

# LETTER TO SHAREHOLDERS

Dear Shareholders

On behalf of our Board of Directors and my 6,000 fellow employees, thank you for your investment in Fannie Mae.

This is our first letter to shareholders in three years, going back to the date Fannie Mae withdrew financial statements covering 2001 to 2004. Since then, we have made fundamental changes to the Fannie Mae of old. While we initiated many changes to correct problems in accounting, controls, and structure, our overall ambition was to build an ever-stronger, more capable business. After more than \$1.6 billion of investment, the work of over 2,000 people, a restatement that reduced our past earnings by \$6.3 billion, the establishment of new strategies, roles, responsibilities, governance, and culture – we are closer to the company we want. I thank you for your patience and encouragement as we did this work.

Today, as we continue to strengthen our company, we are focused on working with our partners to help the housing and mortgage markets weather one of the toughest corrections in recent history. The alignment of our mission and our business has never been clearer. By serving our mission to help provide liquidity, stability, and affordable financing to the market, Fannie Mae's single-family and multifamily credit guaranty businesses are now having one of their strongest years of growth ever, making strong gains in market share – although, of course, our business is also feeling the impact of tough conditions in the credit market. Later in this letter I will tell you how Fannie Mae is doing, and about our "HomeStay" initiative and other efforts to help the market.

In this letter, I hope to bring you – our owners, investors, stakeholders, friends, and critics – up to date in four areas:

1. What we've done to rebuild and strengthen Fannie Mae;
2. How we've performed through a period of enormous organizational transition;
3. What we are doing to address the current market turmoil; and,
4. How we are positioned for the future.

First things first – let me summarize our business and financial performance in 2005 and 2006, which reflected the many challenges we faced.

- GAAP net income was \$6.3 billion in 2005 and \$4.1 billion in 2006.
- Earnings per diluted share of common stock were \$6.01 in 2005 and \$3.65 in 2006.
- Stockholders' equity increased \$400 million in 2005 and \$2.2 billion in 2006, reaching a total of \$41.5 billion.
- Fair value of net assets, which is a non-GAAP measure we use to manage our business, increased by \$2.1 billion in 2005 and \$702 million in 2006, reaching a total of nearly \$43 billion. (More information on this measure, including a reconciliation to stockholders' equity, is included in the enclosed Form 10-K.)
- After reducing common stock dividends from \$2.08 in 2004 to \$1.04 in 2005, we increased the dividend to \$1.18 per share in 2006, and in 2007 brought it to \$1.90. All told, we returned \$2 billion to our common stock shareholders between 2005 and 2006.
- Our mortgage credit book of business grew by 1 percent in 2005 and 7 percent in 2006, reaching \$2.5 trillion.
- Net revenue was \$17 billion in 2005 and declined to \$11.8 billion in 2006.
- Our credit loss ratio — charge offs, net of recoveries and foreclosed property expense (income), as a percentage of our average total mortgage credit book — was 1.9 basis points in 2005 and rose to 2.7 basis points in 2006.
- Guaranty fee income was \$3.9 billion in 2005, growing to \$4.2 billion in 2006.
- Net interest income was \$11.5 billion in 2005, falling to \$6.8 billion in 2006.
- Administrative expenses were \$2.1 billion in 2005, and increased by \$1 billion in 2006 to reach \$3.1 billion, largely due to the cost of restatement and remediation.



DANIEL H. MUDD  
*President and Chief Executive Officer*

Headlines: overall, a tough year. We had modest growth in our book of business, a decline in our net revenues and net income, and a decline in our earnings per share during this period. I'll talk more about the regulatory requirements, remediation and market forces behind these results later in this letter.

That said, we are nearly caught up and current with our financial statements. Providing you with the full, current information you need to gauge the performance and value of our company is one of our most fundamental obligations to our shareholders. We have taken another step toward reestablishing the routines you should expect from a Securities and Exchange Commission (SEC) registrant by mailing this letter, along with our 2006 Form 10-K and a solicitation of shareholders' proxy and other proxy materials, in preparation for our annual shareholders' meeting this December 14 in Washington, DC.

