2007

OFHEO's 2007 Fannie Mae Report of Annual Examination

United States: Office of Federal Housing Enterprise Oversight (OFHEO)

Federal National Mortgage Association
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THIS REPORT OF EXAMINATION IS STRICTLY CONFIDENTIAL
This Report of Examination (ROE) has been made by an examiner appointed by the Director of the Office of Federal Housing Enterprise Oversight (OFHEO) and is designed for use in the supervision of the Enterprise. This copy of the ROE is the property of OFHEO and is furnished to the Enterprise examined solely for its confidential use. The contents of this ROE are strictly confidential and may not be disclosed to anyone not directly associated with the Enterprise. Disclosure of the ROE or its contents by any of the Enterprise's directors, officers, employees, lawyers, auditors, or independent auditors, without authorization by OFHEO, will be considered a violation of 12 CFR §1703.8 and subject to criminal penalties under 18 U.S.C. § 641.

The information contained in this ROE is based on the books and records of the Enterprise, statements made to the examiner by directors, officers, and employees, and information obtained from other sources believed to be reliable and presumed by the examiner to be correct. The examination is not an audit and should not be construed as such. Neither the examination nor the ROE relieves the directors of their responsibility for providing for adequate audits of the Enterprise.

EXAMINATION AUTHORITY AND SCOPE

Examination Authority and Reporting Convention

This Report of Examination contains the results and conclusions of OFHEO's 2007 annual examination of the Federal National Mortgage Association ("Fannie Mae" or the "Enterprise") performed under section 1317(a) of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (12 USC § 4517(a)). The OFHEO annual examination program assesses the Enterprise's financial safety and soundness and overall risk management practices. OFHEO utilizes a "CAMELSO" methodology (Capital Adequacy, Asset Quality, Management, Earnings, Liquidity, Sensitivity to Market Risk, and Operations) similar to that adopted by the federal depository institution regulators to report examination results and conclusions to the Board of Directors and to Congress.

2007 Examination Scope

Our examination activities focused on supervision provided by senior management, enterprise risk management and internal audit, corporate governance functions, credit risk levels and risk management, internal controls, information technology, accounting practices, and compliance with the requirements of the September 2005 Agreement and the May 2006 Consent Order. Our supervisory activities also included, counterparty concentration risk management, market and interest rate risk management practices, earnings performance, capital adequacy, and liquidity.

Rating

The Composite rating is 3 on a scale of 1 to 5. Entities rated 3 exhibit a combination of financial, non-financial, operational or compliance weaknesses ranging from moderately severe to unsatisfactory. When weaknesses relate to financial condition, such Enterprises may be vulnerable to the onset of adverse business conditions and could easily deteriorate if concerted action is not effective in correcting the areas of weakness. An Enterprise that is in significant non-compliance with laws and regulations may also be accorded this rating. Generally, entities with this composite rating give cause for supervisory concern, because the weaknesses create some possibility of failure and the entities require more than normal supervision to address deficiencies. Overall strength and financial capacity, however, are still such as to make failure unlikely. Definitions for all composite ratings can be found in OFHEO's Supervision Handbook.

EXAMINATION CONCLUSIONS

The Enterprise remains a supervisory concern, primarily due to the quantity of credit risk resulting from the continued market deterioration, and its dominant, adverse impact on current and future earnings. Capital levels are expected to be sufficient to absorb losses from the Enterprise's base case projections. During 2007, management achieved several milestones, and implemented fundamental to satisfactory controls in nearly all areas of the Enterprise. However, several projects are in progress but not yet complete, and many of the improvements are relatively new and require time to ensure sustainability.

The quantity of credit risk is high and increasing. The deterioration of asset quality that began in 2H06 generated significant adverse trends for the Enterprise in 2007. Further deterioration is expected for the foreseeable future, generating operational stress and a continued and unknown level of loss from loans, securities price impairment, and potentially from counterparties. To address deteriorating market conditions, management has made significant changes to better manage credit risk, including tightened underwriting standards, increased pricing, improved practices to control loan losses, and decreased servicer exposure. Despite improved practices, losses may significantly increase due to a potential glut of home foreclosures in 2008. Counterparties, which represent a significant exposure to Fannie Mae, may be unable or unwilling to honor obligations should their financial strength continue to decline.

Significant progress has been made in correcting operational and risk management issues or deficiencies, and many projects are complete. However, significant time and effort is still needed to complete the numerous remaining projects to improve efficiency and the quality of controls. Controls are often manually intensive, and full correction in some controls cannot be fully achieved until further progress is made in systems upgrades. Systems issues impact the timeliness and accuracy of some activities, and some performance and risk metrics used in reports. Model quality impacts the underwriting and pricing of mortgage loans. Many of these limitations impede the optimization of performance and risk management, and generate an expensive control structure.

Management's efforts during 2007 established fundamental controls for nearly all functions, and substantially improved the management of performance, risks, and operations. Achieved milestones in financial reporting, controls over data, systems and processes and other major projects demonstrate a proven record of success in planning, prioritizing, monitoring, and controlling projects. Areas with ongoing development but require significant effort to complete include credit model development, economic capital development, data standardization and architecture, HCD operations and risk measurement, and strengthened forecasting or scenarios for earnings and strategic planning. The completion of the process to issue timely financial statements and progress throughout the Enterprise in controls, communication, reporting, staffing, infrastructure, organizational structure, and risk measurement and management has built the foundation for accelerated progress in the future.

The Enterprise has: (1) a qualified and active Board of Directors and a management program that is largely completed; (2) operations with fundamental controls in most areas, but with deficiencies that continue to impact the speed of expansion into new products and some areas of risk and performance management; (3) improved credit risk pricing, underwriting and management but a significant deterioration in asset quality; (4) an interest rate risk program in the lower range of satisfactory due to systems capacity limitations which impede the daily production of some reports, and an aggressive level of interest rate risk in light of high credit related losses; (5) satisfactory liquidity management, satisfactory but declining asset liquidity, but the need to set a position floor for high quality non-mortgage assets, (6) deficient earnings; and (7) adequate regulatory capital levels. Current and future earnings are adversely and materially impacted by significant credit losses and continued deterioration in credit quality, as well as a decreased but stabilizing net interest margin. Structural and economic issues in the mortgage markets and the Enterprise's goal to expand activities in higher risk products heighten the importance of developing or completing several systems and credit models, interest rate risk measurement systems, and economic capital measures to better quantify risks and performance as well as stronger financial performance measurement and attribution analysis.

MATTERS REQUIRING BOARD ATTENTION

The Board should take action or provide strong oversight to:

- Ensure all aspects of credit risk are proactively and aggressively managed by monitoring:
    - ♦ Changes to underwriting standards and pricing to control the quality of products and the appropriate compensation for risk.
    - ♦ Completion of revised front and back end analytics, infrastructure, and staffing.
    - ♦ The progress in credit model development, and hiring sufficient staff for model development.
    - ♦ The effectiveness and operational capacity for controlling loan losses.
    - ♦ The level of counterparty risk, and effectiveness of counterparty risk measurement and exposure mitigation strategies.
    - ♦ The adequacy of capital levels and actions in light of high and increasing credit exposure and losses.

- Ensure the strategic alignment of management's plans and actions to ensure a coherent risk profile for the Enterprise in terms of credit, operational, pricing, models, interest rate risk, and capital levels. Strengthen forecasting and scenario analyses for earnings, capital, and other areas, as well as incorporate a broader range of market events.

- Ensure that the project to measure economic capital is completed in a timely manner.

- Monitor management's progress toward completing the significant number of projects to improve or optimize risk and performance measurement, controls, data, reports, efficiency, and competiveness of the Enterprise. Ensure budget constraints do not impede the progress of important projects and revisions to systems and data.

- Ensure management has completed an infrastructure that has sufficient data, information technology, controls, models, reports, and personnel in place before the Enterprise significantly engages in higher risk strategies.

- Strengthen policies in terms of credit limits, and guidelines for liquidity investments. Ensure management policies and written procedures in progress are completed in a timely manner.

- Ensure public disclosures clearly communicate significant financial and accounting issues, trends, and changes.

BOARD AND MANAGEMENT SUPERVISION

Board of Directors

The Board continued improvements in its operations during the year through revised policies, strengthened expertise, and better reports from and communication with the business units and independent oversight functions. Board activity included an engaged oversight of financial statements published this year, review and approval of policies and strategic plans, monitoring of internal and external audit activities, and policing itself in terms of independence and expertise. Board reports exhibit improved content and are generally satisfactory, but risk and performance metrics are less than optimal in some areas. Continued oversight is needed to ensure appropriate actions and capital levels to address credit deterioration, a reasonable balance between progress and budgetary constraints, and the prioritization, control, and completion of the myriad of projects pending over the next several years.

The Board approved the strategic plans in July 2007, which include the stated goals of leveraging charter activities and managing a higher level of credit risk. Concurrent with these goals are plans to build out controls and systems needed to manage this growth. However, the strategic plans need strengthening with better forecast and scenario analyses in such areas as earnings and capital. The Board and management took appropriate actions as deterioration in the credit market became evident. Actions included price adjustments, tightened underwriting standards, and aggressive loss mitigation strategies, as well as increased capital and reduced dividends.

