FannieMae

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VIA ELECTRONIC MAIL AND HAND DELIVERY

Mr. James B. Lockhart III
Director
Office of Federal Housing Enterprise Oversight
1700 G Street, NW
Washington, DC 20552

Dear Director Lockhart:

I am writing this letter to request immediate relief from the growth limit on our mortgage-related portfolio. We feel this step is necessary and prudent to address current conditions in the secondary mortgage market.

In recent days, we have witnessed growing evidence of turmoil in virtually all sectors of the housing finance market. The immediate crisis in subprime is indicative of a serious liquidity event impacting the entire credit market, not just subprime. If the GSEs, and Fannie Mae in particular, are to fulfill the secondary market liquidity mandate of their charters, balance-sheet flexibility is critical. I believe the market would benefit from the reappearance of long-term agency holders. A number of our customers have called us to indicate that in the absence of our bid, they are cutting out quality, creditworthy production.

A moderate, 10 percent increase in the Fannie Mae portfolio cap would provide us with flexibility to address emerging liquidity concerns, and send a strong signal to the market that the GSEs are able to address liquidity events before they become crises.

Across the board, volatility is increasing and liquidity is deteriorating.

- There have been multiple bankruptcies, initially among subprime lenders, but now growing across the mortgage sector. Of the latter cases, liquidity is a prime factor.
- Spreads between swaps and Treasuries have widened 10 basis points in the last two weeks and by 20 basis points since mid-June.
- Credit default spreads for bulge bracket broker-dealers have widened from a previous range of 20-30 basis points to as high as 135 basis points in the past few days. In the cash market, GSE debt spreads, including those for Fannie Mae, have widened by 6-to-8 basis points versus the swaps curve.

- Spreads have widened most on credits directly associated with subprime. However, liquidity has rapidly been evaporating from investment-grade segments, such as the AAA-rated CMBS sector. Since the end of June, spreads have widened by 33 bp to 62 basis points relative to the swap curve — and 22 basis points of this widening occurred *in the last week.*
- During the 1998 liquidity event, the widening of CMBS spreads was a precursor (by about one month) of a widening in the regular fixed-rate agency MBS market.
- Although pricing in agency MBS has remained fairly liquid, all other sectors are showing some price deterioration. For example, jumbo mortgage prices are more than 1 point behind agency MBS — about ¼ point worse than three weeks ago. This is another sign that liquidity is eroding in areas not directly related to subprime.
- Spreads on "off-the-run" product, particularly affordability products such as fixed I/O and 40-year mortgages, have increased substantially.
- Our lender partners have begun experiencing the lack of liquidity. One lender sought bids recently on a Fannie Mae Multi-Family MBS from more than 10 dealers, yet received only bids from Fannie Mae and a backstop bid from one dealer, clear evidence that "the market" is not there and that the need for long-term buyers is acute.
- The lack of liquidity is affecting primary lenders. Countrywide Financial, the largest mortgage lender, recently disclosed that in the second quarter it retained $3.8 billion in prime home equity loans it would normally securitize due to widening credit spreads on these loans in the securitization markets.
- Some smaller lenders without Countrywide's balance sheet capacity are faring worse. American Home Mortgage Investment, which does not specialize in subprime, is the latest example of a mid-sized lender facing a liquidity crisis.
- This week, an $850 million Bear Stearns-managed fund investing in non-subprime mortgage assets was forced to halt redemptions. As this and the American Home situation indicate, liquidity issues are already impacting the secondary market beyond subprime. If the troubles escalate, and forced liquidations ensue, the liquidity squeeze would likely directly impact the primary market, negatively affecting availability, affordability and access to mortgage credit for current and prospective homeowners.

Fannie Mae is currently unable to fulfill its charter obligations to provide stability in the secondary market.

- Most of our incremental capacity under the OFHEO cap is presently consumed to further our HUD housing goals. Expected liquidations of about $10 billion a month may be sufficient to allow us to invest in product that furthers these goals, but won't allow us to immediately add mortgages to stabilize the market in a meaningful way.
- Further declines in yields could cause us to push against the cap even on a "do nothing" basis, although we are taking actions to remain in compliance. For instance, the decrease in mortgage yields since mid-June boosted the value of our available-for-sale portfolio by about $3 billion. That edged us closer to the cap, reducing the limited flexibility we

currently have to provide market liquidity. For a potential long-term holder such as Fannie Mae to sell into the market simply adds price pressure and uncertainty.

