MEMORANDUM

DATE : July 13, 2005

TO : Members of the Board of Directors

FROM : Brian Graham

SUBJECT : Background Reading for Strategic Retreat

Per the direction of Steve Ashley and Dan Mudd, we have engaged Citigroup and McKinsey to assess Fannie Mae's strategic position and to recommend potential action steps. At various stages in the project, I have had the opportunity to meet with each of you to brief you on the progress to that date.

The Fannie Mae team, Citigroup and McKinsey have each developed large quantities of analysis and documents as part of this effort. Out of respect for your time, I have selected and enclosed a few pages that might be useful to you. These are generally drafts and, therefore, subject to continued refinement between now and next Monday. Note that in many of the documents Fannie Mae is referred to as "Phineas" which is the name assigned to the project.

Of course, should you want more detail behind this information, please contact me and we would be happy to provide the full documents or attempt to answer any questions.

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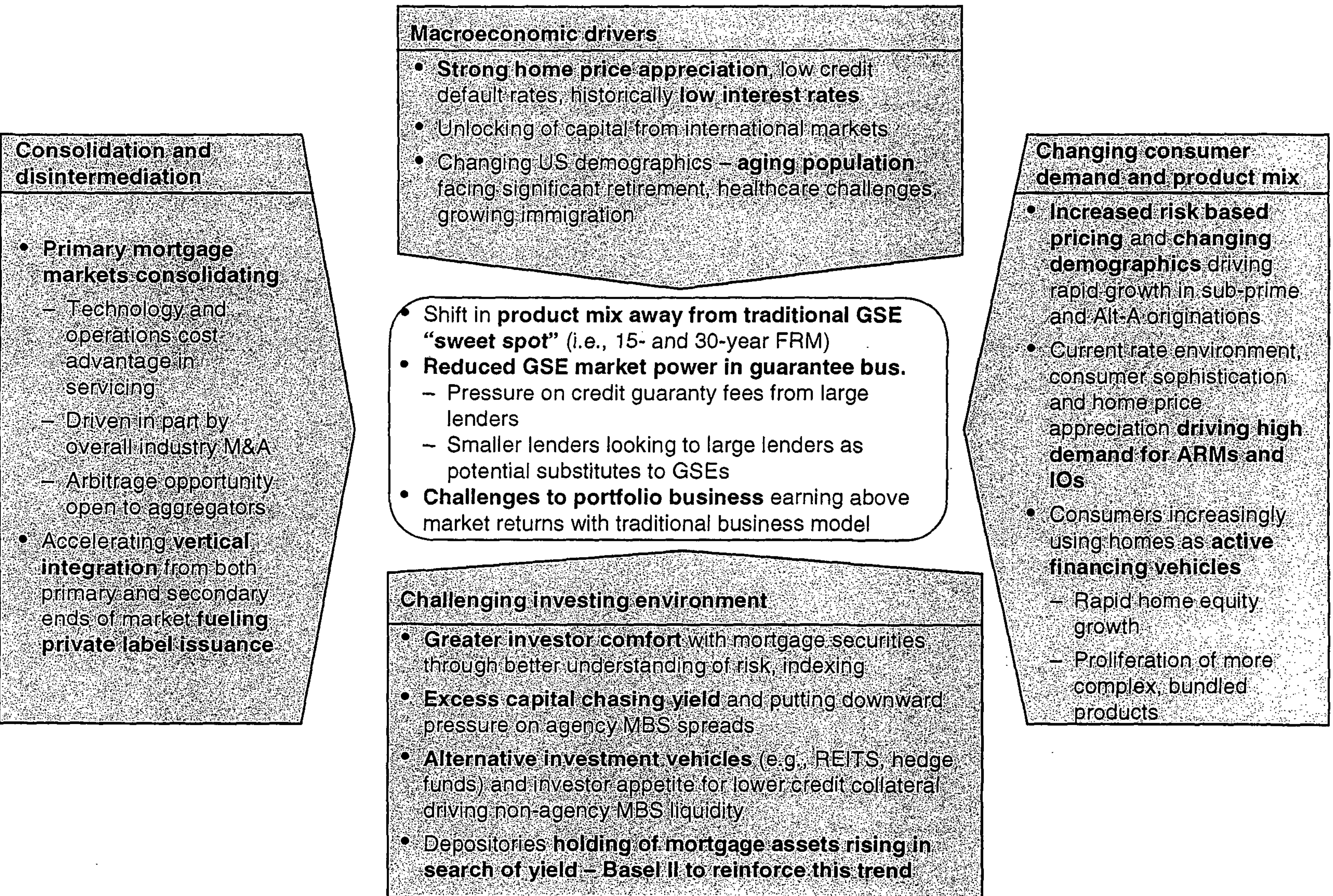
FUNDAMENTAL MARKET FORCES ARE CHALLENGING THE TRADITIONAL GSE MODEL



Macroeconomic drivers

- **Strong home price appreciation**, low credit default rates, historically **low interest rates**
- Unlocking of capital from international markets
- Changing US demographics – **aging population** facing significant retirement, healthcare challenges, growing immigration

Consolidation and disintermediation

- **Primary mortgage markets consolidating**
  - Technology and operations cost advantage in servicing
  - Driven in part by overall industry M&A
  - Arbitrage opportunity open to aggregators
- Accelerating **vertical integration** from both primary and secondary ends of market **fueling private label issuance**

Changing consumer demand and product mix

- **Increased risk based pricing** and **changing demographics** driving rapid growth in sub-prime and Alt-A originations
- Current rate environment, consumer sophistication and home price appreciation **driving high demand for ARMs and IOs**
- Consumers increasingly using homes as **active financing vehicles**
  - Rapid home equity growth
  - Proliferation of more complex, bundled products

Challenging investing environment

- **Greater investor comfort** with mortgage securities through better understanding of risk, indexing
- **Excess capital chasing yield** and putting downward pressure on agency MBS spreads
- **Alternative investment vehicles** (e.g., REITS, hedge funds) and investor appetite for lower credit collateral driving non-agency MBS liquidity
- Depositories **holding of mortgage assets rising in search of yield – Basel II to reinforce this trend**

