FEDERAL NATIONAL MORTGAGE ASSOCIATION FANNIE MAE
Form 10-Q
August 06, 2009

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

Form 10-Q

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

For the quarterly period ended June 30, 2009

OR

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

For the transition period from to

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

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 þ No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes þ No o

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

Large accelerated filer þ Accelerated filer o
Non-accelerated filer o (Do not check if a smaller reporting company) Smaller reporting company o

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

As of June 30, 2009, there were 1,112,020,933 shares of common stock of the registrant outstanding.

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PART I FINANCIAL INFORMATION

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

We have been under conservatorship, with the Federal Housing Finance Agency (FHFA) acting as conservator, since September 6, 2008. As conservator, FHFA succeeded to all rights, titles, powers and privileges of the company, and of any shareholder, officer or director of the company with respect to the company and its assets. The conservator has since delegated specified authorities to our Board of Directors and has delegated to management the authority to conduct our day-to-day operations. We describe the rights and powers of the conservator, the provisions of our agreements with the U.S. Department of Treasury (Treasury), and changes to our business, liquidity, corporate structure, business strategies and objectives since conservatorship in our Annual Report on Form 10-K for the year ended December 31, 2008 (2008 Form 10-K) in Part I Item 1 Business and in our Quarterly Report on Form 10-Q for the quarter ended March 31, 2009 (First Quarter 2009 Form 10-Q) in Part I Item 2 Management s Discussion and Analysis of Financial Condition and Results of Operations Executive Summary.

You should read this Management s Discussion and Analysis of Financial Condition and Results of Operations (MD&A) in conjunction with our unaudited condensed consolidated financial statements and related notes, and the more detailed information contained in our 2008 Form 10-K. This discussion contains forward-looking statements that are based upon management s current expectations and are subject to significant uncertainties and changes in circumstances. Our actual results may differ materially from those included in these forward-looking statements due to a variety of factors including, but not limited to, those described in this report in Part II Item 1A Risk Factors and in our 2008 Form 10-K in Part I Item 1A Risk Factors.

Please also refer to our 2008 Form 10-K in Part I Item 7 MD&A Glossary of Terms Used in This Report for an explanation of terms we use in this report.

INTRODUCTION

Fannie Mae is a government-sponsored enterprise (GSE) that was chartered by Congress in 1938. Fannie Mae has a public mission to support liquidity and stability in the secondary mortgage market, where existing mortgage loans are purchased and sold. We securitize mortgage loans originated by lenders in the primary mortgage market into mortgage-backed securities that we refer to as Fannie Mae MBS, which can then be 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 our own Fannie Mae MBS, for our mortgage portfolio. In addition, we make other investments that increase the supply of affordable housing. Under our charter, we may not lend money directly to consumers in the primary mortgage market. Although we are a corporation chartered by the U.S. Congress, and although our conservator is a U.S. government agency and Treasury owns our senior preferred stock and a warrant to purchase our common stock, the U.S. government does not guarantee, directly or indirectly, our securities or other obligations.

EXECUTIVE SUMMARY

Our Mission

In connection with our public mission to support liquidity and stability in the secondary mortgage market, and in addition to the investments we undertake to increase the supply of affordable housing, FHFA, as our conservator, and the Obama Administration have given us an important role in addressing housing and mortgage market conditions. As we discuss below in Our Business Objectives and Strategy, Homeowner Assistance Initiatives and Providing Mortgage Market Liquidity, pursuant to our mission, we are concentrating our efforts on keeping people in their homes and preventing foreclosures while continuing to support liquidity and stability in the secondary mortgage market.

Our Business Objectives and Strategy

Our Board of Directors and management consult with our conservator in establishing our strategic direction, taking into consideration our role in addressing housing and mortgage market conditions, and FHFA has approved our business objectives.

We face a variety of different, and potentially conflicting, objectives, including:

- providing liquidity, stability and affordability in the mortgage market;
- immediately providing additional assistance to the mortgage market and to the struggling housing market;
- limiting the amount of the investment Treasury must make under our senior preferred stock purchase agreement with Treasury in order to eliminate a net worth deficit;
- returning to long-term profitability; and
- protecting the interests of the taxpayers.

We therefore regularly consult with and receive direction from our conservator on how to balance these objectives. Our pursuit of our mission creates conflicts in strategic and day-to-day decision-making that could hamper achievement of some or all of these objectives. Our financial results are likely to suffer, at least in the short term, as we expand our efforts to assist the mortgage market, thereby increasing the amount of funds that Treasury is required to provide to us and further limiting our ability to return to long-term profitability.

Pursuant to our mission, we currently are concentrating our efforts on keeping people in their homes and preventing foreclosures. We also are continuing our significant role in the secondary mortgage market through our guaranty business. These efforts are intended to support liquidity and affordability in the mortgage market, while we also work to implement foreclosure prevention programs. Currently, one of the principal ways in which we are pursuing these efforts is through our participation in the Obama Administration s Making Home Affordable Program. We provide an update on our participation in the Making Home Affordable Program below.

Concentrating our efforts on keeping people in their homes and preventing foreclosures while continuing to be active in the secondary mortgage market, rather than concentrating solely on returning to long-term profitability, is likely to contribute, at least in the short term, to additional financial losses and declines in our net worth. Continuing

deterioration in the housing and mortgage markets, along with the continuing deterioration in our book of business and the costs associated with these efforts pursuant to our mission, will increase the amount of funds that Treasury is required to provide to us. In turn, these factors put additional pressure on our ability to return to long-term profitability. If, however, the Making Home Affordable Program is successful in reducing foreclosures and keeping borrowers in their homes, it may benefit the overall housing market and help in reducing our long-term credit losses.

Obama Administration Financial Regulatory Reform Plan

In June 2009, the Obama Administration announced a comprehensive financial regulatory reform plan. The Administration s white paper describing the plan notes that [w]e need to maintain the continued stability and strength of the GSEs during these difficult financial times. Although the white paper does not include proposals for reform of Fannie Mae, Freddie Mac and the Federal Home Loan Bank system, the Administration has stated that it expects to provide its recommendations in February 2010. See Legislative and Regulatory Matters Obama Administration Financial Regulatory Reform Plan and Congressional Hearing for more information, including a list of possible reform options for the GSEs outlined in the Administration s white paper.

Housing and Mortgage Market and Economic Conditions

The U.S. residential mortgage market continued to deteriorate in the second quarter of 2009, which adversely affected our financial condition and results of operations. While housing activity, as measured by sales, stabilized in the second quarter of 2009, the number of mortgage delinquencies and mortgage foreclosures continued to increase.

We estimate that home prices on a national basis declined in the first quarter of 2009, but increased slightly in the second quarter of 2009, resulting in an estimated home price decline of 2.2% for the first half of 2009. Although the increase in home prices in the second quarter of 2009 was broad-based, with increases in approximately 75% of large metropolitan statistical areas, the second quarter typically is the highest growth quarter of the year because it is the peak home buying season. Accordingly, as described in Outlook, we believe that home prices will decline from current levels in the second half of 2009. We estimate that home prices on a national basis have declined by 16.1% from their peak in the third quarter of 2006. Our home price estimates are based on preliminary data and are subject to change as additional data become available.

The economic recession that began in December 2007 continued in the second quarter. The U.S. gross domestic product, or GDP, declined by 1.0% in the second quarter of 2009, compared with a decline of 6.4% in the first quarter of 2009. The U.S. has lost a net total of 6.46 million jobs since the start of the recession. The U.S. Bureau of Labor Statistics reported successive increases in the unemployment rate in each month of the second quarter, reaching 9.5% in June. High levels of unemployment and severe declines in home prices have contributed to a continued increase in residential mortgage delinquencies.

The number of single-family unsold homes in inventory increased in the second quarter of 2009 as compared to the first quarter, and the supply of homes as measured by the inventory/sales ratio remains high. In addition, we believe there are a considerable number of foreclosed homes that are not yet on the market, as well as a large number of seriously delinquent loans that will be foreclosed upon. These homes are likely to contribute to a significant increase in the market supply of single-family homes in the future.

The National Association of Realtors reported in June 2009 that existing home sales increased in the second quarter of 2009 to roughly the same level they were in the fourth quarter of 2008. Although affordability measures have risen dramatically as home prices have declined from their peak, the limited availability of conventional financing for many potential homebuyers, low consumer confidence and adverse economic conditions have kept purchase activity at historically low levels. However, on a seasonally adjusted basis, single-family housing starts, new home sales, and existing home sales were all higher in June of this year than in March.

In addition, multifamily housing fundamentals are under increasing stress, reflecting broader unfavorable economic conditions, including higher unemployment and severely restricted capital. These conditions are negatively affecting multifamily property level cash flows, vacancy rates and rent levels. Property values are declining due to both the downward pressure on cash flows and the higher premium required by investors. In addition, as some multifamily

loans begin reaching maturity during the next several years, some portion of those loans may be exposed to refinancing risk.

As of March 31, 2009, 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 $11.9 trillion, including

$11.0 trillion of single-family mortgages. Total U.S. residential mortgage debt outstanding decreased by 0.2% in the first quarter of 2009 on an annualized basis, compared with an increase of 2.7% in the first quarter of 2008. Our mortgage credit book of business, which consists of the mortgage loans and mortgage-related securities we hold in our investment portfolio, Fannie Mae MBS held by third parties and other credit enhancements that we provide on mortgage assets, was $3.1 trillion as of March 31, 2009, or approximately 26.3% of total U.S. residential mortgage debt outstanding. See Part I Item 1A Risk Factors of our 2008 Form 10-K for a description of risks to our business associated with the housing market downturn and continued home price declines.

Summary of Our Financial Results and Condition for the Second Quarter and First Six Months of 2009

Our financial results and condition for the second quarter and first six months of 2009 were adversely affected by the ongoing deterioration in the housing and mortgage markets, the economic recession and rising unemployment.

Consolidated Results of Operations

Quarterly Results

We recorded a net loss of $14.8 billion and a diluted loss per share of $2.67 for the second quarter of 2009. Our net loss was driven by significant credit-related expenses, which totaled $18.8 billion in the second quarter, and more than offset our net revenues of $5.6 billion generated from net interest income and guaranty fee income, and $823 million in fair value gains.

In comparison, we recorded a net loss of $23.2 billion and a diluted loss per share of $4.09 for the first quarter of 2009, which was primarily due to credit-related expenses of $20.9 billion, other-than-temporary impairment losses of $5.7 billion and fair value losses of $1.5 billion, which more than offset our net revenues of $5.2 billion. Our net loss of $2.3 billion and diluted loss per share of $2.54 for the second quarter of 2008 reflected credit-related expenses of $5.3 billion that more than offset our net revenues of $4.0 billion and $517 million in fair value gains.

The $8.4 billion decrease in our net loss for the second quarter of 2009 from the first quarter of 2009 was driven principally by: a substantial decrease in other-than-temporary impairment, a significant portion of which was attributable to a change in the accounting standard relating to the assessment of other-than-temporary impairment; a reduction in credit-related expenses; and a shift to fair value gains from fair value losses in the first quarter of 2009.

The $12.5 billion increase in our net loss for the second quarter of 2009 from the second quarter of 2008 was driven principally by a $13.4 billion increase in credit-related expenses that more than offset a $1.7 billion increase in net interest income.

Year-to-Date Results

We recorded a net loss attributable to Fannie Mae of $37.9 billion and a diluted loss per share of $6.76 for the first six months of 2009, driven primarily by credit-related expenses of $39.7 billion and other-than-temporary impairment of $6.4 billion that more than offset our net revenues of $10.8 billion. In comparison, we recorded a net loss attributable to Fannie Mae of $4.5 billion and a diluted loss per share of $5.11 for the first six months of 2008, driven primarily by $8.6 billion in credit-related expenses and $3.9 billion in fair value losses that more than offset our net revenues of $7.7 billion.

