

FEDERAL NATIONAL MORTGAGE ASSOCIATION FANNIE MAE

Form 10-K

May 02, 2007

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

**Form 10-K**

**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the fiscal year ended December 31, 2005**

**Commission File No.: 0-50231**

**Federal National Mortgage Association**  
*(Exact name of registrant as specified in its charter)*  
**Fannie Mae**

**Federally chartered corporation**  
*(State or other jurisdiction of  
incorporation or organization)*

**52-0883107**  
*(I.R.S. Employer  
Identification No.)*

**3900 Wisconsin Avenue,  
NW Washington, DC**  
*(Address of principal executive offices)*

**20016**  
*(Zip Code)*

**Registrant's telephone number, including area code:**  
**(202) 752-7000**

**Securities registered pursuant to Section 12(b) of the Act:**  
**None**

**Securities registered pursuant to Section 12(g) of the Act:**  
**Common Stock, without par value**  
*(Title of class)*

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Act. Yes  No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes  No

The aggregate market value of the common stock held by non-affiliates of the registrant computed by reference to the price at which the common stock was last sold on June 30, 2006 (the last business day of the registrant's most recently completed second fiscal quarter) was approximately \$46,790 million.

As of February 28, 2007, there were 973,046,601 shares of common stock of the registrant outstanding.

**DOCUMENTS INCORPORATED BY REFERENCE**

None.

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**PART I**

**Item 1. Business**

**EXPLANATORY NOTE ABOUT THIS REPORT**

We filed our Annual Report on Form 10-K for the year ended December 31, 2004 ( 2004 Form 10-K ) on December 6, 2006, which represented a significant step in our efforts to return to timely financial reporting. Our 2004 Form 10-K contained our consolidated financial statements and related notes for the year ended December 31, 2004, as well as a restatement of our previously issued consolidated financial statements and related notes for the years ended December 31, 2003 and 2002, and for the quarters ended June 30, 2004 and March 31, 2004. The filing of this Annual Report on Form 10-K for the year ended December 31, 2005 ( 2005 Form 10-K ) has been delayed significantly as a result of the substantial time and effort devoted to ongoing controls remediation and systems reengineering and development necessary to complete the restatement of our financial results for 2003 and 2002. Because of the delay in our periodic reporting and the changes that have occurred in our business since December 31, 2005, where appropriate, the information contained in this report reflects current information about our business. All amounts in this Annual Report on Form 10-K affected by the restatement adjustments reported in our 2004 Form 10-K reflect such amounts as restated.

We have not filed our Annual Report on Form 10-K for the year ended December 31, 2006 ( 2006 Form 10-K ) or quarterly reports on Form 10-Q for 2005 or 2006. In lieu of filing quarterly reports for 2005, we have included in this report substantially all of the information required to be included in quarterly reports. We previously announced that we expect to file our 2006 Form 10-K by the end of 2007. We are assessing how the timing of the filing of this 2005 Form 10-K will impact the timing of our filing the 2006 Form 10-K. We have made significant progress in our efforts to remediate operational weaknesses that have prevented us from reporting our financial results on a timely basis. We intend to continue to provide periodic updates regarding our progress toward timely financial reporting.

**OVERVIEW**

Fannie Mae's activities enhance the liquidity and stability of the mortgage market and contribute to making housing in the United States more affordable and more available to low-, moderate- and middle-income Americans. These activities include providing funds to mortgage lenders through our purchases of mortgage assets, and issuing and guaranteeing mortgage-related securities that facilitate the flow of additional funds into the mortgage market. We also make other investments that increase the supply of affordable housing.

We are a government-sponsored enterprise ( GSE ) chartered by the U.S. Congress under the name Federal National Mortgage Association and are aligned with national policies to support expanded access to housing and increased opportunities for homeownership. We are subject to government oversight and regulation. Our regulators include the Office of Federal Housing Enterprise Oversight ( OFHEO ), the Department of Housing and Urban Development ( HUD ), the Securities and Exchange Commission ( SEC ) and the Department of the Treasury.

While we are a Congressionally-chartered enterprise, the U.S. government does not guarantee, directly or indirectly, our securities or other obligations. We are a stockholder-owned corporation, and our business is self-sustaining and funded exclusively with private capital. Our common stock is listed on the New York Stock Exchange, or NYSE, and traded under the symbol FNM. Our debt securities are actively traded in the over-the-counter market.

**RECENT SIGNIFICANT EVENTS**



*OFHEO Consent Order.* In 2003, OFHEO commenced a special examination of our accounting policies and practices, internal controls, financial reporting, corporate governance, and other matters. On May 23, 2006, concurrently with OFHEO's release of its final report of the special examination, we agreed to OFHEO's

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issuance of a consent order that resolved open matters relating to their investigation of us. Under the consent order, we neither admitted nor denied any wrongdoing and agreed to make changes and take actions in specified areas, including our accounting practices, capital levels and activities, corporate governance, Board of Directors, internal controls, public disclosures, regulatory reporting, personnel and compensation practices. We also agreed not to increase our net mortgage portfolio assets above the amount shown in our minimum capital report to OFHEO for December 31, 2005 (\$727.75 billion), except in limited circumstances at OFHEO's discretion. Our net mortgage portfolio assets refer to the unpaid principal balance of our mortgage assets, net of market valuation adjustments, impairments, allowances for loan losses, and unamortized premiums and discounts. In addition, we agreed to continue to maintain a 30% capital surplus over our statutory minimum capital requirement until the Director of OFHEO, in his discretion, determines the requirement should be modified or allowed to expire, taking into account factors such as resolution of our accounting and internal control issues. As part of the OFHEO consent order, we also agreed to pay a \$400 million civil penalty, with \$50 million payable to the U.S. Treasury and \$350 million payable to the SEC for distribution to stockholders pursuant to the Fair Funds for Investors provision of the Sarbanes-Oxley Act of 2002, also known as SOX. We have paid this civil penalty in full.

*Investigation by the U.S. Attorney's Office.* In October 2004, the U.S. Attorney's Office for the District of Columbia notified us that it was investigating our past accounting practices. In August 2006, the U.S. Attorney's Office advised us that it had discontinued its investigation and would not be filing any charges against us.

*Stockholder Lawsuits and Other Litigation.* Several lawsuits related to our accounting practices prior to December 2004 are currently pending against us and certain of our current and former officers and directors. On December 12, 2006, we filed suit against KPMG LLP, our former outside auditor, to recover damages related to the accounting restatement for negligence and breach of contract. For more information on these lawsuits, see Item 3 Legal Proceedings.

*Impairment Determination.* On May 1, 2007, the Audit Committee of our Board of Directors reviewed the conclusion of our Chief Financial Officer and our Controller that we are required under GAAP to recognize the other-than-temporary impairment charges described in this 2005 Form 10-K for the year ended December 31, 2005. Following discussion with our independent registered public accounting firm, the Audit Committee affirmed that material impairments have occurred. Additional information relating to the other-than-temporary impairment charges, including the amounts of the other-than-temporary impairment charges, is included in Item 7 MD&A Consolidated Results of Operations Investment Losses, Net.

## **RESIDENTIAL MORTGAGE MARKET OVERVIEW**

We operate in the U.S. residential mortgage market, specifically in the secondary mortgage market where mortgages are bought and sold. The following discusses the dynamics of the residential mortgage market and our role in the secondary mortgage market.

### **Residential Mortgage Market**

Our business operates within the U.S. residential mortgage market and, therefore we consider the amount of U.S. residential mortgage debt outstanding to be the best measure of the size of our overall market. As of December 31, 2006, the latest date for which information was available, the amount of U.S. residential mortgage debt outstanding was estimated by the Federal Reserve to be approximately \$10.9 trillion (including \$10.2 trillion of single-family mortgages). Our mortgage credit book of business, which includes mortgage assets we hold in our investment portfolio, our Fannie Mae mortgage-backed securities held by third parties and credit enhancements that we provide on mortgage assets, was \$2.5 trillion as of December 31, 2006, or approximately 23% of total U.S. residential mortgage debt outstanding. Fannie Mae mortgage-backed securities or Fannie Mae MBS generally

refers to those mortgage-related securities that we issue and with respect to which we guarantee to the related trusts that we will supplement amounts received by those MBS trusts as required to permit timely payment of principal and interest on the Fannie Mae MBS. We also issue some forms of mortgage-related securities for which we do not provide this guaranty.

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The residential mortgage market has experienced strong long-term growth. According to Federal Reserve estimates, total U.S. residential mortgage debt outstanding increased each year from 1945 to 2006. Growth in U.S. residential mortgage debt outstanding averaged 10.6% per year over that period, which is faster than the 6.9% average growth in the overall U.S. economy over the same period, as measured by nominal gross domestic product. Growth in U.S. residential mortgage debt outstanding was particularly strong during 2001 through 2005. As indicated in the table below, which provides a comparison of overall housing market statistics to our business activity, total U.S. residential mortgage debt outstanding grew at an estimated annual rate of 13.6% and 14.5% in 2005 and 2004, respectively. Growth in U.S. residential mortgage debt slowed to 8.7% in 2006.

**Housing Market Data**

|   | 2006                  | 2005      | 2004     | 2003     | % Change<br>from Prior Year |      |      |
|---|-----------------------|-----------|----------|----------|-----------------------------|------|------|
|   |                       |           |          |          | 2006                        | 2005 | 2004 |
|   | (Dollars in billions) |           |          |          |                             |      |      |
| Housing and mortgage market: <sup>(1)</sup>     |                       |           |          |          |                             |      |      |
| Home sale units (in thousands)                  | 7,531                 | 8,359     | 7,981    | 7,264    | (10)%                       | 5%   | 10%  |
| House price appreciation <sup>(2)</sup>         | 9.1%                  | 13.1%     | 10.7%    | 6.8%     |                             |      |      |
| Single-family mortgage originations             | \$ 2,760              | \$ 3,034  | \$ 2,790 | \$ 3,852 | (9)                         | 9    | (28) |
| Purchase share                                  | 52.2%                 | 49.6%     | 47.8%    | 29.0%    |                             |      |      |
| Refinance share                                 | 47.8%                 | 50.4%     | 52.2%    | 71.0%    |                             |      |      |
| ARM share <sup>(3)</sup>                        | 28.6%                 | 32.4%     | 33.4%    | 20.0%    |                             |      |      |
| Fixed-rate mortgage share                       | 71.4%                 | 67.6%     | 66.6%    | 80.0%    |                             |      |      |
| Residential mortgage debt outstanding           | \$ 10,921             | \$ 10,046 | \$ 8,847 | \$ 7,725 | 9                           | 14   | 15   |
| Fannie Mae:                                     |                       |           |          |          |                             |      |      |
| New business acquisitions <sup>(4)</sup>        | \$ 615                | \$ 612    | \$ 725   | \$ 1,423 |                             | (16) | (49) |
| Mortgage credit book of business <sup>(5)</sup> | \$ 2,528              | \$ 2,356  | \$ 2,340 | \$ 2,223 | 7                           | 1    | 5    |
| Interest rate risk market share <sup>(6)</sup>  | 6.6%                  | 7.2%      | 10.2%    | 11.6%    |                             |      |      |
| Credit risk market share <sup>(7)</sup>         | 21.6%                 | 21.8%     | 24.2%    | 27.1%    |                             |      |      |

<sup>(1)</sup> The sources of the housing and mortgage market data are the Federal Reserve Board, the Bureau of the Census, HUD, the National Association of Realtors, the Mortgage Bankers Association, and OFHEO. Mortgage originations, as well as the purchase and refinance shares, are estimates from Fannie Mae's Economic & Mortgage Market Analysis Group. Certain previously reported data may have been changed to reflect revised historical data from any or all of these organizations.

- (2) OFHEO publishes a House Price Index (HPI) quarterly using data provided by Fannie Mae and Freddie Mac. The HPI is a weighted repeat transactions index, meaning that it measures average price changes in repeat sales or refinancings on the same properties. House price appreciation reported above reflects the annual average HPI of the reported year compared with the annual average HPI of the prior year.
- (3) The ARM share is the ARM share of the number of conventional mortgage applications, reported in the Mortgage Banker's Association's Weekly Mortgage Applications Survey.
- (4) Represents the sum in any given period of the unpaid principal balance of: (1) the mortgage loans and mortgage-related securities we purchase for our investment portfolio; and (2) the mortgage loans we securitize into Fannie Mae MBS that are acquired by third parties. Excludes mortgage loans we securitize from our portfolio.
- (5) Represents the sum of the unpaid principal balance of: (1) the mortgage loans we hold in our investment portfolio; (2) the Fannie Mae MBS and non-Fannie Mae mortgage-related securities we hold in our investment portfolio; (3) Fannie Mae MBS held by third parties; and (4) credit enhancements that we provide on mortgage assets.
- (6) Represents the estimated share of total U.S. residential mortgage debt outstanding on which we bear the interest rate risk. Calculated based on the unpaid principal balance of mortgage loans and mortgage-related securities we hold in our mortgage portfolio as a percentage of total U.S. residential mortgage debt outstanding.
- (7) Represents the estimated share of total U.S. residential mortgage debt outstanding on which we bear the credit risk. Calculated based on the unpaid principal balance of mortgage loans we hold in our mortgage portfolio and Fannie Mae MBS outstanding as a percentage of total U.S. residential mortgage debt outstanding.

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Growth in U.S. residential mortgage debt outstanding in recent years has been driven primarily by record home sales, strong home price appreciation and historically low interest rates. Also contributing to growth in U.S. residential mortgage debt outstanding in recent years was the increased use of mortgage debt financing by homeowners and demographic trends that contributed to increased household formation and higher homeownership rates. Growth in U.S. residential mortgage debt outstanding moderated in 2006 in response to slower home price growth, a sharp drop-off in home sales and declining refinance activity. While total U.S. residential mortgage debt outstanding as of December 31, 2006 was about 9% higher than year-ago levels, the annualized growth rate in the fourth quarter of 2006 slowed to 6.4%. We expect that growth in total U.S. residential mortgage debt outstanding will continue at a slower pace in 2007, as the housing market cools further and average home prices possibly decline modestly.

We believe the housing market slowdown has occurred because of affordability challenges after many years of strong home price appreciation, augmented by a decline in investor demand for housing as home price gains have slowed (and prices have fallen in some areas). Additionally, subprime and Alt-A mortgage originations have represented an elevated level of market activity by historical standards in recent years, but we believe guidance by depository institution regulators will likely slow their growth significantly. We believe that the continuation of positive demographic trends, such as stable household formation rates and a growing economy, will help mitigate this slowdown in the growth in residential mortgage debt outstanding, but these trends are unlikely to offset the slowdown in the short- to medium-term.

Over the past 30 years, home values and income (as measured by per capita disposable personal income) have both risen at around a 6% annualized rate. During 2001 through 2006, however, this comparability between home values and income eroded, with income growth averaging 3.7% and home price appreciation averaging 9.1%. Home price appreciation was especially rapid in 2004 and 2005, with rates of home price appreciation of approximately 11% in 2004 and 13% in 2005 on a national basis (with some regional variation). There was a decline in this extraordinary rate of home price appreciation in 2006. Home prices increased nationally by approximately 9.1% in 2006, but according to the OFHEO House Price Index, only by a four-quarter growth rate of 5.9% in the fourth quarter, which was the slowest four-quarter pace of home price appreciation since 1999. We believe that average home prices could go down in 2007.

The amount of residential mortgage debt available for us to purchase or securitize and the mix of available loan products are affected by several factors, including the volume of single-family mortgages within the loan limits imposed under our charter, consumer preferences for different types of mortgages, and the purchase and securitization activity of other financial institutions. See **Item 1A Risk Factors** for a description of the risks associated with the recent slowdown in home price appreciation, as well as competitive factors affecting our business.

### **Our Role in the Secondary Mortgage Market**

The mortgage market comprises a major portion of the domestic capital markets and provides a vital source of financing for the large housing segment of the economy, as well as one of the most important means for Americans to achieve their homeownership objectives. The U.S. Congress chartered Fannie Mae and certain other GSEs to help ensure stability and liquidity within the secondary mortgage market. Our activities are especially valuable when economic or financial market conditions constrain the flow of funds for mortgage lending. In addition, we believe our activities and those of other GSEs help lower the costs of borrowing in the mortgage market, which makes housing more affordable and increases homeownership, especially for low- to moderate-income families. We believe our activities also increase the supply of affordable rental housing.

Our principal customers are lenders that operate within the primary mortgage market by originating mortgage loans for homebuyers and for current homeowners refinancing their existing mortgage loans. Our customers include

mortgage banking companies, investment banks, savings and loan associations, savings banks, commercial banks, credit unions, community banks, and state and local housing finance agencies. Lenders originating mortgages in the primary market often sell them in the secondary mortgage market in the form of loans or in the form of mortgage-related securities.

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We operate in the secondary mortgage market where mortgages are bought and sold. We securitize mortgage loans originated by lenders in the primary market into Fannie Mae MBS, which can then be readily bought and sold in the secondary mortgage market. We also participate in the secondary mortgage market by purchasing mortgage loans (often referred to as "whole loans") and mortgage-related securities, including Fannie Mae MBS, for our mortgage portfolio. By delivering loans to us in exchange for Fannie Mae MBS, lenders gain the advantage of holding a highly liquid instrument and the flexibility to determine under what conditions they will hold or sell the MBS. By selling loans to us, lenders replenish their funds and, consequently, are able to make additional loans. Pursuant to our charter, we do not lend money directly to consumers in the primary mortgage market.

## **BUSINESS SEGMENTS**

We operate an integrated business that contributes to providing liquidity to the mortgage market and increasing the availability and affordability of housing in the United States. We are organized in three complementary business segments:

Our **Single-Family Credit Guaranty** ( "Single-Family" ) business works with our lender customers to securitize single-family mortgage loans into Fannie Mae MBS and to facilitate the purchase of single-family mortgage loans for our mortgage portfolio. Our Single-Family business has responsibility for managing our credit risk exposure relating to the single-family Fannie Mae MBS held by third parties (such as lenders, depositories and global investors), as well as the single-family mortgage loans and single-family Fannie Mae MBS held in our mortgage portfolio. Our Single-Family business also has responsibility for pricing the credit risk of the single-family mortgage loans we purchase for our mortgage portfolio. Revenues in the segment are derived primarily from the guaranty fees the segment receives as compensation for assuming the credit risk on the mortgage loans underlying single-family Fannie Mae MBS and on the single-family mortgage loans held in our portfolio.

Our **Housing and Community Development** ( "HCD" ) business helps to expand the supply of affordable and market-rate rental housing in the United States by working with our lender customers to securitize multifamily mortgage loans into Fannie Mae MBS and to facilitate the purchase of multifamily mortgage loans for our mortgage portfolio. Our HCD business also helps to expand the supply of affordable housing by making investments in rental and for-sale housing projects, including investments in rental housing that qualify for federal low-income housing tax credits. Our HCD business has responsibility for managing our credit risk exposure relating to the multifamily Fannie Mae MBS held by third parties, as well as the multifamily mortgage loans and multifamily Fannie Mae MBS held in our mortgage portfolio. Our HCD business also has responsibility for pricing the credit risk of the multifamily mortgage loans we purchase for our mortgage portfolio. Revenues in the segment are derived from a variety of sources, including the guaranty fees the segment receives as compensation for assuming the credit risk on the mortgage loans underlying multifamily Fannie Mae MBS and on the multifamily mortgage loans held in our portfolio, transaction fees associated with the multifamily business and bond credit enhancement fees. In addition, HCD's investments in housing projects eligible for the low-income housing tax credit and other tax credits generate both tax credits and net operating losses that reduce our federal income tax liability. Other investments in rental and for-sale housing generate revenue from operations and the eventual sale of the assets.

Our **Capital Markets** group manages our investment activity in mortgage loans and mortgage-related securities, and has responsibility for managing our assets and liabilities and our liquidity and capital positions. Through the issuance of debt securities in the capital markets, our Capital Markets group attracts capital from investors globally to finance housing in the United States. In addition, our Capital Markets group increases the liquidity of the mortgage market by maintaining a constant, reliable presence as an active investor in mortgage assets. Our



Capital Markets group has responsibility for managing our interest rate risk. Our Capital Markets group generates income primarily from the difference, or spread, between the yield on the mortgage assets we own and the cost of the debt we issue in the global capital markets to fund these assets.

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Although we operate our business through three separate business segments, there are important interrelationships among the functions of these three segments. For example:

*Mortgage Acquisition.* As noted above, our Single-Family and HCD businesses work with our lender customers to securitize mortgage loans into Fannie Mae MBS and to facilitate the purchase of mortgage loans for our mortgage portfolio. Accordingly, although the Single-Family and HCD businesses principally manage the relationships with our lender customers, our Capital Markets group works closely with Single-Family and HCD in making mortgage acquisition decisions. Our Capital Markets group works directly with our lender customers on structured Fannie Mae MBS transactions.

*Portfolio Credit Risk Management.* Our Single-Family and HCD businesses support our Capital Markets group by assuming and managing the credit risk of borrowers defaulting on payments of principal and interest on the mortgage loans held in our mortgage portfolio or underlying Fannie Mae MBS held in our mortgage portfolio. Our Single-Family and HCD businesses also price the credit risk of the mortgage loans purchased by our Capital Markets group for our mortgage portfolio.

*Securitization Activities.* All three of our businesses engage in securitization activities. Our Single-Family business issues our single-family single-class Fannie Mae MBS. These securities are principally created through lender swap transactions and constitute the substantial majority of our Fannie Mae MBS issues. Our HCD business issues multifamily single-class Fannie Mae MBS that are principally created through lender swap transactions. Our Capital Markets group issues Fannie Mae MBS from mortgage loans that we hold in our mortgage portfolio and also issues structured Fannie Mae MBS.

*Liquidity Support.* The Capital Markets group supports the liquidity of single-family and multifamily Fannie Mae MBS by holding Fannie Mae MBS in our mortgage portfolio. This support of our Fannie Mae MBS helps to maintain the competitiveness of our Single-Family and HCD businesses, and increases the value of our Fannie Mae MBS.

*Mission Support.* All three of our businesses contribute to meeting the statutory housing goals established by HUD. We meet our housing goals both by purchasing mortgage loans for our mortgage portfolio and by securitizing mortgage loans into Fannie Mae MBS. Both our Single-Family and HCD businesses securitize mortgages that contribute to our housing goals. In addition, our Capital Markets group purchases mortgages for our mortgage portfolio that contribute to our housing goals.

The table below displays the revenues, net income and total assets for each of our business segments for each of the three years in the period ended December 31, 2005.

**Business Segment Summary Financial Information**

|                                   | <b>For the Year Ended December 31,</b> |             |             |
|-----------------------------------|--|-------------|-------------|
|                                   | <b>2005</b>                            | <b>2004</b> | <b>2003</b> |
|                                   | <b>(Dollars in millions)</b>           |             |             |
| Revenues: <sup>(1)</sup>          |  |             |             |
| Single-Family Credit Guaranty     | \$ 5,805                               | \$ 5,153    | \$ 4,994    |
| Housing and Community Development | 743                                    | 538         | 398         |
| Capital Markets                   | 43,601                                 | 46,135      | 47,293      |
| Total                             | \$ 50,149                              | \$ 51,826   | \$ 52,685   |

|                                   |          |          |          |
|-----------------------------------|----------|----------|----------|
| Net income:                       |          |          |          |
| Single-Family Credit Guaranty     | \$ 2,889 | \$ 2,514 | \$ 2,481 |
| Housing and Community Development | 462      | 337      | 286      |
| Capital Markets                   | 2,996    | 2,116    | 5,314    |
| Total                             | \$ 6,347 | \$ 4,967 | \$ 8,081 |

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|                                   | <b>As of December 31,</b> |              |
|-----------------------------------|---------------------------|--------------|
|                                   | <b>2005</b>               | <b>2004</b>  |
| Total assets:                     |                           |              |
| Single-Family Credit Guaranty     | \$ 12,871                 | \$ 11,543    |
| Housing and Community Development | 11,829                    | 10,166       |
| Capital Markets                   | 809,468                   | 999,225      |
| Total                             | \$ 834,168                | \$ 1,020,934 |

<sup>(1)</sup> Includes interest income, guaranty fee income, and fee and other income.

We use various management methodologies to allocate certain balance sheet and income statement line items to the responsible operating segment. For a description of our allocation methodologies, see Notes to Consolidated Financial Statements Note 14, Segment Reporting. For further information on the results and assets of our business segments, see Item 7 MD&A Business Segment Results.