- Current expectation is that the GSEs will not be a backstop in the event of a liquidity crisis, a perception that could add to the instability. Analysts recently warned investors that, in light of the cap, the GSEs no longer had the powder to "corral MBS spreads." This perception, we believe, is driving spreads higher.

We are asking for the flexibility to exceed the current cap by 10 percent.

Increasing our purchases would help build a firewall against further deterioration in prime secondary market liquidity caused by rapidly widening spreads. The size of the increase must be big enough to have a meaningful impact on the market or it will be viewed by lenders and investors as a token gesture. It should also be an increase that we can prudently manage in a safe and sound manner.

Some perspective:

- In 1998, the GSE portfolios grew by about 39 percent to address market illiquidity.
- During liquidity events in 1998 and 2003, our portfolio grew by about $100 billion, which is between 1.5 percent and 2 percent of total mortgage-debt outstanding (MDO) at that time. A 10 percent increase would be well below 1 percent of current MDO.
- The increase would ameliorate illiquidity, not cure it altogether. Given that our portfolio is now a smaller component of the total market, this increment is likely a low estimate of the amount we would need to support the market if the current dislocation becomes a full-blown crisis later.
- Fannie Mae MBS purchases would also address growing negative differentiation between Freddie Mac and Fannie Mae MBS. Further pricing deterioration of our MBS relative to Freddie Mac will significantly reduce the economics of our guarantee business and harm the most liquid MBS in the market.
- Because outstanding Fannie Mae MBS is disproportionally larger than the size of Freddie Mac's guarantee book, Fannie Mae is at a competitive disadvantage with the asymmetric portfolio cap in place.
- Our increase in purchases would be targeted to provide the most effective liquidity support where it is most needed. Purchases would be concentrated in: (1) multi-family loans and CMBS where spreads have suffered due to lack of liquidity; (2) affordable loan products where Fannie Mae remains as one of a limited number of liquidity providers; (3) our own MBS product to limit further spread widening; and (4) specific pockets of discontinuity by product and/or geography.

Finally, this is a number that is both significant and comprehensible to the market, and is prudent from a risk management standpoint.

Such a step would be consistent with our Consent Order.

Our consent order with OFHEO allows for lifting the portfolio cap should the Director determine such a step is necessary to address "market liquidity issues." As outlined in this letter, we believe such issues currently exist, and could worsen. In addition, housing goals, portfolio flexibility and competitive considerations are all factors used by OFHEO when considering any request to increase our portfolio cap.

Remediation of our accounting and internal controls is largely complete.

We have filed our 2004 and 2005 10K. We expect to file the 2006 10K in August. We expect to file our 2007 10K in February, on time.

Our Sarbanes-Oxley remediation is largely complete. We have reduced material weaknesses from 25 in 2004 to four as of our 2006 10K filing. We anticipate clearing all current weaknesses this year: Two of the four require timely filing in order to clear.

We have complied with nearly all major items identified in the Consent Order, and have been in compliance with the consent order for 14 months. We have:

- Improved journal entry policies and procedures;
- Implemented key accounting systems, including the FAS 91 Amortization System, the Securities Cost Basis Subledger, the Whole Loan Cost Basis Subledger, and the Guaranty Fee Accounting System;
- Built out controller's office and internal audit department with appropriate talent;
- Separated the business planning and forecasting as well as the accounting policy functions from the controller's department;
- Created independent price verification group with the controller's department; and
- Established Business Unit CFO organization to strengthen finance/accounting in the business units.

In addition, significant portions of the threat from potential adverse litigation have been removed.

As you properly note in your July 27 letter to me, we do have additional remediation work to complete, and we continue to do so apace, consistent with good practice, the OFHEO consent order, and the ongoing OFHEO examination.

That said, our charter requires us to provide liquidity and stability to the secondary market. It is for market dislocations such as we are now experiencing that the agencies were created. It is important to have the flexibility to avert a "crisis," not merely to respond to one.

Ultimately, this request is about restoring market confidence that the GSEs can fulfill their stabilizing role in housing. OFHEO is of course a partner in this important mission. My belief is that, together with OFHEO, we can reassure investors the world over that the U.S. mortgage market has the wherewithal to maintain stable secondary market operations.

We respectfully ask that you consider this urgent request. Given the ongoing instability in the secondary market, a response from you by the end of this week would facilitate the timely release of information to the marketplace. My staff and I are available immediately to respond to OFHEO requests.

Sincerely,