FEDERAL NATIONAL MORTGAGE ASSOCIATION FANNIE MAE
Form 10-Q
November 08, 2011

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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 September 30, 2011**
	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 (§ 232.405 of this chapter) 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 o Accelerated filer þ Non-accelerated filer o Smaller reporting company o
(Do not check if a smaller reporting company)

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 September 30, 2011, there were 1,158,227,237 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. Our directors do not have any duties to any person or entity except to the conservator and, accordingly, are not obligated to consider the interests of the company, the holders of our equity or debt securities or the holders of Fannie Mae MBS unless specifically directed to do so by the conservator. We describe the rights and powers of the conservator, key provisions of our agreements with the U.S. Department of the Treasury (Treasury), and their impact on shareholders in our Annual Report on Form 10-K for the year ended December 31, 2010 (2010 Form 10-K) in Business Conservatorship and Treasury Agreements.

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 in our 2010 Form 10-K.

This report contains forward-looking statements that are based on management s current expectations and are subject to significant uncertainties and changes in circumstances. Please review Forward-Looking Statements for more information on the forward-looking statements in this report. Our actual results may differ materially from those reflected in these forward-looking statements due to a variety of factors including, but not limited to, those described in Risk Factors and elsewhere in this report and in Risk Factors in our 2010 Form 10-K.

You can find a Glossary of Terms Used in This Report in the MD&A of our 2010 Form 10-K.

INTRODUCTION

Fannie Mae is a government-sponsored enterprise (GSE) that was chartered by Congress in 1938 to support liquidity, stability and affordability in the secondary mortgage market, where existing mortgage-related assets are purchased and sold. Our charter does not permit us to originate loans or lend money directly to consumers in the primary mortgage market. Our most significant activity is securitizing mortgage loans originated by lenders into Fannie Mae mortgage-backed securities that we guarantee, which we refer to as Fannie Mae MBS. We also purchase mortgage loans and mortgage-related securities for our mortgage portfolio. We use the term acquire in this report to refer to both our guarantees and our purchases of mortgage loans. We obtain funds to support our business activities by issuing a variety of debt securities in the domestic and international capital markets.

We are a corporation chartered by the U.S. Congress. Our conservator is a U.S. government agency. Treasury owns our senior preferred stock and a warrant to purchase 79.9% of our common stock, and Treasury has made a commitment under a senior preferred stock purchase agreement to provide us with funds under specified conditions to maintain a positive net worth. The U.S. government does not guarantee our securities or other obligations.

Our common stock was delisted from the New York Stock Exchange and the Chicago Stock Exchange on July 8, 2010 and since then has been traded in the over-the-counter market and quoted on the OTC Bulletin Board under the

symbol FNMA. Our debt securities are actively traded in the over-the-counter market.

EXECUTIVE SUMMARY

In the first nine months of 2011, we continued our work to provide liquidity and support to the mortgage market, grow the strong new book of business we have been acquiring since January 1, 2009, and minimize losses on loans we acquired prior to 2009.

Providing Liquidity and Support to the Mortgage Market

Our Liquidity and Support Activities

We provide liquidity and support to the U.S. mortgage market in a number of important ways:

- We serve as a stable source of liquidity for purchases of homes and multifamily rental housing, as well as for refinancing existing mortgages. We provided approximately $2.1 trillion in liquidity to the mortgage market from January 1, 2009 through September 30, 2011 through our purchases and guarantees of loans, including over 7.6 million single-family mortgage loans, which enabled borrowers to purchase homes or refinance their mortgages, and multifamily loans that financed nearly 967,000 units of multifamily housing.

- We are a consistent market presence as we continue to provide liquidity to the mortgage market even when other sources of capital have exited the market, as evidenced by the events of the last few years. We estimate that we, Freddie Mac and Ginnie Mae have collectively guaranteed more than 80% of the single-family mortgages originated in the United States since January 1, 2009.

- We have strengthened our underwriting and eligibility standards to support sustainable homeownership. Our support enables borrowers to have access to a variety of conforming mortgage products, including long-term, fixed-rate mortgages, such as the prepayable 30-year fixed-rate mortgage that protects homeowners from interest rate swings.