Corporate policies were reviewed and revised on schedule, and were largely satisfactory. Policies were revised to conform to new format and content standards. In addition, many policy components were significantly strengthened, such as the new interest rate risk limit structure which controls Fannie Mae's specific risk profile. The Corporate credit risk policy is satisfactory, but is expected to be strengthened in 2008 with additional limits based on the allocation of economic capital. The liquidity policy was significantly improved during 2007, but requires a few revisions to comply with additional requirements, which are currently in negotiation with OFHEO, to comply with the September 2005 Agreement.

The Board structure and independence are satisfactory, and members bring the expertise necessary for evaluation and oversight of Fannie Mae's activities. Communication remains satisfactory with regular and ad hoc management presentations. Board reports were significantly improved during 2007, and reports are satisfactory for most areas with notable improvements in market risk and internal audit. However, metrics reporting is less than optimal in some areas due to systems limitations and/or pending projects which should provide completed metrics in 2008. Risk and performance measurement in several areas will not meet industry standards until the Enterprise can measure economic capital for transactions, business units, and the entire Enterprise. These deficiencies impact the quality of some reports in such areas as operational and credit risks, and risk adjusted returns.

Management

Management's supervision program has significantly progressed. Many areas have been satisfactorily or adequately addressed, but several projects and corrective actions are in varying stages of progress. The correction of data standardization and normalization issues is in its early stage, and the development of some credit models to address recent loan products and market events is lagging. The completion in late 2007 of a process to produce timely financial statements allowed management to shift its emphasis and resources to other critical projects.

Deficiencies in management have been significantly reduced in the areas of operations, controls, communication, and information used in managing risk and performance. Remaining issues or deficiencies are in varying stages of completion, and continue to have some impact on the optimization of risk and performance management. Remaining issues or deficiencies include:

- Controls for processes, data, and information technology are generally adequate but remain manually intensive with less than optimum controls in some areas. Data consolidation is incomplete, and corrective actions are in their early stages.

- Some models which contribute to the estimation of price and risk for loan products are less than optimal, and their development is lagging.

- Corporate policies are largely complete, but liquidity policies need some revision to meet new requirements.

- Management policies were substantially completed, but some policies and many written procedures are in varying stages of completion.

- Report content and format as well as risk and performance metrics significantly improved. However, not all metrics have been populated with information, and systems limitations continue to impact the content and timeliness of a few reports, with the largest issues seen in operational risk metrics and reports for the National Underwriting Center.

- All desired interest rate risk scenarios cannot be consistently produced daily due to systems capacity issues.

- Determination of levels of economic capital for transactions is near completion, but the aggregation of economic capital by function, business unit, or the entire corporation is not complete.

- The MBS trust compliance program review to ensure compliance with trust obligations is in its initial stages, with corrective actions to begin in 2008.

Management made significant progress in addressing issues in nearly all areas, and corrective projects progressed or were completed for major deficiencies in all business lines. Projects were satisfactorily planned and prioritized, completing interim solutions in many areas while long term programs to address Fannie Mae's deficiencies were being addressed. Progress varied widely due to the resource demands needed to address financial reporting. Efforts appropriately focused on the timely filing of financial statements, accounting policies, and control issues in the Controller department. Several critical projects beyond financial statements were completed. However, the focus on financial statements delayed several critical but lower priority projects needed for current production. Progress is expected to accelerate as attention and resources are moved from financial statements to other areas. Major accomplishments and progress include:

- Improved policy standardization and content. Board and management policies are largely complete. Revised delegations of authority shifted more accountability to the business units, and established a dual approval protocol which escalates disputed projects through both the CRO division and the business units.

- Completed corrective actions needed to file 10-Qs and developed a significantly manual but repeatable process which successfully met the monthly 11 day closings during 4Q07.

- Established controls that are compliant with Sarbanes Oxley requirements, and conducted risk control self assessments in high risk areas beyond financial statements to identify deficiencies and assess the risk profile.

- Established controls for information technology (IT) and many processes. Made significant progress in the re-engineering or replacement of antiquated systems.

- Databases were completed for financial reporting and largely completed for capital markets risk measurement. Completed company-wide data inventory and assessment, and initiated data standardization and controls.

- Established correction plans and project management for all key projects.

- Improved and completed the Board and management committee structure.

- Completed an assessment of management and key personnel to determine their best use, and moved several to positions more aligned with their skill sets.

- Improved metrics and reports, with remaining report production issues due to systems limitations, and report content deficiencies due to uncompleted metrics.

- Corrected the high risk issues and 70% of all issues in Operations identified by internal audit.

- Improved coordination among business units, operations and other business units, and the CRO and business units.

- Responded to the deteriorating credit environment with better pricing, tightened underwriting standards, aggressive loss mitigation practices, portfolio diversification, and higher capital and loan loss reserves.

- Improved counterparty risk analysis to be consistent with industry standards, and initiated actions to reduce risk to loan servicers.

- Completed the lean six sigma project for bond credit enhancement in HCD resulting in initiatives to be addressed in 2008, and launched the lean six sigma project for MBS trust compliance.

The expertise of management and staff has been significantly improved. Management and many key staff positions have been filled with external hires with strong skills, and by moving personnel to positions that better fit their skill sets. However, several staff positions in control and risk management functions are unfilled. Control and risk management deficiencies were often mitigated by efforts from the CRO division during early 2007, but were appropriately moved to the strengthened business unit functions by midyear 2007.

The number of contractors and personnel was significantly reduced by 28% during 2007. Contractors were materially reduced as financial statements were completed, and improved vendor management eliminated redundancies. The voluntary retirement program cut expenses, but contributed to the loss of seasoned individuals with unique knowledge in proprietary functions. The loss of some seasoned individuals significantly impacted the progress in the development of some models.

Enterprise Risk Management

The CRO division infrastructure was largely completed during 2007, and remaining issues are in the process of correction. Four separate teams covering credit, market, operational, and model validation are staffed with consistently strong personnel, although two key management vacancies in market risk have remained open for an extended period. Model validation is amply staffed. The business unit risk officer function was strengthened with greater expertise and numbers of officers, and now exhibits better integration and coordination with oversight functions and projects. Independence in metrics and report information improved with the CRO division generating several reports or validating information in several of the business unit reports it uses. However, information and risk measurement independence will not be fully resolved until the CRO division has the ability to independently run the systems and models.

The CRO division developed a strong risk oversight function during 2007, and remained a key driver in the improvement of business unit risk controls and management. The CRO demonstrated appropriate authority through active influence over business unit risk levels and practices, policy and limit development, exception reviews, and transaction review and prevention where appropriate. The CRO division appropriately continued its training and assistance for business units to strengthen their controls, reports, and risk management. CRO independence significantly improved during 2007, and is largely satisfactory. Independence remains compromised in one area due to assistance in projects for Housing and Community Development (HCD), but this issue will be resolved when these projects are completed during 2008. In addition, the development of models and risk measurement methodology for economic capital, including operational risk, has progressed, but is incomplete.

Counterparty risk oversight significantly improved during 2007 and is adequate: some programs are in progress but not yet complete. The CRO division developed a comprehensive plan to measure, monitor and control counterparty risks, and accelerated corrective actions due to deterioration in the credit environment. Limits and reports are in place, and counterparty stress tests and other analysis were strengthened and made consistent with industry standards in 4Q07. Accuracy in the aggregation of risks by counterparty is maintained with a manual process that addresses limitations in the RiskNet application.

Audit

The satisfactory Internal Audit (IA) program continued to improve during 2007. The overall quality of individual audits was satisfactory and improved during the year. IA met program goals and deadlines during the year, and successfully integrated audit activities with the external auditor. An independent review determined IA's compliance with industry standards for quality assurance and automated data analysis. Progress and accomplishments include:

- Automation was expanded, increasing the efficiency in strategic planning and individual audits. The use of automation in individual audits was increased by 70%, which has allowed for larger sample sizes, and strengthened independence from business unit analysis and reports.

- Summary reports for the Board and management satisfactorily highlight issues and root causes. Report content and format were further strengthened during 2007, with improvements including reports tailored to each business unit.

- IA resources stabilized, with turnover better than industry standards. External resources were used to help meet deadlines and provide expertise not routinely required.

- Audits in 2007 appropriately focused on controls in entity business processes. Audits conducted during 2008 will be expanded for a more holistic evaluation of entities and entire processes across several functions. Many of these audits will combine reviews of models and information technology with business audits. The change is expected to provide better insight into controls and root causes.

- The external auditor relied on eight IA audits in 2007 and has identified 27 audits for potential reliance in 2008.

Compliance

The Compliance and Ethics division (C&E) made substantial progress in building its organizational structure and initiating programs to meet its function. C&E includes the following groups: Enterprise Compliance, Ethics, Investigations, Anti-fraud and Privacy and Regulatory Affairs. Compliance with the May 23, 2006 Consent Order remained one of Fannie Mae's highest priorities. The established Program Management Office within the C&E continued to ensure coordination and consistent execution of remediation and reporting efforts.