- Shift in **product mix away from traditional GSE "sweet spot"** (*i.e.*, 15- and 30-year FRM)
- **Reduced GSE market power in guarantee bus.**
  - Pressure on credit guaranty fees from large lenders
  - Smaller lenders looking to large lenders as potential substitutes to GSEs
- **Challenges to portfolio business** earning above market returns with traditional business model

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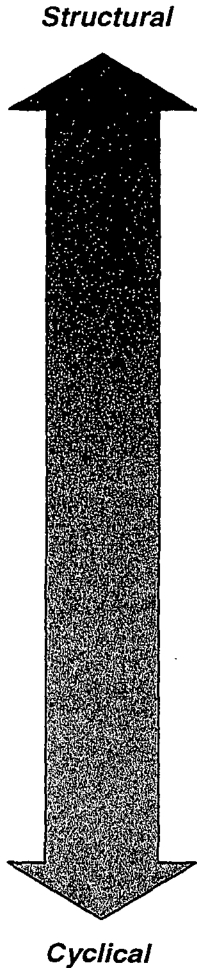
MANY OF THE SHIFTS OBSERVED IN THE MORTGAGE INDUSTRY APPEAR STRUCTURAL



Major trend	Nature of trend	Rationale
• **Primary market consolidation**	Structural	• Scale benefits in technology, operations and retail access
• **Depository mortgage assets**	Structural	• Search for yield structural – likely to be reinforced by Basel II
• **Vertical integration**	Structural	• Build up of skills; ability to "cherry-pick" best assets
• **Global capital markets deepening**	Structural	• Improving efficiency in global markets
• **Home equity growth**	Mostly structural	• Shift in consumer behavior toward using homes as active financing vehicles
• **Narrowing of portfolio OAS**	Mostly structural	• Structural deepening of global capital markets; increased investor comfort in substituting agency debt with MBS
• **Sub-prime, Alt-A growth**	Both structural and cyclical	• Lower income customers driving new starts; low credit default cyclical; expansion of product availability through risk based pricing
• **Private label issuance**	Both structural and cyclical	• Increased investor appetite for subordinate bonds, some cyclical demand for ARM products
• **ARMs and IOs demand**	Mostly cyclical	• Fueled by current rate environment and home price appreciation, hybrid ARMs structural
• **Home price appreciation**	Cyclical	• Benefiting from long economic "bull run"

Source: McKinsey Analysis

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Shifting mortgage industry landscape

Largest Threat / Structural → Cyclical / Smallest Threat	Issues	Type Of Trend	Impact On Phineas
	Impact of Basel II implementation	Regulatory	Retaining mortgages will become more attractive to depositories; resulting in a potential decrease in availability of loans to purchase or guaranty
	Consolidation amongst top originators	Competitive	Larger competitors compete more aggressively for assets, have greater pricing power and ability to develop new products; consequently they are less reliant on Phineas and compete directly with Phineas
	Increased (hybrid) ARM origination	Primary Market	Lower share of originations sold to Phineas due to its lower market share in the ARM market versus fixed rate products
	Increased sub-prime and Alt-A origination	Primary Market	Reduction in share of agency-eligible loans reduces Phineas' target market
	Increased presence of MBS investors, incl. foreign central banks, REITs, conduits, CDOs, hedge funds and financing companies	Competitive	Crowded competitive landscape seeking to acquire risky assets causes spread compression, thus limiting Phineas' new business opportunities
	Increased use of private label markets	Secondary Market	Decrease in guaranty business as issuers pursue alternative executions
	Growing homeownership rates	Macro-economic	Increased mortgage debt creates increased market opportunity; increased volume for guaranty business may be partially offset by use of non-conforming products
	Growth of affordability products (IO, Option ARMs)	Primary Market	Phineas initially disadvantaged due to high credit standards; a severe credit event facilitated by irrational competitors could lead to spread widening over time; thus making the market more attractive to Phineas
	Decreased spreads on subordinated bonds	Secondary Market	Increases relative attractiveness of private label execution driving business away from Phineas
	Fall in the rate of conforming mortgage origination	Primary Market	Phineas business volumes will remain cyclical to the extent driven by fixed rate conventional originations which will continue to be volatile
	Potentially slowing home price appreciation	Macro-economic	Recent price appreciation will maintain strong credit metrics; any reduction in home price appreciation, however, may impede growth

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FANNIE MAE HAS ~10 % OF THE $ 60 BILLION U.S. MORTGAGE PRE-TAX PROFIT POOL

$ Billion, 2005 Estimate

Fannie Mae primary focus

Growth expectation

Origination	Servicing	Insurance	Credit Risk Mgmt	Portfolio	Trading
Jumbo ~2.5 (M)	Jumbo ~1 (M)	Mortgage insurance ~2 (L)	Agency ~5 (L)	Agency ~6 (L)	Agency debt ~1 (L)
Sub-prime, Alt-A ~9.5 (H)	Sub-prime, Alt-A ~1 (H)		Conduit/ private label* ~3 (H)	Banks & Others ~11 (M)	Agency MBS, CMOs ~1 (M)
Prime ~2.5 (L)	Prime ~3 (L)	Title insurance ~2 (L)	Whole loans ~4 (M)	Asset mgmt ~2 (M)	Non-Agency MBS ~0.5 (H)
Home equity ~2 (H)	Home equity ~0.5 (H)				
Total pre-tax profit					
~16.5	**~5.5**	**~4**	**~12**	**~19**	**~2.5**