**Single-Family Credit Guaranty**

Our Single-Family Credit Guaranty business works with our lender customers to securitize single-family mortgage loans into Fannie Mae MBS and to facilitate the purchase of single-family mortgage loans for our mortgage portfolio. Our Single-Family business manages our relationships with over 1,000 lenders from which we obtain mortgage loans. These lenders are part of the primary mortgage market, where mortgage loans are originated and funds are loaned to borrowers. Our lender customers include mortgage banking companies, investment banks, savings and loan associations, savings banks, commercial banks, credit unions, community banks, and state and local housing finance agencies.

In our Single-Family business, mortgage lenders generally deliver mortgage loans to us in exchange for our Fannie Mae MBS. In a typical MBS transaction, we guaranty to each MBS trust that we will supplement amounts received by the MBS trust as required to permit timely payment of principal and interest on the related Fannie Mae MBS. In return, we receive a guaranty fee. Our guaranty supports the liquidity of Fannie Mae MBS and makes it easier for lenders to sell these securities. When lenders receive Fannie Mae MBS in exchange for mortgage loans, they may hold the Fannie Mae MBS for investment or sell the MBS in the capital markets. This option allows lenders to manage their assets so that they continue to have funds available to make new mortgage loans. In holding Fannie Mae MBS created from a pool of whole loans, a lender has securities that are generally more liquid than whole loans, which provides the lender with greater financial flexibility. The ability of lenders to sell Fannie Mae MBS quickly allows them to continue making mortgage loans even under economic and capital markets conditions that might otherwise constrain mortgage financing activities.

Our Single-Family business manages the risk that borrowers will default in the payment of principal and interest due on the single-family mortgage loans held in our investment portfolio or underlying Fannie Mae MBS (whether held in our investment portfolio or held by third parties). We provide a breakdown of our single-family mortgage credit book of business as of December 31, 2005, 2004 and 2003 in Item 7 MD&A Risk Management Credit Risk Management.

To ensure that acceptable loans are received from lenders as well as to assist lenders in efficiently and accurately processing loans that they deliver to us, we have established guidelines for the types of loans and credit risks that we accept. These guidelines also ensure compliance with the types of loans that our charter authorizes us to purchase. For

a description of our charter requirements, see Our Charter and Regulation of Our Activities. We have developed technology-based solutions that assist our lender customers in delivering loans to us efficiently and at lower costs. Our automated underwriting system for single-family mortgage loans, known as Desktop Underwriter<sup>®</sup>, assists lenders in applying our underwriting guidelines to the single-family loans they originate. Desktop Underwriter<sup>®</sup> is designed to help lenders process mortgage applications in a more efficient and accurate manner and to apply our underwriting criteria to prospective borrowers consistently and objectively. After assessing the creditworthiness of the borrowers and originating the loans,

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lenders deliver the whole loans to us and represent and warrant to us that the loans meet our guidelines and any agreed-upon variances from the guidelines.

***Guaranty Services***

Our Single-Family business provides guaranty services by assuming the credit risk of the single-family mortgage loans underlying our guaranteed Fannie Mae MBS held by third parties. Our Single-Family business also assumes the credit risk of the single-family mortgage loans held in our investment portfolio, as well as the single-family mortgage loans underlying Fannie Mae MBS held in our portfolio.

Our most common type of guaranty transaction is referred to as a lender swap transaction. Lenders pool their loans and deliver them to us in exchange for Fannie Mae MBS backed by these loans. After receiving the loans in a lender swap transaction, we place them in a trust that is established for the sole purpose of holding the loans separate and apart from our assets. We serve as trustee for the trust. Upon creation of the trust, we deliver to the lender (or its designee) Fannie Mae MBS that are backed by the pool of mortgage loans in the trust and that represent a beneficial ownership interest in each of the loans. We guarantee to each MBS trust that we will supplement amounts received by the MBS trust as required to permit timely payment of principal and interest on the related Fannie Mae MBS. The mortgage servicers for the underlying mortgage loans collect the principal and interest payments from the borrowers. We permit them to retain a portion of the interest payment as compensation for servicing the mortgage loans before distributing the principal and remaining interest payments to us. We retain a portion of the interest payment as the fee for providing our guaranty. Then, on behalf of the trust, we make monthly distributions to the Fannie Mae MBS certificate holders from the principal and interest payments and other collections on the underlying mortgage loans.

The following diagram illustrates the basic process by which we create a typical Fannie Mae MBS in the case where a lender chooses to sell the Fannie Mae MBS to a third-party investor.

To better serve the needs of our lender customers as well as to respond to changing market conditions and investor preferences, we offer different types of Fannie Mae MBS backed by single-family loans, as described below:

*Single-Family Single-Class Fannie Mae MBS* represent beneficial interests in single-family mortgage loans held in an MBS trust that were delivered to us typically by a single lender in exchange for the single-class Fannie Mae MBS. The certificate holders in a single-class Fannie Mae MBS issue receive principal and interest payments in proportion to their percentage ownership of the MBS issue.

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*Fannie Majors*<sup>®</sup> are a form of single-class Fannie Mae MBS in which generally two or more lenders deliver mortgage loans to us, and we then group all of the loans together in one MBS pool. In this case, the certificate holders receive beneficial interests in all of the loans in the pool. As a result, the certificate holders may benefit from having a diverse group of lenders contributing loans to the MBS rather than having an interest in loans obtained from only one lender, as well as increased liquidity due to a larger-sized pool.

*Single-Family Whole Loan Multi-Class Fannie Mae MBS* are multi-class Fannie Mae MBS that are formed from single-family whole loans. Our Single-Family business works with our Capital Markets group in structuring these single-family whole loan multi-class Fannie Mae MBS. Single-family whole loan multi-class Fannie Mae MBS divide the cash flows on the underlying loans and create several classes of securities, each of which represents a beneficial ownership interest in a separate portion of the cash flows.

### ***Guaranty Fees***

We enter into agreements with our lender customers that establish the guaranty fee arrangements for those customers Fannie Mae MBS transactions. Guaranty fees are generally paid to us on a monthly basis from a portion of the interest payments made on the underlying mortgage loans in the MBS trust.

The aggregate amount of single-family guaranty fees we receive in any period depends on the amount of Fannie Mae MBS outstanding during that period and the applicable guaranty fee rates. The amount of Fannie Mae MBS outstanding at any time is primarily determined by the rate at which we issue new Fannie Mae MBS and by the repayment rate for the loans underlying our outstanding Fannie Mae MBS. Less significant factors affecting the amount of Fannie Mae MBS outstanding are the rates of borrower defaults on the loans and the extent to which lenders repurchase loans from the pools because the loans do not conform to the representations made by the lenders.

Since we began issuing our Fannie Mae MBS over 25 years ago, the total amount of our outstanding single-family Fannie Mae MBS (which includes both Fannie Mae MBS held in our portfolio and Fannie Mae MBS held by third parties) has grown steadily. As of December 31, 2006, 2005 and 2004, total outstanding single-family Fannie Mae MBS was \$2.0 trillion, \$1.8 trillion and \$1.7 trillion, respectively. Growth in our total outstanding Fannie Mae MBS has been supported by the value that lenders and other investors place on Fannie Mae MBS.

### ***Our Customers***

Our Single-Family business is primarily responsible for managing the relationships with our lender customers that supply mortgage loans both for securitization into Fannie Mae MBS and for purchase by our mortgage portfolio. During 2005, over 1,000 lenders delivered mortgage loans to us, either for purchase by our mortgage portfolio or for securitization into Fannie Mae MBS. We acquire a significant portion of our single-family mortgage loans from several large mortgage lenders. During 2005, our top five lender customers, in the aggregate, accounted for approximately 49% of our single-family business volume. This was a small decline from 2004 when our top five lender customers accounted for approximately 53% of our single-family business volume. Our top customer, Countrywide Financial Corporation (through its subsidiaries), accounted for approximately 25% of our single-family business volume in 2005. Due to consolidation within the mortgage industry, we, as well as our competitors, have been competing for business from a decreasing number of large mortgage lenders. See Item 1A Risk Factors for a discussion of the risks to our business resulting from this customer concentration.

### ***TBA Market***

The TBA, or to be announced, securities market is a forward, or delayed delivery, market for 30-year and 15-year fixed-rate single-family mortgage-related securities issued by us and other agency issuers. Most of our single-class

single-family Fannie Mae MBS are sold by lenders in the TBA market. Lenders use the TBA market both to purchase and sell Fannie Mae MBS.



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A TBA trade represents a forward contract for the purchase or sale of single-family mortgage-related securities to be delivered on a specified future date. In a typical TBA trade, the specific pool of mortgages that will be delivered to fulfill the forward contract are unknown at the time of the trade. Parties to a TBA trade agree upon the issuer, coupon, price, product type, amount of securities and settlement date for delivery. Settlement for TBA trades is standardized to occur on one specific day each month. The mortgage-related securities that ultimately will be delivered, and the loans backing those mortgage-related securities, frequently have not been created or originated at the time of the TBA trade, even though a price for the securities is agreed to at that time. Some trades are stipulated trades, in which the buyer and seller agree on specific characteristics of the mortgage loans underlying the mortgage-related securities to be delivered (such as loan age, loan size or geographic area of the loan). Some other transactions are specified trades, in which the buyer and seller identify the actual mortgage pool to be traded (specifying the pool or CUSIP number). These specified trades typically involve existing, seasoned TBA-eligible securities issued in the market. TBA sales enable originating mortgage lenders to hedge their interest rate risk and efficiently lock in interest rates for mortgage loan applicants throughout the loan origination process. The TBA market lowers transaction costs, increases liquidity and facilitates efficient settlement of sales and purchases of mortgage-related securities.

### ***Credit Risk Management***

Our Single-Family business bears the credit risk of borrowers defaulting on their payments of principal and interest on the single-family mortgage loans that back our guaranteed Fannie Mae MBS, including Fannie Mae MBS held in our mortgage portfolio. In return, the Single-Family business receives a guaranty fee for bearing this credit risk. In addition, Single-Family bears the credit risk associated with the single-family mortgage loans held in our mortgage portfolio. In return for bearing this credit risk, Single-Family is allocated fees from the Capital Markets group comparable to the guaranty fees that Single-Family receives on guaranteed Fannie Mae MBS. As a result, in our segment reporting, the expenses of the Capital Markets group include the transfer cost of the guaranty fees and related fees allocated to Single-Family, and the revenues of Single-Family include the guaranty fees and related fees received from the Capital Markets group.

The credit risk associated with a single-family mortgage loan is largely determined by the creditworthiness of the borrower, the nature and terms of the loan, the type of property securing the loan, the ratio of the unpaid principal amount of the loan to the value of the property that serves as collateral for the loan (the loan-to-value ratio or LTV ratio ) and general economic conditions, including employment levels and the rate of increases or decreases in home prices. We actively manage, on an aggregate basis, the extent and nature of the credit risk we bear, with the objective of ensuring that we are adequately compensated for the credit risk we take, consistent with our mission goals. One important part of our management strategy is the use of credit enhancements, including primary mortgage insurance. For a description of our methods for managing mortgage credit risk and a description of the credit characteristics of our single-family mortgage credit book of business, refer to Item 7 MD&A Risk Management Credit Risk Management. Refer to Item 1A Risk Factors for a description of the risks associated with our management of credit risk.

Our Single-Family business is also responsible for managing the credit risk to our business posed by defaults by most of our institutional counterparties, such as our mortgage insurance providers and mortgage lenders and servicers. See Item 7 MD&A Risk Management Credit Risk Management for a description of our methods for managing institutional counterparty credit risk and Item 1A Risk Factors for a description of the risks associated with our management of credit risk.

### **Housing and Community Development**

Our Housing and Community Development business engages in a range of activities primarily related to increasing the supply of affordable rental and for-sale housing, as well as increasing liquidity in the debt and equity markets

related to such housing. In 2006, approximately 95% of the units financed by the multifamily mortgage loans we purchased or securitized contributed to the achievement of the housing goals established by HUD. See [Our Charter and Regulation of Our Activities](#) [Regulation and Oversight of Our Activities](#) [HUD Regulation](#) [Housing Goals](#) for a description of our housing goals.

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Our HCD business also engages in other activities through our Community Investment and Community Lending Groups, including investing in affordable rental properties that qualify for federal low-income housing tax credits, making equity investments in other rental and for-sale housing, investing in acquisition, development and construction ( AD&C ) financing for single-family and multifamily housing developments, providing loans and credit support to public entities such as housing finance agencies and public housing authorities to support their affordable housing efforts, and working with not-for-profit entities and local banks to support community development projects in underserved areas.

### ***Multifamily Group***

HCD s Multifamily Group securitizes multifamily mortgage loans into Fannie Mae MBS and facilitates the purchase of multifamily mortgage loans for our mortgage portfolio. The amount of multifamily mortgage loan volume that we purchase for our portfolio as compared to the amount that we securitize into Fannie Mae MBS fluctuates from period to period. In recent years, the percentage of our multifamily business that has consisted of purchases for our investment portfolio has increased relative to our securitization activities. Our multifamily mortgage loans relate to properties with five or more residential units. The properties may be apartment communities, cooperative properties or manufactured housing communities.

Most of the multifamily loans we purchase or securitize are made by lenders that participate in our Delegated Underwriting and Servicing, or DUS<sup>tm</sup>, program. Under the DUS program, we delegate the underwriting of loans to qualified lenders. As long as the lender represents and warrants that eligible loans meet our underwriting guidelines, we will not require the lender to obtain loan-by-loan approval before acquisition by us. DUS lenders generally act as servicers on the loans they sell to us, and servicing transfers must be approved by us. We also work with DUS lenders to provide credit enhancement for taxable and tax-exempt bonds issued by entities such as housing finance authorities. DUS lenders generally share the credit risk of loans they sell to us by absorbing a portion of the loss incurred as a result of a loan default. DUS lenders receive a higher servicing fee to compensate them for this risk. We believe that the risk-sharing feature of the DUS program aligns our interests and the interests of the lenders in making a sound credit decision at the time the loan is originated by the lender and acquired by us, and in servicing the loan throughout its life.

Our HCD business manages the risk that borrowers will default in the payment of principal and interest due on the multifamily mortgage loans held in our investment portfolio or underlying Fannie Mae MBS (whether held in our investment portfolio or held by third parties). We provide a breakdown of our multifamily mortgage credit book of business as of December 31, 2005, 2004 and 2003 in Item 7 MD&A Risk Management Credit Risk Management.

Unlike single-family loans, most multifamily loans require that the borrower pay a prepayment premium if the loan is paid before the maturity date. Additionally, some multifamily loans are subject to lock-out periods during which the loan may not be prepaid. The prepayment premium can take a variety of forms, including yield maintenance, defeasance or declining percentage. These prepayment provisions may reduce the likelihood that a borrower will prepay a loan during a period of declining interest rates, thereby providing incremental levels of certainty and reinvestment cash flow protection to investors in multifamily loans and mortgage-related securities.

Our Multifamily Group generally creates multifamily Fannie Mae MBS in the same manner as our Single-Family business creates single-family Fannie Mae MBS. Mortgage lenders deliver multifamily mortgage loans to us in exchange for our Fannie Mae MBS, which thereafter may be held by the lenders or sold in the capital markets. We guarantee to each MBS trust that we will supplement amounts received by the MBS trust as required to permit timely payment of principal and interest on the related multifamily Fannie Mae MBS. In return for our guaranty, we are paid a guaranty fee out of a portion of the interest on the loans underlying the multifamily Fannie Mae MBS. For a

description of a typical lender swap transaction by which we create Fannie Mae MBS, see Single-Family Credit Guaranty Guaranty Services above.

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As with our Single-Family business, our Multifamily Group offers different types of Fannie Mae MBS as a service to our lenders and as a response to specific investor preferences. The most commonly issued multifamily Fannie Mae MBS are described below:

*Multifamily Single-Class Fannie Mae MBS* represent beneficial interests in multifamily mortgage loans held in an MBS trust and that were delivered to us by a lender in exchange for the single-class Fannie Mae MBS. The certificate holders in a single-class Fannie Mae MBS issue receive principal and interest payments in proportion to their percentage ownership of the MBS issue.

*Discount Fannie Mae MBS* are short-term securities that generally have maturities between three and nine months and are backed by one or more participation certificates representing interests in multifamily loans. Investors earn a return on their investment in these securities by purchasing them at a discount to their principal amounts and receiving the full principal amount when the securities reach maturity. Discount MBS have no prepayment risk since prepayments are not allowed prior to maturity.

*Multifamily Whole Loan Multi-Class Fannie Mae MBS* are multi-class Fannie Mae MBS that are formed from multifamily whole loans, Federal Housing Administration (FHA) participation certificates and/or Government National Mortgage Association (Ginnie Mae) participation certificates. Our HCD business works with our Capital Markets group in structuring these multifamily whole loan multi-class Fannie Mae MBS. Multifamily whole loan multi-class Fannie Mae MBS divide the cash flows on the underlying loans or participation certificates and create several classes of securities, each of which represents a beneficial ownership interest in a separate portion of the cash flows.

The fee and guaranty arrangements between HCD and Capital Markets are similar to the arrangements between Single-Family and Capital Markets. Our HCD business bears the credit risk of borrowers defaulting on their payments of principal and interest on the multifamily mortgage loans that back our guaranteed Fannie Mae MBS, including Fannie Mae MBS held in our mortgage portfolio. In addition, HCD bears the credit risk associated with the multifamily mortgage loans held in our mortgage portfolio. The HCD business receives a guaranty fee in return for bearing the credit risk on guaranteed multifamily Fannie Mae MBS, including Fannie Mae MBS held in our mortgage portfolio. In return for bearing credit risk on the multifamily mortgage loans held in our mortgage portfolio, our HCD business is allocated fees from the Capital Markets group comparable to the guaranty fees that it receives on guaranteed Fannie Mae MBS. As a result, in our segment reporting, the expenses of the Capital Markets group include the transfer cost of the guaranty fees and related fees allocated to our HCD segment, and the revenues of the HCD segment include the guaranty fees and related fees received from the Capital Markets group.

HCD's Multifamily Group manages credit risk in a manner similar to that of our Single-Family business by managing the quality of the mortgages we acquire for our portfolio or securitize into Fannie Mae MBS, diversifying our exposure to credit losses, continually assessing the level of credit risk that we bear, and actively managing problem loans and assets to mitigate credit losses. Additionally, multifamily loans sold to us are often subject to lender risk-sharing or other lender recourse arrangements. As of December 31, 2005, credit enhancements existed on approximately 95% of the multifamily mortgage loans that we owned or that backed our Fannie Mae MBS. As described above, in our DUS program, lenders typically bear a portion of the credit losses incurred on an individual DUS loan. From time to time, we acquire multifamily loans in transactions where the lenders do not bear any credit risk on the loans and we therefore bear all of the credit risk. In such cases, our compensation takes into account the fact that we are bearing all of the credit risk on the loan. For a description of our management of multifamily credit risk, see Item 7 MD&A Risk Management Credit Risk Management. Refer to Item 1A Risk Factors for a description of the risks associated with our management of credit risk.

***Community Investment Group***

HCD s Community Investment Group makes investments that increase the supply of affordable housing. Most of these investments are in rental housing that qualifies for federal low-income housing tax credits, and the remainder are in conventional rental and primarily entry-level, for-sale housing. These investments are

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consistent with our focus on serving communities in need and making affordable housing more available and easier to rent or own.

The Community Investment Group's investments have been made predominantly in low-income housing tax credit ( LIHTC ) limited partnerships or limited liability companies (referred to collectively in this report as LIHTC partnerships ) that directly or indirectly own an interest in rental housing that the partnerships or companies have developed or rehabilitated. By renting a specified portion of the housing units to qualified low-income tenants over a 15-year period, the partnerships become eligible for the federal low-income housing tax credit. The low-income housing tax credit was enacted as part of the Tax Reform Act of 1986 to encourage investment by private developers and investors in low-income rental housing. To qualify for this tax credit, among other requirements, the project owner must irrevocably elect that either (1) a minimum of 20% of the residential units will be rent-restricted and occupied by tenants whose income does not exceed 50% of the area median gross income, or (2) a minimum of 40% of the residential units will be rent-restricted and occupied by tenants whose income does not exceed 60% of the area median gross income. The LIHTC partnerships are generally organized by fund manager sponsors who seek out investments with third-party developers who in turn develop or rehabilitate the properties and subsequently manage them. We invest in these partnerships as a limited partner with the fund manager acting as the general partner.

In making investments in these LIHTC partnerships, our Community Investment Group identifies qualified sponsors and structures the terms of our investment. Our risk exposure is limited to the amount of our investment and the possible recapture of the tax benefits we have received from the partnership. To manage the risks associated with a partnership, we track compliance with the LIHTC requirements, as well as the property condition and financial performance of the underlying investment throughout the life of the investment. In addition, we evaluate the strength of the partnership's sponsor through periodic financial and operating assessments. Furthermore, in some of our partnership investments, our exposure to loss is further mitigated by our having a guaranteed economic return from an investment grade counterparty.

Our recorded investment in these LIHTC partnerships totaled approximately \$7.7 billion and \$6.8 billion as of December 31, 2005 and 2004, respectively. We earn a return on our investments in LIHTC partnerships through reductions in our federal income tax liability as a result of the use of the tax credits for which the LIHTC partnerships qualify, as well as the deductibility of the partnerships' net operating losses. For additional information regarding our investments in LIHTC partnerships, refer to Item 7 MD&A Off-Balance Sheet Arrangements and Variable Interest Entities LIHTC Partnership Interests.

In addition to investing in LIHTC partnerships, HCD's Community Investment Group provides equity investments for rental and for-sale housing. These investments are typically made through fund managers or directly with developers and operators that are well-recognized firms within the industry. Because we invest as a limited partner or as a non-managing member in a limited liability company, our exposure is generally limited to the amount of our investment. Most of our investments in for-sale housing involve the construction of entry-level homes that are generally eligible for conforming mortgages. Our recorded investment in these transactions totaled approximately \$1.6 billion and \$1.3 billion as of December 31, 2005 and 2004, respectively.

### ***Community Lending Group***

HCD's Community Lending Group supports the expansion of available housing by participating in specialized debt financing for a variety of customers and by acquiring mortgage loans. These activities include:

- helping to meet the financing needs of single-family and multifamily home builders by purchasing participation interests in AD&C loans from lending institutions;

acquiring small multifamily loans from a variety of lending institutions that do not participate in our DUS<sup>tm</sup> program;

providing loans to Community Development Financial Institution intermediaries to re-lend for community revitalization projects that expand the supply of affordable housing stock; and



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providing financing for single-family and multifamily housing to housing finance agencies, public housing authorities and municipalities.

In July 2006, OFHEO advised us to suspend new AD&C business until we have finalized and implemented specified policies and procedures required to strengthen risk management practices related to this business. We are implementing these new policies and procedures and are also implementing new controls and reporting mechanisms relating to our AD&C business. We are currently in discussions with OFHEO regarding these improvements.

## **Capital Markets**

Our Capital Markets group manages our investment activity in mortgage loans, mortgage-related securities and other liquid investments. We purchase mortgage loans and mortgage-related securities from mortgage lenders, securities dealers, investors and other market participants. We also sell mortgage loans and mortgage-related securities.

We fund these investments primarily through proceeds from our issuance of debt securities in the domestic and international capital markets. By using the proceeds of this debt funding to invest in mortgage loans and mortgage-related securities, we directly and indirectly increase the amount of funding available to mortgage lenders. By managing the structure of our debt obligations and through our use of derivatives, we strive to substantially limit adverse changes in the net fair value of our investment portfolio that result from interest rate changes.

Our Capital Markets group earns most of its income from the difference, or spread, between the interest we earn on our mortgage portfolio and the interest we pay on the debt we issue to fund this portfolio, which is referred to as our net interest yield. As described below, our Capital Markets group uses various debt and derivative instruments to help manage the interest rate risk inherent in our mortgage portfolio. Changes in the fair value of the derivative instruments we hold impact the net income reported by the Capital Markets group business segment. Our Capital Markets group also earns transaction fees for issuing structured Fannie Mae MBS, as described below under *Securitization Activities*.

