior to entry into the lower-rated private-label securities ("PLS") market as intended by management. Systems deficiencies in the operational control area were correctly predicted to require one or more years to correct fully.

e. Earnings

As early as 2005, when the Enterprise's entry into the Alt-A market was in its infancy, the Agency began to stress the need for strengthened risk management procedures for this business line. The 2005 ROE found that Fannie Mae would be exposed to higher credit costs and strategic risks to the extent that it acquired alternative loan products with higher credit risks to meet HUD housing goals. The lack of adequate expertise and systems to process and monitor such activities would amplify that risk.

f. Capital Adequacy

In 2005, the Enterprise remained subject to a capital surplus requirement of 30% over its minimum capital requirement. While the Enterprise was able to attain a 34% capital surplus, it was required to reduce the size of its mortgage portfolio and accumulate capital through earnings to do so. This strategy generally was feasible while the Enterprise had a liquid portfolio. However, as the Enterprise embarked on a strategy of increasing its holdings of subprime and other alternative products, in an increasingly unfavorable economic climate, its ability to liquidate its holdings for capital purposes became impaired, contributing to its current condition. This is a factor that was also noted in subsequent examinations.

2. 2006 Condition

In 2006, the Agency found Fannie Mae to be a "significant supervisory concern," citing among other things the slow pace at which previous deficiencies were being addressed, particularly in light of the Enterprise's increasing risk profile. In the 2006 review cycle, HCD and counterparty risk were highlighted as issues of particular concern. Operational controls, especially in the risk management area for new products, were weak. The Enterprise, moreover, still did not appear to have fully analyzed and quantified the risk of its imprudent venture into the Alt-A market. These fundamental failures continued to set the stage for the current condition of Fannie Mae.

a. Management Supervision

The Agency again found management's supervision program for the Enterprise to be incomplete in 2006, with uncorrected deficiencies adversely impacting or impeding effective supervision and decision-making at the Enterprise. Risk management, performance, and operational monitoring were all impacted by continuing shortcomings, and many management reports were not meaningful due to these deficiencies. For example, aggregate counterparty exposure was not properly reported, reducing the effectiveness of counterparty risk monitoring.

The CRO, although improved from the prior year, continued to suffer from insufficient staffing and a lack of independent metrics, reports, and risk measurements. Its reliance on reports generated by the business units necessarily compromised its ability to assess Enterprise-wide risk independently. The audit function continued to suffer from poor decisions made by previous management, but had shown some progress. The restatement process, moreover, though progressing, continued to consume enormous resources, limiting the Enterprise's ability to make progress in other much-needed areas.

The Enterprise's IT platforms continued to suffer from a lack of updating and from inflexibility, contributing to an ineffective control environment and an inability to adapt to the changes made by management to the business model, such as entrance into the subprime market. These inadequacies were not addressed sufficiently, in part because of the ongoing remediation effort, and the effects of these IT deficiencies have continued to hamper the Enterprise's operations.

b. Asset Quality and Credit Risk Management

Credit risk continued to grow incrementally in 2006 due to increasing exposure to subprime and other Alt-A products. Credit exposure associated with these loans was being managed through underwriting standards, credit enhancements, and position limits, but these efforts proved inadequate. Moreover, the counterparty risk inherent in the credit enhancements was underappreciated, despite specific notation in the 2005 and subsequent ROEs of the "significant level" of counterparty risk posed to the Enterprise by mortgage insurers. More generally, the ROE noted that "counterparty risk represents significant exposure to the Enterprise." The Enterprise was again criticized for inadequate aggregation of exposure to individual counterparties. The Housing and Community Development ("HCD") portfolio credit risk, in addition, appeared to be rising, as indicated by the increase in Watchlist assets. This risk exposure was exacerbated by a lack of the thorough Watchlist analysis necessary to estimate accurately the Watchlist's potential impact on actual credit problems.