* Pre-tax profit pool for Jumbo credit risk management = $2 bn

Source: McKinsey Analysis

Total returns to shareholders analysis

Total Return Analysis					
	Actual Return	Annual Total Return since:			
	Since 1/1/2005	1/1/2004	1/1/2002	1/1/2000	1/1/1995
Phineas	(15.0%)	(11.9%)	(5.7%)	1.6%	14.4%
GSEs					
Freddie Mac	(6.9)	10.6	2.4	7.9	17.4
Thrifts					
Golden West Financial Corporation	10.0	19.9	26.5	30.9	26.1
Washington Mutual, Inc.	1.5	6.6	9.6	21.4	20.6
Mortgage Banks					
Countrywide Financial Corporation	11.7	36.9	48.1	40.1	26.8
Mortgage Insurers					
MGIC Investment Corporation	(4.9)	10.5	1.8	3.7	13.4
Radian Group Inc.	(9.2)	(0.7)	3.3	15.2	18.9
PMI Group, Inc.	(5.5)	3.9	4.3	10.2	12.0
Market Indices					
S&P 500	2.6	7.0	1.4	(2.6)	10.1
S&P Financial Services Index	(3.8)	4.4	3.8	5.1	14.1

Source: Powerdata, Bloomberg and WinEZ. Market data as of July 11, 2005.
Total return calculated as total dividends reinvested plus stock price appreciation.

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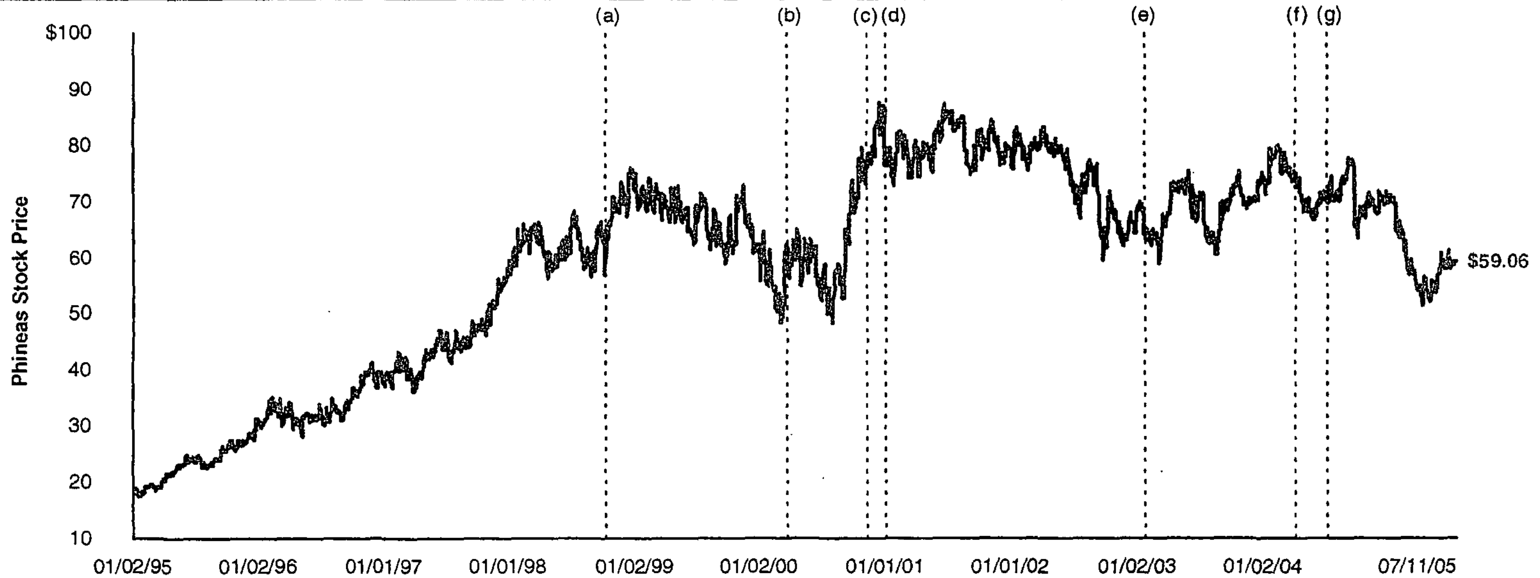
Historical stock price performance versus portfolio and EPS growth



(a) 10/09/1998: Freddie Mac's mortgage insurance proposal fails.
(b) 03/22/2000: Gary Gensler addresses role of GSEs and their increasing potential risk to the capital markets.
(c) 11/08/2000: George W. Bush elected President.
(d) 1/03/2001: First in a series of 13 rate decreases by the Federal Reserve Board.
(e) 1/23/2003: Freddie Mac announces it will revise earnings for at least the previous two years.
(f) 3/30/2004: Regulators announce that Phineas may have to correct published financial statements as a result of the government accounting review.
(g) 6/30/2004: First in a series of 9 rate increases by the Federal Reserve Board.

	1998				1999				2000				2001				2002				2003				2004				2005	
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
YoY EPS Growth (%)	16	16	12	12	13	14	14	16	16	12	16	14	7	33	9	70	7	6	(18)	(51)	65	(24)	158	135	(2)	1	NA	NA	NA	NA
YoY Core Earnings Growth (%)	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	18	21	22	25	23	22	22	19	24	20	13	7	10	3	NA	NA	NA	NA
Portfolio Growth (%)	NA	NA	NA	NA	35	36	34	26	22	16	13	16	19	21	20	16	15	12	9	12	42	26	15	18	8	9	(1)	1	(2)	(7)

Source: Company reports and Powerdata.
Note: Growth rates represent quarterly growth. 2Q 2005 Portfolio growth from May 2005 company update. Earnings data are prior to restatement. Phineas adopted FAS 133 on Jan 1, 2001.