The $33.4 billion increase in our net loss for the first six months of 2009 from the first six months of 2008 was driven principally by a $31.1 billion increase in credit-related expenses, coupled with a $5.8 billion increase in other-than-temporary impairment, that more than offset a $3.2 billion increase in net interest income and a $3.2 billion

decrease in fair value losses.

Credit Overview

Table 1 below presents information about the credit performance of mortgage loans in our single-family guaranty book of business for each quarter of 2008 and the first two quarters of 2009, illustrating the worsening trend in performance throughout 2008 and continuing in the first half of 2009.

Table 1: Credit Statistics, Single-Family Guaranty Book of Business[1]

	2009			2008				
	Q2 YTD	Q2	Q1	Full Year	Q4	Q3	Q2	Q1
	(Dollars in millions)							
As of the end of each period:								
Serious delinquency rate[2]	3.94%	3.94%	3.15%	2.42%	2.42%	1.72%	1.36%	1.15%
On-balance sheet nonperforming loans[3]	$ 26,300	$ 26,300	$ 23,145	$ 20,484	$ 20,484	$ 14,148	$ 11,275	$ 10,947
Off-balance sheet nonperforming loans[4]	$ 144,183	$ 144,183	$ 121,378	$ 98,428	$ 98,428	$ 49,318	$ 34,765	$ 23,983
Combined loss reserves[5]	$ 54,152	$ 54,152	$ 41,082	$ 24,649	$ 24,649	$ 15,528	$ 8,866	$ 5,140
Foreclosed property inventory (number of properties)[6]	62,615	62,615	62,371	63,538	63,538	67,519	54,173	43,167
During the period:								
Loan modifications (number of loans)[7]	29,130	16,684	12,446	33,388	6,313	5,291	10,229	11,555
HomeSaver Advance problem loan workouts (number of loans)[8]	32,093	11,662	20,431	70,967	25,788	27,278	16,749	1,152
Foreclosed property	57,469	32,095	25,374	94,652	20,998	29,583	23,963	20,108

acquisitions (number of properties)[9]								
Single-family credit-related expenses [10]	$ 38,721	$ 18,391	$ 20,330	$ 29,725	$ 11,917	$ 9,215	$ 5,339	$ 3,254
Single-family credit losses[11]	$ 5,766	$ 3,301	$ 2,465	$ 6,467	$ 2,197	$ 2,164	$ 1,249	$ 857

(1) The single-family guaranty book of business consists of single-family mortgage loans held in our mortgage portfolio, single-family Fannie Mae MBS held in our mortgage portfolio, single-family Fannie Mae MBS held by third parties, and other credit enhancements that we provide on single-family mortgage assets. It excludes non-Fannie Mae mortgage-related securities held in our investment portfolio for which we do not provide a guaranty.

(2) Calculated based on number of conventional single-family loans that are three or more months past due and loans that have been referred to foreclosure but not yet foreclosed upon, divided by the number of loans in our conventional single-family guaranty book of business. We include all of the conventional single-family loans that we own and those that back Fannie Mae MBS in the calculation of the single-family serious delinquency rate.

(3) Represents the total amount of nonaccrual loans, troubled debt restructurings, and first-lien loans associated with unsecured HomeSaver Advance loans including troubled debt restructurings and HomeSaver Advance first-lien loans on accrual status. A troubled debt restructuring is a restructuring of a mortgage loan in which a concession is granted to a borrower experiencing financial difficulty. Prior to the fourth quarter of 2008, we generally classified loans as nonperforming when the payment of principal or interest on the loan was three months or more past due. In the fourth quarter of 2008, we began classifying loans as nonperforming at an earlier stage in the delinquency cycle, generally when the payment of principal or interest on the loan is two months or more past due.

(4) Represents unpaid principal balance of nonperforming loans in our outstanding and unconsolidated Fannie Mae MBS held by third parties, including first-lien loans associated with unsecured HomeSaver Advance loans that are not seriously delinquent. Prior to the fourth quarter of 2008, we generally classified loans as nonperforming when the payment of principal or interest on the loan was three months or more past due. In the fourth quarter of 2008, we began classifying loans as nonperforming at an earlier stage in the delinquency cycle, generally when the payment of principal or interest on the loan is two months or more past due. Loans have been classified as nonperforming according to the classification standard in effect at the time the loan became a nonperforming loan, and prior periods have not been revised to reflect changes in classification.

(5) Consists of the allowance for loan losses for loans held for investment in our mortgage portfolio and reserve for guaranty losses related to both loans backing Fannie Mae MBS and loans that we have guaranteed under long-term standby commitments.

(6) Reflects the number of single-family foreclosed properties we held in inventory as of the end of each period. Includes properties we acquired through deeds in lieu of foreclosure.

(7) Modifications are granted for borrowers experiencing financial difficulty and include troubled debt restructurings as well as other modifications to the terms of the loan. A troubled debt restructuring of a mortgage loan is a restructuring in which a concession is granted to the borrower. It is the only form of modification in which we agree to accept less than the full original contractual principal and interest amount due under the loan, although other resolutions and modifications may result in our receiving the full amount due, or certain installments due, under the loan over a period of time that is longer than the period of time originally provided for under the terms of the loans.

(8) Represents number of first-lien loans associated with unsecured HomeSaver Advance loans.

(9) Includes deeds in lieu of foreclosure.

(10) Consists of the provision for credit losses and foreclosed property expense.

(11) Consists of (a) charge-offs, net of recoveries and (b) foreclosed property expense; adjusted to exclude the impact of SOP 03-3 and HomeSaver Advance fair value losses for the reporting period. Interest forgone on single-family nonperforming loans in our mortgage portfolio is not reflected in our credit losses total. In addition, we exclude other-than-temporary impairment losses resulting from deterioration in the credit quality of our mortgage-related securities and accretion of interest income on single-family loans subject to Statement of Position No. 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer* (SOP 03-3), from credit losses. See Consolidated Results of Operations Credit-Related Expenses Provision Attributable to SOP 03-3 and HomeSaver Advance Fair Value Losses for a discussion of SOP 03-3.

As shown in Table 1 above, we continued to experience deterioration in the credit performance of mortgage loans in our guaranty book of business throughout the second quarter of 2009, reflecting the ongoing impact of the adverse conditions in the housing market, as well as the economic recession and rising unemployment. See Housing and Mortgage Market and Economic Conditions above for more detailed information regarding these conditions. We expect these conditions to continue to adversely affect our credit results in 2009 and into 2010.

We increased our single-family loss reserves to $54.2 billion as of June 30, 2009, or 31.76% of the amount of our single-family nonperforming loans, from $41.1 billion as of March 31, 2009, or 28.43% of the amount of our nonperforming loans, and $24.6 billion as of December 31, 2008, or 20.73% of the amount of our nonperforming loans. The increase in our loss reserves in the second quarter and first six months of 2009 reflected the continued deterioration in the overall credit performance of loans in our guaranty book of business, as evidenced by the significant increase in delinquent, seriously delinquent and nonperforming loans. In addition, our average loss severity, or average initial charge-off per default, increased as a result of the decline in home prices during the first half of 2009. We recorded a lower provision for credit losses in the second quarter of 2009 than in the first quarter of 2009, however, due to a slower rate of increase in both our estimated default rate and average loss severity as compared with the prior quarter.

We are experiencing increases in delinquency and default rates for our entire guaranty book of business, including on loans with fewer risk layers. Risk layering is the combination of risk characteristics that could increase the likelihood of default, such as higher loan-to-value ratios, lower FICO credit scores, higher debt-to-income ratios and adjustable-rate mortgages. This general deterioration in our guaranty book of business is a result of the stress on a broader segment of borrowers due to the rise in unemployment and the decline in home prices. Certain loan categories

continue to contribute disproportionately to the increase in nonperforming loans and credit losses for the second quarter and first six months of 2009. These categories include: loans on properties in the Midwest, California, Florida, Arizona and Nevada; loans originated in 2006 and 2007; and loans related to higher-risk product types, such as Alt-A loans. The term Alt-A loans generally refers to mortgage loans that can be underwritten with reduced or alternative documentation than that required for a full documentation mortgage loan but may also include other alternative product features. In reporting our credit exposure, we classify mortgage loans as Alt-A if the lenders that delivered the mortgage loans to us classified the loans as Alt-A based on documentation or other product features. See Risk Management Credit Risk Management Mortgage Credit Risk Management Mortgage Credit Book of Business for more detailed information on the risk profile and the performance of the loans in our mortgage credit book of business.

Current market and economic conditions have also adversely affected the liquidity and financial condition of many of our institutional counterparties, particularly mortgage insurers and mortgage servicers, which has

significantly increased the risk to our business of defaults by these counterparties due to bankruptcy or receivership, lack of liquidity, insufficient capital, operational failure or other reasons. See Risk Management Credit Risk Management Institutional Counterparty Credit Risk Management for more information about our institutional counterparty credit risk.

Consolidated Balance Sheet

Total assets of $911.4 billion as of June 30, 2009 decreased by $1.0 billion, or 0.1%, from December 31, 2008. Total liabilities of $922.0 billion decreased by $5.6 billion, or 0.6%, from December 31, 2008. Total Fannie Mae stockholders deficit decreased by $4.6 billion during the first six months of 2009, to a deficit of $10.7 billion as of June 30, 2009 from a deficit of $15.3 billion as of December 31, 2008. The decrease in total Fannie Mae stockholders deficit was attributable to the $34.2 billion in funds received from Treasury under the senior preferred stock purchase agreement, $5.9 billion in unrealized gains on available-for-sale securities and a $3.0 billion reduction in our accumulated deficit to reverse a portion of our deferred tax asset valuation allowance in conjunction with our April 1, 2009 adoption of the new accounting guidance for assessing other-than-temporary impairment, partially offset by our net loss attributable to Fannie Mae of $37.9 billion for the first six months of 2009.

Our mortgage credit book of business increased to $3.2 trillion as of June 30, 2009, from $3.1 trillion as of December 31, 2008 as our market share of mortgage-related securities issuance remained high and new business acquisitions outpaced liquidations. Our estimated market share of new single-family mortgage-related securities issuance was 53.5% for the second quarter of 2009, compared with 44.2% for the first quarter of 2009. As described in Liquidity and Capital Management Liquidity Contingency Planning Unencumbered Mortgage Portfolio, we securitized approximately $94.6 billion of whole loans held for investment in our mortgage portfolio into Fannie Mae MBS in the second quarter of 2009 in order to hold these assets in a more liquid form. These Fannie Mae MBS were retained in our mortgage portfolio and consolidated on our consolidated condensed balance sheets, rather than issued to third parties. Excluding these Fannie Mae MBS from both Fannie Mae and total market mortgage-related securities issuance volumes, our estimated market share of new single-family mortgage-related securities issuance was 44.5% for the second quarter of 2009. We did not issue Fannie Mae MBS backed by whole loans held for investment in our mortgage portfolio in the first quarter of 2009. Fannie Mae was the largest single issuer of mortgage-related securities in the secondary market in the second quarter of 2009.

We provide more detailed discussions of key factors affecting changes in our results of operations and financial condition in Consolidated Results of Operations, Business Segment Results, Consolidated Balance Sheet Analysis, Supplemental Non-GAAP Information Fair Value Balance Sheets, and Risk Management Credit Risk Management Mortgage Credit Risk Management Mortgage Credit Book of Business.

Net Worth Deficit

We had an estimated net worth deficit of $10.6 billion as of June 30, 2009, compared with a net worth deficit of $18.9 billion as of March 31, 2009 and $15.2 billion as of December 31, 2008. This net worth deficit equals the total deficit that we report in our condensed consolidated balance sheets, and is calculated by subtracting our total liabilities from our total assets, each as shown on our condensed consolidated balance sheets prepared in accordance with generally accepted accounting principles (GAAP) for that fiscal quarter.