Major accomplishments within C&E included the redesign of the Enterprise Compliance Program to apply a risk-based approach to analyzing the compliance risks associated with the company's business processes. Compliance Risk Assessments were completed for the Capital Markets, Housing & Community Development and Single Family businesses. A Chief Privacy Officer was appointed under which a Privacy strategic program plan was established. An enterprise anti-fraud framework was established to assist the businesses in assessing and addressing fraud risk. Investigations implemented a new case management system which reduced the average time needed to complete investigations and eliminated the case backlogs. In addition, as mandated in the Consent Order, the Corporate Policies and Procedures Repository (CoPPeR) was established to provide employees, contractors and regulators with access to all Fannie Mae approved policies, standards, procedures, guidelines and supporting documentation.

Accounting

During 2007, the Enterprise had to respond to various accounting challenges: material weaknesses in disclosure and financial reporting controls; timely filing of financial reports with the SEC; the issuance of new accounting standards by the Financial Accounting Standards Board; and later in the year deteriorating credit markets. OFHEO finds that Fannie Mae generally met these challenges well during the year. However, our assessment work in the accounting area is ongoing. Inasmuch as GAAP provides a considerable amount of discretion in the selection and implementation of accounting standards, there are some safety and soundness issues, which need further exploration and discussion, as discussed below. Generally, these issues are found in the valuation and quality of capital areas. OFHEO is developing accounting guidance, especially for the new standards, designed to encourage a consistent, transparent, and economically faithful implementation of these standards, for both of the Enterprises. Both of the Enterprises will be expected to adjust their approaches to adoption of the fair value option going forward, once the guidance is finalized. Following are some of the more significant issues which have been under review by OFHEO at the Enterprise:

Reported Material Weaknesses - In its 2006 Annual Report filed on Form 10K, management reported that, the Enterprise did not maintain effective internal control over financial reporting, as of December 31, 2006. Also, in the same annual report, the Enterprise's outside auditors reported that they had audited management's assessment, and opined that management's assessment was fairly stated. Since that time, the Enterprise reports that it has made significant progress in remediating its material weaknesses, and the Enterprise reported in its 2007 annual report that its material weaknesses have been remediated. During 2008 OFHEO will review the success of the Enterprise's remediation efforts. Also, during 2008, OFHEO will review the significant progress made by the Enterprise on the implementation of Section 404 of the Sarbanes-Oxley Act of 2002.

SEC Registration and Reporting - Fannie Mae, which is a registrant with the SEC, is now current on the filing of its financial statements with the SEC. In August 2007 Fannie Mae filed its 2006 Annual Report on Form 10K, and in November 2007, Fannie Mae filed with the SEC its 2007 first, second, and third quarter reports on form 10Q. Finally, Fannie Mae filed its 2007 annual report on Form 10K with the SEC on time. Going forward, OFHEO will continue to monitor improvement of Fannie Mae's accounting and disclosure infrastructure, which supports the timely filing of the Enterprise's financial statements.

Accounting Policies - Fannie Mae's management has completed an evaluation of the Enterprise's accounting policies and has provided OFHEO with most of the supporting documents responsive to the requirements of OFHEO's *Accounting Guidance*. However, our assessment is ongoing and further work will likely be required to develop complete accounting policies and procedures to meet the standards articulated in OFHEO's *Accounting Guidance*. To assess Fannie Mae' design and implementation of its accounting policies, OFHEO performed several targeted reviews during the year including: securities which have become impaired in value (FAS 115); the fair value option (FAS 159); and credit loss reserves (FAS 5), as discussed below.

Impaired Securities Accounting - In our review of the Enterprise's accounting policy on impairments, OFHEO concluded that the policy was in accord with the applicable GAAP requirements. Also, OFHEO reviewed the implementation of the Enterprise's accounting policy in this area and concluded that the firm had properly and faithfully implemented its accounting policy in this area. However, due to the current conditions in the credit markets, which suggests that further declines in the values of mortgage-related assets may occur in the coming year, OFHEO will continue to monitor the Enterprise's implementation of its impairment accounting policies in the coming year.

Fair Value Option Implementation - OFHEO reviewed the Enterprise's implementation of FAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. Our preliminary conclusions are that: the firm has documented its election appropriately; the accounting policy to implement the new standard needs to be fleshed out with more guidance for the line accounting staff; and during 2008 OFHEO should review the policies developed for the ongoing application of the standard. The latter point is important, because the Enterprise elected fair value accounting for only approximately 7% of its assets. OFHEO believes that a broader election may be possible and beneficial. Going forward, the Enterprise will have the option of selecting between mixed attribute accounting (FAS 115) and fair value accounting (FAS 159) for its new purchases of securities and issuances of debt. During the coming year OFHEO plans to work with Fannie Mae to further study its application of accounting to its portfolio of securities, to help assure that the accounting principles utilized will provide accounting results which are consistent with the underlying economics for the entire portfolio, across-the-board.

Reserves for Credit Losses - OFHEO began a review of the firm's approach to the calculation of its reserves for credit losses. Beginning in the latter part of 2007, OFHEO became concerned with the possible impact of the deteriorating credit markets upon the earnings, regulatory capital, and general financial condition of Fannie Mae and Freddie Mac. Accordingly, at the Enterprises OFHEO has paid special attention to the impact of the rising rates of delinquencies in the calculation of the loan loss reserves. OFHEO has been generally satisfied that Fannie Mae's application of the standard in providing adequate reserves and related loss recognition in the income statement. OFHEO has identified various issues to follow up on during the coming year, related to how the Enterprise has adapted its reserve calculation methodologies to the unique credit environment which came about in the latter part of 2007. For example, both Enterprises have had to make significant adjustments to their credit reserve models and their model outputs, to take into consideration the much higher default rates in connection with mortgage loans made during 2006 and 2007, as compared to earlier years. OFHEO will continue to study the reserve computations of the Enterprises, as the credit situation continues to unfold and evolve during 2008.

During 2008, OFHEO will continue to assess these and other areas.

Model Risk

Inherent model risk increased significantly during 2007 due to deterioration in the credit and housing markets, which rapidly changed conditions and increased uncertainty in projections made by credit and prepayment models. The changes in conditions have increased the potential for controllable and uncontrollable error in key model results for credit risk and pricing as well as other metrics. These potential errors could adversely impact decisions in managing credit and interest rate risk, which could further decrease earnings which are already deficient.

Business Analytics & Decisions (BA&D) appropriately focused resources on developing financial reporting models for the Get Current project. However, the resource focus on financial reporting models coupled with continued vacancies and loss of critical staff caused delays in the development and implementation of production models that represent high to moderate risk. The staff has largely produced needed ad hoc analyses to address changing market conditions, but deficient staffing levels adversely impact the ability to maintain a sustainable program to provide proactive, rigorous, and timely analysis.

Revisions of some models used for credit risk and performance were delayed. The new version of an application for pricing guaranty fees was not placed into production until the end of 2007, resulting in guaranty fee pricing based upon older models for most of 2007. Additional work is needed on credit models because some critical assumptions are based on antiquated historical data which does not fully incorporate the characteristics of relatively new loan products or market events. Model revisions are expected to accelerate in 2008 once staffing is increased, and developers released from the Get Current project return to work on production models. Ongoing work on models for financial statements is substantial, and will continue into 2008. Model deficiencies include:

- The loss severity model relies on loss data from loans made in 2002 or earlier, and does not incorporate losses from relatively new loan products or recent market events.

- The Desktop Underwriter risk assessment models are based on historical data, some from the 1990s that does not take into account new loan products or recent market events.

The model risk management program significantly improved during 2007. The control structure is well designed and full implementation of the program is nearly complete, with only minor program deficiencies remaining. Progress and achievements include:

- BA&D and the CRO division have achieved substantial compliance with the Corporate Model Policy, which sets best practice standards. Full compliance is expected in 2008.

- BA&D's model control group has achieved or made steady progress in strategic planning, model development controls, performance tracking, and project management.

- BA&D appropriately increased the number of positions in the business unit to address delays in model development and accommodate the increase in credit risk. Management has been successful in hiring many qualified individuals, but staff turnover and the increase in needed positions results in a net large number of vacancies remaining,

- The CRO division's independent model validation program is amply staffed, and validation work is meeting deadlines.

- Assumptions are reviewed by an assumption taskforce comprised of BA&D and business unit management.

ASSET QUALITY & CREDIT RISK MANAGEMENT

The quantity of credit risk is high and increasing. The deterioration of asset credit quality generated significant adverse trends for the Enterprise in 2007. Further deterioration is expected for the foreseeable future, generating operational stress and a continued and unknown level of loss from loans, security price impairment, and potentially from counterparties. During the past several years, the Enterprise relaxed some of its underwriting standards, but not as much as many other market players. Much of the recent credit losses were created from these relaxed underwriting standards. To address deteriorating market conditions, management has made significant changes to better manage credit risk, including tightened underwriting standards, increased pricing, improved loss control practices, and decreased exposure to distressed servicers. However, losses could increase due to the following:

- Despite aggressive loss control practices, there may not be a sufficient number of home buyers to avoid higher losses caused by a glut of foreclosed homes.