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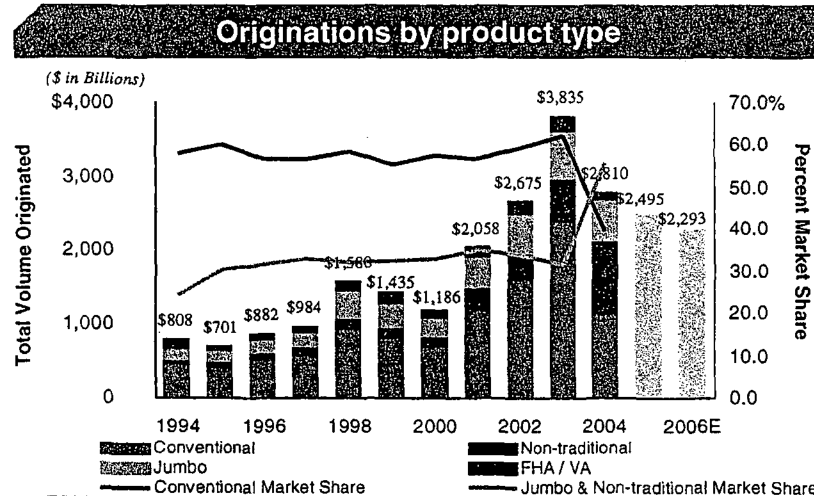
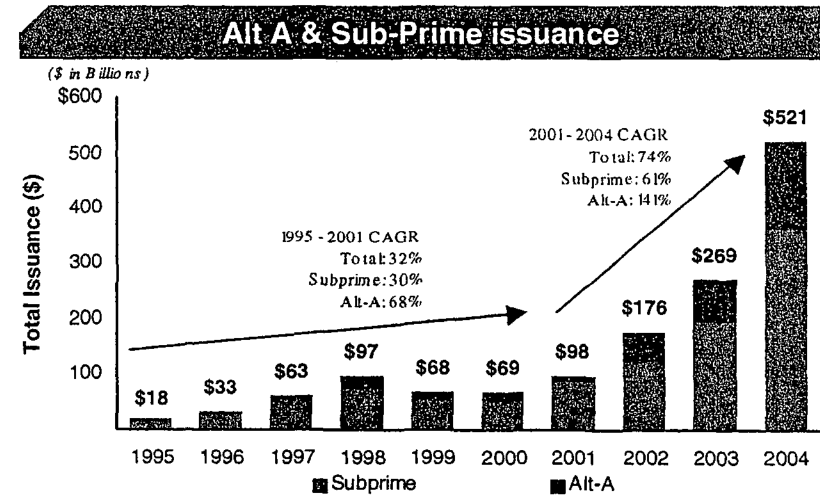
A shift toward non-traditional products diminishes Phineas' competitive advantages

- The rapid increase in home prices, combined with increased competitive pressures, has led originators to offer "affordability" products such as interest only ARMs
- The decline in refinancing activity in the prime market has left lenders with excess capacity, and combined with the favorable credit cycle, has spurred activity in non-prime markets such as Alt-A and sub-prime
- The increase in the conforming loan limit, which is based on national home price increases, has not kept pace with the growth of home prices in high volume states, such as California.

Originations by product type



Alt A & Sub-Prime issuance



Source: Inside MBS & ABS and Mortgage Bankers Association.
(a) Nontraditional originations include Alt-A and sub-prime originations.

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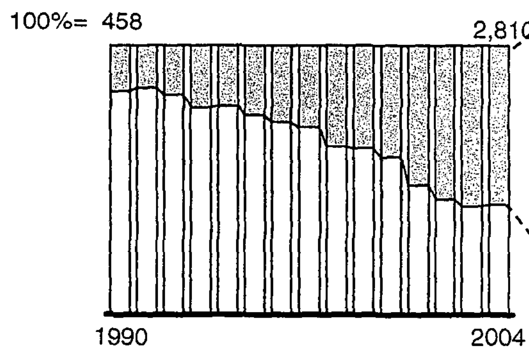
CONTINUED CONSOLIDATION IN ORIGINATION AND SERVICING

$ Billions, Percent

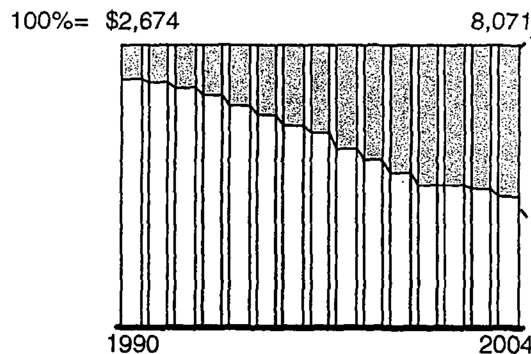
Origination market share*
1990-2004



Top originators – 2004
$ Billions

Player	Volume	Market share Percent
Countrywide	363.0	12.9
Wells Fargo	298.5	10.6
Washington Mutual	255.4	9.1
Chase Home Finance	197.4	7.0
Bank of America	143.6	5.1
Top 5	**1,257.9**	**44.7**
Top 10	**1,596.8**	**58.8**

Servicing market share*
1990-2004



Top servicers – 2004
$ Billions

Player	Volume	Market share Percent
Countrywide	838.3	10.4
Wells Fargo	782.4	9.7
Washington Mutual	727.6	9.0
Chase Home Finance	562.7	7.0
CitiMortgage	364.3	4.5
Top 5	**3,275.3**	**40.6**
Top 10	**4,351.4**	**53.9**

* All data reflects single family mortgage products – including home equity and refinancings.
Source: Mortgage Market Statistical Annual, "Inside Mortgage Finance"; McKinsey analysis