The Enterprise's single family business unit continued to be the primary vehicle for the new subprime initiative. Product growth targeted higher risk products, with a management goal of a 20% market share in subprime loans by 2011. However, deficiencies in policies, staffing, and report quality, as well as in risk-management staffing, restricted the Enterprise's ability to manage this increased risk. The HCD unit exhibited similar deficiencies in controls, reports, policies, and written procedures, as well as in staffing and expertise. Once again, the 2006 ROE found, as with the previous year, that systems, reports, and proactive analysis needed strengthening prior to expanding PLS purchases into the sub-AAA area.

c. Liquidity

Liquidity remained adequate in 2006 due largely to the strong market demand for the Enterprise's repurchase agreements. However, Fannie Mae was again criticized for its continuing inability to fully automate the repo funding process and for the limited utility of its existing systems. Furthermore, liquidity remained heavily dependent on the then-favorable market opinion of Fannie Mae securities offerings, and therefore highly susceptible to changes in investor perceptions.

d. Sensitivity to Market Risk

The interest rate risk management program was deemed in 2006 to be "minimally satisfactory." As with other operational areas, inefficient tools and a heavy reliance on manual controls reduced the effectiveness of risk management efforts. Moreover, the use of data with errors and unproven assumptions reduced the accuracy of risk management practices to suboptimal levels. Although improvements were evident in some areas of controls, such as in Capital Markets, full correction was deemed to be at least a year away due to the allocation of resources to other projects, such as the restatement effort. And once again, examiners noted in 2006 that, while certain elements of interest rate risk could be quantified (such as the retained portfolio and funding), no mechanism for measuring Enterprise-wide interest rate risk was available, impairing management's and the Board's ability to understand the full impact of such risk to economic earnings and capital.

e. Earnings

Earnings in 2006 were volatile, primarily as a result of mark-to-market gains and losses in the derivatives portfolio. A net loss of nearly $400 million in the third quarter prompted a supervisory response from the Agency.

f. Capital Adequacy

In 2006, the Enterprise continued to be subject to a capital surplus requirement of 30% over its minimum capital requirement, a level the Enterprise was able to meet. The agency emphasized the importance of maintaining the capital surplus in excess of this directed requirement on account of the lack of timely financial filings by Fannie Mae and continuing operational weaknesses.

3. 2007 Condition

In the 2007 ROE, delivered earlier this year, the Agency once again found Fannie Mae to be a "supervisory concern," specifically noting that the quantity of credit risk was high and rising. The 2007 examination found that many of the weaknesses that had been widespread during previous years were beginning to be corrected. However, these improvements had been too slow in coming, and the harm from the previous years' significant shortcomings was done. The Enterprise had significantly increased its exposure to subprime and other risky alternative loan products without adequate modeling or analysis tools to permit proper management of the inherent risks of such products. Counterparty risk, which had not been adequately monitored for years due to limitations on the Enterprise's ability to aggregate and quantify such risk, had grown to be a significant concern in light of the poor economic condition of many counterparties--mortgage insurers in particular. Systems limitations that restricted the Enterprise's ability to package mortgages quickly to provide liquidity remained manually-intensive and inefficient, even into 2007 and 2008, compromising the Enterprise's increasingly strained liquidity. Staffing deficiencies, noted repeatedly in each examination cycle for the past several years, had not been fully corrected by 2007, with serious repercussions to key areas such as corporate controls and risk management.

Despite improved credit risk pricing, the Enterprise's existing assets continued to deteriorate in quality as a result of past deficiencies. While reporting functions and the tools used to generate reports continued to show progress, previous actions taken in reliance on outdated models and inadequate reports were beginning to bear fruit, particularly in the Alt-A and subprime area. In sum, while noticeable progress was being made, such progress could not mitigate the damage done as a result of past unsafe or unsound practices.

a. Management Supervision

Board oversight improved in 2007, with revised policies, strengthened expertise, and better reporting from the business units. Additional improvement was required with respect to certain metrics reporting, however, and risk and performance measurement capability was not predicted to meet industry standards until the Enterprise acquired the capability to measure economic capital for transactions, business units, and the entire Enterprise. These deficiencies limited the quality of reporting from the operational and credit risk areas, and also with respect to risk-adjusted returns.

As in prior years, the 2007 examination again criticized the Enterprise for its continued reliance on manually-intensive controls for processes, data, and IT. Models used in estimating loan product price and risk were also a repeat subject of criticism, as were systems capacity issues that prevented the consistent production of daily interest rate risk scenarios. The ability to aggregate economic capital by function, business unit, or the entire Enterprise was also noted as incomplete. With the Enterprise's increasing commitment of capital to non-traditional loan products and the heightened risk associated with that strategy, these continued shortcomings constituted unacceptable impediments to proper management of the Enterprise's business.