## ***Mortgage Investments***

Our net mortgage investments totaled \$736.5 billion and \$924.8 billion as of December 31, 2005 and 2004, respectively. We estimate that the amount of our net mortgage investments was approximately \$722 billion as of December 31, 2006. As described above under *Recent Significant Events*, as part of our May 2006 consent order with OFHEO, we agreed not to increase our net mortgage portfolio assets above \$727.75 billion, except in limited circumstances at OFHEO's discretion. We will be subject to this limitation on mortgage investment growth until the Director of OFHEO has determined that modification or expiration of the limitation is appropriate in light of specified factors such as resolution of accounting and internal control issues. For additional information on our capital requirements and regulations affecting the amount of our mortgage investments, see *Our Charter and Regulation of Our Activities* and *Item 7 MD&A Liquidity and Capital Management Capital Management*.

Our mortgage investments include both mortgage-related securities and mortgage loans. We purchase primarily conventional single-family fixed-rate or adjustable-rate, first lien mortgage loans, or mortgage-related securities backed by such loans. In addition, we purchase loans insured by the FHA, loans guaranteed by the Department of Veterans Affairs ( *VA* ) or by the Rural Housing Service of the Department of Agriculture ( *RHS* ), manufactured housing loans, multifamily mortgage loans, subordinate lien mortgage loans (e.g., loans secured by second liens) and other mortgage-related securities. Most of these loans are prepayable at the option of the borrower. Some of our investments in mortgage-related securities are effected in the TBA market, which is described above under *Single-Family Credit Guaranty TBA Market*. Our investments in mortgage-related securities include structured mortgage-related securities such as real estate mortgage investment conduits ( *REMICs* ). The interest rates on the structured mortgage-related securities held in our portfolio may not be the same as the interest rates on the underlying

loans. For example, we may hold a floating rate REMIC security with an interest rate that adjusts periodically based on changes in a specified market reference rate,

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such as the London Inter-Bank Offered Rate ( LIBOR ); however, the REMIC may be backed by fixed-rate mortgage loans. The REMIC securities we own primarily fall into two categories: agency REMICs, which are generally Fannie Mae-issued REMICs, and non-agency REMICs issued by private-label issuers. For information on the composition of our mortgage investment portfolio by product type, refer to Table 13 in Item 7 MD&A Business Segment Results Capital Markets Group Mortgage Investments.

While our Single-Family and HCD businesses are responsible for managing the credit risk associated with our investments in mortgage loans and Fannie Mae MBS, our Capital Markets group is responsible for managing the credit risk of the non-Fannie Mae mortgage-related securities in our portfolio.

### ***Investment Activities and Objectives***

Our Capital Markets group seeks to maximize long-term total returns while fulfilling our chartered liquidity function. Our total return management involves acquiring mortgage assets that allow us to achieve an acceptable spread over our cost of funding. Prior to 2005, we realized this return primarily by holding assets to maturity.

Beginning in 2005, we also began to look for opportunities to sell assets and accelerate the realization of the spread income. These opportunities occur when the option-adjusted spread of a security tightens, compared to spreads when we acquired the security, causing the security's fair value to increase relative to its expected future cost of funding. By selling these assets, we are able to realize the economic spread we otherwise would earn over the life of the asset. After these sales, we may reinvest the capital we receive from these sales in assets with more attractive risk-adjusted spreads. For the Capital Markets group, we expect that, in normal market conditions, our selling activity will represent a modest portion of the total change in the total portfolio for the year. In 2005 and 2006, total sales were 12% and 8% of the opening mortgage portfolio balances, and 9% and 5% when excluding sales of securities created through the securitization of loans we held for a short time.

The level of our purchases and sales of mortgage assets in any given period has been generally determined by the rates of return that we expect to be able to earn on the equity capital underlying our investments. When we expect to earn returns greater than our cost of equity capital, we generally will be an active purchaser of mortgage loans and mortgage-related securities. When few opportunities exist to earn returns above our cost of equity capital, we generally will be a less active purchaser, and may be a net seller, of mortgage loans and mortgage-related securities. This investment strategy is consistent with our chartered liquidity function, as the periods during which our purchase of mortgage assets is economically attractive to us generally have been periods in which market demand for mortgage assets is low.

The difference, or spread, between the yield on mortgage assets available for purchase or sale and our borrowing costs, after consideration of the net risks associated with the investment, is an important factor in determining whether we are a net buyer or seller of mortgage assets. When the spread between the yield on mortgage assets and our borrowing costs is wide, which is typically when demand for mortgage assets from other investors is low, we will look for opportunities to add liquidity to the market primarily by purchasing mortgage assets and issuing debt to investors to fund those purchases. When this spread is narrow, which is typically when market demand for mortgage assets is high, we will look for opportunities to meet demand by selling mortgage assets from our portfolio. Even in periods of high market demand for mortgage assets, however, we expect to be an active purchaser of less liquid forms of mortgage loans and mortgage-related securities. The amount of our purchases of these mortgage loans and mortgage-related securities may be less than the amortization, prepayments and sales of mortgage loans we hold and, as a result, our investment balances may decline during periods of high market demand.

We determine our total return by measuring the change in the estimated fair value of our net assets (net of tax effect), a non-GAAP measure that we refer to as the fair value of our net assets. The fair value of our net assets will change

from period to period as a result of changes in the mix of our assets and liabilities and changes in interest rates, expected volatility and other market factors. The fair value of our net assets is also subject to change due to inherent market fluctuations in the yields on our mortgage assets relative to the yields on our debt securities. The fair value of our guaranty assets and guaranty obligations will also fluctuate in the

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short term due to changes in interest rates. These fluctuations are likely to produce volatility in the fair value of our net assets in the short-term that may not be representative of our long-term performance. Refer to

Item 7 MD&A Supplemental Non-GAAP Information Fair Value Balance Sheet for information on the fair value of our net assets.

There are factors that may constrain our ability to maximize our return through asset sales including our portfolio growth limitation, operational limitations, and our intent to hold certain temporarily impaired securities until recovery and achieve certain tax consequences, as well as risk parameters applied to the mortgage portfolio.

### ***Customer Transactions and Services***

Our Capital Markets group provides services to our lender customers and their affiliates, which include:

offering to purchase a wide variety of mortgage assets, including non-standard mortgage loan products, which we either retain in our portfolio for investment or sell to other investors as a service to assist our customers in accessing the market;

segregating customer portfolios to obtain optimal pricing for their mortgage loans (for example, segregating Community Reinvestment Act or CRA eligible loans, which typically command a premium);

providing funds at the loan delivery date for purchase of loans delivered for securitization; and

assisting customers with the hedging of their mortgage business, including entering into options and forward contracts on mortgage-related securities, which we offset in the capital markets.

These activities provide a significant source of assets for our mortgage portfolio, help to create a broader market for our customers and enhance liquidity in the secondary mortgage market. Although certain securities acquired in this activity are accounted for as trading securities, we contemporaneously enter into economically offsetting positions if we do not intend to retain the securities in our portfolio.

In connection with our customer transactions and services activities, we may enter into forward commitments to purchase mortgage loans or mortgage-related securities that we decide not to retain in our portfolio. In these instances, we generally will enter into an offsetting sell commitment with another investor or require the lender to deliver a sell commitment to us together with the loans to be pooled into mortgage-related securities.

### ***Mortgage Innovation***

Our Capital Markets group also aids our lender customers in their efforts to introduce new mortgage products into the marketplace. Lenders often face limited secondary market appetite for new or innovative mortgage products. Our Capital Markets group supports these lenders by purchasing new products for our investment portfolio before the products develop full track records for credit performance and pricing. Among the innovations that our Capital Markets group has supported recently are 40-year mortgages, interest-only mortgages and reverse mortgages.

### ***Housing Goals***

Our Capital Markets group contributes to our regulatory housing goals by purchasing goals-qualifying mortgage loans and mortgage-related securities for our mortgage portfolio. In particular, our Capital Markets group is able to purchase highly-rated mortgage-related securities backed by mortgage loans that meet our regulatory housing goals requirements. Our Capital Markets group's purchase of goals-qualifying mortgage loans is a critical factor in our

ability to meet our housing goals.

***Funding of Our Investments***

Our Capital Markets group funds its investments primarily through the issuance of debt securities in the domestic and international capital markets. The objective of our debt financing activities is to manage our liquidity requirements while obtaining funds as efficiently as possible. We structure our financings not only to

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satisfy our funding and risk management requirements, but also to access the market in an orderly manner with debt securities designed to appeal to a wide range of investors. International investors, seeking many of the features offered in our debt programs for their U.S. dollar-denominated investments, have been a significant and growing source of funding in recent years. The most significant of the debt financing programs that we conduct are the following:

*Benchmark Securities*<sup>®</sup>. Through our Benchmark Securities program, we sell large, regularly scheduled issues of unsecured debt. Our Benchmark Securities issues tend to appeal to investors who value liquidity and price transparency. The Benchmark Securities program includes:

*Benchmark Bills*<sup>®</sup> have maturities of up to one year. On a weekly basis, we auction three-month and six-month Benchmark Bills with a minimum issue size of \$1.0 billion. On a monthly basis, we auction one-year Benchmark Bills with a minimum issue size of \$1.0 billion.

*Benchmark Notes*<sup>®</sup> have maturities ranging between two and ten years. Each month, we typically sell one or more new, fixed-rate issues of Benchmark Notes through dealer syndicates. Each issue has a minimum size of \$3.0 billion.

*Discount Notes*. We issue short-term debt securities called Discount Notes with maturities ranging from overnight to 360 days from the date of issuance. Investors purchase these notes at a discount to the principal amount and receive the principal amount when the notes mature.

*Medium-Term Notes*. We issue medium-term notes ( MTNs ) with a wide range of maturities, interest rates and call features. The specific terms of our MTN issuances are determined through individually negotiated transactions with broker-dealers. Our MTNs are often callable prior to maturity. We issue both fixed-rate and floating-rate securities, as well as various types of structured notes that combine features of traditional debt with features of other capital market instruments.

*Subordinated Debt*. Pursuant to voluntary commitments that we made in October 2000, from time to time we have issued qualifying subordinated debt. The terms of our qualifying subordinated debt require us to defer interest payments on this debt in specified limited circumstances. The difference, or spread, between the trading prices of our subordinated debt and our senior debt serves as a market indicator to investors of the relative credit risk of our debt. A narrow spread between the trading prices of our subordinated debt and senior debt implies that the market perceives the credit risk of our debt to be relatively low. A wider spread between these prices implies that the market perceives our debt to have a higher relative credit risk. As of the date of this filing, we had \$9.0 billion in qualifying subordinated debt outstanding. We have not issued any subordinated debt since 2003 and are not likely to resume issuances until we return to timely reporting of our financial results. Our October 2000 voluntary commitments relating to subordinated debt have been replaced by an agreement we entered into with OFHEO on September 1, 2005, pursuant to which we agreed to maintain a specified amount of qualifying subordinated debt. Although we have not issued subordinated debt since 2003, we are in compliance with our obligations relating to the maintenance of qualifying subordinated debt under our September 1, 2005 agreement with OFHEO. For more information on our subordinated debt, see Item 7 MD&A Liquidity and Capital Management Capital Management Capital Activity Subordinated Debt.

We engage in periodic repurchases of our debt securities to support the liquidity and strength of our debt programs, among other reasons. For more information regarding our approach to funding our investments and other activities, see Item 7 MD&A Liquidity and Capital Management Liquidity Debt Funding.

Although we are a corporation chartered by the U.S. Congress, we are solely responsible for our debt obligations, and neither the U.S. government nor any instrumentality of the U.S. government guarantees any of our debt. Our debt

trades in the agency sector of the capital markets, along with the debt of other GSEs. Debt in the agency sector benefits from bank regulations that allow commercial banks to invest in our debt and other agency debt to a greater extent than other debt. These factors, along with the high credit rating of our senior unsecured debt securities and the manner in which we conduct our financing programs, contribute to the favorable trading characteristics of our debt. As a result, we generally are able to borrow at lower interest rates than other corporate debt issuers. For information on the credit ratings of our long-term and



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short-term senior unsecured debt, qualifying subordinated debt and preferred stock, refer to Item 7 MD&A Liquidity and Capital Management Liquidity Credit Ratings and Risk Ratings.

### ***Securitization Activities***

Our Capital Markets group engages in two principal types of securitization activities:

creating and issuing Fannie Mae MBS from our mortgage portfolio assets, either for sale into the secondary market or to retain in our portfolio; and

issuing structured Fannie Mae MBS for customers in exchange for a transaction fee.

Our Capital Markets group creates Fannie Mae MBS using mortgage loans and mortgage-related securities that we hold in our investment portfolio (referred to as portfolio securitizations). We currently securitize a majority of single-family mortgage loans within the first month of purchase. Our Capital Markets group may sell these Fannie Mae MBS into the secondary market or may retain the Fannie Mae MBS in our investment portfolio. The types of Fannie Mae MBS that our Capital Markets group creates through portfolio securitizations include the same types as those created by our Single-Family and HCD businesses, as described in Single-Family Credit Guaranty Guaranty Services and Housing and Community Development Multifamily Group above. In addition, the Capital Markets group issues structured Fannie Mae MBS, which are described below. The structured Fannie Mae MBS are generally created through swap transactions, typically with our lender customers or securities dealer customers. In these transactions, the customer swaps a mortgage-related security they own for one of the types of structured Fannie Mae MBS described below. This process is referred to as resecuritization.

Our Capital Markets group earns transaction fees for issuing structured Fannie Mae MBS for third parties. The most common forms of such securities are the following:

*Fannie Mae Megas*<sup>®</sup>, which are resecuritized single-class Fannie Mae MBS that are created in transactions in which a lender or a securities dealer contributes two or more previously issued single-class Fannie Mae MBS or previously issued Megas, or a combination of Fannie Mae MBS and Megas, in return for a new issue of Mega certificates.

*Multi-class Fannie Mae MBS*, including *REMICs*, which may separate the cash flows from underlying single-class and/or multi-class Fannie Mae MBS, other mortgage-related securities or mortgage loans into separately tradable classes of securities. By separating the cash flows, the resulting classes may consist of: (1) interest-only payments; (2) principal-only payments; (3) different portions of the principal and interest payments; or (4) combinations of each of these. Terms to maturity of some multi-class Fannie Mae MBS, particularly REMIC classes, may match or be shorter than the maturity of the underlying mortgage loans and/or mortgage-related securities. As a result, each of the classes in a multi-class Fannie Mae MBS may have a different coupon rate, average life, repayment sensitivity or final maturity. In some of our multi-class Fannie Mae MBS transactions, we may issue senior classes where we have guaranteed to the trust that we will supplement amounts received by the trust on the underlying mortgage assets as required to permit timely payment of principal and interest on the related senior class. In these multi-class Fannie Mae MBS transactions, we also may issue one or more subordinated classes for which we do not provide a guaranty. Our Capital Markets group may work with our Single-Family or HCD businesses in structuring multi-class Fannie Mae MBS.

### ***Interest Rate Risk Management***

Our Capital Markets group is subject to the risks of changes in long-term earnings and net asset values that may occur due to changes in interest rates, interest rate volatility and other factors within the financial markets. These risks arise because the expected cash flows of our mortgage assets are not perfectly matched with the cash flows of our debt instruments.

Our principal source of interest rate risk arises from our investment in mortgage assets that give the borrower the option to prepay the mortgage at any time without penalty. For example, if interest rates decrease,

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borrowers are more likely to refinance their mortgages. Refinancings could result in prepaid loans being replaced with new investments in lower interest rate loans and, consequently, a decrease in future interest income earned on our mortgage assets. At the same time, we may not be able to redeem or repay a sufficient portion of our existing debt to lower our interest expense by the same amount, which may reduce our net interest yield.

We strive to maintain low exposure to the risks associated with changes in interest rates. To manage our exposure to interest rate risk, we engage in the following activities:

*Issuance of Callable and Non-Callable Debt.* We issue a broad range of both callable and non-callable debt securities to manage the duration and prepayment risk of expected cash flows of the mortgage assets we own.

*Use of Derivative Instruments.* While our debt is the primary means by which we manage our interest rate risk exposure, we supplement our issuance of debt with interest rate-related derivatives to further manage duration and prepayment risk. We use derivatives in combination with our issuance of debt to reduce the volatility of the estimated fair value of our mortgage investments. The benefits of derivatives include:

the speed and efficiency with which we can alter our risk position; and

the ability to modify some aspects of our expected cash flows in a specialized manner that might not be readily achievable with debt instruments.

The use of derivatives also involves costs to our business. Changes in the estimated fair value of these derivatives impact our net income. Accordingly, our net income will be reduced to the extent that we incur losses relating to our derivative instruments. In addition, our use of derivatives exposes us to credit risk relating to our derivative counterparties. We have derivative transaction policies and controls in place to minimize our derivative counterparty risk. See [Item 7 MD&A Risk Management Credit Risk Management Institutional Counterparty Credit Risk Management Derivatives Counterparties](#) for a description of our derivative counterparty risk and our policies and controls in place to minimize such risk. Refer to [Item 1A Risk Factors](#) for a description of the risks associated with transactions with our derivatives counterparties.

*Continuous Monitoring of Our Risk Position.* We continuously monitor our risk position and actively rebalance our portfolio of interest-rate sensitive financial instruments to maintain a close match between the duration of our assets and liabilities. We use a wide range of risk measures and analytical tools to assess our exposure to the risks inherent in the asset and liability structure of our business and use these assessments in the day-to-day management of the mix of our assets and liabilities. If market conditions do not permit us to fund and manage our investments within our risk parameters, we will not be an active purchaser of mortgage assets.

For more information regarding our methods for managing interest rate risk and other market risks that impact our business, refer to [Item 7 MD&A Risk Management Interest Rate Risk Management and Other Market Risks](#).

## **COMPETITION**

Our competitors include the Federal Home Loan Mortgage Corporation, referred to as Freddie Mac, the Federal Home Loan Banks, financial institutions, securities dealers, insurance companies, pension funds and other investors. Our market share of loans purchased for our investment portfolio or securitized into Fannie Mae MBS is affected by the amount of residential mortgage loans offered for sale in the secondary market by loan originators and other market participants, and the amount purchased or securitized by our competitors. Our market share is also affected by the mix of available mortgage loan products and the credit risk and prices associated with those loans.

We are an active investor in mortgage-related assets and we compete with a broad range of investors for the purchase and sale of these assets. Our primary competitors for the purchase and sale of mortgage assets are

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participants in the secondary mortgage market that we believe also share our general investment objective of seeking to maximize the returns they receive through the purchase and sale of mortgage assets. In addition, in recent years, several large mortgage lenders have increased their retained holdings of the mortgage loans they originate. Competition for mortgage-related assets among investors in the secondary market was intense in 2004, 2005 and 2006. The spreads between the yield on our debt securities and expected yields on mortgage assets, after consideration of the net risks associated with the investments, were very narrow in 2004, 2005 and 2006, reflecting strong investor demand from banks, funds and other investors. This high demand for mortgage assets increased the price of mortgage assets relative to the credit risks associated with these assets.

We have been the largest agency issuer of mortgage-related securities in every year since 1990. Competition for the issuance of mortgage-related securities is intense and participants compete on the basis of the value of their products and services relative to the prices they charge. Value can be delivered through the liquidity and trading levels for an issuer's securities, the range of products and services offered, and the reliability and consistency with which it conducts its business. In recent years, there has been a significant increase in the issuance of mortgage-related securities by non-agency issuers. Non-agency issuers, also referred to as private-label issuers, are those issuers of mortgage-related securities other than agency issuers Fannie Mae, Freddie Mac or Ginnie Mae. Private-label issuers have significantly increased their share of the mortgage-related securities market and accounted for more than half of new single-family mortgage-related securities issuances in 2006. As the market share for private-label securities has increased, our market share has decreased. During 2006, our estimated market share of new single-family mortgage-related securities issuance was 23.7%, compared to 23.5% in 2005, 29.2% in 2004 and 45.0% in 2003. Our estimates of market share are based on publicly available data and exclude previously securitized mortgages. We expect our Single-Family business to continue to face significant competition from private-label issuers.

We also expect private-label issuers to provide increased competition to our HCD business. The commercial mortgage-backed securities (CMBS) issued by private-label issuers are typically backed not only by loans secured by multifamily residential property, but also by loans secured by a mix of retail, office, hotel and other commercial properties. We are restricted by our charter to issuing Fannie Mae MBS backed by residential loans, which often have lower yields than other types of commercial real estate loans. Private-label issuers include multifamily residential loans in pools backing CMBS because those properties, while generally generating lower cash flow than other types of commercial properties, generally have lower default rates, which improves the overall performance of CMBS pools. To obtain multifamily residential property loans for CMBS pools, private-label issuers are sometimes willing to purchase loans of a lesser credit quality than the loans we purchase and to price their purchases of these loans more aggressively than we typically price our purchases. Because we usually guarantee our Fannie Mae MBS, we generally maintain high credit standards to limit our exposure to defaults. Private-label issuers often structure their CMBS transactions so that certain classes of the securities issued in each transaction bear most of the default risk on the loans underlying the transaction. These securities are placed with investors that are prepared to assume that risk in exchange for higher yields.

## **OUR CHARTER AND REGULATION OF OUR ACTIVITIES**

We are a stockholder-owned corporation organized and existing under the Federal National Mortgage Association Charter Act, which we refer to as the Charter Act or our charter. We were established in 1938 pursuant to the National Housing Act and originally operated as a U.S. government entity. Title III of the National Housing Act amended our charter in 1954, and we became a mixed-ownership corporation, with our preferred stock owned by the federal government and our non-voting common stock held by private investors. In 1968, our charter was further amended and our predecessor entity was divided into the present Fannie Mae and Ginnie Mae. Ginnie Mae remained a government entity, but all of the preferred stock of Fannie Mae that had been held by the U.S. government was retired, and Fannie Mae became privately owned.



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### **Charter Act**

The Charter Act, as it was further amended from 1970 through 1998, sets forth the activities that we are permitted to conduct, authorizes us to issue debt and equity securities, and describes our general corporate powers. The Charter Act states that our purpose is to:

provide stability in the secondary market for residential mortgages;

respond appropriately to the private capital market;

provide ongoing assistance to the secondary market for residential mortgages (including activities relating to mortgages on housing for low- and moderate-income families involving a reasonable economic return that may be less than the return earned on other activities) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing; and

promote access to mortgage credit throughout the nation (including central cities, rural areas and underserved areas) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing.

In addition to our overall strategy being aligned with these purposes, all of our business activities must be permissible under the Charter Act. Our charter specifically authorizes us to purchase, service, sell, lend on the security of, or otherwise deal in conventional mortgage loans. Our purchase of these mortgage loans is subject to limitations on the maximum original principal balance for single-family loans and requirements for credit enhancement for some loans. Under our Charter Act authority, we can purchase mortgage loans secured by first or subordinate liens, issue debt and issue mortgage-backed securities. In addition, we can guarantee mortgage-backed securities. We can also act as a depository, custodian or fiscal agent for our own account or as fiduciary, and for the account of others. Furthermore, the Charter Act expressly enables us to lease, purchase, or acquire any property, real, personal, or mixed, or any interest therein, to hold, rent, maintain, modernize, renovate, improve, use, and operate such property, and to sell, for cash or credit, lease, or otherwise dispose of the same as we may deem necessary or appropriate and also to do all things as are necessary or incidental to the proper management of [our] affairs and the proper conduct of [our] business.

### ***Loan Standards***

The single-family conventional mortgage loans we purchase or securitize must meet the following standards required by the Charter Act.

*Principal Balance Limitations.* Our charter permits us to purchase and securitize single-family conventional mortgage loans subject to maximum original principal balance limits. Conventional mortgage loans are loans that are not federally insured or guaranteed. The principal balance limits are often referred to as conforming loan limits and are established each year by OFHEO based on the national average price of a one-family residence. For 2005, the conforming loan limit for a one-family residence was \$359,650, and for 2006 and 2007 it is \$417,000. Higher original principal balance limits apply to mortgage loans secured by two- to four-family residences and also to loans in Alaska, Hawaii, Guam and the Virgin Islands. No statutory limits apply to the maximum original principal balance of multifamily mortgage loans (loans secured by properties that have five or more residential dwelling units) that we purchase or securitize. In addition, the Charter Act imposes no maximum original principal balance limits on loans we purchase or securitize that are insured by the FHA or guaranteed by the VA.

*Quality Standards.* The Charter Act requires that, so far as practicable and in our judgment, the mortgage loans we purchase or securitize must be of a quality, type and class that generally meet the purchase standards of private institutional mortgage investors. To comply with this requirement and for the efficient operation of our business, we have eligibility policies and make available guidelines for the mortgage loans we purchase or securitize as well as for the sellers and servicers of these loans.