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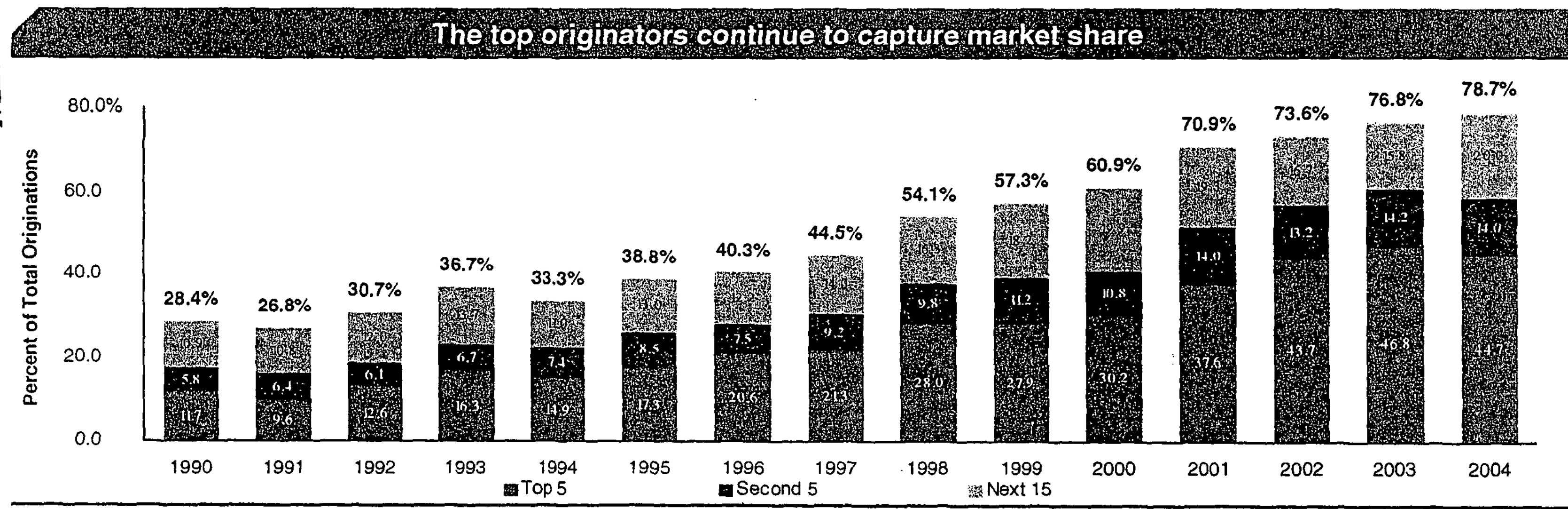
Primary market consolidation increases pricing pressure on G-fees and portfolio assets

- The drive to capitalize on economies of scale and scope have led to rapid consolidation within the mortgage industry over the past 10 years
  - The consolidation of top originators has created competitive pressures as larger, more efficient originators are able to price mortgage loans and securities more aggressively in the secondary market



Source: Inside MBS & ABS.

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Competitive positioning of monolines

Top 10 mortgage originators

1994		2004	
Company	**Market Share**	**Company**	**Market Share**
Countrywide	4.2%	Countrywide	12.9%
Norwest	3.2	Wells Fargo	10.6
Prudential	3.1	Washington Mutual	9.1
Chase Manhattan	2.3	JP Morgan Chase	7.0
Chemical Residential	2.1	Bank of America	5.1
Fleet Mortgage	1.8	Citigroup	3.7
GE Capital	1.6	GMAC	3.1
GMAC	1.4	Ameriquest	2.9
Bank of America	1.3	National City	2.3
North American Mortgage	1.3	ABN AMRO	2.0
	22.3%		58.7%

Source: The 2005 Mortgage Market Statistical Annual.

Top 10 branch based consumer finance companies

1996		2004	
Company	**Market Share**	**Company**	**Market Share**
Household	35.1%	HSBC	43.1%
Associates First Capital	27.0	Citigroup	37.7
Beneficial	13.9	Wells Fargo	12.0
Commercial Credit	6.7	AIG	7.2
Avco	5.5		
Norwest Finance	4.5		
Transamerica Finance	3.5		
American General Finance	2.1		
Aristar	1.7		
	100.0%		100.0%

NB: Market share based on sum of top 9 or 4 consumer finance receivables.

Top 10 credit card issuers

1994		2004 (a)	
Company	**Market Share**	**Company**	**Market Share**
Citigroup	17.4%	Bank of America	25.3%
MBNA America	7.8	JP Morgan Chase	23.8
AT&T Universal	5.5	Citigroup	20.5
First Chicago	5.4	Capital One	9.4
First USA	4.9	HSBC Bank	4.0
Household Bank	4.8	Washington Mutual	3.3
Chase Manhattan	4.6	Wells Fargo	2.4
Chemical Bank	4.0	U.S. Bancorp	1.9
Bank of America	3.6	USAA Federal Savings	1.3
Signet Bank	3.4		
	61.4%		66.4%

Based on volume outstanding of top 50 bank credit card issuers.
(a) Pro forma for recent mergers.

Top mortgage insurers

1994		2004	
Company	**Market Share**	**Company**	**Market Share**
GE Capital	27.6%	Mortgage Guaranty Insurance	23.2%
Mortgage Guaranty Insurance	25.7	PMI Mortgage Insurance	18.7
PMI Mortgage Insurance	13.8	Radian Guaranty	15.9
AIG	13.3	AIG	13.5
Republic Mortgage Insurance	8.7	Genworth Financial	13.5
Commonwealth	7.8	Republic Mortgage Insurance	10.3
Amerin Guaranty	1.9	Triad Guaranty Insurance	4.8
Triad Guaranty Insurance	1.2		
	100.0%		100.0%

Source: The 2005 Mortgage Market Statistical Annual.
Note: Market share based on sum of top 7 or 8 mortgage insurers insurers in 1994 and 2004 respectively.

