



OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

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OFFICE OF THE DIRECTOR

August 10, 2007

Mr. Daniel Mudd
Chief Executive Officer
Fannie Mae
3900 Wisconsin Avenue, NW
Washington, D.C. 20016-4413

Dear Mr. Mudd:

This letter is in response to your August 1 letter requesting a 10 percent increase in the portfolio caps imposed by the consent agreement, the meetings our staffs have had over the last week, and various communications including your most recent letter of August 7. Most recently, you asked for a decision on your request as soon as a meeting held between our staffs concluded yesterday morning. Before giving you that decision I want to thank you and your team for your prompt responses to our requests for information. We certainly share your concern about the secondary housing finance market. We view the current market situation as significant, requiring both you and OFHEO to carefully assess any response to those conditions. That response and the safety and soundness of Fannie Mae are our shared responsibilities.

In my judgment, it is premature to grant the requested increase in the portfolio caps, but we will keep it under active consideration. We will also continue our daily monitoring of mortgage and financial markets and communications with your staff, as well as regular communications with other regulators and market participants. The reasons for this decision are as follows:

1. There is no limit to your and Freddie Mac's ability to securitize mortgages. Combined, that issuance has been over \$500 billion in the first half of the year. We have both agreed that, despite the increase in spreads, the conventional, conforming market is still performing well. We encourage you to continue to increase your securitization efforts which is a valuable liquidity source for mortgages.
2. Fannie Mae remains a "significant supervisory concern" as our April report to Congress states. Granted, progress is being made, but too many of our examination findings are not satisfactory, and the underlying reasons for the implementation of the cap remain unresolved. We are at least six months away from determining that you are fully remediated from the original identified safety and soundness concerns.

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3. As we have also agreed, the key problems in the mortgage market are subprime, Alt-A and jumbo loans. The latter is not in your charter and the others are not markets you can prudently assist. However, we encourage you to continue to develop programs for affordable mortgages, which may include soundly underwritten subprime and Alt-A mortgages.
4. Due to normal liquidations the Enterprises can purchase \$25 billion a month in mortgage products without increasing their portfolios in addition to unlimited securitization activities.
5. Although we have no complete, timely data, the estimate is that your fair market value has declined by more than \$3 billion this year, which is a material portion of your capital. Any potential increase in the cap would, of course, require the injection of capital to allow for the increased exposure and offset any loss in fair value due to market conditions.
6. Discussions with other regulators and some of the largest Enterprise customers and other market participants have confirmed that you have been meeting customer needs at this time and the liquidity you have been providing through your securitization activities has been beneficial.

Going forward it is imperative that we continue to work very closely with you, your team, regulators and others to monitor the markets closely. We would also like to continue our discussions about ways you can support affordable housing, both through multi-family and single-family activities. And, we will continue to work closely with your remediation teams. If you have any further questions please give me a call. I also will be sending you a copy of a letter we are sending to Senator Schumer responding to his letter on potentially increasing the portfolio caps.

Sincerely



James B. Lockhart III
Director

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