Under the Federal Housing Finance Regulatory Reform Act (Regulatory Reform Act), FHFA must place us into receivership if the Director of FHFA makes a written determination that our assets are, and during the preceding 60 days have been, less than our obligations. FHFA has notified us that the measurement period for such a determination begins no earlier than the date of the SEC filing deadline for our quarterly and annual financial statements and continues for a period of 60 days after that date. FHFA also has advised us that, if we receive funds

from Treasury during that 60-day period in order to eliminate our net worth deficit as of the prior period end in accordance with the senior preferred stock purchase agreement, the Director of FHFA will not make a mandatory receivership determination.

Under the senior preferred stock purchase agreement that was entered into between us and Treasury in September 2008 and amended in May 2009, Treasury committed to provide us with funds of up to $200 billion under specified conditions. The agreement requires Treasury, upon the request of our conservator, to provide funds to us after any quarter in which we have a negative net worth (that is, our total liabilities exceed our total assets, as reflected on our GAAP balance sheet). The senior preferred stock purchase agreement does not terminate as of a particular time; however, we may no longer obtain new funds under the agreement once we have received a total of $200 billion under the agreement.

All references to the senior preferred stock purchase agreement in this report are to the agreement as amended in May 2009. We describe the terms of the May 2009 amendment to the senior preferred stock purchase agreement in our First Quarter 2009 Form 10-Q in Part I Item 2 MD&A Executive Summary Amendment to Senior Preferred Stock Purchase Agreement and we describe the terms of the agreement prior to its May 2009 amendment, most of which continue to apply, in our 2008 Form 10-K in Part I Item 1 Business Conservatorship, Treasury Agreements, Our Charter and Regulation of Our Activities Treasury Agreements.

On March 31, 2009, we received $15.2 billion from Treasury under the senior preferred stock purchase agreement, which eliminated our net worth deficit as of December 31, 2008. We received an additional $19.0 billion from Treasury on June 30, 2009, which eliminated our net worth deficit as of March 31, 2009. The Director of FHFA submitted a request to Treasury on August 6, 2009 for an additional $10.7 billion on our behalf to eliminate our net worth deficit as of June 30, 2009, and requested receipt of those funds on or prior to September 30, 2009.

Upon receipt of these funds from Treasury, the aggregate liquidation preference of our senior preferred stock will total $45.9 billion and the annualized dividend on the senior preferred stock will be $4.6 billion, based on the 10% dividend rate. This dividend obligation exceeds our reported annual net income for four of the past seven years and will contribute to increasingly negative cash flows in future periods if we continue to pay the dividends on a quarterly basis. If we do not pay the dividend quarterly and in cash, the dividend rate would increase to 12% annually, and the unpaid dividend would accrue and be added to the liquidation preference of the senior preferred stock, further increasing the amount of the annual dividends.

Due to current trends in the housing and financial markets, we expect to have a net worth deficit in future periods, and therefore will be required to obtain additional funding from Treasury pursuant to the senior preferred stock purchase agreement. As a result, we are dependent on the continued support of Treasury in order to continue operating our business. Our ability to access funds from Treasury under the senior preferred stock purchase agreement is critical to keeping us solvent and avoiding the appointment of a receiver by FHFA under statutory mandatory receivership provisions.

Our senior preferred stock dividend obligation, combined with potentially substantial commitment fees payable to Treasury starting in 2010 (the amounts of which have not yet been determined) and our effective inability to pay down draws under the senior preferred stock purchase agreement, will have a significant adverse impact on our future financial position and net worth. See Part II Item 1A Risk Factors for more information on the risks to our business posed by our dividend obligations under the senior preferred stock purchase agreement.

Fair Value Deficit

Our fair value deficit as of June 30, 2009, which is reflected in our supplemental non-GAAP fair value balance sheet, was $102.0 billion, compared with a deficit of $110.3 billion as of March 31, 2009 and $105.2 billion as of December 31, 2008.

The fair value of our net assets, including capital transactions, increased by $3.1 billion during the first six months of 2009. Included in this increase was $34.2 billion of capital received from Treasury under the senior preferred stock purchase agreement. The fair value of our net assets, excluding capital transactions, decreased by $30.6 billion during the first six months of 2009. This decrease reflected the adverse impact on our net guaranty assets from the continued weakness in the housing market and increases in unemployment resulting

from the economic recession, which contributed to a significant increase in the fair value of our guaranty obligations. We experienced a favorable impact on the fair value of our net assets attributable to an increase in the fair value of our net portfolio primarily due to changes in the net spread between our mortgage assets and our debt.

The amount that Treasury has committed to provide us under the senior preferred stock purchase agreement is determined based on our GAAP balance sheet, not our non-GAAP fair value balance sheet. There are significant differences between our GAAP balance sheet and our non-GAAP fair value balance sheet, which we describe in greater detail in Supplemental Non-GAAP Information Fair Value Balance Sheets.

Significance of Net Worth Deficit, Fair Value Deficit and Combined Loss Reserves

Our net worth deficit, which equals our total deficit as reported on our consolidated GAAP balance sheet, includes the combined loss reserves of $55.1 billion that we recorded in our consolidated balance sheet as of June 30, 2009. Our non-GAAP fair value balance sheet presents all of our assets and liabilities at estimated fair value as of the balance sheet date. Fair value represents the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date, which is also referred to as the exit price. In determining fair value, we use a variety of valuation techniques and processes. In general, fair value incorporates the market s current view of the future, and that view is reflected in the current price of the asset or liability. However, future market conditions may be different from what the market has currently estimated and priced into these fair value measures. We describe our use of assumptions and management judgment and our valuation techniques and processes for determining fair value in more detail in Supplemental Non-GAAP information Fair Value Balance Sheets, Critical Accounting Policies and Estimates Fair Value of Financial Instruments and Notes to Condensed Consolidated Financial Statements Note 18, Fair Value of Financial Instruments.

Our combined GAAP loss reserves reflect probable losses that we believe we have already incurred as of the balance sheet date. In contrast, the fair value of our guaranty obligation is based not only on future expected credit losses over the life of the loans underlying our guarantees as of June 30, 2009, but also on the estimated profit that a market participant would require to assume that guaranty obligation.

Accounting Developments

Elimination of QSPEs and Changes in the Consolidation of Variable Interest Entities

In June 2009, the Financial Accounting Standards Board (the FASB) issued new accounting standards relating to the elimination of qualified special purpose entities (QSPEs) and changes in the consolidation of variable interest entities. We intend to adopt these new accounting standards effective January 1, 2010. The adoption of this new accounting guidance will have a major impact on our consolidated financial statements, including the consolidation of the substantial majority of our MBS trusts. Accordingly, we will record the underlying loans in these trusts on our balance sheet. The outstanding unpaid principal balance of our MBS trusts was approximately $2.8 trillion as of June 30, 2009. In addition, consolidation of these MBS trusts will have a material impact on our statements of operations and cash flows, including a significant increase in our interest income, interest expense and cash flows from investing and financing activities. We continue to evaluate the impact of the adoption of this new accounting guidance, including the impact on our net worth and capital. We also are in the process of making major operational and system changes to implement these new standards by the effective date.

Change in Assessment of Other-Than-Temporary Impairment

In April 2009, the FASB issued a new accounting standard that changed the accounting guidance for assessing other-than-temporary impairment for investments in debt securities. In connection with our adoption of this guidance

on April 1, 2009, we recorded a cumulative-effect adjustment at April 1, 2009 of $8.5 billion on a pre-tax basis ($5.6 billion after tax) to reclassify the noncredit portion of previously recognized other-than-temporary impairments from Accumulated deficit to Accumulated other comprehensive loss. Because we have asserted an intent and ability to hold certain of these securities until recovery, we also

reduced the Accumulated deficit and the valuation allowance for the deferred tax asset by $3.0 billion, which is the deferred tax asset amount related to the noncredit portion of the previously recognized other-than-temporary impairments that was reclassified to Accumulated other comprehensive loss. The adoption of this accounting standard resulted in $344 million of noncredit related losses for the second quarter of 2009 being recognized in Other comprehensive loss instead of being recorded in our condensed consolidated statement of operations, as previously required.

See Critical Accounting Policies and Estimates Other-Than-Temporary Impairment of Investment Securities, Off-Balance Sheet Arrangements and Variable Interest Entities Elimination of QSPEs and Changes in the FIN 46R Consolidation Model and Notes to Condensed Consolidated Financial Statements Note 2, Summary of Significant Accounting Policies for further information on these accounting changes.

Liquidity

In response to the strong demand that we experienced for our debt securities during the first half of 2009, we issued a variety of non-callable and callable debt securities in a wide range of maturities to achieve cost efficient funding and an appropriate debt maturity profile. In particular, we issued a significant amount of long-term debt during this period, which we then used to repay maturing short-term debt and prepay more expensive long-term debt. As a result, our short-term debt decreased as a percentage of our total outstanding debt to 31% as of June 30, 2009 from 38% as of December 31, 2008, and the average interest rate on our long-term debt (excluding debt from consolidations) decreased to 3.81% as of June 30, 2009 from 4.66% as of December 31, 2008.

Our debt roll-over, or refinancing, risk has significantly declined since November 2008 due to the combination of our improved access to long-term debt funding, improved market conditions, the reduced proportion of our outstanding debt that consists of short-term debt, and our expected reduced debt funding needs in the future. We believe that the improvement in our access to long-term debt funding since November 2008 stems from actions taken by the federal government to support us and the financial markets. Accordingly, we believe that our status as a GSE and continued federal government support of our business and the financial markets is essential to maintaining our access to debt funding, and changes or perceived changes in the government s support of us or the markets could lead to an increase in our debt roll-over risk in future periods and have a material adverse effect on our ability to fund our operations. Demand for our debt securities could decline in the future if the government does not extend or replace the Treasury credit facility and the Federal Reserve s agency debt and MBS purchase programs, each of which expire on December 31, 2009, or for other reasons. As of the date of this filing, however, demand for our long-term debt securities continues to be strong.

See Liquidity and Capital Management Liquidity Management Debt Funding for more information on our debt funding activities and Part II Item 1A Risk Factors of this report and Part I Item 1A Risk Factors of our 2008 Form 10-K for a discussion of the risks to our business posed by our reliance on the issuance of debt to fund our operations.

Homeowner Assistance Initiatives

During the second quarter of 2009, we continued our efforts, pursuant to our mission, to help homeowners avoid foreclosure. Much of our effort during the quarter was focused on implementing the Making Home Affordable Program, the details of which were first announced by the Obama Administration on March 4, 2009. That program is designed to significantly expand the number of borrowers who can refinance or modify their mortgages to achieve a monthly payment that is more affordable now and into the future or to obtain a more stable loan product, such as a fixed-rate mortgage loan in lieu of an adjustable-rate mortgage loan. In addition, if it is determined that a borrower is not eligible for a refinance or modification under that program, we will attempt to find another foreclosure alternative solution for the borrower.

The Making Home Affordable Program

Key elements of the Making Home Affordable Program are the Home Affordable Refinance Program and the Home Affordable Modification Program.

The Home Affordable Refinance Program provides for us to acquire or guarantee loans that are refinancings of mortgage loans we own or guarantee, and for Freddie Mac to acquire or guarantee loans that are refinancings of mortgage loans that it owns or guarantees. The program is targeted at borrowers who have demonstrated an acceptable payment history on their mortgage loans but may have been unable to refinance due to a decline in home values. We make refinancings under the Home Affordable Refinance Program through our Refi Plus[tm] initiatives, which provide refinance solutions for eligible Fannie Mae loans. To qualify for the Home Affordable Refinance Program, the new mortgage loan must either:

- reduce the borrower s monthly principal and interest payment, or

- provide a more stable loan product.