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Whole company competitor comparison

($ in millions)	Phineas		Mortgage Banks	Mortgage Insurers	Financial Guarantors	Thrifts
Price / 2006E	8.3x	9.4x	8.7x	8.6x	10.1x	11.3x
LT EPS Growth	10.0%	9.5%	12.0%	12.0%	13.0%	11.3%
On-Balance Sheet Assets	$1,004,000	$795,284	$128,496	$6,381	$18,585	$207,403
Off-Balance Sheet Assets (a)	$1,311,668	852,270	NM	$30,601	$757,037	NM
Total Common Equity (b)	$26,392	$26,807	$10,310	$3,689	$5,024	$14,250
Net Income	$7,804	$2,937	$2,198	$519	$725	$2,079
ROAA (c)	0.8% / 0.3%	0.4% / 0.2%	1.9%	8.1% / 1.4%	3.9% / 0.1%	1.1%
ROACE	35.0%	10.1%	23. 9%	13.9%	12.7%	15.7%
<u>Capital Measures</u>						
Tangible Common Ratio	2.6%	3.3%	8.0%	NM	NM	5.9%
Equity / Assets	3.5%	3.9%	8.0%	NM	NM	6.9%
Equity / Risk in Force Assets	1.6%	1.8%	NM	12.1%	0.7%	NM

Source: Company financials, IDD and Powerdata. Market data as of July 11, 2005.
As of December 31, 2004. Phineas data based on management estimates. Data for peer groups represent medians for each respective peer group.
Mortgage Banks refer to Countrywide Financial Corp. (CFC); Mortgage Insurers includes MGIC Investment Corp. (MTG), Radian Group Inc. (RDN) and PMI Group Inc. (PMI); Financial Guarantors include MBIA Inc. (MBI), Ambac Financial Group Inc. (ABK) and Assured Guaranty Limited (AGO); Thrifts include Washington Mutual Inc. (WM) and Golden West Financial (GDW).
(a)Off-Balance Assets: For Phineas and FRE measured as total book of business held by 3rd party investors; for mortgage insurers and financial guarantors measured as total risk-in-force assets.
(b)Equity for Phineas estimated to be core capital as reported by OFHEO less preferred equity.
(c)Returns measured against on-balance sheet assets (1st number) and total managed assets for Phineas, Freddie Mac, mortgage insurers and financial guarantors (2nd number).

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Portfolio competitor comparison

($ in millions)	Phineas Portfolio	Residential RMBS REITs	Commercial CMBS REITs	Banks with Mortgage Platform	Thrifts	
Price / 2006E	NM	8.3x	9.9x	11.1x	11.3x	16.9x
LT EPS Growth	NM	4.8%	8.0%	9.9%	11.3%	11.0%
Total Assets	$954,218	$7,319	$3,729	$283,564	$207,403	$636,481 (a)
Total Common Equity	$10,453	$637	$458	$25,340	$14,250	$585
Net Income	$3,131	$78	$43	$4,896	$2,079	$156
ROAA	0.3%	1.3%	2.3%	1.7%	1.1%	15.8%
ROACE	25.0%	14.7%	11.6%	18.2%	15.7%	29.4%
Capital Measures						
Tangible Common Ratio	NM	14.7%	24.3%	5.8%	5.9%	NA
Equity / Assets	2.7%	8.3%	16.2%	9.1%	6.8%	NA

Source: Company financials, IDD and Powerdata. Market data as of July 11, 2005.
As of December 31, 2004. Phineas data on management estimates. Data for Residential RMBS REITs, Commercial CMBS REITs, Banks, Thrifts, and Asset Managers represent medians for selected peer group.
REIT: RMBS includes Annaly Mortgage Management (NLY), Redwood Trust Inc. (RWT), MFA Mortgage Investments Inc. (MFA), Anworth Mortgage Asset Corp. (ANH), and Luminent Mortgage Capital Inc. (LUM); REIT: CMBS includes Newcastle Investment Corp. (NCT), Anthracite Capital Inc. (AHR) and Capital Trust Inc. (CT); Banks w/ Mortgage Platform include Bank of America Corp. (BAC), Wells Fargo & Co. (WFC), National City Corp. (NCC) and North Fork Bancorp. (NFB); Thrifts include Washington Mutual Inc. (WM) and Golden West Financial (GDW); Fixed Income Asset Managers include BlackRock Inc. (BLK), Nuveen Investments (JNC) and Federated Investors Inc. (FII).
(a) Reflects assets under management (AUM).

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Single family competitor comparison

($ in millions)	Phineas Single Family	Financial Guarantors	Mortgage Insurers
Price / 2006E	NM	10.1x	8.6x
LT EPS Growth	NM	13.0%	12.0%
Total Book of Business (a)	$2,106,200	$757,037	$30,601
Total Common Equity (b)	$12,321	$5,024	$3,689
Net Income	$3,050	$725	$519
% Revenue from Guaranty Business	82.8%	54.0%	79.4%
Return on Avg. Book of Business	0.2%	0.1%	1.6%
ROACE	25.2%	12.7%	13.9%
Capital Measures			
Equity/ Risk in Force Assets	0.6%	0.7%	12.1%

Source: Company financials, IDD and Powerdata. Market data as of July 11,2005.
As of December 31, 2004. Phineas data based on management estimates. Data for financial guarantors and mortgage insurers represent medians for selected peer group.
Mortgage Insurers includes MGIC Investment Corp. (MTG), Radian Group Inc. (RDN) and PMI Group Inc. (PMI); Financial Guarantors include MBIA Inc. (MBI), Ambac Financial Group Inc. (ABK) and Assured Guaranty Limited (AGO).
(a) For Phineas and FRE measured as total book of business; for mortgage insurers and financial guarantors measured as total risk-in-force assets. .
(b) Measured as required capital based upon management estimates.

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Multi family competitor comparison

($ in millions)	Phineas Multi-Family	Financial Guarantors	Multi-Family Banks & Thrifts
Price / 2006E	NM	10.1x	12.0x
LT EPS Growth	NM	13.0%	10.0%
Total Book of Business (a)	$110,023	$757,037	$20,399
Total Common Equity (b)	$644	$5,024	$3,186
Net Income	$282	$725	$355
% Revenue from Guaranty Business	95.4%	54.0%	NM
Return on Avg. Book of Business	0.3%	0.1%	NM
ROACE	46.9%	12.7%	12.1%
Capital Measures			
Equity/ Risk in Force Assets	0.6%	0.7%	NM
Tangible Equity/ Tangible Assets	NM	NM	5.2%

Source: Company financials, IDD and Powerdata. Market data as of July 11, 2005.
As of December 31, 2004. *Phineas data for based on management estimates. Data for financial guarantors* and mortgage insurers represent medians for selected peer group.
Financial Guarantors include MBIA Inc. (MBI), Ambac Financial Group Inc. (ABK) and Assured Guaranty Limited (AGO); Multi-Family Banks and Thrifts include Washington Mutual Inc. (WM), New York Community Bancorp (NYB) and New York Community Bancorp (NYCBC).
(a) For Phineas measured as total book of business; for financial guarantors measured as total risk-in-force assets; for multi-family banks and thrifts measured as total on-balance sheet assets.
(b) Measured as required capital based upon management estimates.