- Although capacity to dispose of real estate owned (REO) appears to be satisfactory, operations may be stretched by the expected increase of REO inventory in 2008.

- Servicer and insurance provider counterparties, which represent a significant exposure to Fannie Mae, may be unable or unwilling to honor obligations should their financial strength continue to decline.

Single Family Business

Loans booked in the last few years have shown relatively unchanged profile characteristics in terms of FICO score, loan to value, and level of credit enhancement. Due to recent market events, asset credit quality deterioration in the Single Family business (SF) accelerated during 2H07, with losses exacerbated by both higher volume and loss severity in defaulted loans. In response, Single Family management increased the combined allowance for loan losses and reserve for guaranty losses to $3.3 billion at YE07, with a $2.8 billion provision in 4Q07. The serious delinquency rate was 0.98% at YE07 versus 0.65% at YE06: an increase of 51%. REO increased 34% during 2007, resulting in 33,729 properties at YE07. Economic losses in 2007 were about $644 million or 1.4% of core capital, a 63% increase over 2006 at about $394 million or 0.9%. Year-over-year loss severity increased to 13.5% in 4Q07 from 11.7% in 4Q06.

In 2007, changes to existing underwriting standards for nontraditional mortgage products were made to address OFHEO's directive to implement the interagency Nontraditional Mortgage Product guidelines. SF also developed HomeStay, a lending initiative that helped distressed borrowers through initiatives such as loan modifications and credit counseling. Underwriting standards were tightened and guaranty and other fees were increased for specific higher risk loans as well as all loans guaranteed by Single Family, but several of these increases do not become effective until March 2008.

SF made significant progress during 2007, with improvements noted in many risk management functions. Build out of the risk management structure is nearly complete, but needs additional time to fully implement. Deficiencies continue in such areas as model development, and reports and staffing in some areas of credit loss management. However, most projects are largely complete, with nearly all scheduled for completion before YE08. Management implemented a comprehensive business transformation strategy in 1Q07, which focused on strengthening the risk management framework in such areas as reports, risk measurement, policy and limits, delegations and authority, and operational efficiency and controls. Accomplishments and progress include:

- The SF Credit Risk policy, and many related sub-policies and limits were completed in 2007, and are expected to be implemented during 1Q08.
- The new governance structure is complete for the Credit Risk department, the CRO division, and Board and management committees.
- Departments for servicer management and loss mitigation practices implemented an improved loss control program. Reports for REO are satisfactory. Operational constraints from increased work volume are being mitigated through outsourcing.
- Expertise has been strengthened throughout management and much of staff, including those with servicing and subprime experience.
- Assumptions based on outdated loan samples are used in underwriting criteria and some models used in pricing credit risk. Underwriting standards and credit models were significantly improved during 2007, and the correction of these issues is scheduled for completion during 2008.
- The loan loss model is current, and was validated as each year's financial statement was completed.
- Enhancements or corrections for issues or deficiencies in systems for sales management, and loan execution and securitization are scheduled for completion in 2008.
- Contract provisions are being reviewed to improve Enterprise flexibility in applying risk-based prices.

Housing and Community Development – Multifamily Business

The multifamily portfolio's problem loans were a low impact to earnings and capital during 2007 with a low and stable delinquency rate at 0.08% of the total portfolio: this ratio remained unchanged during 2007. Credit related expenses were $9 million or 0.02% of capital, compared to $5 million or 0.012% during 2006. The low loss and delinquency rates are due to favorable sales on REO and investor contributions to credits with debt service coverage ratios of less than 1.0X. Watchlist assets remain high but decreased slightly to about $13 billion or 10.6% of the total book of business at 3Q07. The debt Watchlist is largely comprised of $1.6 billion or 12% of loans with documentation issues, and $6.3 billion or 45% that have inadequate debt service coverage as of 3Q07. However, inclusion of loans with documentation errors likely overstates problem loans because the documentation errors are not necessarily performance issues. Watchlist loans rated loss, doubtful, substandard or special mention totaled $5.6 billion at 3Q07.

Deficiencies or inefficiency in HCD stem from fragmented systems and manual processes, and issues in risk identification, measurement, management, and controls which are being satisfactorily addressed in pending projects. Data accuracy relies on a manually intensive process which reconciles data among numerous single purpose systems. This process is repeatable, and meets the fundamental requirements necessary to conduct business. The systems limitations and manual process introduce key person dependencies and continue to adversely impact the content and timeliness of some reports. Deficiencies or issues outstanding at YE07 include:

- Fundamental controls are in place for systems and data quality which meet Sarbanes Oxley requirements, but require strengthening in other areas.
- Systems and tools used in linking risk and pricing are deficient, requiring a higher level of judgment in pricing.
- The Credit Review function was significantly improved, but remains incomplete and under staffed. The revised DUS Guide was introduced before Credit Review was fully implemented.
- Many reports lack sufficient granularity and/or qualitative analysis. The report showing performance metrics for 3Q07 was not released until December 2007.
- The Watchlist contains loans with documentation issues as well as performance issues. This combination impeded the report's use in monitoring problem loans. However, the Watchlist Management group implemented a plan in 2007 to identify and manage the criticized loan portfolio.
- Internal review was not consistently applied to pre-reviews of loans in which no loss is shared with the lenders. Justification for waiving site inspections on non-delegated loans was not consistently documented in the files.

HCD made significant progress in addressing deficiencies in technology, controls, reports, credit review, asset management, and risk rating of loans, with several milestones achieved by YE07. However, significant efforts will be needed to fully address all issues and inefficiencies. Fundamental controls are in place for technology and processes, and reports now provide most information needed to adequately manage performance and activities. The CRO division, HCD management, and a dedicated IT project manager coordinated to establish controls and implement a program to address deficiencies in risk ratings, and quality control over both underwriting and credit loss management. In addition, the Project Future taskforce provides project management for HCD's top 10 control deficiencies. Accomplishments and projects in process include:

- Corrected deficiencies in AD&C, but an issue regarding charter compliance remains outstanding while HUD concludes its Financial Activities Review.
- Completed the rewrite of the revised DUS Underwriting Guide, which strengthened credit risk assessment, and made it more responsive to changes and trends in the market.
- Fully implemented delegations of authority across HCD.
- Completed policies and written procedures.
- Completed the manual risk rating of all loans within AD&C. Implementation of risk rating templates and more robust risk rating methodologies for all HCD products is scheduled in 2008.
- Improved risk management staffing levels and expertise, and remains diligent in filling remaining vacancies.
- Strengthened Credit Review's analyses, and began a new credit review process.
- Implemented a plan to identify and manage the criticized loan portfolio. Strengthened the analysis of potential risk in the multifamily debt portfolio, and employed a more proactive management of the risks.

- Launched the initiative to improve or replace systems and the servicing platform. The systems improvements will significantly improve efficiency, risk management, and report content.
- Completed upgrades to the Construction Loan Control System (CLCS) in January 2008.

Retained Mortgage and Liquid Portfolios

At YE07, the Liquid Investment Portfolio (LIP) exhibited good quality with 21% AAA, 7% AA, 10% A rated securities, and 62% in short term securities rated P-1. However, total portfolio size and the amount of short term securities varied significantly during the year to help meet capital requirements and deploy excess regulatory capital, temporarily reducing the amount of higher quality products available for liquidity purposes.

In the retained portfolio, asset quality is satisfactory. Product default losses are controlled by collateral, insurance, and/or first loss coverage. Losses from impaired value totaled about $890 million, and were predominantly from manufactured housing securities. However, recent market events may require recognized losses in private label securities (PLS) that could exceed $2 billion if the securities are ever deemed to be permanently impaired. Virtually all PLS were rated AAA at origination: 0.5% of the portfolio is comprised of subprime PLS with investment grade ratings below AAA at origination, which were booked as trading securities in a pilot program. Traditional single-family fixed-rate mortgages and securities collateralized by them represent about 44% of the portfolio, and all fixed rate product represents about 70%. ARMs, floaters, hybrids, and multi-family product are about 30%. PLS and CMBS are about 13% of the portfolio and is mostly comprised of floating rate product. Some of these categories overlap.

Systems enhancements during 2007 improved management's ability to analyze and proactively manage the portfolio. Weekly and daily reports generated by the new TRI system now contain significantly more granularity and provide data on product sub-sectors of the portfolio. However, accounting and operational constraints impede active management of whole loans, potentially impacting return optimization. Although some improvements were made to the Portfolio Pooling System (PPS), there are still portions of the whole loan portfolio that cannot be readily securitized due to remaining system constraints. Changes to PPS are in progress to improve its securitization capabilities during 2008.