The Home Affordable Modification Program provides for the modification of mortgage loans owned or guaranteed by us or Freddie Mac, as well as other mortgage loans. The program is aimed at helping borrowers whose loan either is currently delinquent or who are at imminent risk of default by modifying their mortgage loan to make their monthly payments more affordable. Under the program, borrowers must satisfy the terms of a trial modification plan for a period of three or four months before the modification of the loan becomes effective. We have advised our servicers that we expect borrowers who are at risk of foreclosure to be evaluated for eligibility under the Home Affordable Modification Program before any other workout alternative is considered. The program is designed to provide a uniform, consistent regime for servicers to use in modifying mortgage loans to prevent foreclosures. For modifications under the program for loans that are not owned or guaranteed by Fannie Mae, we serve as the program administrator for Treasury. More detailed information regarding our role as program administrator for the Home Affordable Modification Program is provided in Part I Item 2 MD&A Executive Summary Homeowner Assistance and Foreclosure Prevention Initiatives of our First Quarter 2009 Form 10-Q.

Both the Home Affordable Refinance Program and the Home Affordable Modification Program are now in operation. We began accepting delivery of newly refinanced mortgage loans under the Home Affordable Refinance Program on April 1, 2009, and we entered into the first trial modification plans for loans that we own or guarantee in March 2009.

We have taken a number of steps since the Home Affordable Refinance Program and the Home Affordable Modification Program were launched in March 2009 to let borrowers know that help may be available to them under the programs. We responded to an average of 7,300 phone calls each week from borrowers inquiring about the Making Home Affordable Program during the second quarter of 2009. During that period, the loan-lookup tool we added to our Web site, which allows borrowers to find out instantly whether we own their loans, was used over three million times. We also have worked with servicers to mail letters to approximately 288,000 Fannie Mae borrowers through July 15, 2009 regarding the possibility of modifying their loans. Together with Treasury, the Department of Housing and Urban Development (HUD), NeighborWorks, and Freddie Mac, we are implementing a Making Home Affordable marketing and communications outreach campaign. As part of that campaign, in June we launched a targeted market campaign that over the coming year will cover 40 communities experiencing high levels of foreclosure to raise awareness about the Making Home Affordable Program, educate borrowers about options available to them, prepare them to work more efficiently with their servicers, and help keep them from falling victim to foreclosure prevention scams. The targeted market campaign includes a variety of outreach activities, including distribution of brochures and other informational materials, community partner roundtables, training sessions with local housing counselors, and borrower foreclosure prevention workshops, where HUD-certified housing counselors

and mortgage servicers meet one-on-one with borrowers.

We have also worked to support servicers who are modifying or refinancing our loans under the Making Home Affordable Program or who are modifying loans that we do not own or guarantee. Servicers face challenges putting in place personnel, training, systems and operations to support the Making Home

Affordable programs. To help them address these challenges, we have established on-site support for 39 of our top servicers, developed recorded tutorials, and we continue to offer live, Web-based training to servicers. We have also revised Desktop Underwriter® (DU®), our proprietary underwriting system that assists lenders in underwriting loans, to permit many refinancings under the Home Affordable Refinance Program to be made using DU.

A number of updates have been announced to expand the Making Home Affordable Program since its initial announcement:

On April 28, 2009, the Obama Administration announced the Second Lien Modification Program. Under the program when a borrower s first lien mortgage loan is modified under the Home Affordable Modification Program, a servicer participating in the Second Lien Program will be required to offer either to modify the associated second lien according to a pre-set protocol or to extinguish the second lien mortgage loan in return for a lump sum payment under a pre-set formula determined by Treasury.

On May 14, 2009, the Obama Administration announced two new components of the Making Home Affordable Program to help distressed borrowers:

- The Foreclosure Alternatives Program is aimed at assisting distressed borrowers by promoting alternatives to foreclosure when it is not an option for the borrower to keep the home. The program is designed to mitigate the impact of foreclosure on borrowers and communities by encouraging a short sale of the home (in which the borrower, working with the servicer, sells the home for less than the amount owed on the mortgage loan in full satisfaction of the loan) or a transfer of the home by a deed in lieu of foreclosure in cases where a borrower meets the eligibility requirements for a Home Affordable Modification but does not receive a modification offer or cannot maintain the required payments during the trial period or following modification.

- Home Price Decline Protection Incentives are intended to provide investors with additional incentives for Home Affordable Modifications of loans secured by homes in areas where home prices have recently declined and where investors are concerned that price declines may persist.

On May 29, 2009, we announced a 2% limit on the cumulative loan level price adjustments and adverse market delivery charge we apply to loans refinanced through our Refi Plus™ initiatives, through which we refinance loans under the Home Affordable Refinance Program. This limit was designed to reduce the cost of refinancing for some borrowers and thereby permit more borrowers to refinance under the program.

On June 25, 2009, we announced that we are easing the restrictions on the type of credit enhancement to which an existing loan can be subject, allowing more loans to be eligible for refinancing through the Home Affordable Refinance Program.

On July 1, 2009, FHFA authorized Fannie Mae and Freddie Mac to expand the Home Affordable Refinance Program to refinance their existing mortgage loans with an unpaid principal balance of up to 125% of the current value of the property covered by the mortgage loan, instead of the program s initial 105% limit. We will begin acquiring these mortgage loans on September 1, 2009.

Not all of the announced program updates have been implemented at this time. More detailed information regarding the Home Affordable Refinance Program and the Home Affordable Modification Program is provided in Part I Item 2 MD&A Executive Summary Homeowner Assistance and Foreclosure Prevention Initiatives of our First Quarter 2009 Form 10-Q.

Refinancing Activity

With long-term interest rates near record lows at the beginning of the second quarter of 2009, many borrowers took the opportunity to refinance their loans and obtain lower interest rates, a more stable loan product (such as a fixed-rate loan instead of an adjustable-rate loan), a lower monthly payment, or cash. During the second quarter and first six months of 2009, we acquired or guaranteed approximately 843,000 and 1,447,000 loans that were refinancings, including approximately 84,000 loans that represented refinancings in the second

quarter through our Refi Plus initiatives. On average, during the second quarter of 2009, borrowers who refinanced through our Refi Plus initiatives reduced their monthly mortgage payments by $192. In addition, approximately 6.2% of the total loans refinanced through our Refi Plus initiatives provided the borrowers with a more stable loan product than their prior loan, such as a fixed-rate loan or a fully amortizing loan.

We acquired approximately 16,000 loans under the Home Affordable Refinance Program for our portfolio or for securitization during the second quarter of 2009. The pace of our acquisitions under the Home Affordable Refinance Program increased notably in July, with an estimated 16,000 loans acquired during the month. During the early phase of the program, we, along with servicers and other mortgage market participants, including mortgage insurers, took a number of steps such as modifying systems and operations, and training personnel that required time to put in place and therefore limited the number of loans that could be refinanced under the program during the second quarter. The number of loans that could be refinanced was also limited by the capacity of lenders to handle the large volume of refinancings generated by record-low rates and by the time it takes to go through the loan origination process from application to closing and delivery. As a result, we expect an increase in refinancings under this program in the third quarter as compared to the second quarter, as second quarter applications are closed and delivered.

We believe the most significant factor that will affect the number of borrowers refinancing under the program is mortgage rates. As rates increase, fewer borrowers benefit from refinancing their mortgage loan; as rates decrease, more borrowers benefit from refinancing. The number of borrowers who refinance under the Home Affordable Refinance Program is also likely to be constrained by a number of other factors, including lack of borrower awareness, lack of borrower action to initiate a refinancing, and borrower ineligibility due, for example, to severe home price declines or to borrowers failing to remain current in their mortgage payments. The increase in the maximum loan-to-value (LTV) ratio of the refinanced loan to up to 125% of the current value of the property and the increasing awareness of the availability of refinance options will, over time, help to lessen the effects of some of these constraints, but will take time to take effect.

Loan Workout Activity

During the second quarter of 2009, we continued our efforts to help homeowners avoid foreclosure through a variety of foreclosure alternatives. We refer to actions taken by servicers with a borrower to resolve the problem of delinquent loan payments as workouts. During the second quarter and first six months of 2009, we completed approximately 41,000 and 88,000 loan workouts, compared with approximately 124,000 workouts during all of 2008. These amounts do not include trial loan modifications under the Home Affordable Modification Program or repayment and forbearance plans that were initiated but not completed as of June 30, 2009. Loan modifications represented 40% of all workouts during the second quarter of 2009, compared with 27% of workouts during all of 2008. The workouts we completed during the second quarter of 2009 included approximately 17,000 loan modifications; 12,000 loans under our HomeSaver Advance[tm] program; and 5,000 repayment plans and forbearances completed.

During the second quarter, borrowers who accepted offers for modifications under the Home Affordable Modification Program entered three or four month trial periods that must be completed prior to the execution of a modification under the program. Activity during the early stages of the program has been affected by the need to build consumer awareness and by servicers success in identifying eligible borrowers and executing trial modification plans. Only a small number of loans had time to complete a trial modification period under the program prior to June 30, 2009.

We expect to see increased activity under the program in the coming months as servicers gain experience with the program, borrower awareness grows, and new updates aimed at expanding the program s reach are implemented. As reported by servicers as part of the Making Home Affordable Program, there have been approximately 85,000 trial modifications started on Fannie Mae loans through July 30, 2009. The number of trial modifications started in July increased notably compared to monthly volumes during the second quarter.

Factors that have affected and may in the future continue to affect the number of loans modified include the following.

Servicer Capacity to Handle a New and Complex Process. Modifications require servicers to handle a multi-step process that includes identifying loans that are candidates for modification, making contact with the borrower, obtaining current financial information from the borrower, evaluating whether the program is a viable workout option, structuring the terms of the modification, communicating those terms to the borrower, providing the legal documentation, and receiving the borrower s agreements to both enter the trial period and modify the loan. As with the Home Affordable Refinance Program, during the early phase of the Home Affordable Modification program, servicers took a number of steps to implement the program, such as establishing or modifying systems and operations, and training personnel, that required time to put in place. Many servicers are still increasing their capacity to implement the program by hiring staff, enhancing technology, and changing their processes. Servicers will need to continue to adapt and take actions to implement new program elements as they are introduced to the program in an effort to assist more borrowers. The number of loans ultimately modified under the program depends on the extent to which servicers are able and willing to increase their capacity sufficiently to address the demand for modifications.

Borrower Awareness, Initiation and Agreement. Before a loan can be modified under the program, a borrower must learn of the program, initiate a request for a modification or respond to solicitations to apply for the program, provide current, accurate financial information, agree to the terms of a proposed modification and successfully complete the trial payment period. Many distressed borrowers are reluctant or unwilling even to contact their lenders, as demonstrated by the substantial percentage of foreclosures that are completed without the borrower having ever contacted the lender. Thus, extensive borrower outreach is required to encourage distressed borrowers to initiate a modification.

Borrower Inability or Unwillingness to Make Payments Even under a Modified Loan. Modifications under the Home Affordable Modification Program, or indeed under any program, will not be sufficient to help some borrowers keep their homes, particularly borrowers who have significant non-mortgage debt obligations or who are suffering from loss of income or other life events that impair their ability to maintain their mortgage even if it is modified. Other borrowers, particularly those whose mortgage obligations significantly exceed the value of their homes, may be unwilling to make payments even on a modified mortgage.

Our efforts to reach out to borrowers and support servicers, as well as the Obama Administration s recently announced program expansions, such as the Second Lien Program, are designed to address these factors and maximize the program s ability to help as many borrowers as possible. We discuss these efforts and program updates above under The Making Home Affordable Program.