Staffing shortages also were a repeat criticism, with voluntary retirements contributing to a loss of seasoned individuals with unique knowledge of proprietary functions. Not only did the loss of these individuals negatively impact the already slow progress of model development in some areas, including risk management, but management's failure to foresee and plan for these departures unnecessarily exposed the Enterprise to excessive risk that could have been avoided.

With specific regard to modeling, the 2007 examination found that loss-severity models relied on data from 2002 and earlier and did not incorporate losses from relatively new loan products or recent market events. These were the very loan products and market events that were adversely impacting the Enterprise's condition. Indeed, the Desktop Underwriter ("DU") program employed models based on historical data that in some instances were from the 1990s, when very different market forces and borrower characteristics prevailed. Although model risk management certainly improved overall in 2007, these continued weaknesses aggravated the already precarious situation that was created by the decision in 2005 and 2006 to initiate and then increase dramatically the Enterprise's exposure to the Alt-A and subprime markets.

b. Asset Quality and Credit Risk Management

Credit risk at the Enterprise was high and rising in 2007, and the continuing deterioration of asset quality exacerbated the already significant adverse trends the Enterprise was exhibiting. This weakened condition was in large part a result of the relaxation in 2005 and 2006 of some of the Enterprise's underwriting standards. Although management had made progress, albeit belatedly, in mitigating these risks on a going-forward basis, the existing credit risk in the portfolio was substantial, and worsening market conditions reduces the likelihood of recovering losses through sale of collateral. Moreover, the counterparty risk about which the agency had repeatedly warned the Enterprise was becoming a larger concern amidst the deteriorating financial condition of many market participants, including mortgage insurers.

Other problems noted in the 2007 ROE included deficiencies in systems and tools used in linking risk and price that made the pricing function more subjective, as well as reports lacking in granularity and/or qualitative analysis. While progress was noted in the HCD area, it was also observed that significant effort still needed to be made to address all issues and inefficiencies. Operationally, the Enterprise was again criticized for its ongoing reliance on manually-intensive controls that were prone to error and that still had not been corrected despite years of prior regulatory criticism.

c. Liquidity

Liquidity remained adequate in 2007, but examiners found that agency MBS, which were readily accepted by the market for sale or repo during stress events, had declined during 2007, while Fannie Mae's holdings of less liquid securities and whole loans increased. A criticism from prior years--that systems limitations that prevented whole loans from being securitized quickly--was again repeated. The Agency warned that, if stressed, the Enterprise's liquidity position could potentially erode because of systems issues and a changing portfolio mix. These warnings have proved to be accurate.

d. Sensitivity to Market Risk

The Enterprise's interest rate risk management program was only minimally enhanced from 2006, falling into the "low range of satisfactory." While risk management activities, reports, and communication had shown some improvement, risk management strategies and exposure levels were unduly aggressive in light of higher and increasing credit-related losses. Systems limitations, particularly in the Capital Markets unit, continued to impede the consistent daily production of risk measurements desired by management and the CRO. The widening spread between the fair value of assets and liabilities, while having little impact on cash flows in 2007, significantly reduced the net fair value of the Enterprise.

Despite repeated supervisory warnings, management still was not including the interest rate risk for the entire Enterprise in its regular interest rate risk reports in 2007, which negatively impacted management's ability to assess the full impact of interest rate risk on the Enterprise's economic earnings and capital. Risk reports continued to be produced manually, a resource-intensive and error-prone exercise that reduced the reports' utility to management. These repeated criticisms stood out in 2007 among an otherwise improving risk management structure.

e. Earnings

Earnings in 2007 were poor as a result of factors both within and outside the Enterprise's control, and as a result Fannie Mae reported its first annual net loss since 1985. These losses were primarily the result of substantially higher credit-related expenses, higher losses on derivatives, and lower net interest income.

f. Capital Adequacy

In 2007 the Enterprise's capital position deteriorated significantly, and significant remediation became necessary for it to remain in compliance with mandated capital requirements. Notably, nearly $9 billion in preferred stock was issued in the second half of 2007 to remain "adequately capitalized," and common stock dividends were reduced. Despite these steps, the cushion Fannie Mae had maintained of surplus capital over the agency-mandated minimum steadily eroded. This downward trend has further intensified in 2008, to the point that the Enterprise, by its own written admission,[3] can no longer access the private equity capital markets in any meaningful way.