PLS management has improved significantly with revised policies, pre- and post-purchase analytics, and timely management reports. However, 20% of the PLS purchased from the beginning of 2006 through midyear 2007 did not comply with policy concerning unapproved or terminated counterparties, indicating a control deficiency in one or more business functions. In addition, the pilot program appropriately controlled the risks in PLS rated below AAA (PLSBA) with a $750 million position limit, and close oversight which terminated the program when losses significantly increased. Although Capital Market Strategy effectively analyzed and identified 23% of the PLSBA portfolio prior to a rating agency downgrade, none were sold. The CRO remains a key driver in incorporating industry standards and the use of benchmarks in portfolio management.

Enterprise Counterparties

Risk from counterparties and concentration in similar types of counterparties represent a significant risk for the Enterprise. Risks from servicers, and mortgage and bond insurers increased due to recent market events which have contributed to bankruptcies for some industry players and an overall deterioration of counterparty financial strength. The top ten servicers processed 74% of the Single Family mortgage credit book of business (BoB) at YE07. The largest servicer, Countrywide, serviced 23% of the $2.7 trillion single family mortgage credit BoB at YE07. Mortgage insurers also represent a significant level of counterparty risk for the

Enterprise, with the seven largest companies providing insurance over 99% of the Enterprise's total coverage, or $521 billion insurance-in-force.

Counterparty risk management significantly improved during 2007, with many projects accelerated in late 2007 to help address increased exposure from recent market events. Several best practices were implemented for several troubled counterparties in response to the mortgage crisis. The CRO division expects to implement many of these same risk mitigant controls and techniques for all counterparties over time. The counterparty risk management function was centralized in the CRO division, consolidating the review and approval process and eliminating the previous fragmentation of separate approvals within each business unit.

Counterparty management deficiencies are centered in risk measurement and aggregation, deficient staff levels, and risk management controls that will take time to fully develop and implement. The CRO division developed but has not yet fully implemented its plan to measure, monitor and control counterparty risks. Limits and reports are in place, and manual processes are used in conjunction with the results from RiskNet to ensure that the aggregation of each counterparty's risk include all types of exposure. Most types of exposure are reasonably estimated, but the methodology to estimate exposure has not been finalized for some risk factors. Issues in RiskNet data entry and risk methodology are in the process of correction. In addition, staffing vacancies represent 24% of approved staff levels, impeding progress in some areas.

The new counterparty risk management program includes regular financial statement analysis and on-site visits, and stress tests with scenarios more conservative than those used by rating companies. In addition, new controls reduce exposure to distressed servicers through collateral and/or frequent collection of mortgage payments, servicer commitments to accept loan processing transferred from distressed servicers and the reduction of As Soon As Pooled (ASAP) funding in the latter part of 2007. Although collection of losses on loans covered by "reps and warrants" contracts has improved, this represents a potentially increasing servicer exposure should the financial strength of some servicers deteriorate further.

OPERATIONS

During 2007, management built an effective infrastructure and approach to implement or strengthen controls. Controls were significantly improved, achieving by YE07 adequate controls over operations processes, information technology (IT), and data used in financial statements and many areas in capital markets. Data assessments completed by the Enterprise and a consultant indicate that overall data quality and controls are adequate, but these efforts were completed in late 2007 and OFHEO could not verify this before YE07. Many controls remain manually intensive and generate a higher potential for error, but prevented excessive problems or losses during 2007. New controls implemented during 2007 for such areas as financial statements and improved automation for some systems have been shown to be reliable for up to two quarters, but need additional time before sustainability is proven.

The strength of internal controls ranges from satisfactory to adequate. Controls are manual but achieved management's objectives, which was validated by testing for Sarbanes Oxley requirements and other monitoring programs. Controls are generally satisfactory for processes with little dependence on systems. However, controls which rely on systems or automation were sometimes less than optimum. Many of the work around solutions are successful, but are redundant and/or require large numbers of individuals to complete processes, such as the reconciliation of databases or reports. Operational controls and efficiencies should improve over the next two years as systems are revised or replaced. Control and efficiency issues include:

- Manually intensive controls prevented excessive losses during 2007, but in some cases created key person dependencies, inefficiencies, and are in some cases ultimately unsustainable over the long term.

- The implementation of data architecture and consolidation beyond the financial statements is in its early stages. Several aspects of data consolidation are dependent upon the pace of systems revisions or replacements that will occur over the next several years.

- Limitations in some systems continue to impact the content and/or timeliness of some reports, with the largest impact in HCD and in some functions in the Single Family business unit. Many of the reports used by the Chief Risk Officer division are produced by the business units, but the CRO performs quality control reviews for many of these reports.

- Deficiencies in some systems contributed to errors. Manual processes designed to compensate for these systems deficiencies failed in some instances. One example is the PPS system, which contributed to the failure to securitize $600 million in whole loans.

- Metrics reports are comprehensive for IT, adequate for operations processes, but incomplete for the CRO's Operational Risk Oversight group. A full complement of risk metrics should be completed in 2008.

During 2007, management made substantial progress in addressing internal controls and other operational weaknesses. Internal controls are adequate in many areas of the company, while several projects in systems and data are in varying stages of completion. Programs which were largely initiated in 2006 were expanded and prioritized, resulting in controls for key areas, and a strengthened foundation for continued improvements over time. Improvements were noted in policies, project management, organizational structure, and staff expertise. Management demonstrated its ability to successfully plan, monitor, control, and complete a high volume of large and complex projects or initiatives. Major areas of improvement or accomplishments include:

- The Restatement, Catch Up, and Get Current projects were satisfactorily controlled and completed, using end-to-end work streams and strong project management. Completion of financial records met the monthly 11 day close deadline without significant difficulties during 4Q07. The integration of Get Current and production operations and databases was successfully completed.

- The SOX review is not complete, but areas reviewed indicate that controls for the financial statements are satisfactory but inefficient. The failure rate in SOX testing is less than 5%, which is consistent with SOX compliant companies.

- Over 70% of deficiencies in Operations noted by Internal Audit and OFHEO have been corrected, with most of the corrective actions focused on high risk areas.

- Operations and Technology established or improved manual or automated controls for processes and IT, and successfully addressed access control deficiencies.

- The business unit, executive management, and committee oversight structures are in place. The Technology and Data divisions were consolidated in late 2007 to improve coordination in these functions.

- The CFO, CRO, Internal Audit, and Compliance divisions have coordinated the independent oversight of operational activities, and established functions to review compliance with SOX requirements, and industry standards for other internal controls.

- Board policies for Operations are current and adequate. Management policies and written procedures used to communicate and standardize operational controls are complete in most areas, and are expected to be finished during 2008.

Information Technology

Technology established an effective organizational structure and governance program which implemented IT controls and provided a foundation for further improvements in controls, efficiency and value. Plans were prioritized and standardized, and addressed necessary application and systems changes through 2010. These changes will correct recognized deficiencies in an inflexible and expensive architecture, which includes silo applications, poor system integration, obsolete technology, and an overreliance on End User Computing (EUC) applications. Dedicated project managers coordinated with business units to ensure projects remained on track and met business requirements. The IT Executive Board, comprised of executive management from the business units, provides a centralized prioritization and approval of all major expenditures in IT and other projects company-wide. Resources remained strained throughout 2007 due to the cumulative effect of maintaining normal business operations while also completing financial statement remediation and addressing operational deficiencies.

Technology successfully remediated internal control weaknesses, reduced the cost and complexity of the technology environment, and improved financial and operational discipline. Major multi-year initiatives are underway to re-engineer or replace several legacy applications, and streamline the technology infrastructure. Eight of the top ten remediation initiatives are on track, with delays in two caused by additional work needed to complete projects for the timely filing of financial statements by YE07.

Legacy applications provide stable performance for traditional loan products and portfolio transactions, but adversely impact the content and timeliness of performance and risk management information in some areas. The IT infrastructure remains complex but now provides satisfactory reliability: no major operational incidents or IT outages occurred during 2007. Pervasive access control issues were remediated by 3Q07. Adequate controls over IT are in place, and will improve over the next few years as systems are revised or replaced. Operational effectiveness is monitored through monthly metrics reports.

Business continuity and crisis management are well controlled. Recovery plans satisfactorily address redundant data, systems, and locations. The primary location for processing critical payments-related transactions is rotated monthly between the primary and backup locations to ensure readiness is maintained. A tertiary site is out of region, and meets the more stringent industry standards established after September 11, 2001. Efforts are now focused on building a back-up environment for the financial reporting applications. The transfer of critical financial reporting applications to a back-up facility will create a brief and low probability deficiency during 1Q08, but one that would have a significant adverse impact should an event occur. The Enterprise acknowledges this risk and is mitigating the concern.

Data

Enterprise Data established a comprehensive data governance and management framework, and addressed data issues for financial statements with the implementation of the Accounting Data Warehouse (ADW). In addition, data quality improvements were made to support Capital Markets risk management with the build out of the Financial Data Warehouse (FDW), and the Portfolio Data Service (PDS) which supports the Total Return Infrastructure (TRI). Efforts appropriately focused on assuring data used in financial statements and interest rate risk management was accurate, complete, and timely. Projects supporting remediation of data issues in other areas of the company are in the early stages.