### 2005-2006: Rebuilding Fannie Mae

Let me pick up this story from the end of 2004, when I was asked to assume the role of interim CEO and Rob Levin became interim Chief Financial Officer. At the time, the SEC determined we had misapplied Generally Accepted Accounting Principles (GAAP) and directed us to restate past earnings. Our safety and soundness regulator, the Office of Federal Housing Enterprise Oversight (OFHEO), had identified numerous control issues in a special examination and declared us "significantly undercapitalized." We were receiving numerous legal and regulatory inquiries. Our relevance to the mortgage capital markets was shrinking.

This is not the place to recount the day-to-day challenges of setting things right, but a brief replay of our actions, major changes, and milestones is in order:

- We rebuilt capital, raising \$7.25 billion through growth in retained earnings (including a painful cut to the dividend, since then mostly restored) and the issuance of \$5 billion of preferred stock. We achieved and maintained capital compliance as of September 30, 2005, including a 30 percent surplus required by our regulator.
- In the restatement of earnings from 2001 through 2004, we undertook and completed a top-to-bottom reassessment of all of our accounting principles and applications.
- Within several months of filing the restatement, we completed and filed our financial results for 2005 and 2006, and indicated our intention to file our 2007 full-year results on time.
- Our finance team worked to remediate virtually all

of our 25 Sarbanes-Oxley material weaknesses – we intend to be completely remediated by the time we file our 2007 10-K – and we invested more than \$300 million in systems and controls to strengthen our reporting capabilities.

- We established independent reporting by our Chief Risk Officer, our Chief Compliance Officer, and our Chief Audit Executive to the Risk, Compliance and Audit Committees of the Board.
- Over 85 percent of our senior officers are new to the company or in new roles; the senior management team has rebuilt key departments, including Finance, Audit, Risk Management, Controller's and Legal, and has overhauled business strategies in each of our segments.
- We replaced all senior officers in our Accounting, Controller's, and Audit departments.
- We replaced our independent auditor with Deloitte & Touche, the same firm that had provided our regulator, OFHEO, with the accounting expertise to support the

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• We replaced our independent auditor with Deloitte & Touche, the same firm that had provided our regulator, OFHEO, with the accounting expertise to support the aforementioned special examination.

- We reached settlements with OFHEO of \$50 million and the SEC (\$350 million returned to shareholders via the Fair Fund), and the Justice Department concluded

its investigation with no action. We supported legislation to create a strong regulatory regime for the government-sponsored housing enterprises, including Fannie Mae; a bill passed in the House of Representatives by a strong, bipartisan vote.

- We launched an Office of Community and Charitable Giving and closed the Fannie Mae Foundation.
- We re-chartered our Community Business Centers around the country to enhance our business and community development strategies.
- We reformed our lobbying approach.
- We overhauled our compensation practices, including the establishment of broad performance goals, and eliminated option grants as the principal form of equity award. Reflecting executive accountability, as well as alignment with our stakeholders, the Board eliminated senior management cash bonuses for 2004 entirely.
- We spelled out acceptable internal culture and external behavior, summarized by the attributes of "Service, Engagement, Accountability and Management." Individual performance and leadership – measured by interviews and 360-degree surveys – are critical factors in determining a significant portion of annual officer compensation.

- Lastly, we undertook a company-wide cost reduction effort, which will achieve a 10 percent reduction in headcount by the end of the year, and restore our operational run rate to efficient and sustainable levels.

Through this period of restatement, remediation and rebuilding at Fannie Mae, our mantra has been “change, progress, more to do.” We are a better company today, but we are not yet finished with change and progress, because we have more to do.

