

Letter to Shareholders

Daniel H. Mudd
*President and
Chief Executive
Officer*



Dear Shareholders,

Last year marked the start of the worst housing market in a generation. The decline and fall of housing, normally a pillar of the U.S. economy, touched off a crisis that has spread from the rows of empty homes in Las Vegas, Detroit and other American cities to the balance sheets of many of the world's largest financial institutions.

Fannie Mae is not immune to the housing market crisis. We serve the U.S. mortgage finance system, and that system is being tested. But with our solid capital position, healthy reserves, and central role in the mortgage finance system, Fannie Mae has brought a much-needed measure of stability to a volatile and uncertain market.

Providing stability, liquidity and affordability amidst the housing market turmoil has not been easy, and our \$2.1 billion net loss in 2007 is a reflection of that. Yet we believe that by performing our mission, and by playing both defense and offense through the disruption, we are creating lasting value that will accrue to our shareholders over time. In market crises, firms that husband capital, invest wisely where others retreat, and prudently manage their risks tend to thrive in the long run. That is our approach at Fannie Mae.

I will discuss the drivers of our 2007 performance in a moment. But before I do, I want to give you a sense of how your capital was used to grow the business in 2007. The total mortgage credit book grew 14 percent and our guaranty fee income grew 19 percent to \$5.1 billion. As many of our competitors left the field and the mortgage market flocked to the quality of our guaranty, we experienced near-record demand for Fannie Mae's flagship business of packaging home loans into our mortgage-backed securities. Our market share of new mortgage-related securities issuances in the fourth quarter nearly doubled year-over-year.

As we grow, we have been vigilant about the quality of new business we are adding to our guaranty book. Our focus is on adding well-priced, high-quality assets, with higher down payments, higher credit scores and more documentation from the borrowers. Therefore, going forward, I believe the long-term gain will outweigh the short-term pain, and the book we are building now will serve our business and shareholders well in the future.

In this letter, I will review our 2007 results and the key drivers, give you my sense of market conditions in 2008, and then describe our plan to work through the correction, get to recovery, and improve our results.



RAHUL N. MERCHANT, EXECUTIVE VICE PRESIDENT AND CHIEF INFORMATION OFFICER AND
KENNETH J. BACON, EXECUTIVE VICE PRESIDENT, HOUSING AND COMMUNITY DEVELOPMENT

2007 Review

Three key drivers affected our 2007 results:

We increased our provision for credit losses on our guaranty book of business by \$2.8 billion to \$3.2 billion.

The second half of 2007 drove the credit story for Fannie Mae. As home prices tipped and fell nationwide, mortgage delinquencies and defaults rose in the final months of the year,



BETH A. WILKINSON, EXECUTIVE VICE PRESIDENT, GENERAL COUNSEL AND CORPORATE SECRETARY

especially in major markets in Florida, Michigan, Indiana, Ohio, California, Nevada and Arizona. These states together generated more than half of our credit losses in 2007. The deteriorating conditions in the fourth quarter led us to increase our provision significantly.

Our loss reserves as of year end were \$3.4 billion, or 12 basis points of our guaranty book. For reference, in 2007 our credit losses were 5.3 basis points of the average guaranty book, and ran 2.2 basis points in 2006.

Market-based valuation losses increased by \$5.1 billion to \$7.3 billion.

Market-based valuation losses were dominated by the \$4.1 billion decline in the fair value of our derivatives book. We use derivatives as a supplement to our debt to manage the interest rate prepayment risk in our mortgage assets. As interest rates fell in the second half of the year, the derivatives we use to hedge against rate increases lost value.

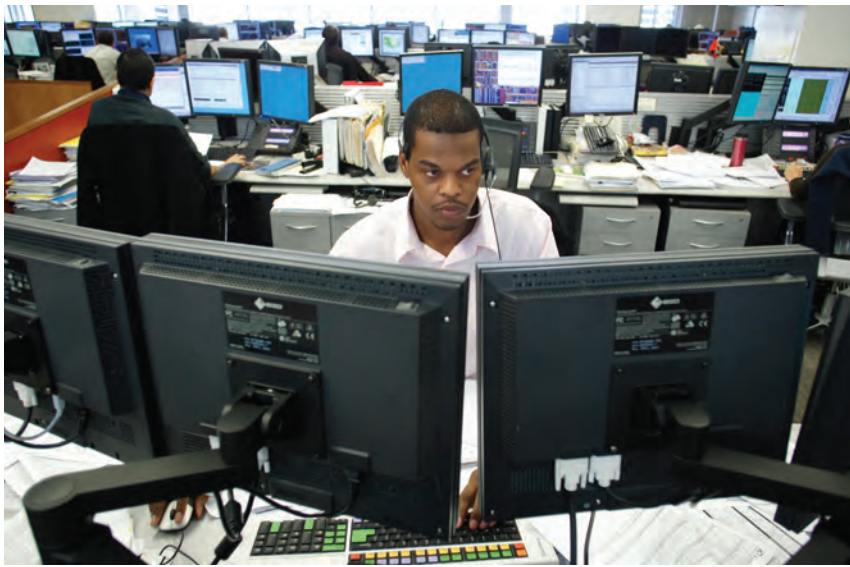
Other items in market-based valuation losses include “losses on certain guaranty contracts” and “losses on delinquent loans purchased from MBS