The actions we are taking and the initiatives introduced to assist homeowners and limit foreclosures, including those under the Making Home Affordable Program, are significantly different from our historical approach to delinquencies, defaults and problem loans. The unprecedented nature of these actions and uncertainties related to interest rates and the broader economic environment mean that it will take time for us to assess and provide information on the success of these efforts. Some of the initiatives we undertook prior to the Making Home Affordable Program have not achieved the results we expected. As we move forward under the Making Home Affordable Program, we will continue to work with our conservator to help us best fulfill our objective of helping homeowners and the mortgage market.

Activity as Program Administrator for Modifications on non-Fannie Mae loans

We have been active in our role as program administrator for loans modified under the Home Affordable Modification Program that are not owned or guaranteed by us. To date, over 30 servicers have signed up to offer modifications on

non-agency loans under the program. Loans serviced by these servicers, together with other loans owned or guaranteed by us or by Freddie Mac, cover over 85% of the loans that may be eligible to be modified under the Home Affordable Modification Program. To help support servicers participating in the program, we have rolled out extensive systems and new technology tools, as well as updates to technology

tools in response to feedback we have received from servicers. Servicers can access these tools, as well as documentation, guidelines and materials for borrowers, on a Web site we launched to support their participation in the program.

Expected Impact of Making Home Affordable Program on Fannie Mae

The unprecedented nature of the Making Home Affordable Program and uncertainties related to interest rates and the broader economic environment make it difficult for us to predict the full extent of our activities under the program and how those will affect us, or the costs that we will incur either in the short term or over the long term. As we gain more experience under these programs, we may recommend supplementing the programs with other initiatives that would allow us, pursuant to our mission, to assist more homeowners.

We have included data relating to our borrower loss mitigation activities for the second quarter, which includes activities under the Making Home Affordable Program, and our borrower loss mitigation activities for prior periods in Risk Management Credit Risk Management Mortgage Credit Risk Management. A discussion of the risks to our business posed by the Making Home Affordable Program is included in Part II Item 1A Risk Factors.

We expect that modifications we make, pursuant to our mission, under the Home Affordable Modification Program of loans we own or guarantee will adversely affect our financial results and condition due to several factors, including:

- The requirement that we acquire any loan held in a Fannie Mae MBS prior to modifying it which, prior to January 1, 2010, will result in fair value loss charge-offs under SOP 03-3 against the Reserve for guaranty losses at the time we acquire the loan;

- Incentive and pay for success fees paid to our servicers for modification of loans we own or guarantee;

- Incentives to some borrowers under the program in the form of principal balance reductions if the borrowers continue to make payments due on the modified loan for specified periods; and

- The effect of holding modified loans in our mortgage portfolio, to the extent the loans provide a below market yield, which may be lower than our cost of funds.

We also expect to incur significant additional operational expenses associated with the Making Home Affordable Program.

Accordingly, the Making Home Affordable Program will likely have a material adverse effect on our business, results of operations and financial condition, including our net worth. If the program is successful in reducing foreclosures and keeping borrowers in their homes, however, it may benefit the overall housing market and help in reducing our long-term credit losses.

Providing Mortgage Market Liquidity

During the first half of 2009, we purchased or guaranteed an estimated $415.2 billion in new business, measured by unpaid principal balance, which provided financing for approximately 1,737,000 conventional single-family loans and approximately 193,000 multifamily units. Most of these purchases and guarantees were of single-family loans and approximately 84% of our single-family business during the first half of 2009 consisted of refinancings. The $415.2 billion in new single-family and multifamily business for the first half of 2009 consisted of $255.8 billion in Fannie Mae MBS that were issued, and $159.4 billion in mortgage loans and mortgage-related securities that we purchased for our mortgage investment portfolio.

We remain a constant source of liquidity in the multifamily market and we have been successful with our goal of reinvigorating our multifamily MBS business and broadening our multifamily investor base. Approximately 71% of total multifamily production in the first half of 2009 was an MBS execution, compared to 17% in the first half of 2008.

In addition to purchasing and guaranteeing mortgage assets, we are taking a variety of other actions to provide liquidity to the mortgage market. These actions include:

Whole Loan Conduit. Whole loan conduit activities involve our purchase of loans principally for the purpose of securitizing them. We purchase loans from a large group of lenders and then securitize them as Fannie Mae MBS, which may then be sold to dealers and investors.

Early Funding. Normally, lenders must wait 30 to 45 days between loan closing and settlement of an MBS transaction before they receive payment for the loans they sell to us. Our early lender funding program allows lenders to deliver closed loans to us and receive payment for those loans within a more accelerated timeframe, which allows lenders to replenish their funds and make new loans as soon as possible.

Dollar Roll Transactions. We have increased the amount of our dollar roll activity in the second quarter of 2009 as a result of continued strain on financial institutions balance sheets, higher lending rates from prepayment uncertainty, attractive discount note funding and a desire to increase market liquidity by lending our balance sheet to the market at positive economic returns to us. A dollar roll transaction is a commitment to purchase a mortgage-related security with a concurrent agreement to re-sell a substantially similar security at a later date or vice versa. An entity who sells a mortgage-related security to us with a concurrent agreement to repurchase a security in the future gains immediate financing for their balance sheet.

Outlook

We anticipate that adverse market dynamics and certain of our activities undertaken, pursuant to our mission, to stabilize and support the housing and mortgage markets will continue to negatively affect our financial condition and performance through the remainder of 2009 and into 2010.

Overall Market Conditions. We expect adverse conditions in the financial markets to continue through 2009. We expect further home price declines and rising default and severity rates during this period, all of which may worsen if unemployment rates continue to increase and if the U.S. continues to experience a broad-based economic recession. We continue to expect further increases in the level of foreclosures and single-family delinquency rates in 2009 and into 2010, as well as in the level of multifamily defaults and loss severity. We expect growth in residential mortgage debt outstanding to be flat in 2009 and 2010.

Home Price Declines: Following a decline of approximately 10% in 2008, we expect that home prices will decline another 7% to 12% on a national basis in 2009. We also continue to expect that we will experience a peak-to-trough home price decline on a national basis of 20% to 30%. Based on the observed home price trend during the first half of 2009, we expect future home price declines to be on the lower end of our estimated ranges. These estimates are based on our home price index, which is calculated differently from the S&P/Case-Shiller U.S. National Home Price Index and therefore results in lower percentages for comparable declines. These estimates also contain significant inherent uncertainty in the current market environment, due to historically unprecedented levels of uncertainty regarding a variety of critical assumptions we make when formulating these estimates, including: the effect of actions the federal government has taken and may take with respect to national economic recovery; the impact of those actions on home prices, unemployment and the general economic environment; and the rate of unemployment and/or wage decline. Because of these uncertainties, the actual home price decline we experience may differ significantly from these estimates. We also expect significant regional variation in home price decline percentages.

Our estimate of a 7% to 12% home price decline for 2009 compares with a home price decline of approximately 12% to 18% using the S&P/Case-Shiller index method, and our 20% to 30% peak-to-trough home price decline estimate compares with an approximately 33% to 46% peak-to-trough decline using the S&P/Case-Shiller index method. Our

estimates differ from the S&P/Case-Shiller index in two principal ways: (1) our estimates weight expectations for each individual property by number of properties, whereas the S&P/Case-Shiller index weights expectations of home price declines based on property value, causing declines in home prices on higher priced homes to have a greater effect on the overall result; and (2) our estimates do

not include sales of foreclosed homes because we believe that differing maintenance practices and the forced nature of the sales make foreclosed home prices less representative of market values, whereas the S&P/Case-Shiller index includes sales of foreclosed homes. The S&P/Case-Shiller comparison numbers shown above are calculated using our models and assumptions, but modified to use these two factors (weighting of expectations based on property value and the inclusion of foreclosed property sales). In addition to these differences, our estimates are based on our own internally available data combined with publicly available data, and are therefore based on data collected nationwide, whereas the S&P/Case-Shiller index is based only on publicly available data, which may be limited in certain geographic areas of the country. Our comparative calculations to the S&P/Case-Shiller index provided above are not modified to account for this data pool difference.

Credit Losses and Credit-Related Expenses. We currently expect our credit losses and our credit loss ratio (each of which excludes fair value losses under SOP 03-3 and our HomeSaver Advance product) in 2009 to exceed our credit losses and our credit loss ratio in 2008 by a significant amount. We also continue to expect a significant increase in our SOP 03-3 fair value losses in 2009 as we increase the number of loans we repurchase from MBS trusts in order to modify them, particularly as more servicers participate in the Home Affordable Modification Program. In addition, we expect our credit-related expenses to be higher in 2009 than they were in 2008.

Expected Lack of Profitability for Foreseeable Future. We expect to continue to have losses as our guaranty book of business continues to deteriorate and as we continue to incur ongoing costs in our efforts to keep people in homes and provide liquidity to the mortgage market. We do not expect to operate profitably in the foreseeable future.

Uncertainty Regarding our Future Status and Long-Term Financial Sustainability: We expect that we will experience adverse financial effects as we seek to fulfill our mission by concentrating our efforts on keeping people in their homes and preventing foreclosures, including our efforts under the Making Home Affordable Program, while remaining active in the secondary mortgage market. In addition, future activities that our regulators, other U.S. government agencies or Congress may request or require us to take to support the mortgage market and help borrowers may contribute to further deterioration in our results of operations and financial condition. Although Treasury s additional funds under the senior preferred stock purchase agreement permit us to remain solvent and avoid receivership, the resulting dividend payments are substantial and will increase as we request additional funds from Treasury under the senior preferred stock purchase agreement. As a result of these factors, along with current and expected market and economic conditions and the deterioration in our single-family and multifamily books of business, there is significant uncertainty as to our long-term financial sustainability. We expect that, for the foreseeable future, the earnings of the company, if any, will not be sufficient to pay the dividends on the senior preferred stock. As a result, future dividend payments will be effectively funded from equity drawn from the Treasury.

Further, as described under Legislative and Regulatory Matters Obama Administration Financial Regulatory Reform Plan and Congressional Hearing, Treasury and HUD are currently engaged in an initiative to develop recommendations on the future of our business. In July 2009, the Treasury Secretary stated that: As a government, we re going to have to figure out [Fannie Mae and Freddie Mac s] future. What they are today is not going to be their future. In addition, a Congressional subcommittee held hearings in June regarding the present condition and future status of our business, and future hearings are expected. We expect significant uncertainty regarding the future of our business, including whether we will continue to exist, to continue until February 2010 and beyond.

LEGISLATIVE AND REGULATORY MATTERS

Obama Administration Financial Regulatory Reform Plan and Congressional Hearing

In June 2009, the Obama Administration announced a comprehensive regulatory reform plan to transform the manner in which the financial services industry is regulated. The Administration s white paper describing the plan notes that

[w]e need to maintain the continued stability and strength of the GSEs during these difficult financial times. The white paper states that Treasury and HUD, in consultation with other government

agencies, will engage in a wide-ranging initiative to develop recommendations on the future of Fannie Mae, Freddie Mac and the Federal Home Loan Bank system, and will report its recommendations to Congress and the American public at the time of the President s 2011 budget release. The President s 2011 budget is currently expected to be released in February 2010.

The Obama Administration s white paper notes that there are a number of options for the reform of the GSEs, including:

- returning them to their previous status as GSEs with the paired interests of maximizing returns for private shareholders and pursuing public policy home ownership goals;
- gradually winding down the GSEs operations and liquidating their assets;
- incorporating the GSEs functions into a federal agency;
- implementing a public utility model where the government regulates the GSEs profit margin, sets guarantee fees, and provides explicit backing for GSE commitments;
- converting the GSEs role to providing insurance for covered bonds; and
- dissolving Fannie Mae and Freddie Mac into many smaller companies.