Enterprise Data completed the first phase of a company wide critical data inventory and quality assessment. Work to date indicates the majority of the data meets the needs of the business and trusted sources contain sufficient critical data needed for the operation of the business. However, there are numerous, unintegrated databases in use throughout the company. In many cases, significant resources are needed to manually reconcile related data in multiple databases to ensure consistency and reasonable accuracy in the numbers used to manage risk, performance, and operations. Enterprise Data has launched a multi-year project to set data standards, and consolidate data in fewer databases to a few that provide a complete and consistent set of data for use company-wide. Progress in addressing data deficiencies is partly dependent upon the pace of systems re-engineering or replacement, driving the timing for full correction to two or more years.

Internal Controls

Operations

Operations has established an effective infrastructure and completed much of the program to identify, control, monitor, and report operations risks. Adequate controls have been implemented over most processes. These controls are the best possible in the current systems environment, but cannot fully mitigate risks until key systems and applications re-engineering or replacement is complete. Controls are better in Capital Markets Operations, but of lower quality in operations overseeing HCD and Single Family operations. Management recognizes deficiencies in MBS trust compliance, and expects to begin corrective actions during 2008. The voluntary retirement program decreased staff levels by 15% during 2H07, with the largest adverse impact to Single Family operations. Operations made significant progress during 2007 in such areas as:

- 70% of all Operations audit findings were closed during 2007, with the remainder expected to be resolved in 2008. No audits completed during 2007 were rated “red.”

- Pricing methodology improvements for use in financial statements met 2007 goals, with efforts to provide real time pricing continuing into 2008. Final prices for financial reporting are verified by Independent Price Verification (IPV) with disputes resolved by the CFO. There were no disputes in 2007.

- Policies were completed by YE07, with written procedures expected to be completed in midyear 2008.

- Reports were improved to provide a Board report package, monthly operations metrics package for management, and daily reports on transactions, transaction volume, settlements, and MBS activity.

Operational Risk Oversight

The CRO’s Operational Risk Oversight (ORO) has established its infrastructure and a fundamental program for risk identification, measurement, mitigation, monitoring, and reporting. Significant progress was made during 2007, although the program will require two more years to fully refine and complete. The oversight program is being designed to comply with the Basel 2003 Supervisory Guidance, which stresses a risk based approach. ORO met its commitments for the first year in its three-year operational risk oversight plan. The second year, 2008, will refine risk measurement, control techniques, and reports initiated in 2007. Third year objectives include the completion of a database and a more quantitative measurement of operational risk for both operations management and economic capital as well as a reassessment and realignment of the operational risk program. Accomplishments and progress include:

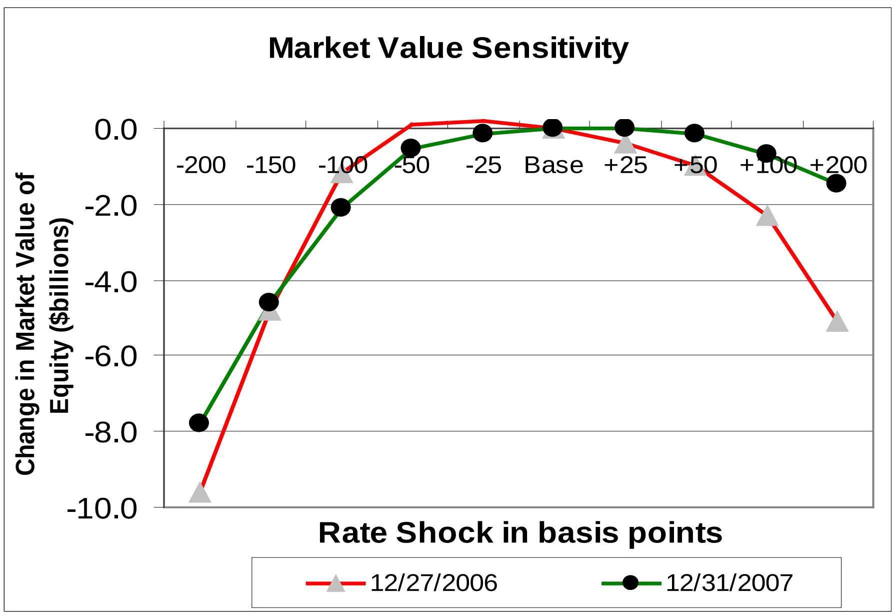
- The ORO foundation is complete, with structure and staffing in place.

- The risk assessment framework is largely complete. Risk control self assessments (RCSA) were completed during 2007 in Capital Markets, HCD, Single Family, and Operations business units, with RCSAs for Technology started in 2007 and scheduled for completion in 2008.

- Business unit level reporting and corporate reporting were completed in 2007 using data available. Reports will be expanded to cover key risk indicators, and an operational risk dashboard report, and are expected to be in use during 2008.

SENSITIVITY TO INTEREST RATE RISK

The overall program for interest rate risk (IRR) is in the low range of satisfactory. Risk management activities, reports, and communication are satisfactory. However, the risk management strategy, exposure levels and some limits are aggressive in light of higher and increasing credit related losses. Interim milestones in systems and data upgrades achieved during 2007 significantly improved the accuracy of interest rate risk measurement, increasing the accuracy of management decisions in controlling IRR during 2007. However, Capital Markets uses a risk measurement system with capacity issues that impedes the consistent daily production of the significantly increased number of scenarios desired by management and the CRO division.



The portfolios and related funding unhedged by derivatives represent a high level of risk. Hedged interest rate risk is moderate in terms of capital exposure, but represents a potentially significant, adverse impact to already depressed earnings. In addition, the widened spread between the fair value of assets and liabilities had relatively little impact on actual cash flows during 2007, but significantly reduced the net fair value of the Enterprise. Exposure and limits include:

- The Board limit for the market value of equity (MVE) sensitivity is -$9.5 billion or about 30% of MVE. MVE sensitivity for shocks of +200bp and -150bp were -$1.5 billion or -5% of MVE, and -$4.6 billion or -15% respectively at YE07.

- The Board limit for value at risk (VaR) is -$4.5 billion, with the intent to control losses to less than one year of normal earnings. Although the Enterprise reduced the actual VaR to $640MM at YE07, this amount likely remains a significant impact to 2008 earnings, which are expected to be well below normal earnings.

- Board advisory thresholds for fair value peak to trough losses were exceeded during most of 4Q07, and widened spreads during 2007 reduced the net fair value of the Enterprise by more than $9 billion post-tax. Spread risk is high, causing a $2.6 billion decline in net fair value for each 10bp widening in the mortgage option adjusted spread (OAS).

The reliance on delta hedging, and the level of the convexity limit can contribute to a potentially higher level of volatility in both economic and Generally Accepted Accounting Principles (GAAP) earnings. Delta hedging is used to hedge the portfolio's duration and convexity through the active purchase and sale of swaps in an attempt to replicate the performance of swaptions. This reliance could require access to significant amounts of swaps during a period of major market stress that could impede rebalancing efforts.

Management appropriately measures the IRR from the retained portfolios and funding, but does not also include IRR for the entire GSE within its regular, internal IRR management reporting process. The current measurement covers the retained portfolios and related funding, but does not include the cash flows from the guaranty fee business or expenses. The integration of all accounts would allow management and the Board to understand the full impact of IRR to economic earnings and capital.

Improvements to models, data, and assumptions implemented near the end of 2007 significantly improved the accuracy of IRR measurement, increasing the effectiveness of management decisions in controlling IRR. Data improvements include the use of more detailed product attributes as well as more granular, real time data on loans and securities at the CUSIP/transaction level. These changes in data have improved prepayment and cash flow modeling. In addition, systems changes permit the use of daily prices for financial instruments, allowing the production of more frequent risk reports and eliminating the use of a settled book that was up to three months old. In addition, some prepayment models were validated or reviewed by the CRO division, and the user acceptance found no significant errors. However, remaining systems capacity limitations create some delays in system results, which impede fully effective interest rate risk and performance measurement and management. These issues also impact the production and accuracy of daily attribution analysis, interest rate risk measurement, and risk reports used in delta hedging. Remaining inefficiencies or deficiencies are expected to be addressed in 2008, and include:

- The Total Return Infrastructure (TRI) has insufficient capacity to consistently run a daily measurement of IRR using the granular data now available for the significantly increased number of scenarios now requested by management and the CRO division. Standard risk calculations are prepared. However, the source/reason for some daily variances noted in the daily risk report could not always be easily determined.

- Issues or deficiencies created some degree of inaccuracy in the measurement of pre-tax MVE and the intra-month duration gap.

- Risk reports are manually produced from systems' results, requiring significant resources and increasing the potential for error in information used in management decisions.

- Capital Markets Pricing conducts monthly pricing on all assets for financial reporting, which is also used in month end risk management. Capital Markets Strategy provides frequent pricing for liquid products but less than fully comprehensive pricing intramonth for less liquid products. More frequent, comprehensive pricing would improve the accuracy of profit/loss attribution analyses.