trusts” — which together totaled \$2.8 billion. These loss items were largely attributable to the current credit and liquidity crisis, which significantly increased the market value of our guaranty obligations and reduced the market value of mortgage assets. Although we expect to ultimately recover a substantial portion of these losses over time, we recognize the full fair value loss up front, which is appropriate under generally accepted accounting principles, or GAAP. The last item in market-based valuation losses was \$365 million in net losses on our trading securities, reflecting the decline in market value of mortgage-related securities in our trading portfolio due to the significant widening of credit spreads during 2007.

Net interest income fell by \$2.2 billion to \$4.6 billion.

Net interest income, a major component of our revenue, declined primarily due to compression in the net interest yield on our mortgage investments. This decline more than offset an \$821 million increase in guaranty fee income, the other major component of our revenue.

We believe that by performing our mission, and by playing both defense and offense, we are creating lasting value that will accrue to our shareholders over time.



FANNIE MAE'S MARKET ROOM

Here's how our results broke out by business segment:

- Our **Single-Family Credit Guaranty** business works with our lender customers to securitize single-family mortgage loans into Fannie Mae mortgage-backed securities. We provide a guaranty that ensures the timely payment of principal and interest on the mortgage-backed securities. For that service, we charge a guaranty fee. In 2007, our Single-Family guaranty fee income grew by 22 percent to \$5.8 billion. But credit-related expenses, including charge-offs on failed loans and the cost of selling foreclosed properties, rose significantly to \$5.0 billion. Together with other expenses, including administrative costs and losses on certain guaranty contracts, the Single-Family business posted a net loss of \$858 million.
- Our **Housing and Community Development** business securitizes multifamily loans into Fannie Mae mortgage-backed securities, and invests debt and equity in affordable housing. We receive a guaranty fee for assuming the credit risk on the mortgage loans underlying multifamily Fannie Mae mortgage-backed securities, while many of our investments in affordable housing projects generate tax benefits. In 2007, the multifamily guaranty book of business grew by 22.5 percent in a booming rental housing market, and multifamily credit-related expenses remained low. Net income for the HCD business was \$157 million.
- Our **Capital Markets** group manages our investments in mortgage-related assets. Net interest income, the primary driver of Capital Markets revenue, fell 25 percent in 2007.

The compression in our net interest yield was driven by the replacement of older, maturing debt with new issuances at higher rates. Capital Markets also had higher unrealized investment losses on our trading portfolio and significantly higher derivatives fair value losses, which I mentioned earlier. Capital Markets' net loss was \$1.35 billion. Capital Markets is a central and, I believe, profitable part of our business model over the long haul, but its sensitivity to changes in interest rates and market spreads makes its performance extremely volatile quarter-to-quarter and even year-to-year.



STEPHEN M. SWAD, EXECUTIVE VICE PRESIDENT AND CHIEF FINANCIAL OFFICER



ROBERT J. LEVIN, EXECUTIVE VICE PRESIDENT AND CHIEF BUSINESS OFFICER AND
MICHAEL J. WILLIAMS, EXECUTIVE VICE PRESIDENT AND CHIEF OPERATING OFFICER

Net, we posted a disappointing \$2.1 billion loss for the year — the first full-year loss for Fannie Mae in more than 20 years.

There were some positive notes. We closed the year with more core capital than we began — \$45.4 billion versus \$42.0 billion. Our \$8.9 billion in preferred stock issuances in the second half of 2007 helped us fuel the growth of our guaranty business and helped us manage the drain on capital from rising

credit-related expenses and derivatives losses. We completed our internal controls and regulatory remediation and issued current financial statements, putting the past behind us. We cut more than \$400 million in administrative expenses, twice our goal.

Fannie Mae won major new accounts with large customers, and stood by longstanding partners as market shocks hit them. Together with our customers and partners, we provided mortgage financing to more than 2.4 million low- and moderate-income households — 340,000 more than in 2006.

The company provided record levels of support for multifamily housing, with \$59.9 billion in acquisitions. Lastly, we helped more than 100,000 homeowners avoid foreclosure or refinance out of subprime mortgages, and worked with counseling organizations nationwide so that troubled consumers could find a lifeline.