*Loan-to-Value and Credit Enhancement Requirements.* The Charter Act requires credit enhancement on any conventional single-family mortgage loan that we purchase or securitize if it has a loan-to-value ratio



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over 80% at the time of purchase or securitization. Credit enhancement may take the form of insurance or a guaranty issued by a qualified insurer, a repurchase arrangement with the seller of the loans or seller-retained loan participation interests. In addition, our policies and guidelines have loan-to-value ratio requirements that depend upon a variety of factors, such as the borrower credit history, the loan purpose, the repayment terms and the number of dwelling units in the property securing the loan. Depending on these factors and the amount and type of credit enhancement we obtain, our underwriting guidelines provide that the loan-to-value ratio for loans that we purchase or securitize can be up to 100% for conventional single-family loans; however, from time to time, we may make an exception to these guidelines and acquire loans with a loan-to-value ratio greater than 100%.

### ***Other Charter Act Limitations and Requirements***

In addition to specifying our purpose, authorizing our activities and establishing various limitations and requirements relating to the loans we purchase and securitize, the Charter Act has the following provisions related to issuances of our securities, exemptions for our securities from the registration requirements of the federal securities laws, the taxation of our income, the structure of our Board of Directors and other limitations and requirements.

*Issuances of Our Securities.* The Charter Act authorizes us, upon approval of the Secretary of the Treasury, to issue debt obligations and mortgage-related securities. At the discretion of the Secretary of the Treasury, the U.S. Department of the Treasury may purchase obligations of Fannie Mae up to a maximum of \$2.25 billion outstanding at any one time. We have not used this facility since our transition from government ownership in 1968. Neither the United States nor any of its agencies guarantees our debt or is obligated to finance our operations or assist us in any other manner. On June 13, 2006, the U.S. Department of the Treasury announced that it would undertake a review of its process for approving our issuances of debt. We cannot predict whether the outcome of this review will materially impact our current business activities.

*Exemptions for Our Securities.* Securities we issue are exempted securities under laws administered by the SEC. As a result, registration statements with respect to offerings of our securities are not filed with the SEC. In March 2003, however, we voluntarily registered our common stock with the SEC pursuant to Section 12(g) of the Securities Exchange Act of 1934 (the Exchange Act). We are thereby required to file periodic and current reports with the SEC, including annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K. Since undertaking to restate our 2002 and 2003 consolidated financial statements and improve our accounting practices and internal control over financial reporting, we have not been a timely filer of our periodic reports on Form 10-K or Form 10-Q. We are continuing to improve our accounting and internal control over financial reporting and are striving to become a timely filer as soon as practicable. We are also required to file proxy statements with the SEC. In addition, our directors and certain officers are required to file reports with the SEC relating to their ownership of Fannie Mae equity securities.

*Exemption from Certain Taxes and Qualifications.* Pursuant to the Charter Act, we are exempt from taxation by states, counties, municipalities or local taxing authorities, except for taxation by those authorities on our real property. We are not exempt from the payment of federal corporate income taxes. In addition, we may conduct our business without regard to any qualification or similar statute in any state of the United States, including the District of Columbia, the Commonwealth of Puerto Rico, and the territories and possessions of the United States.

*Structure of Our Board of Directors.* The Charter Act provides that our Board of Directors will consist of 18 persons, five of whom are to be appointed by the President of the United States and the remainder of whom are to be elected annually by our stockholders at our annual meeting of stockholders. All members of our Board of Directors either are elected by our stockholders or appointed by the President for one-year terms, or until their successors are elected and qualified. The five appointed director positions have been vacant since May 2004. Of

the remaining 13 director positions, two are vacant. Our Board has determined that all of our current directors, except our Chief Executive Officer, are independent directors

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under New York Stock Exchange standards. Because we have not held an annual meeting of stockholders since 2004, some of our directors are serving terms that have exceeded one year. In accordance with OFHEO regulation, we have elected to follow the applicable corporate governance practices and procedures of the Delaware General Corporation Law, as it may be amended from time to time.

*Other Limitations and Requirements.* Under the Charter Act, we may not originate mortgage loans or advance funds to a mortgage seller on an interim basis, using mortgage loans as collateral, pending the sale of the mortgages in the secondary market. In addition, we may only purchase or securitize mortgages originated in the United States, including the District of Columbia, the Commonwealth of Puerto Rico, and the territories and possessions of the United States.

## **Regulation and Oversight of Our Activities**

As a federally chartered corporation, we are subject to Congressional legislation and oversight and are regulated by HUD and OFHEO. In addition, we are subject to regulation by the U.S. Department of the Treasury and by the SEC. The Government Accountability Office is authorized to audit our programs, activities, receipts, expenditures and financial transactions.

### ***HUD Regulation***

#### *Program Approval*

HUD has general regulatory authority to promulgate rules and regulations to carry out the purposes of the Charter Act, excluding authority over matters granted exclusively to OFHEO. We are required under the Charter Act to obtain approval of the Secretary of HUD for any new conventional mortgage program that is significantly different from those approved or engaged in prior to the 1992 amendment of the Charter Act through enactment of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (the 1992 Act ). The Secretary must approve any new program unless the Charter Act does not authorize it or the Secretary finds that it is not in the public interest.

On June 13, 2006, HUD announced that it would conduct a review of our investments and holdings, including certain equity and debt investments classified in our consolidated financial statements as other assets/other liabilities, to determine whether our investment activities are consistent with our charter authority. We are fully cooperating with this review, but cannot predict the outcome of this review or whether it may require us to modify our investment approach or restrict our current business activities.

#### *Housing Goals*

The Secretary of HUD establishes annual housing goals pursuant to the 1992 Act for housing (1) for low- and moderate-income families, (2) in HUD-defined underserved areas, including central cities and rural areas, and (3) for low-income families in low-income areas and for very low-income families, which is referred to as special affordable housing. Each of these three goals is set as a percentage of the total number of dwelling units financed by eligible mortgage loan purchases. A dwelling unit may be counted in more than one category of goals. Included in eligible mortgage loan purchases are loans underlying our Fannie Mae MBS issuances, subordinate mortgage loans and refinanced mortgage loans. Several activities are excluded from eligible mortgage loan purchases, such as most purchases of non-conventional mortgage loans, equity investments (even if they facilitate low-income housing), mortgage loans secured by second homes and commitments to purchase or securitize mortgage loans at a later date. In addition, beginning in 2005, HUD also established three home purchase mortgage subgoals that measure our purchase or securitization of loans by the number of loans (not dwelling units) providing purchase money for owner-occupied single-family housing in metropolitan areas. We also have a subgoal for multifamily special affordable housing that is

expressed as a dollar amount. Each year, we are required to submit an annual report on our performance in meeting our housing goals. We deliver the report to the Secretary of HUD as well as to the House Committee on Financial Services and the Senate Committee on Banking, Housing and Urban Affairs.

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On November 2, 2004, HUD published a final regulation amending its housing goals rule effective January 1, 2005. The regulation increased housing goal levels and also created the three new home purchase mortgage subgoals described above. The housing goals for the period 2002-2004 and the increased housing goals and new subgoals for the period 2005-2008 are shown below.

**Housing Goals and Subgoals**

|  | 2008    | 2007    | 2006    | 2005    | 2002-2004 |
|--|---------|---------|---------|---------|-----------|
| Housing goals: <sup>(1)</sup>  |         |         |         |         |           |
| Low- and moderate-income housing   | 56.0%   | 55.0%   | 53.0%   | 52.0%   | 50.0%     |
| Underserved areas  | 39.0    | 38.0    | 38.0    | 37.0    | 31.0      |
| Special affordable housing   | 27.0    | 25.0    | 23.0    | 22.0    | 20.0      |
| Home purchase subgoals: <sup>(2)</sup>                                     |         |         |         |         |           |
| Low- and moderate-income housing   | 47.0%   | 47.0%   | 46.0%   | 45.0%   |           |
| Underserved areas  | 34.0    | 33.0    | 33.0    | 32.0    |           |
| Special affordable housing   | 18.0    | 18.0    | 17.0    | 17.0    |           |
| Multifamily minimum in special affordable housing subgoal (\$ in billions) | \$ 5.49 | \$ 5.49 | \$ 5.49 | \$ 5.49 | \$ 2.85   |

(1) Goals are expressed as a percentage of the total number of dwelling units financed by eligible mortgage loan purchases during the period.

(2) Home purchase subgoals measure our performance by the number of loans (not dwelling units) providing purchase money for owner-occupied single-family housing in metropolitan areas.

The following table compares our performance against the housing goals and subgoals for the years 2003 through 2006.

**Housing Goals and Subgoals Performance**

|  | 2006                  |       | 2005                  |       | 2004                  |       | 2003                  |       |
|--|-----------------------|-------|-----------------------|-------|-----------------------|-------|-----------------------|-------|
|  | Result <sup>(1)</sup> | Goal  | Result <sup>(2)</sup> | Goal  | Result <sup>(2)</sup> | Goal  | Result <sup>(2)</sup> | Goal  |
| Housing goals: <sup>(3)</sup>          |                       |       |                       |       |                       |       |                       |       |
| Low- and moderate-income housing       | 56.9%                 | 53.0% | 55.1%                 | 52.0% | 53.4%                 | 50.0% | 52.3%                 | 50.0% |
| Underserved areas                      | 43.6                  | 38.0  | 41.4                  | 37.0  | 33.5                  | 31.0  | 32.1                  | 31.0  |
| Special affordable housing             | 27.8                  | 23.0  | 26.3                  | 22.0  | 23.6                  | 20.0  | 21.2                  | 20.0  |
| Home purchase subgoals: <sup>(4)</sup> |                       |       |                       |       |                       |       |                       |       |
| Low- and moderate-income               | 46.9%                 | 46.0% | 44.6%                 | 45.0% |                       |       |                       |       |

|                    |          |         |          |         |         |         |          |         |
|--------------------|----------|---------|----------|---------|---------|---------|----------|---------|
| housing            |          |         |          |         |         |         |          |         |
| Underserved areas  | 34.5     | 33.0    | 32.6     | 32.0    |         |         |          |         |
| Special affordable |          |         |          |         |         |         |          |         |
| housing            | 17.9     | 17.0    | 17.0     | 17.0    |         |         |          |         |
| Multifamily        |          |         |          |         |         |         |          |         |
| minimum in special |          |         |          |         |         |         |          |         |
| affordable housing |          |         |          |         |         |         |          |         |
| subgoal            |          |         |          |         |         |         |          |         |
| (\$ in billions)   | \$ 13.39 | \$ 5.49 | \$ 10.39 | \$ 5.49 | \$ 7.32 | \$ 2.85 | \$ 12.23 | \$ 2.85 |

- (1) The source of this data is our Annual Housing Activities Report for 2006. HUD has not yet determined our results for 2006.
- (2) The source of this data is HUD's analysis of data we submitted to HUD. Some results differ from the results we reported in our Annual Housing Activities Reports for 2005, 2004 and 2003. Actual results reflect the impact of provisions that allow us to estimate the affordability of units with missing income and rent data. Actual results for 2003 reflect the impact of incentive points for small multifamily and owner-occupied rental housing, which were no longer available starting in 2004.
- (3) Goals are expressed as a percentage of the total number of dwelling units financed by eligible mortgage loan purchases during the period.
- (4) Home purchase subgoals measure our performance by the number of loans (not dwelling units) providing purchase money for owner-occupied single-family housing in metropolitan areas.

As shown by the table above, we were able to meet our housing goals and subgoals in 2006, 2004 and 2003. In 2005, we met all three of our affordable housing goals: the low- and moderate-income housing goal, the underserved areas goal and the special affordable housing goal. We also met three of the four subgoals: the underserved areas home purchase subgoal, the special affordable home purchase subgoal, and the special

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affordable multifamily subgoal. We fell slightly short of the low- and moderate-income home purchase subgoal.

The affordable housing goals are subject to enforcement by the Secretary of HUD. HUD's regulations allow HUD to require us to submit a housing plan if we fail to meet our housing goals and HUD determines that achievement was feasible, taking into account market and economic conditions and our financial condition. The housing plan must describe the actions we will take to meet the goals in the next calendar year. If HUD determines that we have failed to submit a housing plan or to make a good faith effort to comply with the plan, HUD has the right to take certain administrative actions. The potential penalties for failure to comply with HUD's housing plan requirements are a cease-and-desist order and civil money penalties. Pursuant to the 1992 Act, the low- and moderate-income housing subgoal and the underserved areas subgoal are not enforceable by HUD. As noted above, we did not meet the low- and moderate-income home purchase subgoal in 2005. Because this subgoal is not enforceable, there is no penalty for failing to meet this subgoal.

These new housing goals and subgoals are designed to increase the amount of mortgage financing that we make available to target populations and geographic areas defined by the goals.

We have made, and continue to make, significant adjustments to our mortgage loan sourcing and purchase strategies in an effort to meet these increased housing goals and the subgoals. These strategies include entering into some purchase and securitization transactions with lower expected economic returns than our typical transactions. We have also relaxed some of our underwriting criteria to obtain goals-qualifying mortgage loans and increased our investments in higher-risk mortgage loan products that are more likely to serve the borrowers targeted by HUD's goals and subgoals, which could increase our credit losses. The Charter Act explicitly authorizes us to undertake activities ... involving a reasonable economic return that may be less than the return earned on other activities in order to support the secondary market for housing for low- and moderate-income families.

We believe that we are making progress toward achieving our 2007 housing goals and subgoals. Meeting the higher goals and subgoals for 2007 is challenging, as increased home prices and higher interest rates have reduced housing affordability during the past several years. Since HUD set the home purchase subgoals in 2004, the affordable housing markets have experienced a dramatic change. Home Mortgage Disclosure Act data released in 2006 show that the share of the primary mortgage market serving low- and moderate-income borrowers declined in 2005, reducing our ability to purchase and securitize mortgage loans that meet the HUD subgoals. The National Association of REALTORS® housing affordability index has dropped from 130.7 in 2003 to 106.1 in 2006. Our housing goals and subgoals continue to increase in 2007 and 2008. If our efforts to meet the new housing goals and subgoals prove to be insufficient, we may need to take additional steps that could have an adverse effect on our profitability. See

Item 1A Risk Factors for more information on how changes we are making to our business strategies in order to meet HUD's new housing goals and subgoals may reduce our profitability.

### ***OFHEO Regulation***

OFHEO is an independent office within HUD that is responsible for ensuring that we are adequately capitalized and operating safely in accordance with the 1992 Act. OFHEO has examination authority with respect to us, and we are required to submit to OFHEO annual and quarterly reports on our financial condition and results of operations. OFHEO is authorized to levy annual assessments on Fannie Mae and Freddie Mac, to the extent authorized by Congress, to cover OFHEO's reasonable expenses. OFHEO's formal enforcement powers include the power to impose temporary and final cease-and-desist orders and civil monetary penalties on us and our directors and executive officers. OFHEO also may use other informal supervisory procedures of the type that are generally used by federal bank regulatory agencies.

### ***OFHEO Consent Order***

In 2003, OFHEO commenced a special examination of our accounting policies and practices, internal controls, financial reporting, corporate governance, and other matters. On May 23, 2006, concurrently with OFHEO's release of its final report of the special examination, we agreed to OFHEO's issuance of a consent order that



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resolved open matters relating to their investigation of us. Under the consent order, we neither admitted nor denied any wrongdoing and agreed to make changes and take actions in specified areas, including our accounting practices, capital levels and activities, corporate governance, Board of Directors, internal controls, public disclosures, regulatory reporting, personnel and compensation practices. We also agreed to continue to maintain a 30% capital surplus over our statutory minimum capital requirement until the Director of OFHEO, in his discretion, determines the requirement should be modified or allowed to expire, taking into account factors such as resolution of our accounting and internal control issues.

We also agreed not to increase our net mortgage portfolio assets above the amount shown in our minimum capital report to OFHEO for December 31, 2005 (\$727.75 billion), except in limited circumstances at OFHEO's discretion. We may propose to OFHEO increases in the size of our portfolio to respond to disruptions in the mortgage markets. We submitted an updated business plan to OFHEO on February 28, 2007 that included an update on our progress in remediating our internal control deficiencies, completing the requirements of the consent order and other matters. OFHEO reviewed our business plan and has directed us to maintain compliance with the \$727.75 billion portfolio cap. Until the Director of OFHEO has determined that modification or expiration of the limitation is appropriate, we will remain subject to this limitation on portfolio growth.

As part of the OFHEO consent order, our Board of Directors agreed to review all individuals who at the time of the review were affiliated with us, including Board members, and who were mentioned in OFHEO's final report of the special examination as participating in any misconduct for suitability to remain in their positions or for other remedial actions. The Board created a special committee made up of independent Board members, none of which had joined the Board prior to December 2004, to conduct this review. In October 2006, the special committee completed its review and reported its findings and recommendations to OFHEO. We have since implemented the actions recommended in the special committee's report to OFHEO.

In addition, as part of the OFHEO consent order, we agreed to pay a \$400 million civil penalty, with \$50 million payable to the U.S. Treasury and \$350 million payable to the SEC for distribution to stockholders pursuant to the Fair Funds for Investors provision of the Sarbanes-Oxley Act of 2002. We have paid this civil penalty in full.

### *Capital Requirements*

As part of its responsibilities under the 1992 Act, OFHEO has regulatory authority as to the capital requirements established by the 1992 Act, issuing regulations on capital adequacy and enforcing capital standards. The 1992 Act capital standards include minimum and critical capital requirements calculated as specified percentages of our assets and our off-balance sheet obligations, such as outstanding guaranties. In addition, the 1992 Act capital requirements include a risk-based capital requirement that is calculated as the amount of capital needed to withstand a severe ten-year stress period characterized by extreme movements in interest rates and simultaneous severe credit losses. Moreover, to allow for management and operations risks, an additional 30% is added to the amount necessary to withstand the ten-year stress period. On a quarterly basis, we are required by regulation to report to OFHEO on the level of our capital and whether we are in compliance with the capital requirements established by OFHEO. We also provide weekly and monthly reports to OFHEO on our current capital standing.

Compliance with the capital requirements could limit our ability to make investments or provide mortgage guaranties and also could restrict our ability to make payments on our qualifying subordinated debt or pay dividends on our preferred and common stock. OFHEO is permitted or required to take remedial action if we fail to meet our capital requirements, depending on the requirement we fail to meet. We are required to submit a capital restoration plan if OFHEO classifies us as significantly undercapitalized. As described below, we currently operate under a capital restoration plan. Even if we meet our capital requirements, OFHEO has the ability to take additional supervisory actions if the Director determines that we have failed to make reasonable efforts to comply with that plan or are

engaging in unapproved conduct that could result in a rapid depletion of our core capital, or if the value of the property securing mortgage loans we hold or have securitized has decreased significantly.

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The 1992 Act gives OFHEO the authority, after following prescribed procedures, to appoint a conservator. Under OFHEO's regulations, appointment of a conservator is mandatory, with limited exceptions, if we are critically undercapitalized (that is, our core capital is less than our required critical capital). Appointment of a conservator is discretionary under OFHEO's rules if we are significantly undercapitalized (that is, our core capital is less than our required minimum capital), and alternative remedies are unavailable. The 1992 Act and OFHEO's rules also specify other grounds for appointing a conservator.

In December 2004, OFHEO determined that we were significantly undercapitalized as of September 30, 2004. We submitted, and in February 2005, OFHEO approved, a capital restoration plan intended to comply with OFHEO's directive that we achieve a 30% surplus over our statutory minimum capital requirement by September 30, 2005. OFHEO announced on November 1, 2005 that we had achieved a 30% surplus over our minimum capital requirement as of September 30, 2005. Under our May 2006 consent order with OFHEO, we agreed to continue to maintain a 30% capital surplus over our statutory minimum capital requirement until the Director of OFHEO, in his discretion, determines the requirement should be modified or allowed to expire, taking into account factors such as resolution of accounting and internal control issues. For additional information on our capital requirements, see

Item 7 MD&A Liquidity and Capital Management Capital Management Capital Adequacy Requirements.

### *Dividend Restrictions*

Our capital requirements under the 1992 Act and as administered by OFHEO may restrict the ability of our Board of Directors to declare dividends, authorize repurchases of our preferred or common stock, or approve any other capital distributions. If such an action would decrease our total capital below the risk-based capital requirement or our core capital below the minimum capital requirement, we may not make the distribution without the approval of OFHEO.

In addition, under our May 2006 consent order with OFHEO, we agreed to the following additional restrictions relating to our capital distributions:

as long as the capital restoration plan is in effect, we must seek the approval of the Director of OFHEO before engaging in any transaction that could have the effect of reducing our capital surplus below an amount equal to 30% more than our statutory minimum capital requirement; and

we must submit a written report to OFHEO detailing the rationale and process for any proposed capital distribution before making the distribution.

Refer to Item 7 MD&A Liquidity and Capital Management Capital Management Capital Adequacy Requirements for a description of our statutory capital requirements and our core capital, total capital and other capital classification measures as of December 31, 2005 and 2004.

### *Recent Legislative Developments and Possible Changes in Our Regulations*

The U.S. Congress continues to consider legislation that would change the regulatory framework under which we, Freddie Mac and the Federal Home Loan Banks operate. On March 29, 2007, the House Financial Services Committee approved a bill that would establish a new, independent regulator for us and the other GSEs, with broad authority over both safety and soundness and mission. The bill, if enacted into law, would affect Fannie Mae in significant ways, including:

authorizing the regulator to limit the size and composition of our mortgage investment portfolio;

authorizing the regulator to increase the level of our required capital;

changing the approval process for products and activities and expanding the extent of regulatory oversight of us and our officers, directors and employees;

changing the method for enforcing compliance with housing goals; and

authorizing, and in some instances requiring, the appointment of a receiver if the company becomes critically undercapitalized.

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In addition, the House bill would require us and Freddie Mac to contribute an amount equal to 1.2 basis points of our average total mortgage portfolios (including whole loans and securitized obligations, whether held in portfolio or sold in any form) to a fund to support affordable housing that would be managed by the new GSE regulator.

As of the date of this filing, the only GSE reform bill that has been introduced in the Senate is S. 1100, co-sponsored by four Republican members of the Senate Committee on Banking, Housing, and Urban Affairs. This bill is substantially similar to a bill that was approved by the Committee in July 2005, and differs from the House bill in a number of respects. It is expected that the Democratic Chairman of the Committee will bring his own version of GSE reform legislation to the Committee, but the timing is uncertain. Further, we cannot predict the content of any Senate bill that may be introduced or its prospects for Committee approval or passage by the full Senate.

Even if bills for GSE regulatory oversight reform are passed by both the House and the Senate, the specific provisions of any legislation of this type, as well as the timing for enactment of such legislation, are uncertain. We support any legislation that would improve our effectiveness in increasing liquidity and lowering the cost of borrowing in the mortgage market and, as a result, expanding access to housing and increasing opportunities for homeownership.

As Fannie Mae has testified before Congress, we continue to support legislation that would:

create a single independent, well-funded regulator that combines safety and soundness supervision with authority over our mission;

provide the regulator with bank-like regulatory authority to adjust capital levels and on-balance sheet activities, to the extent needed to ensure safe and sound operations;

provide the regulator with bank-like supervisory authorities, including prompt corrective action powers and authority over our activities;

provide a structure for housing goals that includes an affordable housing fund administered by the GSEs that strengthens our housing and liquidity mission.

It is possible, however, that the enactment of legislation could have a material adverse effect on our earnings and the prospects for our business. Refer to Item 1A Risk Factors for a description of how the changes in the regulation of our business contemplated by these GSE reform bills or other legislative proposals could materially adversely affect our business and earnings.

## **EMPLOYEES**

As of December 31, 2005, we employed approximately 5,600 personnel, including full-time and part-time employees, term employees and employees on leave. During 2005 and 2006, we increased the number of our employees, both as part of significantly improving our accounting practices, risk management, internal controls and corporate governance, and as appropriate to complete the restatement of our previously issued consolidated financial statements. As of March 31, 2007, we employed approximately 6,600 personnel, including full-time and part-time employees, term employees and employees on leave.

## **WHERE YOU CAN FIND ADDITIONAL INFORMATION**

We file reports, proxy statements and other information with the SEC. We make available free of charge through our Web site our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and all other SEC reports and amendments to those reports as soon as reasonably practicable after we electronically file the

material with, or furnish it to, the SEC. Our Web site address is [www.fanniemae.com](http://www.fanniemae.com). Materials that we file with the SEC are also available from the SEC's Web site, [www.sec.gov](http://www.sec.gov). In addition, these materials may be inspected, without charge, and copies may be obtained at prescribed rates, at the SEC's Public Reference Room at 100 F Street, NE, Room 1580, Washington, DC 20549. You may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. You may also request

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copies of any filing from us, at no cost, by telephone at (202) 752-7000 or by mail at 3900 Wisconsin Avenue, NW, Washington, DC 20016.