In June 2009, a Congressional subcommittee held a hearing to discuss the present condition and future status of Fannie Mae and Freddie Mac. The subcommittee chairman indicated that this was the first of many hearings regarding the roles and functions of Fannie Mae and Freddie Mac. In July 2009, GSE reform legislation was introduced in the House of Representatives that, if enacted, would substantially alter our current structure and provide for the eventual wind-down of the GSEs. It is unclear what action the House of Representatives will take on this legislation, if any. In addition, we believe additional GSE reform legislation is likely to be introduced in the future. As a result, there continues to be significant uncertainty regarding the future of our company, including whether we will continue to exist.

The Administration s financial regulatory reform plan also proposes significantly altering the current regulatory framework applicable to the financial services industry, with enhanced and more comprehensive regulation of financial firms and markets. This regulation may directly and indirectly affect many aspects of our business and that of our business partners. The plan includes proposals relating to the enhanced regulation of securitization markets, changes to existing capital and liquidity requirements for financial firms, additional regulation of the over-the-counter derivatives market, stronger consumer protection regulations, regulations on compensation practices and changes in accounting standards. In July 2009, the House Financial Services Committee began a series of hearings on the Administration s plan and proposed legislation.

We cannot predict the ultimate impact of these proposed regulatory reforms on our company or our industry.

Pending Legislation

In June 2009, the House of Representatives passed a bill that, among other things, would impose upon Fannie Mae and Freddie Mac a duty to develop loan products and flexible underwriting guidelines to facilitate a secondary market for energy-efficient and location-efficient mortgages. The legislation would also allow Fannie Mae and Freddie Mac additional credit toward their housing goals for purchases of energy-efficient and location-efficient mortgages. It is unclear what action the Senate will take on this legislation, or what impact it may have on our business if this

legislation is enacted.

In May 2009, the House of Representatives passed a bill that, among other things, would require originators to retain a level of credit risk for certain mortgages that they sell, enhance consumer disclosures, impose new servicing standards and allow for assignee liability. If enacted, the legislation would impact our business and the overall mortgage market. However, it is unclear when, or if, the Senate will consider comparable legislation.

In March 2009, the House of Representatives passed a housing bill that, among other things, includes provisions intended to stem the rate of foreclosures by allowing bankruptcy judges to modify the terms of

mortgages on principal residences for borrowers in Chapter 13 bankruptcy. Specifically, the House bill would allow bankruptcy judges to adjust interest rates, extend repayment terms and lower the outstanding principal amount to the current estimated fair value of the underlying property. If enacted, this legislation could have an adverse impact on our business. The Senate passed a similar housing bill in May 2009 that did not include comparable bankruptcy-related provisions. It is unclear when, or if, the Senate will reconsider other alternative bankruptcy-related legislation.

Housing Goals

On July 30, 2009, FHFA issued a final rule changing our 2009 housing goals from the goals initially set by the Regulatory Reform Act. FHFA determined that, in light of current market conditions, the previously established 2009 housing goals were not feasible unless adjusted. The final rule reduces our 2009 base housing goals and home purchase subgoals approximately to the levels that prevailed in 2004 through 2006. The final rule also raises our multifamily special affordable housing subgoal. The subgoal is 1% of the average annual dollar volume of combined (single-family and multifamily) mortgages purchased by Fannie Mae during specified years. To adjust the subgoal, FHFA changed the base years on which the average is calculated. HUD s 2004 rule used the years 2000-2002 to set the subgoal. FHFA s rule uses the years 1999-2008. The final rule also permits loan modifications that we make in accordance with the Making Home Affordable Program to be treated as mortgage purchases and count towards the housing goals. In addition, the final rule excludes from counting towards the 2009 housing goals any purchases of loans on one-to four-unit properties with a maximum original principal balance higher than the nationwide conforming loan limit (currently set at $417,000).

The following table sets forth our revised 2009 housing goals and subgoals.

	2009 Goal
Housing goals:[1]	
Low- and moderate-income housing	43.0%
Underserved areas	32.0
Special affordable housing	18.0
Housing subgoals:	
Home purchase subgoals:[2]	
Low- and moderate-income housing	40.0%
Underserved areas	30.0
Special affordable housing	14.0
Multifamily special affordable housing subgoal ($ in billions)[3]	$ 6.56

(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.

(3) The multifamily subgoal is measured by loan amount and expressed as a dollar amount.

Regulation of New Products and Activities

In July 2009, FHFA published an interim final rule, Prior Approval for Enterprise Products, setting forth a process for FHFA to review new products and activities prior to their launch by Fannie Mae or Freddie Mac. This interim final rule, which became effective upon publication, implements a provision of the Housing and Economic Recovery Act of 2008 that requires Fannie Mae and Freddie Mac to obtain the approval of the Director of FHFA before initially offering a new product. The interim final rule requires that we submit detailed information about all new products and activities to the Director of FHFA prior to launching the product or commencing the activity. The Director will determine which proposed new activities require a 30-day public notice and comment period and prior approval. In determining whether to approve a proposed

new product, the Director will consider whether the product is consistent with our charter, the public interest, and safety and soundness. We have received instructions from the Director of FHFA regarding compliance with the rule during the period that FHFA is receiving and considering comments on the interim final rule. Pursuant to these instructions, we are working with FHFA to finalize the processes and procedures to implement this statutory requirement. Depending on the manner in which it is implemented, this rule could have an adverse impact on our ability to develop and introduce new products and activities to the marketplace.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The preparation of financial statements in accordance with GAAP requires management to make a number of judgments, estimates and assumptions that affect the reported amount of assets, liabilities, income and expenses in the condensed consolidated financial statements. Understanding our accounting policies and the extent to which we use management judgment and estimates in applying these policies is integral to understanding our financial statements. We describe our most significant accounting policies in Notes to Consolidated Financial Statements Note 2, Summary of Significant Accounting Policies of our 2008 Form 10-K and in Notes to Condensed Consolidated Financial Statements Note 2, Summary of Significant Accounting Policies of this report.

We have identified four of our accounting policies as critical because they involve significant judgments and assumptions about highly complex and inherently uncertain matters and the use of reasonably different estimates and assumptions could have a material impact on our reported results of operations or financial condition. These critical accounting policies and estimates are as follows:

- Fair Value of Financial Instruments
- Other-Than-Temporary Impairment of Investment Securities
- Allowance for Loan Losses and Reserve for Guaranty Losses
- Deferred Tax Assets

We evaluate our critical accounting estimates and judgments required by our policies on an ongoing basis and update them as necessary based on changing conditions. We describe below significant changes in the judgments and assumptions we made during the second quarter of 2009 in applying our critical accounting policies and estimates. Management has discussed any significant changes in judgments and assumptions in applying our critical accounting policies with the Audit Committee of the Board of Directors. See Part II Item 7 MD&A Critical Accounting Policies and Estimates of our 2008 Form 10-K for additional information about our critical accounting policies and estimates.

Fair Value of Financial Instruments

The use of fair value to measure our financial instruments is fundamental to our financial statements and is a critical accounting estimate because we account for and record a substantial portion of our assets and liabilities at fair value. SFAS No. 157, *Fair Value Measurements* (SFAS 157), defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (also referred to as an exit price).

In April 2009, the FASB issued FSP FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly* (FSP FAS 157-4). FSP FAS 157-4 provides guidance on how to determine the fair value when the volume and level of activity for the asset or liability have significantly decreased. If there has been a significant decrease in the volume and

level of activity for an asset or liability as compared to the normal level of market activity for the asset or liability, there is an increased likelihood that quoted prices or transactions for the instrument are not reflective of an orderly transaction and may therefore require significant adjustment to estimate fair value. We evaluate the existence of the following conditions in determining whether there is an inactive market for our financial instruments: (1) there are few transactions for the financial instrument; (2) price quotes are not based on current market information; (3) the price quotes we receive vary significantly

either over time or among independent pricing services or dealers; (4) price indices that were previously highly correlated are demonstrably uncorrelated; (5) there is a significant increase in implied liquidity risk premiums, yields or performance indicators, such as delinquency rates or loss severities, for observed transactions or quoted prices when compared with our estimate of expected cash flows, considering all available market data about credit and other nonperformance risk for the financial instrument; (6) there is a wide bid-ask spread or significant increase in the bid-ask spread; (7) there is a significant decline or absence of a market for new issuances (*i.e.,* primary market) for the financial instrument or similar financial instruments; or (8) there is limited availability of public market information.

In determining fair value, we use various valuation techniques. We disclose the carrying value and fair value of our financial assets and liabilities and describe the specific valuation techniques used to determine the fair value of these financial instruments in Notes to Condensed Consolidated Financial Statements Note 18, Fair Value of Financial Instruments. Our adoption of FSP FAS 157-4 effective April 1, 2009 did not result in a change in our valuation techniques for estimating fair value.

SFAS 157 provides a three-level fair value hierarchy for classifying financial instruments. This hierarchy is based on whether the inputs to the valuation techniques used to measure fair value are observable or unobservable. Each asset or liability is assigned to a level based on the lowest level of any input that is significant to the fair value measurement. The three levels of the SFAS 157 fair value hierarchy are described below:

Level 1: Quoted prices (unadjusted) in active markets for identical assets or liabilities.

Level 2: Observable market-based inputs, other than quoted prices in active markets for identical assets or liabilities.

Level 3: Unobservable inputs.

The majority of our financial instruments carried at fair value fall within the level 2 category and are valued primarily utilizing inputs and assumptions that are observable in the marketplace, that can be derived from observable market data or that can be corroborated by recent trading activity of similar instruments with similar characteristics. For example, we generally request non-binding prices from at least four independent pricing services to estimate the fair value of our trading and available-for-sale investment securities at an individual security level. We use the average of these prices to determine the fair value. In the absence of such information or if we are not able to corroborate these prices by other available, relevant market information, we estimate their fair values based on single source quotations from brokers or dealers or by using internal calculations or discounted cash flow techniques that incorporate inputs, such as prepayment rates, discount rates and delinquency, default and cumulative loss expectations, that are implied by market prices for similar securities and collateral structure types. Because items classified as level 3 are valued using significant unobservable inputs, the process for determining the fair value of these items is generally more subjective and involves a high degree of management judgment and assumptions. These assumptions may have a significant effect on our estimates of fair value, and the use of different assumptions as well as changes in market conditions could have a material effect on our results of operations or financial condition.

Fair Value Hierarchy Level 3 Assets and Liabilities

Our level 3 assets and liabilities consist primarily of financial instruments for which the fair value is estimated using valuation techniques that involve significant unobservable inputs because there is limited market activity and therefore little or no price transparency. Our level 3 financial instruments include certain mortgage- and asset-backed securities and residual interests, certain performing residential mortgage loans, nonperforming mortgage-related assets, our guaranty assets and buy-ups, our master servicing assets and certain highly structured, complex derivative instruments. We use the term buy-ups to refer to upfront payments that we make to lenders to adjust the monthly

contractual guaranty fee rate so that the pass-through coupon rates on Fannie Mae MBS are in more easily tradable increments of a whole or half percent.

Fair value measurements related to financial instruments that are reported at fair value in our condensed consolidated financial statements each period, such as our trading and available-for-sale securities and derivatives, are referred to as recurring fair value measurements. Fair value measurements related to financial instruments that are not reported at fair value each period, such as held-for-sale mortgage loans, are referred to as non-recurring fair value measurements. The following discussion identifies the primary types of financial assets and liabilities within each balance sheet category that are reported at fair value on a recurring basis and are based on level 3 inputs, We also describe the valuation techniques we use to determine their fair values, including key inputs and assumptions.