III. <u>Current Status of the Enterprise</u>

Based upon a mid-year review of the condition of the Enterprise, using the agency's GSE Enterprise Risk rating system ("GSEER"), the Enterprise's current composite rating has been reduced to "Critical Concerns," reflecting critical safety and soundness concerns with the Enterprise. This rating 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.

The financial condition of the Enterprise is vulnerable to continuing adverse business conditions, and it is unable to raise sufficient capital to cover continued credit losses and related expenses. In addition, almost one-half of the Enterprise's capital is comprised of deferred tax assets, which cannot be monetized and provide no protection against substantial embedded losses not yet realized. Given the unsafe or unsound practices and conditions that gave rise to the Enterprise's existing condition, and the resulting deterioration in overall asset quality and significant impairment in earnings experienced throughout 2008 and forecast for the future, the Enterprise is in an unsafe or unsound condition.

The decisions of the Board of Directors and senior management prior to 2007 to acquire Alt-A loans and other higher risk loan products is a principal contributor to Fannie Mae's current earnings losses and deteriorated financial position. 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 in the recent past to purchase or guarantee higher risk mortgage products contributed to the Enterprise's continuing

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[3] Fannie Mae advised the Treasury Department as recently as August 25, 2008, that it is "[i]nfeasible to raise capital from private sector in [the] current environment."

deteriorated financial condition. Senior management and the Board of Directors made these decisions to increase market share, raise revenue, and meet housing goals. However, many of these decisions were unsafe or unsound because they were based on a flawed lending strategy because management failed to price these loans for risk adequately relaxed underwriting and eligibility standards, such as mortgages that were unwritten without full documentation. Unfortunately, the Board and. When housing prices and the economy generally deteriorated nationwide, 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 have not abated.

Until recently, models used to guide credit decisions were deficient, had been 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. In addition, these models assumed a much healthier economic environment than exists currently. Moreover, management has not been sufficiently proactive in modifying liquidity and interest rate risk strategies, interest rate risk limits, or the quality of independent market risk oversight, all of which are essential to keeping the aggregate levels of risk at reasonable levels. 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 mortgage and securities portfolios and inherent in its guarantee obligations. The Enterprise is therefore vulnerable to further deterioration given the current conditions in the mortgage and other markets.

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 without appropriate levels of capital resources to absorb those losses. The Enterprise also remains significantly exposed to the health of key counterparties, especially mortgage insurers, financial guarantors, and key seller/servicers.

The remainder of this memorandum summarizes the current safety and soundness condition of the Enterprises determined under FHFA's GSEER rating system. The ratings and summary descriptions of the Enterprise's condition have been determined as of the date of this memorandum and have been communicated to the Enterprise.

A. Governance

Governance has been rated "Significant Concerns." The Governance rating 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.

1. Board and Executive Management Practices

The Board and senior management failed to develop or complete many corporate management practices for credit until late 2007. As noted above, the plans to meet market share targets 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 grown its Alt-A portfolio and other higher risk products rapidly without adequate controls in place. Significantly, pricing and post-purchase quality control of higher risk products is not commensurate with the additional risk they pose. Further, the rapidly deteriorating performance indicators of the Alt-A portfolio illustrates Fannie Mae management's failure to adequately assess the credit performance of these higher risk products with unknown, uncertain performance. Additionally, management's failure to tighten Alt-A eligibility and underwriting standards until mid-2007 demonstrate a belated response to a deteriorating market environment.

Despite clear signs in the latter half of 2006 and 2007 of growing problems in the economy, management continued activity in riskier 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 finally tightened underwriting and eligibility standards. However, by that time, the earlier unsafe or unsound practices in which the Enterprise had engaged caused significant and growing losses to be embedded in the portfolio.

Until recently, many credit decisions were driven by market share, distorting some credit decisions and allowing for an infrastructure that did not properly control or fully take into account pricing and risk. Management viewed the Enterprise's mortgage business as low risk, and many controls implemented in the past did not meet industry standards. Examples of the faulty management practices found by the Agency to continue to be prevalent include the following:

(a) Early warning reports that showed poor performance of new mortgage products, such as Alt-A mortgages, were ignored.

(b) During 2006 and 2007, modeled loan fees were higher than actual fees charged, due to an emphasis on growing market share and competing with Wall Street and the other GSE.

(c) Quality control ("QC") over documentation and other standards, and actions to collect on loan repurchases, were lax, which resulted, among other things, in a massive backlog of loan repurchases with Countrywide. Management only recently improved the loan QC process and efforts to force servicers to buy back noncompliant loans. Execution was inconsistent, such that 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 manifest and was deteriorating.