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Attorney-Client Communication
Preliminary Draft for Discussion Purposes
July 13, 2005

MEMORANDUM FOR JEFF CRAVATH

Re: Enterprise Affiliates

The Charter Act and its status as a Government Sponsored Enterprise ("GSE") provide Fannie Mae with both benefits and constraints. For example, as you know, the Charter provides Fannie Mae with an exemption from certain state taxes and from securities registration, and Fannie Mae securities benefit from an exemption from certain bank and thrift investment limits and from lower bank/thrift capital risk weights. Ultimately, of course, GSE status provides the practical ability to borrow at lower rates than other entities. However, federal laws and GSE status also impose constraints, including restrictions on permissible activities, "new program" approval requirements, and housing goals established by the Department of Housing and Urban Development ("HUD").

You asked for a summary overview of how these Charter Act and 1992 Act benefits and constraints might apply to Fannie Mae affiliates.

In brief, the 1992 Act by its terms regulates "enterprises," a term that is expressly defined to include Fannie Mae "affiliate[s]," *i.e.* any parent holding company, subsidiary, or entity under common control with Fannie Mae.[1] This definition appears to suggest that all the restrictive and limiting provisions of the 1992 Act would apply to Fannie Mae affiliates. OFHEO's regulations also define "enterprise" by reference to affiliates and provide that OFHEO's enforcement jurisdiction extends to Fannie Mae affiliates. 12 C.F.R. §§ 1780.1, 1780.3. Therefore, OFHEO and HUD would likely take the position that a subsidiary or acquiror of Fannie Mae would be subject to all the provisions of the 1992 Act, including those regarding minimum and risk-based capital, enforcement and prompt-corrective action, "new program" approval, and housing goals.

The language of the Charter Act, however, only expressly refers to Fannie Mae (defined in the Charter as the "corporation" to distinguish it from Ginnie Mae, the "association"), not any affiliates. Thus, it is not clear that the Charter's benefits would extend to Fannie Mae affiliates. One would expect state tax authorities, the SEC, and others to argue that the Charter exemptions by their terms do not apply to legal entities other than Fannie Mae.

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[1] The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 ("1992 Act") provides that: "The term "enterprise" means -- (A) the Federal National Mortgage Association and any affiliate thereof" and "Except as provided by the [OFHEO] Director, the term 'affiliate' means any entity that controls, is controlled by, or is under common control with, an enterprise." 12 U.S.C. § 4502(1) and (6).

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An argument could also be made that the Charter Act's restrictions on activities, such as the prohibition on loan origination, do not apply to Fannie Mae affiliates. This position could be based on an argument of symmetry: if a Fannie Mae affiliate does not receive the Charter's benefits, then it should not be subject to its restrictions. Nevertheless, absent the agreement of HUD and OFHEO, and perhaps even with such approval, it may be practically and politically difficult for an affiliate of Fannie Mae to conduct activities that Fannie Mae itself is not permitted to do.

The prospect of being regulated as a GSE should thus pose a significant obstacle to any potential acquiror of Fannie Mae. Moreover, a provision in the Federal Deposit Insurance Act further bars depository institutions from affiliating with Fannie Mae. 12 U.S.C. § 1828(s)(1) provides that: "No depository institution may be an affiliate of, be sponsored by, or accept financial support, directly or indirectly, from any Government-sponsored enterprise." For these purposes, "affiliate" is again defined to include any company that controls, is controlled by, or is under common control with Fannie Mae, and covered "depository institution[s]" include national or state banks and savings associations. *See* 12 U.S.C. §§ 1813, 1841(k).

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Memorandum Regarding Sallie Mae's Privatization

Summary. The key points we take from a review of Sallie Mae's privatization are the following: (1) Privatization was driven by the Clinton Administration's program introduced in 1993 for the government to begin lending directly to students and imposition of user fees on Sallie Mae's loan portfolio, which took away Sallie Mae's core business as a GSE. In order to survive, Sallie Mae had to change its business model, which provided a compelling business justification for privatization legislation. (2) Although Sallie Mae successfully obtained legislation authorizing its privatization model, the legislative process was also used by its opponents and the government to impose exit fees on it of $5 million plus warrants equal to 1% of its stock. These fees were modest, but so were Sallie Mae's prospects. (3) Long before the privatization was completed, the uncertainties created by the process unleashed forces that led to shareholder proxy fights over the future privatized company's corporate governance and business strategy, resulting in a dissident takeover.

Sallie Mae before privatization. Prior to privatization, the Charter generally restricted Sallie Mae's activities to student loan and educational facility financing functions, defined the types of obligations it could incur, and subjected it to limited oversight by the Education and Treasury Departments. The following were the key characteristics of Sallie Mae:

- President appointed not only seven of Sallie Mae's twenty one Directors but also the Chairman of the Board. The other fourteen Directors elected by Sallie Mae's shareholders were required to be affiliated with either educational or financial institutions.
- Sallie Mae's GSE "benefits" included exemptions from SEC registration requirements and state/local taxes, as well as access to low-cost borrowing from the Federal Financing Bank, an opportunity that Sallie Mae tapped from 1974 to 1982.
- Sallie Mae's GSE "burdens" included a leverage (but not risk-based) capital requirement equal to 2% of assets (plus 0.5% of the credit equivalent of certain off-balance sheet items), which was said to be comparable to the risk-adjusted standard applied to Sallie Mae's private-sector competitors.
- Generally, Sallie Mae was subject to less of a regulatory burden than the Enterprises: the Education Department lacked new-program approval responsibility or powers comparable to HUD's housing goal authority, and Treasury had almost no power to ensure Sallie Mae's safety/soundness or capital adequacy.