Effective March 31, 2003, we voluntarily registered our common stock with the SEC under Section 12(g) of the Exchange Act. Our common stock, as well as the debt, preferred stock and mortgage-backed securities we issue, are exempt from registration under the Securities Act of 1933 and are exempt securities under the Exchange Act. The voluntary registration of our common stock does not affect the exempt status of the debt, equity and mortgage-backed securities that we issue.

With regard to OFHEO's regulation of our activities, you may obtain materials from OFHEO's Web site, [www.ofheo.gov](http://www.ofheo.gov). These materials include the September 2004 interim report of OFHEO's findings of its special examination and the May 2006 final report on its findings.

We are providing our Web site address and the Web site addresses of the SEC and OFHEO solely for your information. Information appearing on our Web site or on the SEC's Web site or OFHEO's Web site is not incorporated into this Annual Report on Form 10-K except as specifically stated in this Annual Report on Form 10-K.

**FORWARD-LOOKING STATEMENTS**

This report contains forward-looking statements, which are statements about matters that are not historical facts. In addition, our senior management may from time to time make forward-looking statements orally to analysts, investors, the news media and others. Forward-looking statements often include words such as expects, anticipates, intends, plans, believes, seeks, estimates, will, would, should, could, may, or similar words. All forward-looking statements in this report are statements relating to:

our expectation that we will file our 2006 Form 10-K by the end of 2007;

our expectations regarding industry and economic trends, including our expectations that:

growth in total U.S. residential mortgage debt outstanding will continue at a slower pace in 2007, as the housing market cools further and average home prices possibly decline modestly;

the continuation of positive demographic trends, such as stable household formation rates and a growing economy, will help mitigate the slowdown in the growth in residential mortgage debt outstanding, but are unlikely to offset the slowdown in the short- to medium-term;

average home prices could go down in 2007;

over the next decade, demographic demand (primarily from stable household formation rates, a positive age structure of the population for homebuying and rising homeownership rates because of the high level of immigration over the past 25 years) will be at a level that should lead to a fundamentally strong mortgage market, and will support continued long-term demand for new capital to finance the substantial and sustained housing finance needs of American homebuyers;

guidance by depository institution regulators will likely slow significantly the growth of subprime and Alt-A mortgage originations, which have represented an elevated level of market activity by historical standards in recent years;

our expectation that, when we expect to earn returns greater than our cost of equity capital, we generally will be an active purchaser of mortgage loans and mortgage-related securities, and that when few opportunities exist to earn returns above our cost of equity capital, we generally will be a less active purchaser, and may be a net seller, of mortgage loans and mortgage-related securities;

our expectation that we will be an active purchaser of less liquid forms of mortgage loans and mortgage-related securities even in periods of high market demand for mortgage assets;

our expectation that private-label issuers of mortgage-related securities will continue to provide significant competition for our Single-Family and HCD businesses;



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our expectation that the costs associated with the preparation of our post-2004 consolidated financial statements and periodic SEC reports will continue to have a substantial impact on administrative expenses at least until we are current in filing our periodic financial reports with the SEC;

our expectation that our recently implemented cost-cutting measures will reduce our administrative expenses by approximately \$200 million for 2007 as compared to 2006, and our expectation that we will reduce our administrative expenses, excluding costs associated with returning to timely financial reporting, to approximately \$2 billion per year in 2008;

our expectation that, based on the composition of our derivatives, we generally expect to report decreases in the aggregate fair value of our derivatives as interest rates decrease;

our expectation that, as a result of the variety of ways in which we record financial instruments in our consolidated financial statements, our earnings will vary, perhaps substantially, from period to period and result in volatility in our stockholders' equity and regulatory capital;

our belief that the estimated fair value of our derivatives may fluctuate substantially from period to period because of changes in interest rates, expected interest rate volatility and our derivative activity;

our expectation that we will experience high levels of period to period volatility in our results of operations and financial condition as part of our normal business activities, primarily due to changes in market conditions that result in periodic fluctuations in the estimated fair value of our derivatives;

our expectation of the continued strength of our quarterly fee income, moderate increases in our provision for credit losses and somewhat lower derivative fair value losses, as interest rates have generally trended up since the end of 2005 and remain at overall higher levels;

our expectation of a reduction in our net interest income and net interest yield in 2006 as a result of the decrease in the volume of our interest-earning assets and the decline in the spread between the average yield on these assets and our borrowing costs that we began experiencing at the end of 2004;

our expectation that net interest income will fluctuate based on changes in interest rates and changes in the amount and composition of our interest-earning assets and interest-bearing liabilities;

our expectation that unrealized gains and losses on trading securities will fluctuate each period with changes in volumes, interest rates and market prices;

our belief that the continued upward trend in interest rates during 2006, which caused a further decline in the fair value of our mortgage-related securities, is likely to result in our recognition of material other-than-temporary impairment charges in 2006 for impaired securities that we have identified for possible sale or that we sold prior to recovery of the impairment;

our intent to hold certain temporarily impaired securities until recovery;

our expectation that in normal market conditions, our selling activity will represent a modest portion of the total changes in the total portfolio for the year;

our expectation that tax credits and net operating losses resulting from our investments in LIHTC partnerships, which reduce our federal income tax liability, will grow in the future, and that it is more likely than not that the

results of future operations will generate sufficient taxable income to realize the entire tax benefit;

our intent to use the remainder of unused tax credits received in 2005 to reduce our income tax liability in future years;

our intent to continue to invest in LIHTC partnerships, and our expectation that our increased investments in LIHTC partnerships in 2006 will generate additional net operating losses and tax credits in the future;

our belief that the guaranty fee income generated from future business activity will largely replace any guaranty fee income lost as a result of mortgage prepayments;

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our expectation that loans that permit a borrower to defer principal or interest payments, such as negative-amortizing and interest-only loans, will default more often than traditional mortgage loans;

our current belief that we do not have credit concerns on multifamily properties related to the Gulf Coast Hurricanes Katrina and Rita;

our belief that our credit exposure to the subprime mortgage loans underlying the private-label mortgage-related securities in our portfolio is limited because we have focused our purchases on the highest-rated tranches of these securities to date;

our belief that our credit losses will increase and serious delinquencies may trend upward, as a result of the sharp decline in the rate of home price appreciation during 2006 and the possibility of home price declines in 2007;

our expectation of increasing foreclosure and REO incidence and credit losses in the Midwestern states, in light of the continued weakness of economic fundamentals, such as employment levels and lack of home price appreciation;

our expectation that our short-term and long-term funding needs and uses of cash in 2007 and 2008 will remain generally consistent with our needs during 2005 and 2006;

our expectation that, over the long term, our funding needs and sources of liquidity will remain relatively consistent with current needs and sources;

our belief that we continue to meet our regulatory capital requirements;

our intent to consider an increase in our issuance of debt in future years if we decide to increase our purchase of mortgage assets following the modification or expiration of the current limitation on the size of our mortgage portfolio;

our expectation that the outcome of the current Financial Accounting Standards Board ( FASB ) assessment of what activities a QSPE may perform might affect the entities we consolidate in future periods;

our belief that the measures that we have implemented to remediate the material weaknesses in internal control over financial reporting have had a material impact on our internal control over financial reporting since December 31, 2004;

our expectation that there will not be any change in our ability to borrow funds through the issuance of debt securities in the capital markets in the foreseeable future;

our expectation that our internal control environment will continue to be modified and enhanced in order to enable us to file periodic reports with the SEC on a current basis in the future;

our intention to continue to make significant adjustments to our mortgage loan sourcing and purchase strategies in an effort to meet HUD's increased housing goals and subgoals;

our belief that we achieved all of our housing goals for 2006, and that we are making progress toward our 2007 housing goals and subgoals;

our intent that, in the event that we were required to make payments under Fannie Mae MBS guaranties, we would pursue recovery of these payments by exercising our rights to the collateral backing the underlying loans or through available credit enhancements (which includes all recourse with third parties and mortgage insurance);

our expectation that we will experience periodic fluctuations in the estimated fair value of our net assets due to our business activity and changes in market conditions, including changes in interest rates, changes in relative spreads between our mortgage assets and debt, and changes in implied volatility;

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our expectation that changes in implied volatility, and relative changes between mortgage OAS and debt OAS are the market conditions that will have the most significant impact on the fair value of our net assets;

our expectation that the reduction in the size of our mortgage portfolio and higher administrative expenses will continue to negatively impact our earnings in 2006 and 2007;

our belief that we have defenses to the claims in the lawsuits pending against us and our intention to defend these lawsuits vigorously;

our intention to continue to work on improving our internal controls and procedures relating to the management of operational risk; and

descriptions of assumptions underlying or relating to any of the foregoing.

Forward-looking statements reflect our management's expectations or predictions of future conditions, events or results based on various assumptions and management's estimates of trends and economic factors in the markets in which we are active, as well as our business plans. They are not guarantees of future performance. By their nature, forward-looking statements are subject to risks and uncertainties. Our actual results and financial condition may differ, possibly materially, from the anticipated results and financial condition indicated in these forward-looking statements. There are a number of factors that could cause actual conditions, events or results to differ materially from those described in the forward-looking statements contained in this report. A discussion of factors that could cause actual conditions, events or results to differ materially from those expressed in any forward-looking statements appears in Item 1A Risk Factors.

Readers are cautioned not to place undue reliance on forward-looking statements in this report or that we make from time to time, and to consider carefully the factors discussed in Item 1A Risk Factors in evaluating these forward-looking statements. These forward-looking statements are representative only as of the date they are made, and we undertake no obligation to update any forward-looking statement as a result of new information, future events or otherwise.

## **GLOSSARY OF TERMS USED IN THIS REPORT**

Terms used in this report have the following meanings, unless the context indicates otherwise.

*Agency issuers* refers to the government-sponsored enterprises Fannie Mae and Freddie Mac, as well as Ginnie Mae.

*Alt-A mortgage* generally refers to a loan underwritten with lower or alternative documentation than a full documentation mortgage loan and may include other alternative product features. As a result, Alt-A mortgage loans generally have a higher risk of default than full documentation mortgage loans.

*ARM or adjustable-rate mortgage* refers to a mortgage loan with an interest rate that adjusts periodically over the life of the mortgage based on changes in a specified index.

*Business volume or new business acquisitions* refers to the sum in any given period of the unpaid principal balance of: (1) the mortgage loans and mortgage-related securities we purchase for our investment portfolio; and (2) the mortgage loans we securitize into Fannie Mae MBS that are acquired by third parties. It excludes mortgage loans we securitize from our portfolio.

*Charter Act or our charter* refers to the Federal National Mortgage Association Charter Act, 12 U.S.C. §1716 *et seq.*

*Conforming mortgage* refers to a conventional single-family mortgage loan with an original principal balance that is equal to or less than the applicable conforming loan limit, which is the applicable maximum original principal balance for a mortgage loan that we are permitted by our charter to purchase or securitize. The conforming loan limit is established each year by OFHEO based on the national average price of a one-family residence. The current conforming loan limit for a one-family residence in most geographic areas is \$417,000.

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*Conventional mortgage* refers to a mortgage loan that is not guaranteed or insured by the U.S. government or its agencies, such as the VA, FHA or RHS.

*Conventional single-family mortgage credit book of business* refers to the sum of the unpaid principal balance of: (1) the conventional single-family mortgage loans we hold in our investment portfolio; (2) the Fannie Mae MBS and non-Fannie Mae mortgage-related securities backed by conventional single-family mortgage loans we hold in our investment portfolio; (3) Fannie Mae MBS backed by conventional single-family mortgage loans that are held by third parties; and (4) credit enhancements that we provide on conventional single-family mortgage assets.

*Core capital* refers to a statutory measure of our capital that is the sum of the stated value of our outstanding common stock (common stock less treasury stock), the stated value of our outstanding non-cumulative perpetual preferred stock, our paid-in capital and our retained earnings, as determined in accordance with GAAP.

*Credit enhancement* refers to a method to reduce credit risk by requiring collateral, letters of credit, mortgage insurance, corporate guaranties, or other agreements to provide an entity with some assurance that it will be recompensed to some degree in the event of a financial loss.

*Critical capital requirement* refers to the amount of core capital below which we would be classified by OFHEO as critically undercapitalized and generally would be required to be placed in conservatorship. Our critical capital requirement is generally equal to the sum of: (1) 1.25% of on-balance sheet assets; (2) 0.25% of the unpaid principal balance of outstanding Fannie Mae MBS held by third parties; and (3) up to 0.25% of other off-balance sheet obligations.

*Delinquency* refers to an instance in which a principal or interest payment on a mortgage loan has not been made in full by the due date.

*Derivative* refers to a financial instrument that derives its value based on changes in an underlying, such as security or commodity prices, interest rates, currency rates or other financial indices. Examples of derivatives include futures, options and swaps.

*Duration* refers to the sensitivity of the value of a security to changes in interest rates. The duration of a financial instrument is the expected percentage change in its value in the event of a change in interest rates of 100 basis points.

*Fannie Mae mortgage-backed securities* or *Fannie Mae MBS* generally refer to those mortgage-related securities that we issue and with respect to which we guarantee to the related trusts that we will supplement amounts received by the MBS trust as required to permit timely payment of principal and interest on the related Fannie Mae MBS. We also issue some forms of mortgage-related securities for which we do not provide this guaranty. The term *Fannie Mae MBS* refers to all forms of mortgage-related securities that we issue, including single-class Fannie Mae MBS and multi-class Fannie Mae MBS.

*Fixed-rate mortgage* refers to a mortgage loan with an interest rate that does not change during the entire term of the loan.

*GAAP* refers to generally accepted accounting principles in the United States.

*GSEs* refers to government-sponsored enterprises such as Fannie Mae, Freddie Mac and the Federal Home Loan Banks.

*HUD* refers to the Department of Housing and Urban Development.

*Implied volatility* refers to the market's expectation of potential changes in interest rates.

*Interest-only loan* refers to a mortgage loan that allows the borrower to pay only the monthly interest due, and none of the principal, for a fixed term. After the end of that term the borrower can choose to refinance, pay the principal balance in a lump sum, or begin paying the monthly scheduled principal due on the loan, which results in a higher monthly payment at that time. Interest-only loans can be adjustable-rate or fixed-rate mortgage loans.



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*Interest rate swap* refers to a transaction between two parties in which each agrees to exchange payments tied to different interest rates or indices for a specified period of time, generally based on a notional principal amount. An interest rate swap is a type of derivative.

*Intermediate-term mortgage* refers to a mortgage loan with a contractual maturity at the time of purchase equal to or less than 15 years.

*LIHTC partnerships* refer to low-income housing tax credit limited partnerships or limited liability companies. For a description of these partnerships, refer to Business Segments Housing and Community Development Community Investment Group above.

*Liquid assets* refers to our holdings of non-mortgage investments, cash and cash equivalents, and funding agreements with our lenders, including advances to lenders and repurchase agreements.

*Loans, mortgage loans and mortgages* refer to both whole loans and loan participations, secured by residential real estate, cooperative shares or by manufactured housing units.

*Loan-to-value ratio* or *LTV ratio* refers to the ratio, at any point in time, of the unpaid principal amount of a borrower's mortgage loan to the value of the property that serves as collateral for the loan (expressed as a percentage).

*Minimum capital requirement* refers to the amount of core capital below which we would be classified by OFHEO as undercapitalized. Our minimum capital requirement is generally equal to the sum of: (1) 2.50% of on-balance sheet assets; (2) 0.45% of the unpaid principal balance of outstanding Fannie Mae MBS held by third parties; and (3) up to 0.45% of other off-balance sheet obligations.

*Mortgage assets*, when referring to our assets, refers to both mortgage loans and mortgage-related securities we hold in our portfolio.

*Mortgage credit book of business or book of business* refers to the sum of the unpaid principal balance of: (1) the mortgage loans we hold in our investment portfolio; (2) the Fannie Mae MBS and non-Fannie Mae mortgage-related securities we hold in our investment portfolio; (3) Fannie Mae MBS that are held by third parties; and (4) credit enhancements that we provide on mortgage assets.

*Mortgage-related securities or mortgage-backed securities* refer generally to securities that represent beneficial interests in pools of mortgage loans or other mortgage-related securities. These securities may be issued by Fannie Mae or by others.

*Multifamily mortgage loan* refers to a mortgage loan secured by a property containing five or more residential dwelling units.

*Multifamily business volume* refers to the sum in any given period of the unpaid principal balance of: (1) the multifamily mortgage loans we purchase for our investment portfolio; (2) the multifamily mortgage loans we securitize into Fannie Mae MBS; and (3) credit enhancements that we provide on our multifamily mortgage assets.

*Multifamily mortgage credit book of business* refers to the sum of the unpaid principal balance of: (1) the multifamily mortgage loans we hold in our investment portfolio; (2) the Fannie Mae MBS and non-Fannie Mae mortgage-related securities backed by multifamily mortgage loans we hold in our investment portfolio; (3) Fannie Mae MBS backed by multifamily mortgage loans that are held by third parties; and (4) credit enhancements that we provide on multifamily

mortgage assets.

*Negative-amortizing loan* refers to a mortgage loan that allows the borrower to make monthly payments that are less than the interest actually accrued for the period. The unpaid interest is added to the principal balance of the loan, which increases the outstanding loan balance. Negative-amortizing loans are typically adjustable-rate mortgage loans.

*Net mortgage portfolio assets* refers to the unpaid principal balance of our mortgage assets, net of market valuation adjustments, impairments, allowance for loan losses, and amortized premiums and discounts.

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*Notional principal amount* refers to the hypothetical dollar amount in an interest rate swap transaction on which exchanged payments are based. The notional principal amount in an interest rate swap transaction generally is not paid or received by either party to the transaction and is typically significantly greater than the potential market or credit loss that could result from such transaction.

*OFHEO* refers to the Office of Federal Housing Enterprise Oversight, our safety and soundness regulator.

*Option-adjusted spread* or *OAS* refers to the incremental expected return between a security, loan or derivative contract and a benchmark yield curve (typically, U.S. Treasury securities, LIBOR and swaps, or agency debt securities). The OAS provides explicit consideration of the variability in the security's cash flows across multiple interest rate scenarios resulting from any options embedded in the security, such as prepayment options. For example, the OAS of a mortgage that can be prepaid by the homeowner without penalty is typically lower than a nominal yield spread to the same benchmark because the OAS reflects the exercise of the prepayment option by the homeowner, which lowers the expected return of the mortgage investor. In other words, OAS for mortgage loans is a risk-adjusted spread after consideration of the prepayment risk in mortgage loans. The market convention for mortgages is typically to quote their OAS to swaps. The OAS of our debt and derivative instruments are also frequently quoted to swaps. The OAS of our net mortgage assets is therefore the combination of these two spreads to swaps and is the option-adjusted spread between our assets and our funding and hedging instruments.

*Outstanding Fannie Mae MBS* refers to the total unpaid principal balance of Fannie Mae MBS that is held by third-party investors and held in our mortgage portfolio.

*Private-label issuers* or *non-agency issuers* refers to issuers of mortgage-related securities other than agency issuers Fannie Mae, Freddie Mac and Ginnie Mae.

*Private-label securities* or *non-agency securities* refers to mortgage-related securities issued by entities other than agency issuers Fannie Mae, Freddie Mac or Ginnie Mae.

*Qualifying subordinated debt* refers to our subordinated debt that contains an interest deferral feature that requires us to defer the payment of interest for up to five years if either: (1) our core capital is below 125% of our critical capital requirement; or (2) our core capital is below our minimum capital requirement and the U.S. Secretary of the Treasury, acting on our request, exercises his or her discretionary authority pursuant to Section 304(c) of the Charter Act to purchase our debt obligations.

*REO* refers to real-estate owned by Fannie Mae, generally because we have foreclosed on the property or obtained the property through a deed in lieu of foreclosure.

*Reverse mortgage* refers to a financial tool that provides seniors with funds from the equity in their homes. Generally, no borrower payments are made on a reverse mortgage until the borrower moves or the property is sold. The final repayment obligation is designed not to exceed the proceeds from the sale of the home.

*Risk-based capital requirement* refers to the amount of capital necessary to absorb losses throughout a hypothetical ten-year period marked by severely adverse circumstances. Refer to [Item 7 MD&A Liquidity and Capital Management Capital Management Capital Adequacy Requirements Statutory Risk-Based Capital Requirements](#) for a detailed definition of our statutory risk-based capital requirement.

*Secondary mortgage market* refers to the financial market in which residential mortgages and mortgage-related securities are bought and sold.

*Single-family* mortgage loan refers to a mortgage loan secured by a property containing four or fewer residential dwelling units.

*Single-family business volume* refers to the sum in any given period of the unpaid principal balance of: (1) the single-family mortgage loans that we purchase for our investment portfolio; and (2) the single-family mortgage loans that we securitize into Fannie Mae MBS.

*Single-family mortgage credit book of business* refers to the sum of the unpaid principal balance of: (1) the single-family mortgage loans we hold in our investment portfolio; (2) the Fannie Mae MBS and non-Fannie

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Mae mortgage-related securities backed by single-family mortgage loans we hold in our investment portfolio; (3) Fannie Mae MBS backed by single-family mortgage loans that are held by third parties; and (4) credit enhancements that we provide on single-family mortgage assets.

*Subprime mortgage* generally refers to a mortgage loan made to a borrower with a weaker credit profile than that of a prime borrower. As a result of the weaker credit profile, subprime borrowers have a higher likelihood of default than prime borrowers. Subprime mortgage loans are often originated by lenders specializing in this type of business, using processes unique to subprime loans. In reporting our subprime exposure, we have classified mortgage loans as subprime if the mortgage loans are originated by one of these specialty lenders or, for the original or resecuritized private-label, mortgage-related securities that we hold in our portfolio, if the securities were labeled as subprime when sold.

*Swaptions* refers to options on interest rate swaps in the form of contracts granting an option to one party and creating a corresponding commitment from the counterparty to enter into specified interest rate swaps in the future. Swaptions are usually traded in the over-the-counter market and not through an exchange.

*Total capital* refers to a statutory measure of our capital that is the sum of core capital plus the total allowance for loan losses and reserve for guaranty losses in connection with Fannie Mae MBS, less the specific loss allowance (that is, the allowance required on individually-impaired loans).

*Yield curve* or *shape of the yield curve* refers to a graph showing the relationship between the yields on bonds of the same credit quality with different maturities. For example, a normal or positive sloping yield curve exists when long-term bonds have higher yields than short-term bonds. A flat yield curve exists when yields are relatively the same for short-term and long-term bonds. A steep yield curve exists when yields on long-term bonds are significantly higher than on short-term bonds. An inverted yield curve exists when yields on long-term bonds are lower than yields on short-term bonds.

## **Item 1A. Risk Factors**

This section identifies specific risks that should be considered carefully in evaluating our business. The risks described in *Company Risks* are specific to us and our business, while those described in *Risks Relating to Our Industry* relate to the industry in which we operate. Any of these risks could adversely affect our business, results of operations, cash flow or financial condition. Although we believe that these risks represent the material risks relevant to us, our business and our industry, new material risks may emerge that we are currently unable to predict. As a result, this description of the risks that affect our business and our industry is not exhaustive. The risks discussed below could cause our actual results to differ materially from our historical results or the results contemplated by the forward-looking statements contained in this report.

### **COMPANY RISKS**

***Competition in the mortgage and financial services industries, and the need to develop, enhance and implement strategies to adapt to changing trends in the mortgage industry and capital markets, may adversely affect our business and earnings.***

*Increasing Competition.* We compete to acquire mortgage loans for our mortgage portfolio or for securitization based on a number of factors, including our speed and reliability in closing transactions, our products and services, the liquidity of Fannie Mae MBS, our reputation and our pricing. We face increasing competition in the secondary mortgage market from other GSEs and from large commercial banks, savings and loan institutions, securities dealers, investment funds, insurance companies and other financial institutions. In addition, increasing consolidation within

the financial services industry has created larger private financial institutions, which has increased pricing pressure. The recent decreased rate of growth in U.S. residential mortgage debt outstanding in 2006 and 2007 also has increased competition in the secondary mortgage market by decreasing the number of new mortgage loans available for purchase. This increased competition may adversely affect our business and earnings.