All in all, it was a year of progress in our operations and growth in our business. But these positives were more than offset by starkly negative market conditions.

Looking Ahead in 2008

In 2008 the market will remain challenging. We expect rising credit costs as the housing correction and its accompanying symptoms continue to play out.

We believe home prices will continue to fall in 2008, and falling home prices, as you have read in this letter, are a principal driver of credit losses. In some markets, prices are stable. But the severe correction in Florida, Arizona, Nevada, California and other epicenters of the pre-2007 speculation-driven housing boom has made the national picture look bleak. Another wave of foreclosures is expected as homeowners who took on adjustable-rate subprime loans with low initial

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rates and short resets see their payments spike. Mortgage lending has pulled back significantly, especially in the non-conforming market.

Home sales have also stalled.

In February, the nation had over 10 months' supply of unsold homes, and the overhang is worse in places like Las Vegas (25 months); Anaheim, California (26 months); and Miami (49 months' supply — and 80 months' supply of condos).

Fannie Mae's Strategy

As I said in my opening, in times of market disruptions and panic, companies that protect against current risk while prudently building for the future tend to do well after the crisis passes. That is our strategy for 2008: protect and build. Underlying the strategy is a keen focus on capital — on ensuring we have the capital necessary to protect our business, while investing that capital for long-term value creation.

Protect

Working through a credit downturn begins and ends with “loss mitigation.” In plain English, that means minimizing losses when homeowners fall behind, preferably by helping them work out their loans and avoid default.

As of January 2008, Fannie Mae had roughly 190,000 seriously delinquent borrowers out of nearly 18 million loans we own or guarantee. Preventing delinquencies from falling into

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foreclosure is a top priority for 2008. We want to minimize the harm to homeowners, their finances and their neighborhoods, and minimize the impact on our company and our capital. The math proves the point: on average, working out a loan has historically cost about 90 percent less than a foreclosure.

We have increased some of our incentive fees for loan servicers to offer workout solutions instead of foreclosure, and last year we began offering foreclosure attorneys incentives to do workouts instead of executing a foreclosure. We've also just launched a new option for our loan servicers to help delinquent homeowners catch up. It's called HomeSaver Advance™, and it's aimed at homeowners who've fallen behind because of a temporary life event or hardship. This effort is part of our comprehensive HomeStay™ initiative, aimed at promoting and enabling the best solutions for at-risk borrowers through loan workouts, counseling, loan servicing enhancements and, especially, refinancing subprime borrowers into prime loans.

Many of these initiatives cost money, and their tangible results are not reflected in revenue, but in loss reduction. Yet that is the nature of credit cycles. These loss mitigation efforts will have tangible effects on our bottom line now, in the same manner that our efforts to grow the business will in the future.

Build

While we protect against the risk in our current book, we are also building a solid business going forward. For our new business acquisitions, we have implemented tighter underwriting guidelines and we are requiring higher down payments, higher credit scores and more documents proving ability to pay. Further, in markets where home prices are falling, we're requiring lower loan-to-value ratios so that new homeowners don't start their first year “upside down” — owing more than the house is worth. Better guidelines protect both us and the homeowner.

At the same time, we've adjusted our guaranty prices — the fees we charge to guarantee mortgages — to reflect the higher credit risk in the market. Our average effective guaranty fee rate in 2007 was 23.7 basis points, up from 22.2 basis points in 2006. And in the fourth quarter, the average rate was 28.5 basis points, up from 22.8 basis points in the third quarter. Further price adjustments took effect in March of this year, so we expect the average effective guaranty fee rate to rise again in 2008.

We recognize that the tightening of credit terms and pricing changes are difficult for our customers and partners. But, as a company committed to remaining in the market during a severe housing downturn, these measures are calibrated to prudently manage our risk while at the same time ensuring creditworthy borrowers have ready access to mortgage loans.



ENRICO DALLAVECCHIA, EXECUTIVE VICE PRESIDENT AND CHIEF RISK OFFICER

In this market, capital is indeed king — both to absorb potential losses and pursue growth opportunities. We will allocate our capital available for business growth where it will yield the best results — for the market and for our shareholders.

Capital

To bolster our capital position, Fannie Mae raised \$8.9 billion of preferred stock in the second half of 2007. Our Board of Directors also made the difficult but prudent decision to reduce the common stock dividend by 30 percent beginning in the first quarter of 2008. In this market, capital is indeed king — both to absorb potential losses and pursue growth opportunities.

We will allocate our capital available for business growth where it will yield the best results — for the market and for our shareholders. Our guaranty business is highly capital-efficient and offers attractive long-term risk-adjusted returns on that capital. It also enjoys a distinct competitive advantage — in fact, most of our private-label competitors have left the field, at least for now. We believe this business will continue to experience healthy growth in 2008.