While a number of past control deficiencies have since 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 Enterprise's aggressive interest rate risk limits and positions due to protracted vacancies in senior positions and an inadequate number of personnel. Moreover, the failure to maintain an effective MRO function during this very challenging period in the housing finance and capital markets exposes the company to increased governance risk and constitutes an unsafe or unsound practice.

The Enterprise's practice of relying on repo financing of its agency collateral to raise cash in a systemic liquidity event is also an unsafe or unsound practice, given the unavailability of willing lenders to provide secured financing in significant size. Management failed to ensure that the Enterprise could convert unencumbered agency MBS to cash through secured lines of credit, sales of MBS, or an active repo funding program. This failure has impaired the Enterprise's ability to ensure sufficient liquidity. 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 by 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 sufficient 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, deficiencies in corporate decision-making have the potential to adversely impact Fannie Mae further. For example, certain senior management officials have been viewed as fungible, with the result that people with insufficient skill sets have been shifted into key management positions. As just one example, the head of Human Resources was moved to SVP of business relations in Fannie Mae's Central region, notwithstanding his lack of requisite background, experience, or skills to perform the new responsibilities. Additionally, administrative costs have been cut several times in recent years, with many cuts coming through voluntary retirement programs. Many experienced people with knowledge or skills of proprietary systems were lost. As a result, model development was significantly adversely impacted by the retirement of several long time employees.

2. 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 devise models rapidly and accurately based on more realistic assumptions about the future. Failure to have done this 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 weakened and uncertain 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 still has not been addressed fully. 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 which 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.

a. 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 only been updated this year. Although the incorporation of current market data has become timelier, 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. While algorithms used for decision making at the back end of the credit life cycle, such as Loss Mitigation models, short sale models, and real estate owned ("REO") pricing models, have begun to be updated, until just recently their development seriously lagged that of front end models, such as those used for underwriting.

The version of DU used for most of this year was calibrated with data from cohorts of loans originated before 1996 before the development of the robust subprime and Alt-A products in the mid-2000's. Nonetheless a substantial volume of such 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.

b. Market Risk Models

While model risk remains high, there has been progress in improving model risk management processes. Progress has been made to assess, independently validate and enhance models, and in the formulation and funding of a Strategic Initiative for 2008 to 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 faces 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. Staffing to meet these challenges may be difficult. In addition to the challenges in credit risk modeling, market risk models also have been challenged by the unprecedented behavior of spreads in capital markets. Furthermore, the absence of earnings creates the likelihood that inherent errors in model results will 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).

c. Economic Capital Model

Fannie Mae does not have effective economic capital models including market, credit, and operational risk. The development of necessary models has been to delayed. These models, if in place before, could have been used to inform management that the Enterprise needed more capital to face current market conditions.

3. Accounting

FHFA has had 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 to 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 is nearing completion of 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. FHFA also is focused on the appropriate recognition of losses through "other than temporary impairment" ("OTTI") of investment securities. In this regard, FHFA has concerns regarding the relaxation by the Enterprise of previously stated policies. FHFA issued 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. The implementation of this guidance may result in a material increase in OTTI recognized by the Enterprise.

The continuing failures of the Board of Directors and Management have raised serious concerns about the continuing safety and soundness of the Enterprise. These failures are unsafe or unsound practices and have caused the Enterprise to be operating in an unsafe or unsound condition to transact business.

B. Solvency

Solvency is rated as "Critical Concerns." The Solvency rating 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.

The Agency expects the Enterprise to maintain capital commensurate with the nature and extent of its risk. Accordingly, the types and quantity of risks 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 $7.4 billion of capital raised in May 2008 and the effect of lowering the FHFA-directed capital and surplus requirement in both March and May 2008 have been significantly offset by the continuing 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 concerned that the failure to properly estimate loan loss reserves, losses through the OTTI and potential loss of tax benefits from use of DTA and low income housing tax credits ("LIHTC") results in capital that is materially understated, which is an unsafe or unsound practice and causes the Enterprise to be in an unsafe or unsound condition.