*Potential Decrease in Earnings Resulting from Changes in Industry Trends.* The manner in which we compete and the products for which we compete are affected by changing trends in our industry. If we do not effectively respond to these trends, or if our strategies to respond to these trends are not as successful as our

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prior business strategies, our business, earnings and total returns could be adversely affected. For example, in recent years, an increasing proportion of single-family mortgage loan originations has consisted of non-traditional mortgages such as interest-only mortgages, negative-amortizing mortgages and subprime mortgages, while demand for traditional 30-year fixed-rate mortgages, which represents the largest portion of our business volume, has decreased. We did not participate in large amounts of these non-traditional mortgages in 2004, 2005 and 2006 because we determined that the pricing of these mortgages often offered insufficient compensation for the additional credit risk associated with these mortgages. These trends and our decision not to participate in large amounts of these non-traditional mortgages contributed to a significant loss in our share of new single-family mortgage-related securities issuances to private-label issuers during this period, with our market share decreasing from 45.0% in 2003 to 29.2% in 2004, 23.5% in 2005 and 23.7% in 2006.

We have modified and enhanced a number of our strategies as part of our ongoing efforts to adapt to recent changes in the industry. For example, our Capital Markets group focused on buying and holding mortgage assets to maturity prior to 2005. Beginning in 2005, however, in response to both our capital plan requirements and market conditions at that time, our Capital Markets group engaged in more active management of our portfolio as we continued to purchase and hold assets but also began to look for appropriate opportunities to sell mortgage assets and accelerate our realization of spread income, with the dual goals of supporting our chartered purpose of providing liquidity to the secondary mortgage market and maximizing long-term total returns, subject to various constraints on our purchases and sales of mortgage assets, as discussed in more detail below. In addition, we have been working with our lender customers to support a broad range of mortgage products, including subprime products, while closely monitoring credit risk and pricing dynamics across the full spectrum of mortgage product types.

We may not be able to execute successfully any new or enhanced strategies that we adopt. For example, the ability of our Capital Markets group to maximize long-term total returns from its investment activities is constrained by the limitation on the size of our portfolio under the OFHEO consent order; our risk parameters; operational limitations, including limitations relating to our current operating systems; regulatory limitations; and our intent to hold certain temporarily impaired assets until recovery and achieve certain tax consequences. In addition, our strategies, even if fully implemented, may not increase our share of the secondary mortgage market, our revenues or our total returns. A description of our method for assessing available-for-sale securities for other-than-temporary impairment is described in more detail in Item 7 MD&A Consolidated Results of Operations Investment Losses, Net.

***Material weaknesses and other control deficiencies relating to our internal controls could result in errors in our reported results and could have a material adverse effect on our operations, investor confidence in our business and the trading prices of our securities.***

Management's assessment of our internal control over financial reporting as of December 31, 2005 identified several material weaknesses in our internal control over financial reporting. As described in Item 9A Controls and Procedures Remediation Activities and Changes in Internal Control Over Financial Reporting, we have not remediated material weaknesses in our financial reporting process, access controls for information technology applications and infrastructure, pricing controls, and multifamily lender loss sharing modifications. Until they are remediated, these material weaknesses could lead to errors in our reported financial results and could have a material adverse effect on our operations, investor confidence in our business and the trading prices of our securities. In addition, we have not filed our 2006 Form 10-K and we are not able at this time to file our periodic reports with the SEC on a timely basis. We believe that we will not have remediated the material weakness relating to our disclosure controls and procedures until we are able to file required reports with the SEC and the NYSE on a timely basis.

In the future, we may identify further material weaknesses or significant deficiencies in our internal control over financial reporting that we have not discovered to date. In addition, we cannot be certain that we will be able to maintain adequate controls over our financial processes and reporting in the future.





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***The lack of current financial and operating information about the company, along with the restatement of our consolidated financial statements and related events, have had, and likely will continue to have, a material adverse effect on our business and reputation.***

We have become subject to several significant risks since our announcement in December 2004 that we would restate our previously filed consolidated financial statements. The 2004 Form 10-K that we filed in December 2006, which included restated consolidated financial statements for the years ended December 31, 2003 and 2002, was our first periodic report for periods after June 30, 2004. Our need to restate our historical financial statements and the delay in producing both restated and more current consolidated financial statements has resulted in several risks to our business, as discussed in the following paragraphs.

*Risks Relating to Lack of Current Information about our Business.* Material information about our current operating results and financial condition is unavailable because of the delay in filing our periodic financial reports for periods after December 31, 2005 with the SEC. As a result, investors do not have access to full information about the current state of our business. When this information becomes available to investors, it may result in an adverse effect on the trading price of our common stock.

*Risks Relating to Suspension and Delisting of Our Securities from the NYSE.* The delay in filing our 2006 Form 10-K with the SEC could cause the NYSE to commence suspension and delisting proceedings of our common stock. Pursuant to the NYSE's rules, if we do not file our 2006 Form 10-K by February 29, 2008 (twelve months after its due date), the NYSE will be required to commence suspension and delisting proceedings of our listed securities. If the NYSE were to delist our common stock it likely would result in a significant decline in the trading price, trading volume and liquidity of our common stock and the seven series of our preferred stock currently listed on the NYSE. In addition, we expect that the suspension and delisting of our common stock would be likely to lead to decreases in analyst coverage and market-making activity relating to our common stock, as well as reduced information about trading prices and volume.

*Risks Associated with Pending Civil Litigation.* We are subject to pending civil litigation that, if decided against us, could require us to pay substantial judgments or settlement amounts or provide for other relief, as discussed in Item 3 Legal Proceedings.

*Reputational Risks and Other Risks Relating to Negative Publicity.* We have been subject to continuing negative publicity as a result of our recent restatement of prior period financial statements and related problems, which we believe has contributed to significant declines in the price of our common stock. Continuing negative publicity could increase our cost of funds and also could adversely affect our customer relationships and the trading price of our stock. Negative publicity associated with our accounting restatement and related problems also has resulted in increased regulatory and legislative scrutiny of our business.

*Decrease in Common Stock Dividends and Limitation on Our Ability to Increase Our Dividend Payments.* In January 2005, in an effort to accelerate our achievement of a 30% capital surplus over our minimum capital requirement as required by OFHEO, we reduced our previous quarterly common stock dividend rate by 50%, from \$0.52 per share to \$0.26 per share. Under our May 2006 consent order with OFHEO, we are required to continue to operate under the capital restoration plan that OFHEO approved in February 2005. Our consent order with OFHEO also requires us to provide OFHEO with prior notice of any planned dividend and a description of the rationale for its payment. In addition, our Board of Directors is not permitted to increase the dividend at any time if payment of the increased dividend would reduce our capital surplus to less than 30% above our minimum capital requirement. In December 2006, the Board of Directors increased the common stock dividend to \$0.40 per share and on May 1, 2007 increased the dividend to \$0.50 per share.

***We are subject to credit risk relating to the mortgage loans that we purchase or that back our Fannie Mae MBS, and any resulting delinquencies and credit losses could adversely affect our financial condition and results of operations.***

Borrowers of mortgage loans that we purchase or that back our Fannie Mae MBS may fail to make the required payments of principal and interest on those loans, exposing us to the risk of credit losses. In addition, due to the current competitive dynamics of the mortgage market, we have recently increased our purchase and securitization of loans that pose a higher credit risk, such as negative-amortizing loans, interest-only loans and

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subprime mortgage loans. We also have increased the proportion of reduced documentation loans that we purchase or that back our Fannie Mae MBS.

For example, negative-amortizing adjustable-rate mortgages ( ARMs ) represented approximately 3% of our conventional single-family business volume in both 2005 and 2006. Interest-only ARMs represented approximately 9% of our conventional single-family business volume in both 2005 and 2006. We estimate that negative-amortizing ARMs and interest-only ARMs together represented approximately 6% of our conventional single-family mortgage credit book of business as of December 31, 2005 and 2006. We also estimate that subprime loans represented approximately 2.2% of our single-family mortgage credit book of business as of December 31, 2006, of which approximately 0.2% consisted of subprime mortgage loans or structured Fannie Mae MBS backed by subprime mortgage loans and approximately 2% consisted of private-label mortgage-related securities backed by subprime mortgage loans and, to a lesser extent, resecuritizations of private-label mortgage-related securities backed by subprime mortgage loans.

The increase in our exposure to credit risk resulting from the increase in these loans with higher credit risk may cause us to experience increased delinquencies and credit losses in the future, which could adversely affect our financial condition and results of operations. A discussion of how we manage mortgage credit risk and a description of the risk characteristics of our mortgage credit book of business is included in Item 7 MD&A Risk Management Credit Risk Management Mortgage Credit Risk Management.

***Changes in interest rates could have a material adverse effect on our financial condition and our earnings.***

We fund our operations primarily through the issuance of debt and invest our funds primarily in mortgage-related assets that permit the mortgage borrowers to prepay the mortgages at any time. These business activities expose us to market risk, which is the risk of loss from adverse changes in market conditions. Our most significant market risks are interest rate risk and option-adjusted spread risk. Interest rate risk is the risk of changes in our long-term earnings or in the value of our net assets due to changes in interest rates. Changes in interest rates affect both the value of our mortgage assets and prepayment rates on our mortgage loans. Changes in interest rates could have a material adverse impact on our business results and financial condition, including asset impairments or losses on assets sold, particularly if actual conditions differ significantly from our expectations.

Our ability to manage interest rate risk depends on our ability to issue debt instruments with a range of maturities and other features at attractive rates and to engage in derivative transactions. We must exercise judgment in selecting the amount, type and mix of debt and derivative instruments that will most effectively manage our interest rate risk. The amount, type and mix of financial instruments we select may not offset possible future changes in the spread between our borrowing costs and the interest we earn on our mortgage assets. A discussion of how we manage interest rate risk is included in Item 7 MD&A Risk Management Interest Rate Risk Management and Other Market Risks.

Option-adjusted spread risk is the risk that the option-adjusted spreads on our mortgage assets relative to those on our funding and hedging instruments (referred to as the OAS of our net assets) may increase or decrease. These increases or decreases may be a result of market supply and demand dynamics, including credit pricing basis risk between our assets and swaps and between swaps and our funding and hedging instruments. A widening of the OAS of our net mortgage assets typically causes a decline in the fair value of the company. A narrowing of the OAS of our net mortgage assets will reduce our opportunities to acquire mortgage assets and therefore could have a material adverse effect on our future earnings and financial condition. We do not attempt to actively manage or hedge the impact of changes in the OAS of our net mortgage assets after we purchase mortgage assets except through asset monitoring and disposition.

We make significant use of business and financial models to manage risk, although we recognize that models are inherently imperfect predictors of actual results because they are based on assumptions about factors such as future loan demand, prepayment speeds and other factors that may overstate or understate future experience. Our business could be adversely affected if our models fail to produce reliable results.

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***Our ability to operate our business, meet our obligations and generate net interest income depends primarily on our ability to issue substantial amounts of debt frequently and at attractive rates.***

The issuance of short-term and long-term debt securities in the domestic and international capital markets is our primary source of funding for purchasing assets for our mortgage portfolio and repaying or refinancing our existing debt. Moreover, our primary source of revenue is the net interest income we earn from the difference, or spread, between our borrowing costs and the return that we receive on our mortgage assets. Our ability to obtain funds through the issuance of debt, and the cost at which we are able to obtain these funds, depends on many factors, including:

- our corporate and regulatory structure, including our status as a GSE;
- legislative or regulatory actions relating to our business, including any actions that would affect our GSE status;
- rating agency actions relating to our credit ratings;
- our financial results and changes in our financial condition;
- significant events relating to our business or industry;
- the public's perception of the risks to and financial prospects of our business or industry;
- the preferences of debt investors;
- the breadth of our investor base;
- prevailing conditions in the capital markets;
- foreign exchange rates;
- interest rate fluctuations; and
- general economic conditions in the United States and abroad.

In addition, the other GSEs, such as Freddie Mac and the Federal Home Loan Banks, also issue significant amounts of AAA-rated agency debt to fund their operations, which may negatively affect the prices we are able to obtain for these securities.

Approximately 49.1% of the Benchmark Notes we issued in 2006 were purchased by non-U.S. investors, including both private institutions and non-U.S. governments and government agencies. Accordingly, a significant reduction in the purchase of our debt securities by non-U.S. investors could have a material adverse effect on both the amount of debt securities we are able to issue and the price we are able to obtain for these securities. Many of the factors that affect the amount of our securities that foreign investors purchase, including economic downturns in the countries where these investors are located, currency exchange rates and changes in domestic or foreign fiscal or monetary policies, are outside our control.

If we are unable to issue debt securities at attractive rates in amounts sufficient to operate our business and meet our obligations, it would have a material adverse effect on our liquidity, financial condition and results of operations. A

description of how we obtain funding for our business by issuing debt securities in the capital markets is contained in Item 7 MD&A Liquidity and Capital Management Liquidity Debt Funding. For a description of how we manage liquidity risk, see Item 7 MD&A Liquidity and Capital Management Liquidity Liquidity Risk Management.

On June 13, 2006, the U.S. Department of the Treasury announced that it would undertake a review of its process for approving our issuances of debt, which could adversely impact our flexibility in issuing debt securities in the future. We cannot predict whether the outcome of this review will materially impact our current business activities.

***A decrease in our current credit ratings would have an adverse effect on our ability to issue debt on acceptable terms, which would adversely affect our liquidity and our results of operations.***

Our borrowing costs and our broad access to the debt capital markets depend in large part on our high credit ratings. Our senior unsecured debt currently has the highest credit rating available from Moody's Investors Service ( Moody's ), Standard & Poor's, a division of The McGraw-Hill Companies ( Standard & Poor's ),

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and Fitch Ratings ( Fitch ). These ratings are subject to revision or withdrawal at any time by the rating agencies. Any reduction in our credit ratings could increase our borrowing costs, limit our access to the capital markets and trigger additional collateral requirements in derivative contracts and other borrowing arrangements. A substantial reduction in our credit ratings would reduce our earnings and materially adversely affect our liquidity, our ability to conduct our normal business operations and our competitive position. A description of our credit ratings and current ratings outlook is included in Item 7 MD&A Liquidity and Capital Management Liquidity Credit Ratings and Risk Ratings.

***We depend on our institutional counterparties to provide services that are critical to our business, and our financial condition and results of operations may be adversely affected by defaults by our institutional counterparties.***

We face the risk that our institutional counterparties may fail to fulfill their contractual obligations to us. Our primary exposure to institutional counterparty risk is with our mortgage insurers, mortgage servicers, depository institutions, lender customers, dealers that commit to sell mortgage pools or loans to us, issuers of investments held in our liquid investment portfolio, and derivatives counterparties. The products or services that these counterparties provide are critical to our business operations and a default by a counterparty with significant obligations to us could adversely affect our financial condition and results of operations. A discussion of how we manage institutional counterparty credit risk is included in Item 7 MD&A Risk Management Credit Risk Management Institutional Counterparty Credit Risk Management.

***Mortgage Insurers.*** Mortgage insurers may provide primary mortgage insurance or pool mortgage insurance. Primary mortgage insurance is insurance on an individual loan, while pool mortgage insurance is insurance that applies to a defined group of loans. A mortgage insurer could fail to fulfill its obligation to reimburse us for claims under our mortgage insurance policies, which would require us to bear the full loss of the borrower default on the mortgage loans. As of December 31, 2005, we were the beneficiary of primary mortgage insurance coverage on \$263.1 billion, and the beneficiary of pool mortgage insurance coverage on \$71.7 billion, of single-family loans, including conventional and government loans, held in our portfolio or underlying Fannie Mae MBS, which represented approximately 13% and 4%, respectively, of our single-family mortgage credit book of business.

***Mortgage Servicers.*** One or more of our mortgage servicers could fail to fulfill its mortgage loan servicing obligations, which include collecting payments from borrowers under the mortgage loans that we own or that back our Fannie Mae MBS, paying taxes and insurance on the properties secured by the mortgage loans, monitoring and reporting loan delinquencies, and repurchasing any loans that are subsequently found to have not met our underwriting criteria. In that event, we could incur credit losses associated with loan delinquencies or penalties for late payment of taxes and insurance on the properties that secure the mortgage loans serviced by that mortgage servicer. In addition, we likely would be forced to incur the costs necessary to replace the defaulting mortgage servicer. These events would result in a decrease in our net income. As of December 31, 2005, our ten largest single-family mortgage servicers serviced 72% of our single-family mortgage credit book of business, and Countrywide Financial Corporation, which is our largest single-family mortgage servicer, serviced 22% of the single-family mortgage credit book of business. Accordingly, the effect of a default by any one of these servicers could result in a more significant decrease in our net income than if our loans were serviced by a more diverse group of servicers.

***Lender Risk-Sharing Agreements.*** We enter into risk-sharing agreements with some of our lender customers that require them to reimburse us for losses under the loans that are the subject of those agreements. A lender's default in its obligation to reimburse us could decrease our net income.

***Custodial Depository Institutions.*** In connection with our mortgage servicers' obligations to collect funds from borrowers and make payments to us relating to the properties securing the mortgage loans, the servicers deposit borrower payments in a depository institution that the servicer selects. In the event that one or more of these

depository institutions becomes insolvent, or if the funds it holds become subject to claims of the institution's creditors, both we and the servicer may be unable to access the funds held by the depository institution. In that event, we would be unable to make required payments to holders of Fannie Mae MBS using the funds that are owed to us but in the possession of the depository institution and instead would be required



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to use other funds or funding sources to make the required payments. The need to fund required payments from alternative sources could have an adverse effect on our net income, depending on the amount involved and when and whether we are able to regain possession of the amounts held by the depository institution.

*Agreements with Dealers and Mortgage Originators and Investors.* We enter into agreements with dealers under which they commit to deliver pools of mortgages to us at an agreed-upon date and price. We commit to sell Fannie Mae MBS based in part on these commitments. If a dealer defaults in its commitment obligation, it could cause us to default in our obligation to deliver the Fannie Mae MBS on our commitment date or may force us to replace the loans at a higher cost in order to meet our commitment. Similarly, we enter into agreements with mortgage originators and mortgage investors to purchase or sell mortgage loans or mortgage-related securities. If the originator or investor fails to deliver mortgage assets or pay the fee otherwise required to fulfill its obligations under the agreement, we may be unable to sell or purchase equivalent mortgage loans or mortgage-related securities or to purchase or sell them on equally favorable terms, which would decrease or eliminate the profit or fees we expected to earn from the transaction.

*Liquid Investment Portfolio Issuers.* The primary credit exposure associated with investments held in our liquid investment portfolio is that the issuers of these investments will not repay principal and interest in accordance with the contractual terms. The failure of these issuers to make these payments could have a material adverse effect on our business results.

*Derivatives Counterparties.* If a derivatives counterparty defaults on payments due to us, we may need to enter into a replacement derivative contract with a different counterparty at a higher cost or we may be unable to obtain a replacement contract. As of December 31, 2005, we had 21 interest rate and foreign currency derivatives counterparties. Seven of these counterparties accounted for approximately 79% of the total outstanding notional amount of our derivatives contracts, and each of these seven counterparties accounted for between approximately 6% and 17% of the total outstanding notional amount. The insolvency of one of our largest derivatives counterparties combined with an adverse move in the market before we are able to transfer or replace the contracts could adversely affect our financial condition and results of operations. A discussion of how we manage the credit risk posed by our derivatives transactions and a detailed description of our derivatives credit exposure is contained in Item 7 MD&A Risk Management Credit Risk Management Institutional Counterparty Credit Risk Management Derivatives Counterparties.

***Our business faces significant operational risks and an operational failure could materially adversely affect our business.***

Shortcomings or failures in our internal processes, people or systems could have a material adverse effect on our risk management, liquidity, financial condition and results of operations; disrupt our business; and result in legislative or regulatory intervention, damage to our reputation and liability to customers. For example, our business is dependent on our ability to manage and process, on a daily basis, a large number of transactions across numerous and diverse markets. These transactions are subject to various legal and regulatory standards. We rely on the ability of our employees and our internal financial, accounting, cash management, data processing and other operating systems, as well as technological systems operated by third parties, to process these transactions and to manage our business. As a result of events that are wholly or partially beyond our control, these employees or third parties could engage in improper or unauthorized actions, or these systems could fail to operate properly. In the event of a breakdown in the operation of our or a third party's systems, or improper actions by employees or third parties, we could experience financial losses, business disruptions, legal and regulatory sanctions, and reputational damage.

Because we use a process of delegated underwriting for the single-family mortgage loans we purchase and securitize, we do not independently verify most borrower information that is provided to us. This exposes us to mortgage fraud risk, which is the risk that one or more of the parties involved in a transaction (the borrower, seller, broker, appraiser, title agent, lender or servicer) will misrepresent the facts about a mortgage loan. We may experience financial losses

and reputational damage as a result of mortgage fraud.

In addition, our operations rely on the secure processing, storage and transmission of a large volume of private borrower information, such as names, residential addresses, social security numbers, credit rating data and

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other consumer financial information. Despite the protective measures we take to reduce the likelihood of information breaches, this information could be exposed in several ways, including through unauthorized access to our computer systems, employee error, computer viruses that attack our computer systems, software or networks, accidental delivery of information to an unauthorized party and loss of unencrypted media containing this information. Any of these events could result in significant financial losses, legal and regulatory sanctions, and reputational damage. A description of our risk management programs for mortgage fraud and information security is included in

Item 7 MD&A Risk Management Operational Risk Management.

***We have several key lender customers, and the loss of business volume from any one of these customers could adversely affect our business, market share and results of operations.***

Our ability to generate revenue from the purchase and securitization of mortgage loans depends on our ability to acquire a steady flow of mortgage loans from the originators of those loans. We acquire a significant portion of our single-family mortgage loans from several large mortgage lenders. During 2005, our top five lender customers accounted for approximately 49% and 38% of our single-family and multifamily business volumes, respectively. In addition, during 2005, our largest lender customer accounted for approximately 25% of our single-family business volume and 10% of our multifamily business volume, respectively. Accordingly, maintaining our current business relationships and business volumes with our top lender customers is critical to our business. If any of our key lender customers significantly reduces the volume of mortgage loans that the lender delivers to us or that we are willing to buy from them, we could lose significant business volume that we might be unable to replace. The loss of business from any one of our key lender customers could adversely affect our business, market share and results of operations. In addition, a significant reduction in the volume of mortgage loans that we securitize could reduce the liquidity of Fannie Mae MBS, which in turn could have an adverse effect on their market value.

***Our business is subject to laws and regulations that may restrict our ability to compete optimally. In addition, legislation that would change the regulation of our business could, if enacted, reduce our competitiveness and adversely affect our results of operations and financial condition. The impact of existing regulation on our business is significant, and both existing and future regulation may adversely affect our business.***

As a federally chartered corporation, we are subject to the limitations imposed by the Charter Act, extensive regulation, supervision and examination by OFHEO and HUD, and regulation by other federal agencies, such as the U.S. Department of the Treasury and the SEC. We are also subject to many laws and regulations that affect our business, including those regarding taxation and privacy. A description of the laws and regulations that affect our business is contained in Item 1 Business Our Charter and Regulation of Our Activities.

***Regulation by OFHEO.*** OFHEO has broad authority to regulate our operations and management in order to ensure our financial safety and soundness. For example, to meet our capital plan requirements in 2005, we were required to make significant changes to our business in 2005, including reducing the size of our mortgage portfolio by approximately 20% and reducing our quarterly common stock dividend by 50%. Pursuant to our May 2006 consent order with OFHEO, we may not increase our net mortgage portfolio assets above \$727.75 billion, except in limited circumstances at OFHEO's discretion. This reduction in the size of our mortgage portfolio contributed to a significant reduction in our net interest income for the year ended December 31, 2005, as compared to the years ended December 31, 2004 and 2003. In addition, we have incurred significant administrative expenses in connection with complying with our remediation obligations, resulting in a reduction in our earnings for the year ended December 31, 2005, as compared to the years ended December 31, 2004 and 2003. We expect this reduction in the size of our mortgage portfolio and higher administrative expenses to continue to have a negative impact on our earnings in 2006 and 2007. If we fail to comply with any of our agreements with OFHEO or with any OFHEO regulation, we may incur penalties and could be subject to further restrictions on our activities and operations, or to investigation and enforcement actions by OFHEO.