Size. At the end of 1996, the year the Sallie Mae Reorganization Act was signed into law, Fannie Mae was significantly larger than Sallie Mae in terms of both net income and total assets. According to Fannie Mae's Annual Report, its total assets were about $351 billion and its net income was about $2.7 billion. Sallie Mae's 10-K reports that its total assets for 1996 were about $47 billion and net income was about $408 million. Fannie Mae's total assets were about

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seven times larger than Sallie Mae's in 1996 and its net income was about six times larger than Sallie Mae's.

Holding Company -- GSE Subsidiary Structure. The privatization legislation prescribed a reorganization plan along the following lines: Old Sallie Mae shares would be exchanged for shares in a new state-chartered corporation, SLM Holding Company. (The plan was designed to achieve a reorganization that would be tax-free for existing shareholders and debtholders under the Internal Revenue Code.) The Holding Company would wholly own the old GSE, which would be wound down over 12 years. Key aspects of the structure were:

- All non-financial assets and personnel would be transferred from the GSE to the Holding Company.
- The Holding Company would raise its own capital and be free to conduct new activities through non-GSE subsidiaries generally without regulatory oversight except to the extent that such activities would have a substantial financial impact on the GSE subsidiary. (The Holding Company and its non-GSE subsidiaries would not, however, be able to conduct secondary-market purchasing activities unless the GSE ceased doing so.)
- The GSE would retain its debt obligations and its student loan portfolio and could generally continue performing its GSE functions subject to the old regulatory regime as it was wound down and dissolved by 2008.
- The GSE's capital requirements were raised to 2.25%, with the Holding Company required to make capital infusions to cure any shortfalls in the GSE.
- When the GSE is dissolved in 2008, any remaining debt obligations would be defeased through the creation of a fully collateralized trust with cash flows matching the interest and principal obligations of the defeased bonds.
- Any surplus may be distributed to the Holding Company, which would also have to make up any shortfall.

Exit Fees. The legislation provided that the Holding Company would pay a $5 million fee in order to continue using the name "Sallie Mae," and after reorganization would issue common stock warrants equal to one percent of its common stock (ultimately valued at $37 million) to the District of Columbia Financial Responsibility and Management Assistance Authority. The fees were structured to benefit the D.C. public schools. We have not been able to find any detail on the rationale for the specific amount of the exit fee, however, the legislative history is clear that the rationale for the fee was that the government should be able to play a part in Sallie Mae's future success because Sallie Mae benefited in large part from its status as a GSE. The principal proponents of an exit fee were competitor-lenders who feared Sallie Mae would benefit from the capital base accumulated out of its GSE profits and some large shareholders opposed the imposition of a large fee.

As a measure of its size, the $42 million exit fee that Sallie Mae paid ($5 million fee plus stock warrants valued at $37 million) was about 10% of its net income at the time and only a small percentage of its total assets.

Shareholder Fights. Privatization caused a rift among Sallie Mae's shareholders and generated shareholder fights.

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- Well before the privatization was completed, shareholders divided into two groups, one backing management and the other backing a dissident group calling itself the Committee to Restore Value or "CRV," led by Albert Lord, who became a Sallie Mae Director in 1995. In April 1995, as Congress was considering the privatization legislation and after a bitter proxy fight, Lord and seven CRV associates were elected to the Sallie Mae Board by effective use of the cumulative voting provision in Sallie Mae's Charter. Lord and his associates were instrumental in convincing the Board to implement certain changes, including a securitization program and a share buyback, that (along with interest generated by the privatization talk and the failure of the government's direct lending program to meet certain targets) resulted in Sallie Mae's share price beginning to climb back up.
- In September 1996, Congress passed the privatization legislation, and in January 1997, the Sallie Mae Board (over the objections of Lord and his allies) proposed an extremely management-friendly reorganization plan. Perhaps most onerously, the plan linked the shareholders' votes on privatization and corporate governance, so that if the shareholders wanted to vote to privatize they effectively would only be able to do so by installing the management-supported Board. Management scheduled a shareholder vote on its proposal for May 1997. Lord called the management proposal "an embarrassment," and CRV decided to offer an alternative slate of Directors and wage a full proxy fight for the company's future. CRV came up with a plan separating the privatization and corporate governance votes and generally proposing a much more shareholder-friendly governance structure. At a July 31, 1997 meeting, the CRV slate was voted into office, receiving 25 million votes to management's 18 million. After shareholder approval, Sallie Mae was fully privatized effective in August 1997.

After Privatization. Since privatization, Sallie Mae has transformed itself, principally through a series of acquisitions. It has become a significant originator of student loans and entered into a wide variety of new businesses along the entire student loan chain, including servicing and guarantee activities, and collections. Sallie Mae has also changed its marketing strategy, shifting attention from its former lender-partners to develop direct relationships with college financial aid offices.

Stock Price. Between the time Sallie Mae privatized and mid-2002, its stock price more than doubled, from approximately $42 in mid-1997 to $96.50 as of closing on May 28, 2002. In May 2002, Sallie Mae announced a stock split and since that time, its price has continued to rise. Several factors account for the rise in stock price: growth (and significant expected growth) in the student loan market, increased market share through loan originations and acquisitions, new diversified income sources, cost control and stock repurchases.

Timing. In December 2004 Sallie Mae completed its privatization, four years ahead f schedule public filings announced that it expects to complete the dissolution of Sallie Mae, the GSE by June 2006, more than two years ahead of schedule. The GSE intends to stop buying loans by 2006 and does not intend to issue any new debt obligations that mature beyond

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