The Board and management policy limits provide a comprehensive risk control structure. In 2007, the Board approved the Market Risk Limit policy which defines responsibilities and provides a set of limit types which satisfactorily control and communicate Fannie Mae's IRR profile. The Board limit structure provides limits for VaR, convexity, spread sensitivity, and MVE sensitivity to larger rate shocks. The management policy has sub-limits for each of the Board limits. In addition, management policy has five additional limits to formally control the components of IRR. The Chief Risk Officer division revised management's market risk policy in late 2007 to better address roles and responsibilities, and escalation practices when limits are exceeded.

Management continues a program of satisfactory risk management practices, and communication of IRR. Risk is controlled and communicated through daily or weekly meetings with management and risk committees. Board and management reports provide an effective portrayal of the risk profile for major sources of IRR by showing limit compliance, scenario analysis, and other risk information. Management's analysis, awareness and communication of risks were strengthened in late 2007 when risk measurement accuracy improved and variances between daily risk measurements became more traceable. The CRO produces a daily profit/loss attribution analysis independent of Capital Markets, and expects to improve its accuracy and comprehensiveness during 2008. Capital Markets and the CRO continue to discuss Capital Market's generation of a daily profit/loss attribution, which will allow Capital Markets to achieve best practices in understanding and managing risks, as well as explain and improve performance.

LIQUIDITY

Liquidity risk is low due to satisfactory asset liquidity relative to net cash needs and effective management which is in the process of further enhancing policy, reports, and operations to strengthen controls and communication. Liquidity is satisfactorily managed with liquidity issues appropriately escalated through key management, the CRO, and committees based on set triggers.

The Liquid Investment Portfolio (LIP) and the more liquid securities in the retained mortgage portfolio provide sufficient coverage of FNM's net cash needs within 90 days at about 1.3x at YE07 using conservative values for the securities. However, coverage from assets that quickly generate funds during stress events declined for year ending December 31, 2007. Management continues its analysis to determine the impact of more than $100 billion in sales or repurchase agreements (repo) during a 90 day period. Asset liquidity places a high reliance on repos. Fannie Mae transacts its repurchase agreements using a tri-party arrangement which provides Fannie Mae some anonymity.

Agency MBS readily accepted by the market for sale or repo during stress events declined during 2007, while less liquid securities and whole loans increased. Whole loans represent decreased liquidity because these loans cannot be securitized quickly due to systems limitations. Positions and trends include:

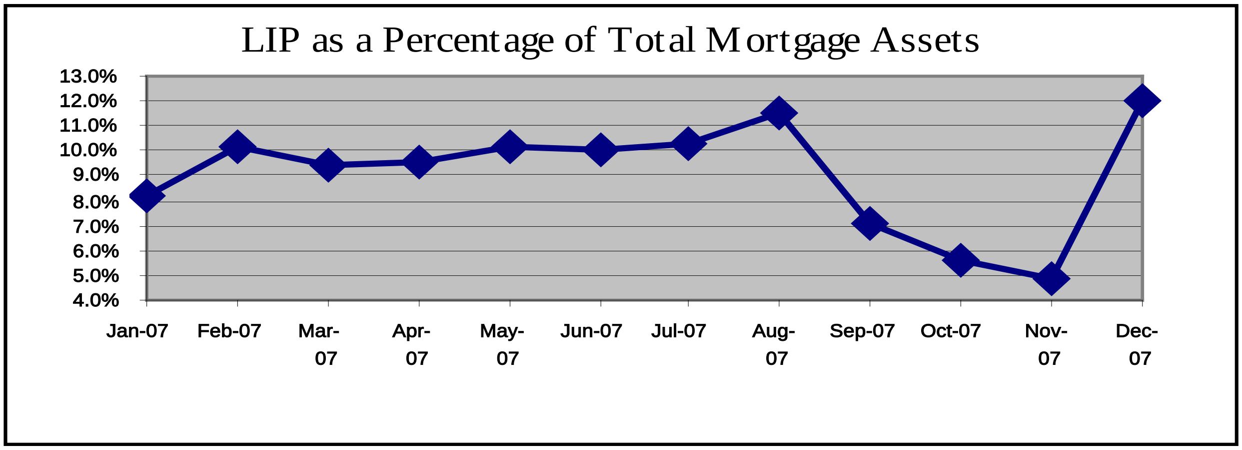
- Fixed rate 15 and 30 year MBS readily accepted for sale and repos totaled about $155 billion or 22% of the $728 billion mortgage portfolio at YE07. These MBS provide 1.26x coverage of the $123 billion in YE07 net cash needs over 90 days, and 1.07x coverage with the CRO-approved 15% decline in book value to conservatively estimate stress event values in these securities.

- Mortgage loans increased 16% during 2007 to $323 billion or 45% of the mortgage portfolio. This increase includes an additional $81 billion of securities classified as whole loans at YE07.

The LIP provided at least two weeks coverage of 90-day net cash flows throughout 2007, and remained above 5% of portfolio assets except for a few weeks near YE07. However, the outstanding balances in LIP varied significantly. The decline was generated in part to manage capital constraints and help meet regulatory capital requirements. Key positions, trends, and credit quality include:

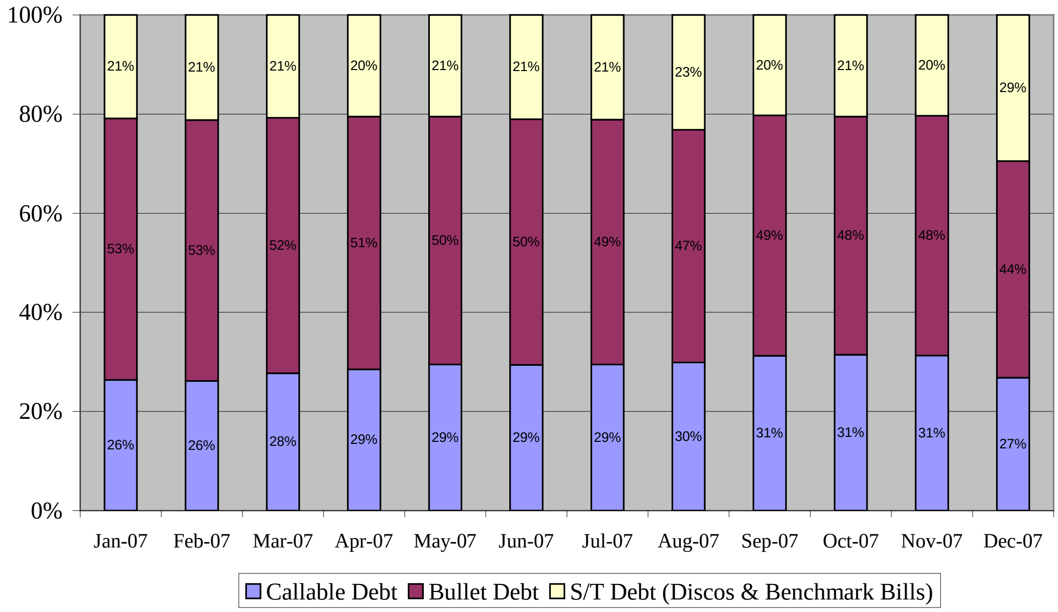
- Assets in LIP declined 57% from August 2007 to $35 billion ($5 billion in short term securities, $30 billion in long term) in November 2007, but increased to $93 billion by YE07.

- The LIP was primarily comprised of bank deposits, with longer term securities comprised of corporate and asset backed securities in late 2007. At YE07, 62%, or $57.8 billion, of the LIP consisted of high quality, short term securities with a rating of P-1. The remaining $35.6 billion represent 21% AAA, 7% AA, and 10% A rated securities in the total portfolio.



Debt composition was stable through the year until 4Q 2007 when rates decreased significantly and Fannie Mae exercised its calls on callable debt. This long term debt was replaced by short term discount notes. Discount notes outstanding also increased because of excess capital deployment in the LIP.

Fannie Mae Funding Composition



Debt composition (book value in $ billions)

	12/31/2006		12/31/2007	
	Book Value	Remaining Term to Maturity	Book Value	Remaining Term to Maturity
Short Term	165	78 days	235	74 days
Callable	191	6.8 years	213	8.0 years
Bullet	403	3.7 years	342	4.2 years
Total Debt	768		791	

Revised corporate policies and a corporate level liquidity risk limits were approved in early 2007. The policies and limits provide guidance for responsibilities, short term funding, credit quality standards for LIP securities, and the use of a severe scenario which assumes no new debt issuance for 90 days. During 2007, management agreed to further revise limits and controls which limit the maximum amount of liabilities maturing each day at $20 billion, provide a more conservative credit quality standard for LIP securities and amend the LIP policy to prohibit 144A securities as a source of short-term liquidity. To meet the remaining liquidity requirements in the September 2005 agreement, both GSEs expect to finalize consistent requirements concerning minimum net cash flow coverage requirements for non-mortgage securities in early 2008. Further policy revisions expected during 2008 include:

- Short term, flight-to-quality securities to cover net cash flows for a defined time period.