Trading and Available-for-Sale Investment Securities. Our financial instruments within these asset categories that are classified as level 3 primarily consist of mortgage-related securities backed by Alt-A loans, subprime loans and manufactured housing loans and mortgage revenue bonds. We have relied on external pricing services to estimate the fair value of these securities and validated those results with our internally derived prices, which may incorporate spread, yield, or vintage and product matrices, and standard cash flow discounting techniques. The inputs we use in estimating these values are based on multiple factors, including market observations, relative value to other securities, and non-binding dealer quotes. If we are not able to corroborate vendor-based prices, we rely on management s best estimate of fair value.

Derivatives. Our derivative financial instruments that are classified as level 3 primarily consist of a limited population of certain highly structured, complex interest rate risk management derivatives. Examples include certain swaps with embedded caps and floors that reference non-standard indices. We determine the fair value of these derivative instruments using indicative market prices obtained from independent third parties. If we obtain a price from a single source and we are not able to corroborate that price, the fair value measurement is classified as level 3.

Guaranty Assets and Buy-ups. We determine the fair value of our guaranty assets and buy-ups based on the present value of the estimated compensation we expect to receive for providing our guaranty. We generally estimate the fair value using proprietary internal models that calculate the present value of expected cash flows. Key model inputs and assumptions include prepayment speeds, forward yield curves and discount rates that are commensurate with the level of estimated risk.

Guaranty Obligations. The fair value of all guaranty obligations, measured subsequent to their initial recognition, reflects our estimate of a hypothetical transaction price that we would receive if we were to issue our guaranty to an unrelated party in a standalone arm s-length transaction at the measurement date. We estimate the fair value of the guaranty obligations using internal valuation models that calculate the present value of expected cash flows based on management s best estimate of certain key assumptions, such as default rates, severity rates and a required rate of return. During 2008, we further adjusted the model-generated values based on our current market pricing to arrive at our estimate of a hypothetical transaction price for our existing guaranty obligations. Beginning in the first quarter of 2009, we concluded that the credit characteristics of the pools of loans upon which we were issuing new guarantees increasingly did not reflect the credit characteristics of our existing guaranteed pools; thus, current market prices for our new guarantees were not a relevant input to our estimate of the hypothetical transaction price for our existing guaranty obligations. Therefore, at June 30, 2009, we based our estimate of the fair value of our existing guaranty obligations solely upon our model without further adjustment.

Table 2 presents a comparison, by balance sheet category, of the amount of financial assets carried in our consolidated balance sheets at fair value on a recurring basis and classified as level 3 as of June 30, 2009 and December 31, 2008. The availability of observable market inputs to measure fair value varies based on changes in market conditions, such as liquidity. As a result, we expect the amount of financial instruments carried at fair value on a recurring basis and classified as level 3 to vary each period.

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Table 2: Level 3 Recurring Financial Assets at Fair Value

Balance Sheet Category	As of June 30, 2009	As of December 31, 2008
	(Dollars in millions)	
Trading securities	$ 9,728	$ 12,765
Available-for-sale securities	39,915	47,837
Derivatives assets	256	362
Guaranty assets and buy-ups	1,483	1,083
Level 3 recurring assets	$ 51,382	$ 62,047
Total assets	$ 911,382	$ 912,404
Total recurring assets measured at fair value	$ 369,205	$ 359,246
Level 3 recurring assets as a percentage of total assets	6%	7%
Level 3 recurring assets as a percentage of total recurring assets measured at fair value	14%	17%
Total recurring assets measured at fair value as a percentage of total assets	41%	39%

Level 3 recurring assets totaled $51.4 billion, or 6% of our total assets, as of June 30, 2009, compared with $62.0 billion, or 7% of our total assets, as of December 31, 2008. The decrease in assets classified as level 3 during the first six months of 2009 was principally the result of a net transfer of approximately $6.3 billion in assets to level 2 from level 3. The transferred assets consisted primarily of private-label mortgage-related securities backed by non-fixed rate Alt-A loans. The market for Alt-A securities continues to be relatively illiquid. However, during the first half of 2009, price transparency improved as a result of recent transactions, and we noted some convergence in prices obtained from third party vendors. As a result, we determined that it was appropriate to rely on level 2 inputs to value these securities.

Financial assets measured at fair value on a non-recurring basis and classified as level 3, which are not presented in the table above, include held-for-sale loans that are measured at lower of cost or fair value and that were written down to fair value during the period. Held-for-sale loans that were reported at fair value, rather than amortized cost, totaled $2.4 billion and $1.3 billion as of June 30, 2009 and December 31, 2008, respectively. In addition, certain other financial assets carried at amortized cost that have been written down to fair value during the period due to impairment are classified as non-recurring. The fair value of these level 3 non-recurring financial assets, which primarily consisted of certain guaranty assets, low income housing tax credit (LIHTC) partnership investments and acquired property, totaled $18.1 billion and $22.4 billion as of June 30, 2009 and December 31, 2008, respectively.

Our LIHTC investments trade in a market with limited observable transactions. There is decreased market demand for LIHTC investments because there are fewer tax benefits derived from these investments by traditional investors, as these investors are currently projecting much lower levels of future profits than in previous years. This decreased demand has reduced the value of these investments. We determine the fair value of our LIHTC investments using internal models that estimate the present value of the expected future tax benefits (tax credits and tax deductions for net operating losses) expected to be generated from the properties underlying these investments. Our estimates are based on assumptions that other market participants would use in valuing these investments. The key assumptions

used in our models, which require significant management judgment, include discount rates and projections related to the amount and timing of tax benefits. We compare the model results to the limited number of observed market transactions and make adjustments to reflect differences between the risk profile of the observed market transactions and our LIHTC investments.

Financial liabilities measured at fair value on a recurring basis and classified as level 3 consisted of long-term debt with a fair value of $1.0 billion and $2.9 billion as of June 30, 2009 and December 31, 2008, respectively, and derivatives liabilities with a fair value of $24 million and $52 million as of June 30, 2009 and December 31, 2008, respectively.

Fair Value Control Processes

We have control processes that are designed to ensure that our fair value measurements are appropriate and reliable, that they are based on observable inputs wherever possible and that our valuation approaches are consistently applied and the assumptions used are reasonable. Our control processes consist of a framework that provides for a segregation of duties and oversight of our fair value methodologies and valuations and validation procedures.

Our Valuation Oversight Committee, which includes senior representation from business areas, our Enterprise Risk Management office and our Finance Division, is responsible for reviewing the valuation and pricing methodologies used in our fair value measurements and any significant valuation adjustments, judgments, controls and results. Actual valuations are performed by personnel independent of our business units. Our Price Verification Group, which is an independent control group separate from the group that is responsible for obtaining the prices, also is responsible for performing monthly independent price verification. The Price Verification Group also performs independent reviews of the assumptions used in determining the fair value of products we hold that have material estimation risk because observable market-based inputs do not exist.

Our validation procedures are intended to ensure that the individual prices we receive are consistent with our observations of the marketplace and prices that are provided to us by pricing services or other dealers. We verify selected prices using a variety of methods, including comparing the prices to secondary pricing services, corroborating the prices by reference to other independent market data, such as non-binding broker or dealer quotations, relevant benchmark indices, and prices of similar instruments, checking prices for reasonableness based on variations from prices provided in previous periods, comparing prices to internally calculated expected prices and conducting relative value comparisons based on specific characteristics of securities. In addition, we compare our derivatives valuations to counterparty valuations as part of the collateral exchange process. We have formal discussions with the pricing services as part of our due diligence process in order to maintain a current understanding of the models and related assumptions and inputs that these vendors use in developing prices. The prices provided to us by independent pricing services reflect the existence of credit enhancements, including monoline insurance coverage, and the current lack of liquidity in the marketplace. If we determine that a price provided to us is outside established parameters, we will further examine the price, including having follow-up discussions with the specific pricing service or dealer. If we conclude that a price is not valid, we will adjust the price for various factors, such as liquidity, bid-ask spreads and credit considerations. These adjustments are generally based on available market evidence. In the absence of such evidence, management s best estimate is used. All of these processes are executed before we use the prices in the financial statement process.

We continually refine our valuation methodologies as markets and products develop and the pricing for certain products becomes more or less transparent. While we believe our valuation methods are appropriate and consistent with those of other market participants, using different methodologies or assumptions to determine fair value could result in a materially different estimate of the fair value of some of our financial instruments.

Other-Than-Temporary Impairment of Investment Securities

We evaluate available-for-sale securities in an unrealized loss position as of the end of each quarter for other-than-temporary impairment. In April 2009, the FASB issued FSP FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments* (FSP FAS 115-2), which modifies the model for assessing other-than-temporary impairment for investments in debt securities. Under this guidance, a debt security is evaluated for other-than-temporary impairment if its fair value is less than its amortized cost basis. Other-than-temporary impairment is recognized in earnings if one of the following conditions exists: (1) the intent is to sell the security; (2) it is more likely than not that we will be required to sell the security before the impairment is recovered; or (3) the amortized cost basis is not expected to be recovered. If, however, we do not intend to sell the security and will not be

required to sell prior to recovery of the amortized cost basis, only the credit component of other-than-temporary impairment is recognized in earnings. The noncredit component is recorded in other comprehensive income (OCI). The credit component is the difference between the security s amortized cost basis and the present value of its expected future cash flows,

while the noncredit component is the remaining difference between the security s fair value and the present value of expected future cash flows. We adopted this new accounting guidance effective April 1, 2009, which resulted in a cumulative-effect pre-tax reduction of $8.5 billion ($5.6 billion after tax) in our accumulated deficit to reclassify to accumulated other comprehensive income (AOCI) the noncredit component of other-than-temporary impairment losses previously recognized in earnings. We also reversed $3.0 billion of our deferred tax asset valuation allowance, which resulted in a $3.0 billion reduction in our accumulated deficit, because we continue to have the intent and ability to hold these securities to recovery.

We conduct periodic reviews of each investment security that has an unrealized loss to determine whether other-than-temporary impairment has occurred. As a result of our April 1, 2009 adoption of the new other-than-temporary impairment guidance, we revised our approach for measuring and recognizing impairment. Our evaluation continues to require significant management judgment and a consideration of various factors to determine if we will receive the amortized cost basis of our investment securities. These factors include, but are not limited to, the severity and duration of the impairment; recent events specific to the issuer and/or industry to which the issuer belongs; the payment structure of the security; external credit ratings and the failure of the issuer to make scheduled interest or principal payments. We rely on expected future cash flow projections to determine if we will recover the amortized cost basis of our available-for-sale securities. These cash flow projections are derived from internal models that consider particular attributes of the loans underlying our securities and assumptions about changes in the economic environment, such as home prices and interest rates, to predict borrower behavior and the impact on default frequency, loss severity and remaining credit enhancement.

We provide more detailed information on our accounting for other-than-temporary impairment in Notes to Condensed Consolidated Financial Statements Note 2, Summary of Significant Accounting Policies. Also refer to Consolidated Balance Sheet Analysis Mortgage Investments Trading and Available-for-Sale Investment Securities Investments in Private-Label Mortgage-Related Securities for a discussion of other-than-temporary impairment recognized on our investments in Alt-A and subprime private-label securities.

Allowance for Loan Losses and Reserve for Guaranty Losses

We maintain an allowance for loan losses for loans in our mortgage portfolio classified as held-for-investment. We maintain a reserve for guaranty losses for loans that back Fannie Mae MBS we guarantee and loans that we have guaranteed under long-term standby commitments. We report the allowance for loan losses and reserve for guaranty losses as separate line items in the consolidated balance sheets. These amounts, which we collectively refer to as our combined loss reserves, represent our best estimate of credit losses incurred in our guaranty book of business as of the balance sheet date.

We have an established process, using analytical tools, benchmarks and management judgment, to determine our loss reserves. Although our loss reserve process benefits from extensive historical loan performance data, this process is subject to risks and uncertainties, including a reliance on historical loss information that may not be representative of current conditions. It is our practice to continually monitor delinquency and default trends and make changes in our historically developed assumptions and estimates as necessary to better reflect the impact of present conditions, including current trends in borrower risk and/or general economic trends, changes in risk management practices, and changes in public policy and the regulatory environment.