*Regulation by HUD and Charter Act Limitations.* HUD supervises our compliance with the Charter Act, which defines our permissible business activities. For example, our business is limited to the U.S. housing finance sector and we may not purchase loans in excess of our conforming loan limits, which are currently

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\$417,000 for a one-family mortgage loan in most geographic regions and may be lower after 2007. As a result of these limitations on our ability to diversify our operations, our financial condition and earnings depend almost entirely on conditions in a single sector of the U.S. economy, specifically, the U.S. housing market. Our substantial reliance on conditions in the U.S. housing market may adversely affect the investment returns we are able to generate. In addition, the Secretary of HUD must approve any new Fannie Mae conventional mortgage program that is significantly different from those approved or engaged in prior to the enactment of the 1992 Act. As a result, we have only limited ability to respond quickly to changes in market conditions by offering new programs in response to these changes. These restrictions on our business operations may negatively affect our ability to compete successfully with other companies in the mortgage industry from time to time, which in turn may adversely affect our market share, our earnings and our financial condition. As described below under "To meet HUD's new housing goals and subgoals, we enter into transactions that may reduce our profitability," we are also subject to housing goals established by HUD, which require that a specified portion of our business relate to the purchase or securitization of mortgages for low- and moderate-income housing, underserved areas and special affordable housing. Meeting these goals may adversely affect our profitability.

*Legislative Proposals.* The U.S. Congress continues to consider legislation that, if enacted, could materially restrict our operations and adversely affect our business and our earnings. On March 29, 2007, the House Financial Services Committee approved a bill that would establish a new, independent regulator for us and the other GSEs, with broad authority over both safety and soundness and mission. The bill, if enacted into law, would affect us in significant ways, including:

authorizing the regulator to limit the size and composition of our mortgage investment portfolio;

authorizing the regulator to increase the level of our required capital;

changing the approval process for products and activities and expanding the extent of regulatory oversight of us and our officers, directors and employees;

changing the method for enforcing compliance with housing goals; and

authorizing, and in some instances requiring, the appointment of a receiver if we become critically undercapitalized.

In addition, the House bill would require us and Freddie Mac to contribute an amount equal to 1.2 basis points of our average total mortgage portfolios (including whole loans and securitized obligations, whether held in portfolio or sold in any form) to a fund to support affordable housing. Unlike the bill that passed the House in October 2005, the new bill would require annual contributions to the fund regardless of the amount of profit, if any, that we or Freddie Mac generate during the preceding year. In addition, the fund would be managed by the new GSE regulator rather than by the GSEs.

As of the date of this filing, the only GSE reform bill that has been introduced in the Senate is S. 1100, co-sponsored by four Republican members of the Senate Committee on Banking, Housing, and Urban Affairs. This bill is substantially similar to a bill that was approved by the Committee in July 2005, and differs from the House bill in a number of respects. It is expected that the Democratic Chairman of the Committee will bring his own version of GSE reform legislation to the Committee, but the timing is uncertain. Further, we cannot predict the content of any Senate bill that may be introduced or its prospects for Committee approval or passage by the full Senate.

Enactment of GSE legislation similar to these bills could significantly increase the costs of our compliance with regulatory requirements and limit our ability to compete effectively in the market, resulting in a material adverse

effect on our business and earnings, our ability to fulfill our mission, and our ability to recruit and retain qualified officers and directors. We cannot predict the prospects for the enactment, timing or content of any legislation in the 110<sup>th</sup> Congress, the form any enacted legislation might take, or its impact on our financial condition or results of operations.

*Changes in Existing Regulations or Regulatory Practices.* Our business and earnings could also be materially affected by changes in the regulation of our business made by any one or more of our existing regulators. A regulator may change its current process for regulating our business, change its current interpretations of our

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regulatory requirements or exercise regulatory authority over our business beyond current practices, and any of these changes could have a material adverse effect on our business and earnings. For example, in the late summer of 2006, HUD commenced a review of specified investments and holdings to determine whether our investment activities are consistent with our charter authority. We cannot predict the outcome of this review, which currently is ongoing, or whether HUD will seek to restrict our current business activities as a result of this or other reviews.

***To meet HUD's new housing goals and subgoals, we enter into transactions that may reduce our profitability.***

HUD has established housing goals and subgoals for our business. HUD's housing goals require that a specified portion of our business relate to the purchase or securitization of mortgage loans that finance housing for low- and moderate-income households, housing in underserved areas and qualified housing under the definition of special affordable housing. HUD has increased our housing goals for 2005 through 2008, and has created new purchase money mortgage subgoals effective beginning in 2005 that also increase over the 2005 to 2008 period. These changes in our housing goals and subgoals, together with increases in home prices and a decrease in our share of the secondary mortgage market in recent years, have made it increasingly challenging to meet our housing goals and subgoals.

As a result, meeting the increased housing goals and subgoals established by HUD for 2007 and future years may reduce our profitability. In order to obtain business that contributes to our new housing goals and subgoals, we have made, and continue to make, significant adjustments to our mortgage loan sourcing and purchase strategies. These strategies include entering into some purchase and securitization transactions with lower expected economic returns than our typical transactions. We have also relaxed some of our underwriting criteria to obtain goals-qualifying mortgage loans and increased our investments in higher-risk mortgage loan products that are more likely to serve the borrowers targeted by HUD's goals and subgoals, which could increase our credit losses.

The specific housing goals and subgoals levels for 2005 through 2008, as well as our performance against these goals in 2005 and 2006, are described in Item 1 Business Our Charter and Regulation of Our Activities Regulation and Oversight of Our Activities HUD Regulation Housing Goals. Several of HUD's housing goals and subgoals increase in 2007. Accordingly, it is possible that we may not meet one or more of our 2007 housing goals or subgoals. Meeting the higher subgoals for 2007 is particularly challenging because increased home prices and higher interest rates have reduced housing affordability during the past several years. Since HUD set the home purchase subgoals in 2004, the affordable housing markets have experienced a dramatic change. Home Mortgage Disclosure Act data released in 2006 show that the share of the primary mortgage market serving low- and moderate-income borrowers declined in 2005, reducing our ability to purchase and securitize mortgage loans that meet the HUD subgoals. If our efforts to meet the new housing goals and subgoals in 2007 and future years prove to be insufficient, we may need to take additional steps that could have an adverse effect on our profitability.

***In many cases, our accounting policies and methods, which are fundamental to how we report our financial condition and results of operations, require management to make estimates and rely on the use of models about matters that are inherently uncertain.***

Our accounting policies and methods are fundamental to how we record and report our financial condition and results of operations. Our management must exercise judgment in applying many of these accounting policies and methods so that these policies and methods comply with U.S. generally accepted accounting principles ( GAAP ) and reflect management's judgment of the most appropriate manner to report our financial condition and results of operations. In some cases, management must select the appropriate accounting policy or method from two or more alternatives, any of which might be reasonable under the circumstances but might affect the amount of assets, liabilities, revenues and expenses that we report. See Notes to Consolidated Financial Statements Note 1, Summary of Significant Accounting Policies for a description of our significant accounting policies.





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We have identified the following four accounting policies as critical to the presentation of our financial condition and results of operations:

estimating the fair value of financial instruments;

amortizing cost basis adjustments on mortgage loans and mortgage-related securities held in our portfolio and underlying outstanding Fannie Mae MBS using the effective interest method;

determining our allowance for loan losses and reserve for guaranty losses; and

determining whether an entity in which we have an ownership interest is a variable interest entity and whether we are the primary beneficiary of that variable interest entity and therefore must consolidate the entity.

We believe these policies are critical because they require management to make particularly subjective or complex judgments about matters that are inherently uncertain and because of the likelihood that materially different amounts would be reported under different conditions or using different assumptions. Due to the complexity of these critical accounting policies, our accounting methods relating to these policies involve substantial use of models. Models are inherently imperfect predictors of actual results because they are based on assumptions, including assumptions about future events, and actual results could differ significantly. More information about these policies is included in Item 7 MD&A Critical Accounting Policies and Estimates.

***The occurrence of a major natural or other disaster in the United States could increase our delinquency rates and credit losses or disrupt our business operations and lead to financial losses.***

The occurrence of a major natural disaster, terrorist attack or health epidemic in the United States could increase our delinquency rates and credit losses in the affected region or regions, which could have a material adverse effect on our financial condition and results of operations. For example, we experienced an increase in our delinquency rates and credit losses as a result of Hurricane Katrina. In addition, as of December 31, 2006, approximately 16% of the gross unpaid principal balance of the conventional single-family loans we held or securitized in Fannie Mae MBS and approximately 26% of the gross unpaid principal balance of the multifamily loans we held or securitized in Fannie Mae MBS were concentrated in California. Due to this geographic concentration in California, a major earthquake or other disaster in that state could lead to significant increases in delinquency rates and credit losses.

Despite the contingency plans and facilities that we have in place, our ability to conduct business also may be adversely affected by a disruption in the infrastructure that supports our business and the communities in which we are located. Potential disruptions may include those involving electrical, communications, transportation and other services we use or that are provided to us. Substantially all of our senior management and investment personnel work out of our offices in the Washington, DC metropolitan area. If a disruption occurs and our senior management or other employees are unable to occupy our offices, communicate with other personnel or travel to other locations, our ability to service and interact with each other and with our customers may suffer, and we may not be successful in implementing contingency plans that depend on communication or travel. A description of our disaster recovery plans and facilities in the event of a disruption of this type is included in Item 7 MD&A Risk Management Operational Risk Management.

***We are subject to pending civil litigation that, if decided against us, could require us to pay substantial judgments, settlements or other penalties.***

A number of lawsuits have been filed against us and certain of our current and former officers and directors relating to our accounting restatement. These suits are currently pending in the U.S. District Court for the District of Columbia and fall within three primary categories: a consolidated shareholder class action lawsuit, a consolidated shareholder derivative lawsuit and a consolidated Employee Retirement Income Security Act of 1974 ( ERISA )-based class action lawsuit. We may be required to pay substantial judgments, settlements or other penalties and incur significant expenses in connection with the consolidated shareholder class action and consolidated ERISA-based class action, which could have a material adverse effect on our business, results of operations and cash flows. In addition, our current and former directors, officers and employees may be

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entitled to reimbursement for the costs and expenses of these lawsuits pursuant to our indemnification obligations with those persons. We are also a party to several other lawsuits that, if decided against us, could require us to pay substantial judgments, settlements or other penalties. These include a proposed class action lawsuit alleging violations of federal and state antitrust laws and state consumer protection laws in connection with the setting of our guaranty fees and a proposed class action lawsuit alleging that we violated purported fiduciary duties with respect to certain escrow accounts for FHA-insured multifamily mortgage loans. We are unable at this time to estimate our potential liability in these matters. We expect all of these lawsuits to be time-consuming, and they may divert management's attention and resources from our ordinary business operations. More information regarding these lawsuits is included in Item 3 Legal Proceedings and Notes to Consolidated Financial Statements Note 19, Commitments and Contingencies.

## **RISKS RELATING TO OUR INDUSTRY**

### ***Changes in general market and economic conditions in the United States and abroad may adversely affect our financial condition and results of operations.***

Our financial condition and results of operations may be adversely affected by changes in general market and economic conditions in the United States and abroad. These conditions include short-term and long-term interest rates, the value of the U.S. dollar as compared to foreign currencies, fluctuations in both the debt and equity capital markets, employment growth and unemployment rates and the strength of the U.S. national economy and local economies. These conditions are beyond our control, and may change suddenly and dramatically.

Changes in market and economic conditions could adversely affect us in many ways, including the following:

fluctuations in the global debt and equity capital markets, including sudden and unexpected changes in short-term or long-term interest rates, could decrease the fair value of our mortgage assets, derivatives positions and other investments, negatively affect our ability to issue debt at attractive rates, and reduce our net interest income; and

an economic downturn or rising unemployment in the United States could decrease homeowner demand for mortgage loans and increase the number of homeowners who become delinquent or default on their mortgage loans. An increase in delinquencies or defaults would likely result in a higher level of credit losses, which would adversely affect our earnings. Also, decreased homeowner demand for mortgage loans could reduce our guaranty fee income, net interest income and the fair value of our mortgage assets. An economic downturn could also increase the risk that our counterparties will default on their obligations to us, increasing our liabilities and reducing our earnings.

### ***A decline in U.S. housing prices or in activity in the U.S. housing market could negatively impact our earnings and financial condition.***

U.S. housing prices have risen significantly in recent years. As described above, this period of extraordinary home price appreciation may have ended. The rate of home price appreciation has slowed, and we believe that a modest decline in national home prices, on average, could occur in 2007. Declines in housing prices could result in increased delinquencies or defaults on the mortgage loans we own or that back our guaranteed Fannie Mae MBS. Further, a significant portion of mortgage loans made in recent years contain adjustable-rate terms in which the interest rates are likely to increase dramatically after an initial period in which the rates are fixed. A substantial number of these adjustable-rate mortgage loans are expected to reset in 2007 and 2008 and will require significant increases in monthly payments, which also could lead to increased delinquencies or defaults. In addition, the prevalence of loans made based on limited or no credit and income documentation also increases the likelihood of future increases in delinquencies or defaults on mortgage loans. An increase in delinquencies or defaults likely will result in a higher

level of credit losses, which in turn will adversely affect our earnings. In addition, housing price declines would reduce the fair value of our mortgage assets.

Our business volume is affected by the rate of growth in total U.S. residential mortgage debt outstanding and the size of the U.S. residential mortgage market. Recently, the rate of growth in total U.S. residential mortgage debt outstanding has slowed, a trend that could be exacerbated if recent increases in delinquencies and defaults

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continue to reduce the number of mortgage lenders operating in the market. A decline in this growth rate reduces the number of mortgage loans available for us to purchase or securitize, which in turn could lead to a reduction in our net interest income and guaranty fee income.

### **Item 1B. Unresolved Staff Comments**

None.

### **Item 2. Properties**

We own our principal office, which is located at 3900 Wisconsin Avenue, NW, Washington, DC, as well as additional Washington, DC facilities at 3939 Wisconsin Avenue, NW and 4250 Connecticut Avenue, NW. We also own two office facilities in Herndon, Virginia, as well as two additional facilities located in Reston, Virginia, and Urbana, Maryland. These owned facilities contain a total of approximately 1,460,000 square feet of space. We lease the land underlying the 4250 Connecticut Avenue building pursuant to a ground lease that automatically renews on July 1, 2029 for an additional 49 years unless we elect to terminate the lease by providing notice to the landlord of our decision to terminate at least one year prior to the automatic renewal date. In addition, we lease approximately 375,000 square feet of office space at 4000 Wisconsin Avenue, NW, which is adjacent to our principal office. The present lease for 4000 Wisconsin Avenue expires in 2008, and we have the option to extend the lease for up to 10 additional years, in 5-year increments. We also lease an additional approximately 470,000 square feet of office space at six locations in Washington, DC, suburban Virginia and Maryland. We maintain approximately 454,000 square feet of office space in leased premises in Pasadena, California; Atlanta, Georgia; Chicago, Illinois; Philadelphia, Pennsylvania; and Dallas, Texas. In addition, we lease offices for 60 Fannie Mae Community Business Centers and satellite offices around the United States, which work with cities, rural areas and underserved communities.

### **Item 3. Legal Proceedings**

This item describes the material legal proceedings, examinations and other matters that: (1) were pending as of December 31, 2005; (2) were terminated during the period from January 1, 2005 through the filing of this report; or (3) are pending as of the filing of this report. Thus, the description of a matter may include developments that occurred since December 31, 2005, as well as those that occurred during 2005. The matters include legal proceedings relating to the restatement of our consolidated financial statements, such as class action and individual securities lawsuits, shareholder derivative actions and governmental proceedings, class action lawsuits alleging antitrust violations and abuse of escrow accounts, and a lawsuit we filed against KPMG LLP, our former outside auditor.

As described below, a number of lawsuits have been filed against us and certain of our current and former officers and directors relating to the accounting matters discussed in our SEC filings and OFHEO's interim and final reports, and in the report issued by the law firm of Paul, Weiss, Rifkind, Wharton & Garrison LLP ( Paul Weiss ) on the results of its independent investigation. These lawsuits currently are pending in the U.S. District Court for the District of Columbia and fall within three primary categories: (1) a consolidated shareholder class action, which includes cross-claims filed by KPMG, (2) a consolidated shareholder derivative lawsuit, and (3) a consolidated ERISA-based class action lawsuit. In addition, the Department of Labor is conducting a review of our Employee Stock Ownership Plan ( ESOP ).

In 2003, OFHEO commenced its special examination of us. The SEC and the U.S. Attorney's Office for the District of Columbia also commenced investigations against us relating to matters discussed in the OFHEO reports. On May 23, 2006, we reached a settlement with OFHEO and the SEC. In August 2006, we were advised by the U.S. Attorney's Office for the District of Columbia that it was discontinuing its investigation of us and does not plan to file charges against us.

Presently, we are also a defendant in a proposed class action lawsuit alleging violations of federal and state antitrust laws and state consumer protection laws in connection with the setting of our guaranty fees. In addition, we are a defendant in a proposed class action lawsuit alleging that we violated purported fiduciary duties with respect to certain escrow accounts for FHA-insured multifamily mortgage loans. We have also filed

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a lawsuit against our former auditor, KPMG LLP, asserting state law negligence and breach of contract claims related to certain audit and other services provided by KPMG.

We are involved in a number of legal and regulatory proceedings that arise in the ordinary course of business. For example, we are involved in legal proceedings that arise in connection with properties acquired either through foreclosure on properties securing delinquent mortgage loans we own or through our receipt of deeds to those properties in lieu of foreclosure. Claims related to possible tort liability occur from time to time, primarily in the case of single-family REO property.

From time to time, we are also a party to legal proceedings arising from our relationships with our sellers and servicers. Litigation can result from disputes with lenders concerning their loan origination or servicing obligations to us, or can result from disputes concerning termination by us (for a variety of reasons) of a lender's authority to do business with us as a seller and/or servicer. In addition, loan servicing and financing issues sometimes result in claims, including potential class actions, brought against us by borrowers.

We also are a party to legal proceedings arising from time to time from the conduct of our business and administrative functions, including contractual disputes and employment-related claims.

Litigation claims and proceedings of all types are subject to many factors that generally cannot be predicted accurately. For additional information on these proceedings, see Notes to Consolidated Financial Statements Note 19, Commitments and Contingencies.

## **RESTATEMENT-RELATED MATTERS**

### **Securities Class Action Lawsuits**

#### *In re Fannie Mae Securities Litigation*

Beginning on September 23, 2004, 13 separate complaints were filed by holders of our securities against us, as well as certain of our former officers, in the U.S. District Court for the District of Columbia, the U.S. District Court for the Southern District of New York and the U.S. District Court for the Southern District of Ohio. The complaints in these lawsuits purport to have been made on behalf of a class of plaintiffs consisting of purchasers of Fannie Mae securities between April 17, 2001 and September 21, 2004. The complaints alleged that we and certain of our officers, including Franklin D. Raines, J. Timothy Howard and Leanne Spencer, made material misrepresentations and/or omissions of material facts in violation of the federal securities laws. Plaintiffs' claims were based on findings contained in OFHEO's September 2004 interim report regarding its findings to that date in its special examination of our accounting policies, practices and controls.

All of the cases were consolidated and/or transferred to the U.S. District Court for the District of Columbia. A consolidated complaint was filed on March 4, 2005 against us and former officers Franklin D. Raines, J. Timothy Howard and Leanne Spencer. The court entered an order naming the Ohio Public Employees Retirement System and State Teachers Retirement System of Ohio as lead plaintiffs. The consolidated complaint generally made the same allegations as the individually-filed complaints, which is that we and certain of our former officers made false and misleading statements in violation of the federal securities laws in connection with certain accounting policies and practices. More specifically, the consolidated complaint alleged that the defendants made materially false and misleading statements in violation of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, and SEC Rule 10b-5 promulgated thereunder, largely with respect to accounting statements that were inconsistent with the GAAP requirements relating to hedge accounting and the amortization of premiums and discounts. Plaintiffs contend that the alleged fraud resulted in artificially inflated prices for our common stock. Plaintiffs seek compensatory

damages, attorneys' fees, and other fees and costs. Discovery commenced in this action following the denial of the motions to dismiss filed by us and the former officer defendants on February 10, 2006.

On April 17, 2006, the plaintiffs in the consolidated class action filed an amended consolidated complaint against us and former officers Franklin D. Raines, J. Timothy Howard and Leanne Spencer, that added purchasers of publicly traded call options and sellers of publicly traded put options to the putative class and sought to extend the end of the putative class period from September 21, 2004 to September 27, 2005. We and



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the individual defendants filed motions to dismiss addressing the extended class period and the deficiency of the additional accounting allegations. On August 14, 2006, while those motions were still pending, the plaintiffs filed a second amended complaint adding KPMG LLP and Goldman, Sachs & Co., Inc. as additional defendants and adding allegations based on the May 2006 report issued by OFHEO and the February 2006 report issued by Paul Weiss. Our answer to the second amended complaint was filed on January 16, 2007. Plaintiffs filed a motion for class certification on May 17, 2006 and briefing on the motion was completed on March 12, 2007.

On April 16, 2007, KPMG filed cross-claims against us for breach of contract, fraudulent misrepresentation, fraudulent inducement, negligent misrepresentation, and contribution. KPMG is seeking unspecified compensatory, consequential, restitutionary, rescissory, and punitive damages, including purported damages related to injury to KPMG's reputation, legal costs, exposure to legal liability, costs and expenses of responding to investigations related to our accounting, and lost fees. KPMG is also seeking attorneys' fees, costs, and expenses. We believe we have defenses to these claims and intend to defend them vigorously.

In addition, two individual securities cases have been filed by institutional investor shareholders in the U.S. District Court for the District of Columbia. The first case was filed on January 17, 2006 by Evergreen Equity Trust, Evergreen Select Equity Trust, Evergreen Variable Annuity Trust and Evergreen International Trust against us and the following current and former officers and directors: Franklin D. Raines, J. Timothy Howard, Leanne Spencer, Thomas P. Gerrity, Anne M. Mulcahy, Frederick V. Malek, Taylor Segue, III, William Harvey, Joe K. Pickett, Victor Ashe, Stephen B. Ashley, Molly Bordonaro, Kenneth M. Duberstein, Jamie Gorelick, Manuel Justiz, Ann McLaughlin Korologos, Donald B. Marron, Daniel H. Mudd, H. Patrick Swygert and Leslie Rahl.

The second individual securities case was filed on January 25, 2006 by 25 affiliates of Franklin Templeton Investments against us, KPMG LLP, and all of the following current and former officers and directors: Franklin D. Raines, J. Timothy Howard, Leanne Spencer, Thomas P. Gerrity, Anne M. Mulcahy, Frederick V. Malek, Taylor Segue, III, William Harvey, Joe K. Pickett, Victor Ashe, Stephen B. Ashley, Molly Bordonaro, Kenneth M. Duberstein, Jamie Gorelick, Manuel Justiz, Ann McLaughlin Korologos, Donald B. Marron, Daniel H. Mudd, H. Patrick Swygert and Leslie Rahl.

The two related individual securities actions assert various federal and state securities law and common law claims against us and certain of our current and former officers and directors based upon essentially the same alleged conduct as that at issue in the consolidated shareholder class action, and also assert insider trading claims against certain former officers. Both cases seek compensatory and punitive damages, attorneys' fees, and other fees and costs. In addition, the Evergreen plaintiffs seek an award of treble damages under state law.

On May 12, 2006, the individual securities plaintiffs voluntarily dismissed defendants Victor Ashe and Molly Bordonaro from both cases. On June 29, 2006 and then again on August 14 and 15, 2006, the individual securities plaintiffs filed first amended complaints and then second amended complaints seeking to address certain of the arguments made by the defendants in their original motions to dismiss and adding additional allegations regarding improper accounting practices. The second amended complaints each added Radian Group Inc. as a defendant. On August 17, 2006, we filed motions to dismiss certain claims and allegations of the individual securities plaintiffs second amended complaints, which motions are still pending. The individual plaintiffs seek to proceed independently of the potential class of shareholders in the consolidated shareholder class action, but the court has consolidated these cases as part of the consolidated shareholder class action for pretrial purposes and possibly through final judgment.

We believe we have defenses to the claims in these lawsuits and intend to defend these lawsuits vigorously.