Earnings likely will be further decreased by the fact that the Enterprise may 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:

- DTA have increased from about $9 billion in the first quarter of 2007 to about $21 billion in the second quarter of 2008 (an amount equaling almost 45% of the Enterprise's capital), and continues to increase primarily due to the increasing loan loss reserve. This increase coupled with the uncertain market has heightened FHFA's concern about the quality and recoverability of this $21 billion tax benefit, calling into question the amount of core capital. The Enterprise's core capital, when adjusted to remove intangible capital, is insufficient to absorb the reasonable, expected losses in the current book of business and ensure the repayment of its obligations.

- OTTI will likely increase earnings losses, further depleting capital. Available for Sale ("AFS") securities, PLS, currently have about $8 billion in unrealized losses. About $2 billion may be a recognized loss in third quarter 2008 earnings.

Additional examination findings that impact the Solvency rating also include, but are not limited to:

- Fannie Mae's written acknowledgement to the U.S. Department of the Treasury on August 25, 2008 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 remain 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 its 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. However, given the current uncertainty in the markets, regulatory changes, 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 as of that date. 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, the fair value of shareholders' equity is expected to decline further in the near term.

The preceding factors and unsafe or unsound practices, taken together, have caused the Enterprise to be operating in an unsafe or unsound condition to transact business.

C. Earnings

Earnings is 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 five years, including 2007, most recently due primarily to increasing credit-related expenses. 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 were 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 as a result of widening interest rate spreads of PLS in the trading portfolio, as well as the security impairments in the AFS portfolio. FHFA's 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 DTA that will cause a further impairment to the adequacy of capital.

Based on the Enterprise's significant shortcomings and weaknesses in internal controls and risk management practices, FHFA has determined that the Enterprise has suffered a substantial dissipation of earnings due to unsafe or unsound practices, and the Enterprise is in an unsafe or unsound condition to transact business.

D. Enterprise Risk

1. 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 uncertainly has grown because of the current unprecedented credit conditions and declining house prices. Significant concerns also remain regarding deteriorating performance of collateral underlying PLS 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 goals, distorting some credit decisions, and allowing 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.

a. 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 unwise strategies to increase the acquisition of Alt-A and other higher-risk products, creating a conflict between prudent credit risk and concentration 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. Specific findings related to the Alt-A portfolio are summarized below:

Executive management for the business unit acknowledged to FHFA examiners 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 imprudent 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 increasing its concentration, it was aware that nearly 1% of all Alt-A deliveries defaulted and became REO. 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 to FHFA examiners 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. These practices fail to meet the requirements of FHFA's directive communicated letter dated April 10, 2007.

b. Housing and Community Development (Multifamily)

The Watchlist data for multi-family loans in HCD is not timely and delays the completion of the HCD book review, which is delivered the third month after quarter end. In 2006, the Agency 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.

c. Other Concerns

Pilot and new initiatives are often not accompanied by benchmarks, defined measurements, or exit strategies. 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.

2. 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 decreases their ability to meet payment obligations, presenting serious safety and soundness issues for the GSEs. Specific findings include:

(a) Mortgage insurers, ("MI") particularly mono-line MIs, continue to deteriorate: four out of seven major MIs are now rated below AA-. Should they be unable to pay their obligations, 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 principal and interest ("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 potential future exposure, ("PFE") such as derivative exposure.

3. Market Risk Management

Market risk has been 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 that, as a whole, and particularly as to funding and liquidity, the 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.

4. Liquidity

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

a. 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 reputational 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 Mae'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 management as callable issuance is a key component to the risk 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 to-be-auctioned ("TBA") MBS are already at historically high levels and incremental sales could widen mortgage rates 25-50 basis points or more.

b. Liquidity-related Safety and Soundness Practices

Fannie Mae's liquidity management practices are critically inadequate and unsafe or 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 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 by 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 sufficient size.

- 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 second quarter 2008, 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 exposed failures because staff were not properly trained. However, Fannie Mae has sought to mitigate this deficiency by holding $20B in agency collateral at a third-party bank, to address any operational issues that arise during an emergency.

5. Interest Rate Risk

Significant interest rate sensitivity and aggressive risk limits make the quantity of risk at Fannie Mae a significant concern. Capital Markets and executive management maintained an imprudently aggressive strategies 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 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 MRO, further reduce the quality of interest rate risk management processes, because MRO resources are not commensurate with the aggressive interest rate risk limits. These unsafe or unsound practices or condition have 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. The Enterprise 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.

6. 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 PLS, including a portion of subprime scurrilities wrapped by a Fannie Mae guarantee. Fannie Mae has improved certain credit risk management processes. However, this non-agency book continues to experience widening spreads, 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 AES (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.