In March 2008, we were granted some additional flexibility when our safety and soundness regulator, the Office of Federal Housing Enterprise Oversight

(OFHEO), released a third of the capital surplus over our statutory minimum capital requirement that we had been required to hold pursuant to our consent order with OFHEO. This additional available capital of about \$3 billion will provide a significant dose of liquidity to the mortgage market through purchases of mortgage assets and support of the guaranty business. We view this capital release as a very positive step in our capital management efforts, and as a strong signal to the market that Fannie Mae will be able to play its traditional role as a market backstop.

Concurrent with the partial release of our regulatory capital surplus, we have begun the process of considering additional capital-raising options so that we can continue to serve our mission and take advantage of market opportunities — play offense and defense — through the downturn.

Now that I've outlined the strategy, I want to spend a moment on our capability to execute on it. A strategy is only as good as the people implementing the strategy. We have completed a three-year rebuilding of the company from top to bottom, with a new executive team and a Board with deep expertise in financial and credit risk management. One prime example is our credit team, both in Washington and at our dedicated servicer and real estate-owned operation in Dallas. Already led by seasoned, tested loss mitigation experts, we will continue to add to the talent in this group as they undertake the daunting challenge ahead of them. I believe they are up to the task.

In a year when our new business acquisitions rose 24 percent, our operations and technology platforms handled near-record volume. Our ability to execute transactions on such a huge scale is a core competency of Fannie Mae and is a tremendous competitive advantage with our customers. But more technology and operational improvements are underway in all of our businesses, particularly in our loan servicing and MBS investor reporting systems. A new, enhanced version of our flagship lender platform Desktop Underwriter® will be rolled out this year. And overlaying all of our technology and operations is an advanced risk management and controls infrastructure that has been fundamentally rebuilt from the ground up since 2005.

Another example of our execution ability was the rapid response Fannie Mae undertook to meet the needs of our partners and homeowners as the subprime fiasco unfolded. In April 2007, we launched our HomeStay initiative in a matter of weeks to coordinate all our efforts on subprime refinance and foreclosure prevention. One tangible result: In 2007, 68,000 borrowers who had taken out loans from subprime borrowers were refinanced into more than \$13 billion of prime, mostly fixed-rate loans funded by Fannie Mae.

These are just a few of the ways that Fannie Mae has proven that it is a different and renewed company, one that has turned its full attention to serving the market and growing our business.



NEW EMPLOYEE ORIENTATION AT FANNIE MAE'S WASHINGTON, DC HEADQUARTERS

Conclusion: Lessons of the Crisis

It's safe to say that 2007-2008 will go down in housing and financial history for all the wrong reasons. Millions of homeowners got stuck in the wrong mortgage. Speculators and home flippers inflated home prices beyond logic and reason. And loose underwriting funded by investors looking for an easy return enabled the whole sorry game.

Two lessons of the past few years are already clear:

- **We still need “stretch” lending.**

The subprime boom-and-bust was a disaster for many homeowners and investors. But the nation still needs innovative, affordable — though sustainable — mortgage credit for working families, even those without perfect or traditional credit histories. The mortgage and housing industry's future, including Fannie Mae's future, will depend on giving people a fair chance at owning a home.

If it is good for borrowers in the long term, it is good for Fannie Mae in the long term. For 70 years, this has guided our company.

- **We need mortgage reforms.**

It's too complicated, cumbersome and expensive to get a mortgage loan. And, as we now know, it has been far too easy for rogue lenders to prey upon unsophisticated borrowers intimidated by the mortgage process. At the very least, mortgage terms, risks and costs should be simplified and more clearly spelled out — and predatory lenders cast out. It is a key priority for Fannie Mae to work with the industry to strengthen the process.

In other words, we need to focus on *homeownership*, not just *home buying*.

Both of these lessons speak to a basic truth that is a core value of our company: If it is good for borrowers in the long term, it is good for Fannie Mae in the long term. For 70 years, this has guided our company — out of the Great Depression, and through multiple booms, busts and cycles as

housing became a pillar of the U.S. economy. And for the last 40 years as a shareholder-owned company, this core value has been a key ingredient in our ability to generate competitive returns for our shareholders — and in our ability to promote affordable housing for hundreds of millions of Americans.

It is this core value that will help Fannie Mae through another challenging year. To bridge us through it, we are conserving our capital, aggressively controlling our credit losses, responding to the demands of a stressed market and working with our partners to keep people in their homes. And all the while, we are investing in the business for the future.

On behalf of our 5,700 employees, thank you for being invested in Fannie Mae, for your patience as we work through this period, and for your belief in America's housing.

Sincerely,



Daniel H. Mudd