Because of the current stress in the housing and credit markets, and the speed and extent to which these markets have deteriorated, our process for determining our loss reserves has become more complex and involves a greater degree of management judgment. As a result of the continued decline in home prices, more limited opportunities for refinancing due to the tightening of the credit markets and the sharp rise in unemployment, mortgage delinquencies have reached record levels. Our historical loan performance data indicates a pattern of default rates and credit losses that typically

occur over time, which are strongly dependent on the age of a mortgage loan. However, we have witnessed significant changes in traditional loan performance and delinquency patterns, including an increase in early-stage delinquencies for certain loan categories and faster transitions to later stage delinquencies. We believe that recently announced government policies and our initiatives under these policies have partly contributed to these newly observed delinquency

patterns. For example, our level of foreclosures and associated charge-offs were lower during the first and second quarters of 2009 than they otherwise would have been due to foreclosure delays resulting from our foreclosure suspension, our requirement that loan modification options be pursued with the borrower before proceeding to a foreclosure sale, and state-driven changes in foreclosure rules to slow and extend the foreclosure process. As a result, we determined that it was necessary to refine our loss reserve estimation process to reflect these newly observed delinquency patterns, as we describe in more detail below.

We historically have relied on internally developed default loss curves derived from observed default trends in our single-family guaranty book of business to determine our single-family loss reserve. These loss curves are shaped by the normal pattern of defaults, based on the age of the book, and informed by historical default trends and the performance of the loans in our book to date. We develop the loss curves by aggregating homogeneous loans into pools based on common underlying risk characteristics, such as origination year and seasoning, original LTV ratio and loan product type, to derive an overall estimate. We use these loss curve models to estimate, based on current events and conditions, the number of loans that will default (default rate) and how much of a loan s balance will be lost in the event of default (loss severity). For the majority of our loan risk categories, our default rate estimates have traditionally been based on loss curves developed from available historical loan performance data dating back to 1980. However, we have recently used a shorter, more near-term default loss curve based on a one quarter look-back period to generate estimated default rates for loans originated in 2006 and 2007 and for Alt-A loans originated in 2005. More recently, we also have relied on a one-quarter look back period to develop loss severity estimates for all of our loan categories.

We experienced a substantial reduction in foreclosures and charge-offs during the periods November 26, 2008 through January 31, 2009 and February 17, 2009 through March 6, 2009 when our foreclosure suspension was in effect and a surge in foreclosures during the two-week period of February 1, 2009 through February 16, 2009. Since February 16, 2009, we have continued to observe a reduced level of foreclosures as our servicers, in keeping with our guidelines, evaluate borrowers for newly introduced workout options before proceeding to a foreclosure. Because of the distortion in defaults caused by these temporary events, we adjusted our loss curves to incorporate default estimates derived from an assessment of our most recently observed loan delinquencies and the related transition of loans through the various delinquency categories. We used this delinquency assessment and our most recent default information prior to the foreclosure suspension to estimate the number of defaults that we would have expected to occur during the first six months of 2009 if the foreclosure moratorium and our new foreclosure guidelines had not been in effect. We then used these estimated defaults, rather than the actual number of defaults that occurred during the first six months of 2009, to estimate our loss curves and derive the default rates used in determining our single-family loss reserves as of June 30, 2009. Consistent with the approach we used as of December 31, 2008, we also made management adjustments to our model-generated results to capture incremental losses that may not be fully reflected in our models related to geographically concentrated areas that are experiencing severe stress as a result of significant home price declines and the sharp rise in unemployment rates.

In determining our multifamily loss reserves, we made several enhancements in the first and second quarters of 2009 to the models used in determining our multifamily loss reserves to reflect the impact of the continuing deterioration in the credit performance of loans in our multifamily guaranty book of business. These model enhancements involved weighting more heavily recent loan default and severity experience to derive the key parameters used in calculating our expected default rates. We expect increased multifamily defaults and loss severities in 2009.

Our combined loss reserves increased by $30.4 billion during the first six months of 2009 to $55.1 billion as of June 30, 2009, reflecting further deterioration in both our single-family and multifamily guaranty book of business, as evidenced by the significant increase in delinquent, seriously delinquent and nonperforming loans, as well as an increase in our average loss severities as a result of the decline in home prices during the first six months of 2009. The incremental management adjustment to our loss reserves for geographic and unemployment stresses accounted for

approximately $8.2 billion of our combined loss reserves of

$55.1 billion as of June 30, 2009, compared with approximately $2.3 billion of our combined loss reserves of $24.8 billion as of December 31, 2008.

We provide additional information on our combined loss reserves and the impact of adjustments to our loss reserves on our condensed consolidated financial statements in Consolidated Results of Operations Credit-Related Expenses and Notes to Condensed Consolidated Financial Statements Note 5, Allowance for Loan Losses and Reserve for Guaranty Losses.

CONSOLIDATED RESULTS OF OPERATIONS

Our business generates revenues from three principal sources: net interest income; guaranty fee income; and fee and other income. Other significant factors affecting our results of operations include: fair value gains and losses; the timing and size of investment gains and losses; credit-related expenses; losses from partnership investments; administrative expenses and our effective tax rate. We expect high levels of period-to-period volatility in our results of operations and financial condition, principally due to changes in market conditions that result in periodic fluctuations in the estimated fair value of financial instruments that we mark-to-market through our earnings. These instruments include trading securities and derivatives. The estimated fair value of our trading securities and derivatives may fluctuate substantially from period to period because of changes in interest rates, credit spreads and expected interest rate volatility, as well as activity related to these financial instruments.

Table 3 presents a condensed summary of our consolidated results of operations for the three and six months ended June 30, 2009 and 2008 and selected performance metrics that we believe are useful in evaluating changes in our results between periods.

Table 3: Summary of Condensed Consolidated Results of Operations and Performance Metrics

	For the Three Months Ended June 30,		For the Six Months Ended June 30,		Quarterly Variance		Year-to-Da Variance
	2009	2008	2009	2008	$	%	$
	(Dollars in millions, except per share amounts)						
t income	$ 3,735	$ 2,057	$ 6,983	$ 3,747	$ 1,678	82%	$ 3,236
ee income	1,659	1,608	3,411	3,360	51	3	51
agement income	13	75	24	182	(62)	(83)	(158)
ner income	184	225	365	452	(41)	(18)	(87)
ues	**5,591**	**3,965**	**10,783**	**7,741**	**1,626**	**41**	**3,042**
gains (losses), net[1]	(45)	(376)	178	(432)	331	88	610
han-temporary impairments[1]	(753)	(507)	(6,406)	(562)	(246)	(49)	(5,844)
gains (losses), net[2]	823	517	(637)	(3,860)	306	59	3,223
m partnership investments	(571)	(195)	(928)	(336)	(376)	(193)	(592)
ative expenses	(510)	(512)	(1,033)	(1,024)	2		(9)
ted expenses[3]	(18,784)	(5,349)	(39,656)	(8,592)	(13,435)	(251)	(31,064)
interest expenses[4]	(508)	(283)	(866)	(788)	(225)	(80)	(78)
	(14,757)	(2,740)	(38,565)	(7,853)	(12,017)	(439)	(30,712)

e federal income taxes and ary losses							
ovision) for federal income	(23)	476	600	3,404	(499)	(105)	(2,804)
ary losses, net of tax effect		(33)		(34)	33	100	34
	(14,780)	**(2,297)**	**(37,965)**	**(4,483)**	**(12,483)**	**(543)**	**(33,482)**
income) loss attributable to the ling interest	26	(3)	43	(3)	29	967	46
tributable to Fannie Mae	**$ (14,754)**	**$ (2,300)**	**$ (37,922)**	**$ (4,486)**	**$ (12,454)**	**(541)**%	**$ (33,436)**
ss per common share	**$ (2.67)**	**$ (2.54)**	**$ (6.76)**	**$ (5.11)**	**$ (0.13)**	**(5.12)**%	**$ (1.65)**
nce metrics:							
t yield[5]	1.69%	1.00%	1.57%	0.91%			
ffective guaranty fee rate (in s)[6]	25.5bp	26.3bp	26.4bp	27.9bp			
ratio (in basis points)[7]	44.1	17.5	38.6	15.1			

[1] Certain prior period amounts have been reclassified to conform with the current period presentation in our consolidated statements of operations.

[2] Consists of the following: (a) derivatives fair value gains (losses), net; (b) trading securities gains (losses), net; (c) hedged mortgage assets losses, net; (d) debt foreign exchange gains (losses), net; and (e) debt fair value gains (losses), net.

[3] Consists of provision for credit losses and foreclosed property expense.

[4] Consists of the following: (a) debt extinguishment gains (losses), net and (b) other expenses.

[5] Calculated based on annualized net interest income for the reporting period divided by the average balance of total interest-earning assets during the period, expressed as a percentage.

[6] Calculated based on annualized guaranty fee income for the reporting period divided by average outstanding Fannie Mae MBS and other guarantees during the period, expressed in basis points.

[7] Calculated based on annualized (a) charge-offs, net of recoveries; plus (b) foreclosed property expense; adjusted to exclude (c) the impact of SOP 03-3 and HomeSaver Advance fair value losses for the reporting period divided by the average guaranty book of business during the period, expressed in basis points.

The section below provides a comparative discussion of our condensed consolidated results of operations for the three and six months ended June 30, 2009 and 2008. Following this section, we provide a discussion of our business segment results. You should read this section together with our Executive Summary where we discuss trends and other factors that we expect will affect our future results of operations.

Net Interest Income

Net interest income represents the difference between interest income and interest expense and is a primary source of our revenue. Our net interest yield represents the difference between the yield on our interest-earning assets and the cost of our debt. We supplement our issuance of debt with interest rate-related derivatives to manage the prepayment and duration risk inherent in our mortgage investments. The effect of these derivatives, in particular the periodic net interest expense accruals on interest rate swaps, is not reflected in net interest income. See Fair Value Gains (Losses), Net for additional information.

We expect net interest income and our net interest yield to fluctuate based on changes in interest rates and changes in the amount and composition of our interest-earning assets and interest-bearing liabilities. Table 4 presents an analysis of our net interest income and net interest yield for the three and six months ended June 30, 2009 and 2008.

Table 4: Analysis of Net Interest Income and Yield

	For the Three Months Ended June 30,					
	2009			2008		
	Average Balance[1]	Interest Income/ Expense	Average Rates Earned/Paid	Average Balance[1]	Interest Income/ Expense	Average Rates Earned/Paid
	(Dollars in millions)					
Interest-earning assets:						
Mortgage loans[2]	$ 428,975	$ 5,611	5.23%	$ 418,504	$ 5,769	5.51%
Mortgage securities	343,031	4,162	4.85	318,396	4,063	5.10
Non-mortgage securities[3]	55,338	68	0.49	57,504	400	2.75
Federal funds sold and securities purchased under agreements to resell	49,678	110	0.87	26,869	186	2.74
Advances to lenders	5,970	29	1.92	3,332	46	5.46
Total interest-earning assets	$ 882,992	$ 9,980	4.52%	$ 824,605	$ 10,464	5.07%
Interest-bearing liabilities:						
Short-term debt	$ 290,189	$ 600	0.82%	$ 242,453	$ 1,685	2.75%
Long-term debt	576,008	5,645	3.92	550,940	6,720	4.88
Federal funds purchased and securities sold under agreements to repurchase	3		4.27	303	2	2.61
Total interest-bearing liabilities	$ 866,200	$ 6,245	2.88%	$ 793,696	$ 8,407	4.23%
Impact of net non-interest bearing funding	$ 16,792		0.05%	$ 30,909		0.16%