7. 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 a exist.

a. 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 in 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 and is an unsafe or unsound practice. 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.

b. 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.

c. 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 filling has been remediated, but validation is pending. The Sarbanes-Oxley ("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.

IV. FACTUAL BASIS FOR CONSERVATORSHIP GROUNDS

A. Unsafe or Unsound Practices

The Enterprise has engaged in numerous unsafe or unsound practices. Board and management oversight and operation of the Enterprise has been, and continues to be inadequate. The Enterprise does not have a sufficient level of capital commensurate with its risk profile, and it has failed to raise additional capital. Despite repeated urgings from the Agency in 2005 and 2006, management failed to timely correct numerous deficiencies in internal controls related to credit and market risk management and governance practices. As a result of increasing credit risk in the Enterprise's portfolio, earnings are poor and deteriorating and are not sufficient to generate adequate capital and reserves. Continued declines in earnings could result in impairment of the DTA, which would further impair capital. In addition to mounting losses, poor and deteriorating earnings and insufficient capital relative to its risk profile, the Enterprise's liquidity management practices are critically inadequate, stressed, and unsafe or unsound.

B. Unsafe or Unsound Condition

The practices described throughout the discussion above, which are contrary to generally accepted standards or prudent operations have placed the Enterprise into an unsafe or unsound condition to transact business. Because of the poor quality of the Enterprise's assets, weak credit administration, risk management practices, wholly inadequate Board and management oversight, dissipation of the Enterprise's earnings and capital is likely to continue. Loan loss reserves must be augmented. Without positive earnings, loan loss provisions must come from capital, which is inadequate, and as the Enterprise has acknowledged, it is unable to raise capital from private sources in the current market.

Liquidity is significantly strained in the current market. The Enterprise's practice of relying upon repo financing of its agency collateral to raise cash in the current credit and liquidity environment is an unsafe or unsound practice that has led to an unsafe or unsound condition, given the unavailability of willing lenders to provide secured financing in significant size to reduce pressure on its discount notes borrowings.

Given the above, and the Enterprise's risk profile, its capital levels are insufficient to support its business. The Enterprise has no meaningful way to augment capital through earnings or private sources. Continuing to operate with insufficient capital is an unsafe or unsound condition to transact business.

As a result of the myriad of unsafe or unsound practices and conditions to transact business, the Enterprise is subject to an abnormal risk of loss. Indeed, these unsafe or unsound practices and conditions call into question the ongoing viability of the Enterprise absent immediate financial assistance.

C. Inability To Meet Obligations

As described throughout the discussion above, the Enterprise has engaged, and continues to engage, in numerous unsafe or unsound practices. Also as described above, the Enterprise is in an unsafe or unsound condition to transact business. As a result of these practices the Enterprise has lost approximately one billion dollars during the first 6 months of this year. In addition, because of the poor quality of the Enterprise's assets and the systemic unsafe or unsound practices, the Enterprise's losses are likely to continue. As a result, the Enterprise's ability to pay its obligations as they become due is subject to question.

D. Impact

As described above, the Enterprise has lost approximately $5.1 billion dollars during the first 6 months of this year. A high level of losses is likely to continue into the foreseeable future. FHFA currently estimates that the low range for losses in 2008 is $18 billion dollars and the high range for such losses is $50 billion dollars. This level of losses represents a significant dissipation of assets and earnings for the Enterprise.

Moreover, the condition of the Enterprise has been severely weakened. Its asset quality, capital levels, and liquidity funding options are severely deficient. The ongoing viability of the Enterprise, absent immediate financial assistance, is a serious concern.

Conclusion

Pursuant to 12 U.S.C. § 4617(a)(3), FHFA may appoint itself to be the conservator of a regulated entity subject to the statute, including Fannie Mae, if certain conditions exist. Based on my familiarity with the facts described above, the Enterprise's conduct has resulted, or is likely to result, in Fannie Mae:

- Experiencing a substantial dissipation of earnings and assets due to unsafe or unsound practices.
- Being in an unsafe or unsound condition to transact business.
- Having an inability to meet its obligations in the normal course of its business.
- Experiencing a weakening of the condition of the Enterprise due to unsafe or unsound practices or condition.

Based on the foregoing conclusions, we recommend that the Director appoint the FHFA as the conservator for the Federal National Mortgage Corporation.