### 2005-2006: Fannie Mae Avoided Market Excesses

As we worked through these transitional changes, we kept our business balanced in a tough market, delivering reasonable – but not stellar – results and maintaining a solid risk profile. Here are the results by business segment:

- Single-Family Credit Guaranty Business, which creates and guarantees Fannie Mae Mortgage-Backed Securities (MBS), generated \$2.6 billion in net income in 2005 and \$2.0 billion in 2006. As the housing and mortgage markets began to weaken, the credit loss ratio – a key measure of risk – increased on this book of business from 1.9 basis points in 2005 to 2.8 basis points in 2006 (compared to our historical range of 4-6 basis points).
- Housing and Community Development (HCD) business, which includes mortgage securitization and guaranty for apartments and multifamily units, generated \$503 million in net income in 2005 and \$338 million in 2006. In a strong rental housing market, the credit loss ratio on the multifamily book of business declined from 2.2 basis points to 0.5 basis points from 2005 to 2006.
- Capital Markets business, which raises global capital to purchase U.S. mortgage assets for investment, generated \$3.2 billion in net income in 2005 and \$1.7 billion in 2006. We kept our chief measures of interest rate risk at very low levels, meaning that our assets and liabilities remained closely matched and our interest rate risk tightly controlled.

All the while, Fannie Mae continued to serve our mission – affordability, liquidity, and stability. We achieved all of our main HUD affordable housing goals in a challenging market, and helped serve four million lower-income and underserved families. When the hurricanes slammed through the Gulf Coast in late 2005, Fannie Mae committed over \$25 billion in investment capital to the recovery, housed over 4,500 evacuees, and donated over \$940,000 in corporate funds to disaster relief (and 16,000 hours of employee volunteer time).

To recall the market environment, a major, cyclical run-up in housing and mortgage activity began in 2000 – and finally ended in August 2007 with collapse and market crisis. During this stretch, home prices spiraled upward. Lending surged in non-standard, risky mortgage products, especially subprime adjustable-rate mortgages with low initial “teaser” rates. Financial firms packaged record quantities of these loans into “private label” securities, often a risky substitute for Fannie Mae’s MBS. We chose to stand back from the frenzy and avoid competing for mortgage assets and securitization business we thought too risky or unprofitable.

As a result, our single-family guaranty business slowed. As we stepped back from the surge in risky lending in 2005 and 2006, our market share of single-family mortgage-related securities issuance fell from 45 percent in 2003 to 24 percent in 2005 and 2006. Recently, as credit issues have shaken the capital markets, investors seeking safety and liquidity have increased demand for our guaranteed MBS, and we have made significant gains in market share as a result (a trend that has accelerated into 2007). Our HCD multifamily guaranty business, which finances affordable apartment buildings, also slowed during this period, as low-cost investor capital flooded the market. But here too, as that flood began to recede in 2006, we regained market share.

Our Capital Markets business also had less opportunity – our net balance, in fact, shrank from \$925 billion to \$726 billion from year-end 2004 to 2006. There are three reasons. First, we let mortgages roll off our books and sold some assets to help us meet our regulatory 30 percent capital surplus requirement. Second, in May 2006 we agreed to a portfolio “cap” of \$727.75 billion while we returned to current financial reporting. Third, intense competition bid mortgage assets higher, so we sold. We changed our portfolio strategy from “buy and hold” to “total return” – meaning we would buy, sell, or hold mortgages opportunistically to maximize the total return over time.

By holding the line on lending standards, we also maintained the quality of our credit book of business, with strong risk characteristics relative to most major mortgage investors. Our single-family mortgages have about 45 percent equity support and strong homeowner credit (averaging 720 FICO). At the same time, since Fannie Mae is not immune from market forces, we saw our credit loss ratio begin to move up towards a more normal, historical level for us.

Looking back, 2005 and 2006 were rebuilding years for Fannie Mae and challenging years for the housing market and our business, and our financial performance reflects those challenges. But we maintained a solid book of business with a relatively low-risk profile in an exceptionally high-risk market, and we increased the value of our overall book. I believe the rebuilding work we did – and choices we made – put Fannie Mae in a stronger position to deal with turmoil in our market today.

### 2007: Working with Partners in a Tough Market

You might wonder how Fannie Mae is weathering the worst crisis in the housing and mortgage markets in decades. Many financial institutions that own or guarantee mortgages are facing downgrades, write-offs, layoffs and worse. Most of the market turmoil originated in the subprime segment, but our exposure to subprime mortgages is minimal, just over 2 percent of our single-family mortgage credit book. The mortgages that make up the vast majority of our book – 15- and 30-year prime-rate mortgages below \$417,000 – have remained available and affordable.