- Separate LIP security type and management requirements for securities used to meet liquidity needs versus securities for excess capital deployment.

Processes and controls for obtaining asset liquidity are satisfactory. Remaining operational inefficiencies in the repo funding process are minor and a total of $23 billion in securities are held at two independent custodians to mitigate residual inefficiencies and eliminate any potential for delays in access to securities. Cash management processes are satisfactory due to the automation of cash forecasting which provides real time monitoring of receipts and disbursements. Manual controls for wire transfer are adequate, but won't meet industry standards until operations are fully automated.

Liquidity is satisfactorily managed with liquidity issues appropriately escalated through key management, the CRO, and committees based on set triggers. In addition, management successfully implemented semi-annual exercises to refine its decision making and escalation procedures in the event of a liquidity crisis. LIP securities will be recorded at market values beginning in January 2008, increasing the transparency in the value of assets available for liquidity and reducing the reluctance to sell securities which exhibit a large loss when compared to their original book value. Reports used in the day to day management of liquidity are generally satisfactory and include cash flow forecasts and funding maturity concentrations. But during most of 2007, the stress test report, which shows asset coverage for net cash flow requirements over 90 days, inappropriately included whole loans which cannot be easily liquidated or securitized in a short timeframe.

EARNINGS

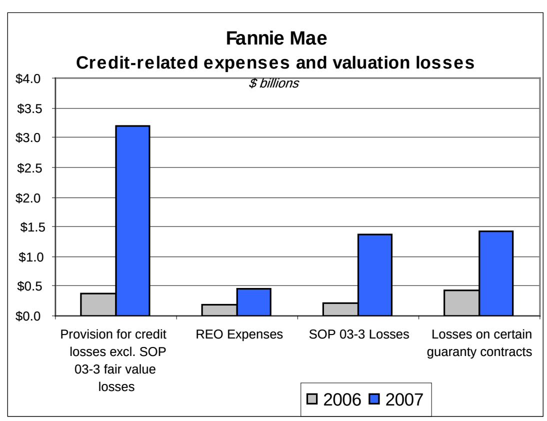
Financial performance was poor for 2007. A confluence of market and company specific factors – deterioration in the housing and credit markets, substantial declines in interest rates in the second half of the year, and replacement of maturing debt – resulted in Fannie Mae reporting a GAAP net loss of $2.1 billion. Fannie Mae has not reported an annual net loss since 1985.

GAAP Financial Performance

Pre-tax income declined by $9.3 billion as a result of substantially higher credit related expenses, higher losses on derivatives and lower net interest income, partially offset by higher guarantee fees and lower administrative expenses.

- Credit-related expenses and valuation losses increased by $5.2 billion as the impact of the deteriorating housing and credit markets in the second half of the year was reflected in:

- Provisions for credit losses (excluding SOP 03-3 fair value losses), which increased $2.8 billion, driven by higher reserves for loan losses, and higher net charge-offs from overall weakness in the housing markets.
- Unprecedented mark-to-market losses on delinquent loans purchased out of trusts (SOP 03-3 fair value losses) of $1.4 billion, driven by substantial declines in market prices for such loans;
- Losses on certain credit guaranty contracts, which increased $1.0 billion, driven by higher expectations of future default costs; and
- REO/foreclosure expenses, which increased $0.3 billion, driven by higher REO volumes and declining sales prices on foreclosed properties.



- Losses on derivatives increased by $2.6 billion as the impact of declines in interest rates were reflected in lower market values for the derivatives portfolio. Potentially offsetting changes in the value of assets and debt were generally not recognized in earnings because of accounting rules.

- Net interest income decreased by $2.2 billion reflecting the impact of short-term liability rollover and maturing long-term debt being replaced by higher cost debt.
- Guarantee fee income increased by $0.8 billion driven by strong growth in the volume of MBS and guarantees of 15.2%, and an increase in the average effective guaranty fee rate. In 2007 guarantee fee income surpassed net interest income as the largest source of revenue.
- Administrative expenses decreased by $0.4 billion driven by reductions in staffing and consulting expenses.

The net loss in the third quarter and further declines in long-term interest rates in October and November depleted capital sufficiently for management to take action by selling assets, issuing preferred stock, reducing the common stock dividend and implementing other changes to business practices to reduce losses and expenses.

Fair Value Financial Performance

Financial performance measured from a fair value perspective also suffered considerably. The fair value of net assets declined by $7.9 billion to $35.8 billion as substantial increases in option-adjusted spreads reduced the value of mortgage assets, and weakening in the housing and credit markets increased expectations of future default costs. The fair value of net assets attributable to common stockholders declined by $14.3 billion to $20.4 billion.

CAPITAL

OFHEO's Office of Capital Supervision formally classifies capital adequacy quarterly in accordance with Subtitle B of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 and with the requirements set forth in OFHEO's minimum and risk-based capital regulations. The Enterprise is required by Federal Statute to meet both minimum and risk-based capital standards to be classified as adequately capitalized. Fannie Mae also remains subject to an OFHEO-directed capital requirement imposed by the Consent Order dated May 23, 2006 and the Capital Restoration Plan approved February 17, 2005. Fannie Mae, upon achieving the initial September 30, 2005 thirty percent surplus over the statutory minimum requirement, has maintained that surplus throughout 2007.

OFHEO classified Fannie Mae as adequately capitalized for year-end 2006 and for all four quarters in 2007. [1] Fannie Mae's capital classifications are consistent with publicly disclosed financial data through the fourth quarter 2007. As of the third quarter 2007 Fannie Mae hit a milestone by returning to current quarterly financial reporting for the first time since the second quarter 2004. The capital classifications, unlike those cited in the 2006 Report of Examination, are no longer based upon estimates provided by management but publicly certified financial statements. While OFHEO classified Fannie Mae as adequately classified during these periods and recognizes the milestone of returning to timely quarterly financial reporting, risk to capital increased dramatically during 2007, primarily because of market and credit risks, which directly impacted capital through reduced current and future earnings.

Fannie Mae's core capital surplus as a percent of the OFHEO-directed requirement declined throughout 2007, with the most significant impacts realized during the latter half of the year. This

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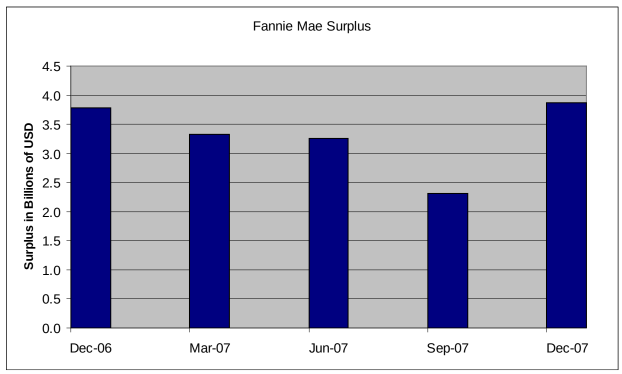
[1] This statement presumes that the 4th quarter capital classification will result in a conclusion of adequately capitalized. The classification process is not yet complete. This is footnoted as a reminder to double check prior to issuance of the report of examination.

decline, a result of market and credit related losses, as well as the projections of continued market and credit related impacts into 2008, resulted in Fannie Mae taking aggressive steps during the third and fourth quarter to issue $1 billion and $7.9 billion, respectively, in preferred stock to ensure ongoing capital adequacy. Growth in MBS during the year also impacted the capital requirement. Additional capital actions, including a reduction of the common stock dividends were also taken in late 2007 in an effort to preserve capital. While the core capital surplus over the OFHEO-directed requirement at year-end 2007 equaled 9.3 percent, worsening economic conditions may result in poor earnings that may erode the surplus during 2008. Further, should additional sources of capital be needed, future flexibility to raise additional preferred stock, a key source of accessible funds, may be reduced.

The chart below shows Fannie Mae's surplus over the OFHEO-directed requirement over the last five quarters. Prior to the issuance of the preferred stock in December 2007, the surplus fell from its $3.8 billion peak (9.9%) in the fourth quarter of 2006 to $2.3 billion (5.9%) as of September 30, 2007. Fannie Mae's internal estimates show that the additional fourth quarter surplus generated by the preferred stock ($3.9 billion or 9.3%) will be reduced throughout 2008 to levels similar to third quarter 2007 results. Given the projected losses from credit and market related risks for 2008, OFHEO considers that it was prudent for Fannie Mae to have taken the action to significantly increase its capital base in the fourth quarter of 2007.



Improvements have occurred during 2007 in the quarterly Capital Plan. Throughout the year, management has increased the detail within the plan regarding stock issuance and dividend payout strategies, more thoroughly incorporating additional capital metrics, which include excess capital based upon the regulatory requirements, GAAP capital, and capital management and corporate governance processes. That said, continued attention to income projections, realistic stress scenarios, and the accuracy and reliability of the projections is a necessity in order to ensure timely and prudent capital actions. Additionally, specific discussion and metrics for fair value of capital and economic capital should also be included in the capital plan.