## **Shareholder Derivative Lawsuits**

*In re Fannie Mae Shareholder Derivative Litigation*

Beginning on September 28, 2004, ten plaintiffs filed twelve shareholder derivative actions (*i.e.*, lawsuits filed by shareholder plaintiffs on our behalf) in three different federal district courts and the Superior Court of the District of Columbia on behalf of the company against certain of our current and former officers and directors

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and against us as a nominal defendant. Plaintiffs contend that the defendants purposefully misapplied GAAP, maintained poor internal controls, issued a false and misleading proxy statement, and falsified documents to cause our financial performance to appear smooth and stable, and that Fannie Mae was harmed as a result. The claims are for breaches of the duty of care, breach of fiduciary duty, waste, insider trading, fraud, gross mismanagement, violations of the Sarbanes-Oxley Act of 2002 and unjust enrichment. Plaintiffs seek compensatory damages, punitive damages, attorneys' fees, and other fees and costs, as well as injunctive relief related to the adoption by us of certain proposed corporate governance policies and internal controls.

All of these individual actions have been consolidated into the U.S. District Court for the District of Columbia and the court entered an order naming Pirelli Armstrong Tire Corporation Retiree Medical Benefits Trust and Wayne County Employees Retirement System as co-lead plaintiffs. A consolidated complaint was filed on September 26, 2005. The consolidated complaint named the following current and former officers and directors as defendants: Franklin D. Raines, J. Timothy Howard, Thomas P. Gerrity, Frederick V. Malek, Joe K. Pickett, Anne M. Mulcahy, Daniel H. Mudd, Kenneth M. Duberstein, Stephen B. Ashley, Ann McLaughlin Korologos, Donald B. Marron, Leslie Rahl, H. Patrick Swygert and John K. Wulff.

When document production commenced in *In re Fannie Mae Securities Litigation*, we agreed to simultaneously provide our document production from that action to the plaintiffs in the shareholder derivative action.

All of the defendants filed motions to dismiss the action on December 14, 2005. These motions were fully briefed but not ruled upon. In the interim, the plaintiffs filed an amended complaint on September 1, 2006, thus mooted the previously filed motions to dismiss. Among other things, the amended complaint added Goldman Sachs Group Inc., Goldman, Sachs & Co., Inc., Lehman Brothers Inc. and Radian Insurance Inc. as defendants, added allegations concerning the nature of certain transactions between these entities and Fannie Mae, added additional allegations from OFHEO's May 2006 report on its special examination and the Paul Weiss report, and added other additional details. The plaintiffs have since voluntarily dismissed those newly added third-party defendants. We filed motions to dismiss the first amended complaint on October 20, 2006, which motions are still pending.

## **ERISA Action**

### *In re Fannie Mae ERISA Litigation (formerly David Gwyer v. Fannie Mae)*

Three ERISA-based cases have been filed against us, our Board of Directors' Compensation Committee, and against the following former and current officers and directors: Franklin D. Raines, J. Timothy Howard, Daniel H. Mudd, Vincent A. Mai, Stephen Friedman, Anne M. Mulcahy, Ann McLaughlin Korologos, Joe K. Pickett, Donald B. Marron, Kathy Gallo and Leanne Spencer.

On October 15, 2004, David Gwyer filed a class action complaint in the U.S. District Court for the District of Columbia. Two additional class action complaints were filed by other plaintiffs on May 6, 2005 and May 10, 2005. All of these cases were consolidated on May 24, 2005 in the U.S. District Court for the District of Columbia. A consolidated complaint was filed on June 15, 2005. The plaintiffs in the consolidated ERISA-based lawsuit purport to represent a class of participants in our ESOP between January 1, 2001 and the present. Their claims are based on alleged breaches of fiduciary duty relating to accounting matters discussed in our SEC filings and in OFHEO's interim report. Plaintiffs seek unspecified damages, attorneys' fees, and other fees and costs, and other injunctive and equitable relief. We filed a motion to dismiss the consolidated complaint on June 29, 2005. Our motion and all of the other defendants' motions to dismiss were fully briefed and argued on January 13, 2006. As of the date of this filing, these motions are still pending. When document production commenced in *In re Fannie Mae Securities Litigation*, we agreed to simultaneously provide our document production from that action to the plaintiffs in the ERISA actions.

We believe we have defenses to the claims in these lawsuits and intend to defend these lawsuits vigorously.

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**Department of Labor ESOP Investigation**

In November 2003, the Department of Labor commenced a review of our ESOP and Retirement Savings Plan. The Department of Labor has concluded its investigation of our Retirement Savings Plan, but continues to review the ESOP. We continue to cooperate fully in this investigation.

**RESTATEMENT-RELATED INVESTIGATIONS BY U.S. ATTORNEY S OFFICE, OFHEO AND THE SEC**

**U.S. Attorney s Office Investigation**

In October 2004, we were told by the U.S. Attorney s Office for the District of Columbia that it was conducting an investigation of our accounting policies and practices. In August 2006, we were advised by the U.S. Attorney s Office for the District of Columbia that it was discontinuing its investigation of us and does not plan to file charges against us.

**OFHEO and SEC Settlements**

On May 23, 2006, we entered into comprehensive settlements with OFHEO and the SEC that resolved open matters related to their recent investigations of us.

*OFHEO Special Examination and Settlement*

In July 2003, OFHEO notified us that it intended to conduct a special examination of our accounting policies and internal controls, as well as other areas of inquiry. OFHEO began its special examination in November 2003 and delivered an interim report of its findings in September 2004. On May 23, 2006, OFHEO released its final report on its special examination. OFHEO s final report concluded that, during the period covered by the report (1998 to mid-2004), a large number of our accounting policies and practices did not comply with GAAP and we had serious problems in our internal controls, financial reporting and corporate governance. The final OFHEO report is available on our Web site ([www.fanniemae.com](http://www.fanniemae.com)) and on OFHEO s Web site ([www.ofheo.gov](http://www.ofheo.gov)).

Concurrently with OFHEO s release of its final report, we entered into comprehensive settlements that resolved open matters with OFHEO, as well as with the SEC (described below). As part of the OFHEO settlement, we agreed to OFHEO s issuance of a consent order. In entering into this settlement, we neither admitted nor denied any wrongdoing or any asserted or implied finding or other basis for the consent order. Under this consent order, in addition to the civil penalty described below, we agreed to undertake specified remedial actions to address the recommendations contained in OFHEO s final report, including actions relating to our corporate governance, Board of Directors, capital plans, internal controls, accounting practices, public disclosures, regulatory reporting, personnel and compensation practices. We also agreed not to increase our net mortgage portfolio assets above the amount shown in our minimum capital report to OFHEO for December 31, 2005 (\$727.75 billion), except in limited circumstances at OFHEO s discretion. The consent order superseded and terminated both our September 27, 2004 agreement with OFHEO and the March 7, 2005 supplement to that agreement, and resolved all matters addressed by OFHEO s interim and final reports of its special examination. As part of the OFHEO settlement, we also agreed to pay a \$400 million civil penalty, with \$50 million payable to the U.S. Treasury and \$350 million payable to the SEC for distribution to certain shareholders pursuant to the Fair Funds for Investors provision of the Sarbanes-Oxley Act of 2002. We have paid this civil penalty in full. This \$400 million civil penalty, which has been recorded as an expense in our 2004 consolidated financial statements, is not deductible for tax purposes.

*SEC Investigation and Settlement*

Following the issuance of the September 2004 interim OFHEO report, the SEC informed us that it was investigating our accounting practices.

Concurrently, at our request, the SEC reviewed our accounting practices with respect to hedge accounting and the amortization of premiums and discounts, which OFHEO's interim report had concluded did not comply

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with GAAP. On December 15, 2004, the SEC's Office of the Chief Accountant announced that it had advised us to (1) restate our financial statements filed with the SEC to eliminate the use of hedge accounting, and (2) evaluate our accounting for the amortization of premiums and discounts, and restate our financial statements filed with the SEC if the amounts required for correction were material. The SEC's Office of the Chief Accountant also advised us to reevaluate the GAAP and non-GAAP information that we previously provided to investors.

On May 23, 2006, without admitting or denying the SEC's allegations, we consented to the entry of a final judgment requiring us to pay the civil penalty described above and permanently restraining and enjoining us from future violations of the anti-fraud, books and records, internal controls and reporting provisions of the federal securities laws. The settlement, which included the \$400 million civil penalty described above, resolved all claims asserted against us in the SEC's civil proceeding. Our consent to the final judgment was filed as an exhibit to the Form 8-K that we filed with the SEC on May 30, 2006. The final judgment was entered by the U.S. District Court of the District of Columbia on August 9, 2006.

## **OTHER LEGAL PROCEEDINGS**

### **Former CEO Arbitration**

On September 19, 2005, Franklin D. Raines, our former Chairman and Chief Executive Officer, initiated arbitration proceedings against Fannie Mae before the American Arbitration Association. On April 10, 2006, the parties convened an evidentiary hearing before the arbitrator. The principal issue before the arbitrator was whether we were permitted to waive a requirement contained in Mr. Raines' employment agreement that he provide six months notice prior to retiring. On April 24, 2006, the arbitrator issued a decision finding that we could not unilaterally waive the notice period, and that the effective date of Mr. Raines' retirement was June 22, 2005, rather than December 21, 2004 (his final day of active employment). Under the arbitrator's decision, Mr. Raines' election to receive an accelerated, lump-sum payment of a portion of his deferred compensation must now be honored. Moreover, we must pay Mr. Raines any salary and other compensation to which he would have been entitled had he remained employed through June 22, 2005, less any pension benefits that Mr. Raines received during that period. On November 7, 2006, the parties entered into a consent award, which partially resolved the issue of amounts due Mr. Raines. In accordance with the consent award, we paid Mr. Raines \$2.6 million on November 17, 2006. By agreement, final resolution of the unresolved issues was deferred until after our accounting restatement results were announced. Each party had the right, within sixty days of the announcement of our accounting restatement results, to notify the arbitrator whether it believes that further proceedings are necessary. The parties have filed a request for an extension with the arbitrator.

### **Antitrust Lawsuits**

#### *In re G-Fees Antitrust Litigation*

Since January 18, 2005, we have been served with 11 proposed class action complaints filed by single-family borrowers that allege that we and Freddie Mac violated the Clayton and Sherman Acts and state antitrust and consumer protection statutes by agreeing to artificially fix, raise, maintain or stabilize the price of our and Freddie Mac's guaranty fees. Two of these cases were filed in state courts. The remaining cases were filed in federal court. The two state court actions were voluntarily dismissed. The federal court actions were consolidated in the U.S. District Court for the District of Columbia. Plaintiffs filed a consolidated amended complaint on August 5, 2005. Plaintiffs in the consolidated action seek to represent a class of consumers whose loans allegedly contain a guarantee fee set by us or Freddie Mac between January 1, 2001 and the present. The consolidated amended complaint alleges violations of federal and state antitrust laws and state consumer protection and other laws. Plaintiffs seek unspecified damages, treble damages, punitive damages, and declaratory and injunctive relief, as well as attorneys' fees and costs.

We and Freddie Mac filed a motion to dismiss on October 11, 2005. The motion to dismiss has been fully briefed and remains pending.



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We believe we have defenses to the claims in these lawsuits and intend to defend these lawsuits vigorously.

### **Escrow Litigation**

*Casa Orlando Apartments, Ltd., et al. v. Federal National Mortgage Association (formerly known as Medlock Southwest Management Corp., et al. v. Federal National Mortgage Association)*

We are the subject of a lawsuit in which plaintiffs purport to represent a class of multifamily borrowers whose mortgages are insured under Sections 221(d)(3), 236 and other sections of the National Housing Act and are held or serviced by us. The complaint identified as a class low- and moderate-income apartment building developers who maintained uninvested escrow accounts with us or our servicer. Plaintiffs Casa Orlando Apartments, Ltd., Jasper Housing Development Company and the Porkolab Family Trust No. 1 allege that we violated fiduciary obligations that they contend we owe to borrowers with respect to certain escrow accounts and that we were unjustly enriched. In particular, plaintiffs contend that, starting in 1969, we misused these escrow funds and are therefore liable for any economic benefit we received from the use of these funds. Plaintiffs seek a return of any profits, with accrued interest, earned by us related to the escrow accounts at issue, as well as attorneys' fees and costs.

The complaint was filed in the U.S. District Court for the Eastern District of Texas (Texarkana Division) on June 2, 2004 and served on us on June 16, 2004. Our motion to dismiss and motion for summary judgment were denied on March 10, 2005. We filed a partial motion for reconsideration of our motion for summary judgment, which was denied on February 24, 2006.

Plaintiffs have filed an amended complaint and a motion for class certification. A hearing on plaintiffs' motion for class certification was held on July 19, 2006, and the motion remains pending.

We believe we have defenses to the claims in this lawsuit and intend to defend this lawsuit vigorously.

### **KPMG Litigation**

On December 12, 2006, we filed suit against KPMG LLP, our former outside auditor, in the Superior Court of the District of Columbia. The complaint alleges state law negligence and breach of contract claims related to certain audit and other services provided by KPMG. We are seeking compensatory damages in excess of \$2 billion to recover costs related to our restatement and other damages. On December 12, 2006, KPMG removed the case to the U.S. District Court for the District of Columbia. KPMG filed a motion to dismiss on February 16, 2007. Both motions are still pending.

See [Restatement Related Matters Securities Class Action Lawsuits In re Fannie Mae Securities Litigation](#), for a discussion of KPMG's cross claims against us.

### **Item 4. *Submission of Matters to a Vote of Security Holders***

None.

**Table of Contents****PART II****Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities**

Our common stock is publicly traded on the New York and Chicago stock exchanges and is identified by the ticker symbol FNM. The transfer agent and registrar for our common stock is Computershare, P.O. Box 43081, Providence, Rhode Island 02940.

**Common Stock Data**

The following table shows, for the periods indicated, the high and low sales prices per share of our common stock in the consolidated transaction reporting system as reported in the Bloomberg Financial Markets service, as well as the dividends per share declared in each period.

| <b>Quarter</b> | <b>High</b> | <b>Low</b> | <b>Dividend</b> |
|----------------|-------------|------------|-----------------|
| <b>2004</b>    |             |            |                 |
| First Quarter  | \$ 80.82    | \$ 70.75   | \$ 0.52         |
| Second Quarter | 75.47       | 65.89      | 0.52            |
| Third Quarter  | 77.80       | 63.05      | 0.52            |
| Fourth Quarter | 73.81       | 62.95      | 0.52            |
| <b>2005</b>    |             |            |                 |
| First Quarter  | \$ 71.70    | \$ 53.72   | \$ 0.26         |
| Second Quarter | 61.66       | 49.75      | 0.26            |
| Third Quarter  | 60.21       | 41.34      | 0.26            |
| Fourth Quarter | 50.80       | 41.41      | 0.26            |
| <b>2006</b>    |             |            |                 |
| First Quarter  | \$ 58.60    | \$ 48.41   | \$ 0.26         |
| Second Quarter | 54.53       | 46.17      | 0.26            |
| Third Quarter  | 56.31       | 46.30      | 0.26            |
| Fourth Quarter | 62.37       | 54.40      | 0.40            |
| <b>2007</b>    |             |            |                 |
| First Quarter  | \$ 60.44    | \$ 51.88   | \$ 0.40         |

**Holder**

As of April 2, 2007, we had approximately 19,000 registered holders of record of our common stock.

**Dividends**

The table set forth under Common Stock Data above presents the dividends we declared on our common stock from the first quarter of 2004 through and including the first quarter of 2007.

In January 2005, our Board of Directors reduced our quarterly common stock dividend rate by 50%, from \$0.52 per share to \$0.26 per share. We reduced our common stock dividend rate in order to increase our capital surplus, which

was a component of our capital restoration plan. See Item 7 MD&A Liquidity and Capital Management Capital Management Capital Adequacy Requirements Capital Restoration Plan and OFHEO-Directed Minimum Capital Requirement for a description of our capital restoration plan. In December 2006, the Board of Directors increased the common stock dividend to \$0.40 per share beginning in the fourth quarter of 2006. On May 1, 2007, the Board of Directors again increased the common stock dividend to \$0.50 per share. The Board determined that this most recent increased dividend would be effective beginning in the second quarter of 2007, and therefore declared a special common stock dividend of \$0.10 per share, payable on May 25, 2007, to stockholders of record on May 18, 2007. This special dividend of \$0.10, combined with our previously declared quarterly dividend of \$0.40, will result in a total common stock

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dividend of \$0.50 per share for the second quarter of 2007. Our Board of Directors will continue to assess dividend payments for each quarter based upon the facts and conditions existing at the time.

Our payment of dividends is subject to certain restrictions, including the submission of prior notification to OFHEO detailing the rationale and process for the proposed dividend and prior approval by the Director of OFHEO of any dividend payment that would cause our capital to fall below specified capital levels. See Item 7 MD&A Liquidity and Capital Management Capital Management Capital Activity OFHEO Oversight of Our Capital Activity for a description of these restrictions. Payment of dividends on our common stock is also subject to the prior payment of dividends on our 11 series of preferred stock, representing an aggregate of 110,175,000 shares outstanding as of April 2, 2007. Quarterly dividends declared on the shares of our preferred stock outstanding totaled \$128.4 million for the quarter ended March 31, 2007. See Notes to Consolidated Financial Statements Note 16, Preferred Stock for detailed information on our preferred stock dividends.

## **Securities Authorized for Issuance under Equity Compensation Plans**

The information required by Item 201(d) of Regulation S-K is provided under Item 12 Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters, which is incorporated herein by reference.

## **Recent Sales of Unregistered Securities**

Information about sales and issuances of our unregistered securities during 2005 and 2006 was provided in Forms 8-K we filed on May 9, 2006, August 9, 2006, November 8, 2006 and February 27, 2007, and in our Annual Report on Form 10-K for the year ended December 31, 2004 filed on December 6, 2006.

The securities we issue are exempted securities under the Securities Act and the Exchange Act to the same extent as obligations of, or guaranteed as to principal and interest by, the United States. As a result, we do not file registration statements with the SEC with respect to offerings of our securities.

**Table of Contents****Purchases of Equity Securities by the Issuer**

The following table shows shares of our common stock we repurchased from January 2005 through December 2006.

|             | <b>Total<br/>Number<br/>of Shares<br/>Purchased<sup>(1)</sup></b> | <b>Average<br/>Price Paid<br/>per Share</b> | <b>Total Number of<br/>Shares Purchased<br/>as Part of Publicly<br/>Announced<br/>Program<sup>(2)</sup><br/>(Shares in thousands)</b> | <b>Maximum<br/>Number<br/>of Shares that<br/>May Yet be<br/>Purchased Under<br/>the Program<sup>(3)(4)</sup></b> |
|-------------|---|---|---|--|
| <b>2005</b> |   |   |   |  |
| January     | 107   | \$ 65.60                                    |   | 63,503   |
| February    | 21  | 57.86                                       |   | 63,234   |
| March       | 3   | 57.17                                       |   | 63,957   |
| April       | 3   | 55.02                                       |   | 63,723   |
| May         | 11  | 57.24                                       |   | 63,510   |
| June        | 9   | 58.79                                       |   | 63,359   |
| July        | 5   | 58.86                                       |   | 63,070   |
| August      | 4   | 52.44                                       |   | 62,951   |
| September   | 15  | 46.70                                       |   | 62,755   |
| October     | 37  | 45.42                                       |   | 62,525   |
| November    | 259   | 47.35                                       |   | 62,123   |
| December    | 18  | 47.67                                       |   | 61,364   |
| Total       | 492   | \$ 52.29                                    |   | 61,364   |
| <b>2006</b> |   |   |   |  |
| January     | 196   | \$ 53.23                                    |   | 60,596   |
| February    | 58  | 58.10                                       |   | 60,112   |
| March       | 61  | 54.04                                       |   | 60,269   |
| April       | 10  | 52.60                                       |   | 61,267   |
| May         | 13  | 50.38                                       | 4   | 61,160   |
| June        | 13  | 48.11                                       | 4   | 61,046   |
| July        | 11  | 48.55                                       |   | 60,983   |
| August      | 52  | 49.29                                       | 23  | 60,900   |
| September   | 19  | 53.91                                       | 7   | 60,669   |
| October     | 210   | 58.32                                       |   | 60,526   |
| November    | 231   | 59.92                                       |   | 60,047   |
| December    | 26  | 60.07                                       | 9   | 59,517   |
| Total       | 900   | \$ 56.32                                    | 47  | 59,517   |

- (1) In addition to shares repurchased as part of the publicly announced programs described in footnote 2 below, these shares consist of: (a) 513,301 shares of common stock reacquired from employees to pay an aggregate of approximately \$29 million in withholding taxes due upon the vesting of restricted stock; (b) 141,239 shares of common stock reacquired from employees to pay an aggregate of approximately \$7.5 million in withholding taxes due upon the exercise of stock options; (c) 671,449 shares of common stock repurchased from employees and members of our Board of Directors to pay an aggregate exercise price of approximately \$36 million for stock options; and (d) 18,794 shares of common stock repurchased from employees in a limited number of instances relating to employees' financial hardship.
- (2) Consists of 47,440 shares of common stock repurchased from employees pursuant to our publicly announced employee stock repurchase program. On May 9, 2006, we announced that the Board of Directors had authorized a stock repurchase program (the "Employee Stock Repurchase Program") under which we may repurchase up to \$100 million of Fannie Mae shares from non-officer employees. On January 21, 2003, we publicly announced that the Board of Directors had approved a share repurchase program (the "General Repurchase Authority") under which we could purchase in open market transactions the sum of (a) up to 5% of the shares of common stock outstanding as of December 31,

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2002 (49.4 million shares) and (b) additional shares to offset stock issued or expected to be issued under our employee benefit plans. Neither the General Repurchase Authority nor the Employee Stock Repurchase Program has a specified expiration date.

- (3) Consists of the total number of shares that may yet be purchased under the General Repurchase Authority as of the end of the month, including the number of shares that may be repurchased to offset stock that may be issued pursuant to the Stock Compensation Plan of 1993 and the Stock Compensation Plan of 2003. Repurchased shares are first offset against any issuances of stock under our employee benefit plans. To the extent that we repurchase more shares than have been issued under our plans in a given month, the excess number of shares is deducted from the 49.4 million shares approved for repurchase under the General Repurchase Authority. Because of new stock issuances and expected issuances pursuant to new grants under our employee benefit plans, the number of shares that may be purchased under the General Repurchase Authority fluctuates from month to month. No shares were repurchased from August 2004 through December 2006 in the open market pursuant to the General Repurchase Authority. See Notes to Consolidated Financial Statements Note 12, Stock-Based Compensation Plans, for information about shares issued, shares expected to be issued, and shares remaining available for grant under our employee benefit plans. Excludes the remaining number of shares authorized to be repurchased under the Employee Stock Repurchase Program. Assuming a price per share of \$59.76, the average of the high and low stock prices of Fannie Mae common stock on December 29, 2006, approximately 1.6 million shares may yet be purchased under the Employee Stock Repurchase Program.
- (4) Does not reflect the determination by our Board of Directors in February 2007 not to pay out certain shares expected to be issued under our plans. See Notes to Consolidated Financial Statements Note 12, Stock-Based Compensation Plans for a description of these shares.

**Table of Contents****Item 6. Selected Financial Data**

The selected consolidated financial data presented below is summarized from our results of operations for the four-year period ended December 31, 2005, as well as selected consolidated balance sheet data as of December 31, 2005, 2004, 2003, 2002 and 2001. In light of the substantial time, effort and expense incurred since December 2004 to complete the restatement of our consolidated financial statements for 2003 and 2002, we determined that extensive additional efforts would be required to restate all 2001 financial data. In particular, significant complexities of accounting standards, turnover of relevant personnel, and limitations of systems and data all limit our ability to reconstruct additional financial information for 2001. Information published for 2001 prior to the filing of our 2004 Form 10-K should not be relied upon. The data presented below should be read in conjunction with the consolidated financial statements and related notes and with Item 7 MD&A included in this Annual Report on Form 10-K.

|  | <b>2005</b>  | <b>As of December 31,</b> |             |             |
|--|--|---------------------------|-------------|-------------|
|  |  | <b>2004</b>               | <b>2003</b> | <b>2002</b> |
|  | <b>(Dollars in millions, except per share amounts)</b> |                           |             |             |
| <b><u>Income Statement Data:</u></b>   |  |                           |             |             |
| Net interest income  | \$ 11,505  | \$ 18,081                 | \$ 19,477   | \$ 18,426   |
| Guaranty fee income  | 3,779  | 3,604                     | 3,281       | 2,516       |
| Derivative fair value losses, net  | (4,196)  | (12,256)                  | (6,289)     | (12,919)    |
| Other income (loss) <sup>(1)</sup>   | (725)  | (812)                     | (4,220)     | (1,735)     |
| Income before extraordinary gains (losses) and cumulative effect of change in accounting principle | \$ 6,294   | \$ 4,975                  |             |             |