As the market turmoil deepened and expanded beyond the subprime segment, Fannie Mae stepped up to play a stabilizing role. Our response falls into nine categories:

1. **Refinancing:** In April 2007, we launched our “HomeStay” initiative to help subprime borrowers refinance into safer prime-rate loans. As of August 2007, we helped lenders refinance about \$7.5 billion of subprime loans into prime loans, serving about 40,000 homeowners.
2. **Workouts:** Fannie Mae’s mortgage servicers have renegotiated loans for more than 27,000 seriously delinquent borrowers, an average of 750 a week, keeping about half of our seriously delinquent borrowers out of foreclosure. Our experience has shown that it is better for both lenders and homeowners to avoid foreclosure. We staffed up our operations that handle foreclosed properties as the scope of the turmoil emerged.

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3. **Support for counseling:** We have provided more than \$7 million in grants to counseling agencies that help struggling homeowners avoid foreclosure. Fannie Mae’s Home Counselor Online service is free to these organizations and to lenders.
4. **Financing rescue packages:** We have committed to fund \$450 million in mortgage rescue packages for housing finance authorities in Ohio, Massachusetts, and New York.
5. **Affordability products:** To provide an alternative to risky subprime products, we have purchased or guaranteed more than \$53 billion this year in Fannie Mae loan products with low down payments, flexible amortization schedules, and other features.
6. **Increased securitization:** Demand for loan securitization in our conventional 15- and 30-year products has increased dramatically, and we expect 2007 to be our single biggest year in history for growth in Fannie Mae MBS outstanding.
7. **Working within our mortgage portfolio limits:**

We have been striving to purchase affordable single-family mortgages, subprime loans, and multifamily mortgage assets to support liquidity in those segments.

### 8. Managing our risk prudently:

Through our new Chief Risk Officer and his staff, as well as the risk managers in each business unit, we are managing our interest rate, credit, and operational exposures amid the turbulence in the markets.

9. **Managing costs and revenues through the cycle:** Like any other business, we have adjusted our cost base and sought revenue and market share opportunities in light of the expectation of higher credit loss ratios during a period of home price declines.

Members of Congress and other national leaders have proposed measures to expand Fannie Mae’s stabilizing role in the housing market. That is our mission in good times and tough times – to provide affordability, stability and liquidity to the market. We are working with policymakers on ways we could do more. We stand ready to do more. As we do, we demonstrate Fannie Mae’s value to the housing finance system.



## Expectations for 2007 and Beyond

We expect the housing and mortgage market correction to continue through this year and next, and these trends will affect our business and financial results this year.

Here's an outlook for 2007:

- We believe our book of business will grow faster than the market we serve as borrowers refinance into longer-term fixed-rate mortgage loans – our specialty.
- We expect further increases in the cost of our debt, which will cause a continued decline in net interest income in 2007.
- We expect our credit losses to rise in 2007 given current market conditions.
- We expect our administrative expenses to decline in 2007.
- We expect certain accounting treatments to have a more pronounced impact on some of our financial results, for example, requiring us to take losses up front while deferring gains.

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We believe Fannie Mae is in a solid position to continue weathering the market turmoil as it continues through 2008. The mortgage market is returning to tighter underwriting, more rational pricing, and more demand for traditional, fixed- and adjustable-rate products that have been our bread and butter. In other words, the market is returning to a place that Fannie Mae never left – safe, sensible, affordable mortgage lending. As it does, we see opportunities ahead for growth in our business and for gain in market share.

All the work we've done since 2004 has made Fannie Mae stronger and better prepared for the future. We've

rebuilt most of the company. Our business is regaining market share. The market demand for the service we provide is growing. Right now we are focused on helping our customers and

partners by providing affordability, liquidity, and stability to the market – the job Congress chartered Fannie Mae to do. For us, that's not just our mission – it's our business.

I will write to you again next spring in our 2007 annual report with more information about where Fannie Mae is heading in the future.

Thank you for reading, and most of all, thank you for sticking with us.



Daniel H. Mudd