- We helped more than 960,000 homeowners struggling to pay their mortgages work out their loans from January 1, 2009 through September 30, 2011, which helped to support neighborhoods, home prices and the housing market.

- We support affordability in the multifamily rental market. Over 85% of the multifamily units we financed during 2009 and 2010 were affordable to families earning at or below the median income in their area.

- Borrowers typically pay a lower interest rate on loans eligible for purchase or guarantee by Fannie Mae, Freddie Mac or Ginnie Mae. Mortgage originators are generally able to offer borrowers lower mortgage rates on conforming loan products, including ours, in part because of the value investors place on GSE-guaranteed mortgage-related securities.

- In addition to purchasing and guaranteeing loans, we provide funds to the mortgage market through short-term financing and other activities. These activities are described in more detail in our 2010 Form 10-K in Business Business Segments Capital Markets.

2011 Acquisitions and Market Share

In the first nine months of 2011, we purchased or guaranteed approximately $445 billion in loans, measured by unpaid principal balance, which includes approximately $51 billion in delinquent loans we purchased from our single-family MBS trusts. These activities enabled our lender customers to finance approximately 1,826,000 single-family conventional loans and loans for approximately 289,000 units in multifamily properties during the first nine months of 2011.

We remained the largest single issuer of mortgage-related securities in the secondary market during the third quarter of 2011, with an estimated market share of new single-family mortgage-related securities issuances of 43.3%. Our estimated market share of new single-family mortgage-related securities issuances was 43.2% in the second quarter of 2011 and 44.5% in the third quarter of 2010.

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We remained a constant source of liquidity in the multifamily market. We owned or guaranteed approximately 20% of the outstanding debt on multifamily properties as of June 30, 2011 (the latest date for which information was available).

Summary of Our Financial Performance for the Third Quarter and First Nine Months of 2011

Our financial results for the third quarter and the first nine months of 2011 reflect the continued weakness in the housing and mortgage markets, which remain under pressure from high levels of unemployment, underemployment and the prolonged decline in home prices since their peak in the third quarter of 2006. Credit-related expenses continue to be a key driver of our net losses for each period presented. Our credit-related expenses vary from period to period primarily based on changes in home prices, borrower payment behavior, the types and volumes of loss mitigation activities completed, and actual and estimated recoveries from our lender and mortgage insurer counterparties. The decline in interest rates during the third quarter of 2011 had a significant impact on the company s derivative losses; however, these losses were mostly offset by fair value gains in the period related to our hedged mortgage investments for which only a portion are recorded at fair value in our financial statements. Derivative instruments are an integral part of how we manage interest rate risk and an inherent part of the cost of funding and hedging our mortgage investments. We expect high levels of period-to-period volatility in our results because our derivatives are recorded at fair value in our financial statements while some of the instruments they hedge are not recorded at fair value in our financial statements.

Comprehensive Loss

We recognized a total comprehensive loss of $5.3 billion in the third quarter of 2011, consisting of a net loss of $5.1 billion and other comprehensive loss of $197 million. In comparison, we recognized a total comprehensive loss of $2.9 billion in the second quarter of 2011, consisting of a net loss of $2.9 billion and other comprehensive income of $2 million. We recognized a total comprehensive loss of $429 million in the third quarter of 2010, consisting of a net loss of $1.3 billion and other comprehensive income of $902 million (other comprehensive income in the third quarter of 2010 was primarily driven by a reduction in our unrealized losses due to significantly improved fair value of available-for-sale securities).

Our total comprehensive loss for the first nine months of 2011 was $14.5 billion, consisting of a net loss of $14.4 billion and other comprehensive loss of $14 million. In comparison, we recognized a total comprehensive loss of $10.1 billion in the first nine months of 2010, consisting of a net loss of $14.1 billion and other comprehensive income of $3.9 billion (other comprehensive income in the first nine months of 2010 was primarily driven by a reduction in our unrealized losses due to significantly improved fair value of available-for-sale securities).

Net Loss

Third Quarter 2011 vs. Second Quarter 2011. The $2.2 billion increase in our net loss was primarily due to $4.5 billion in net fair value losses in the third quarter of 2011 primarily driven by losses on our risk management derivatives due to a significant decline in swap interest rates during the quarter, compared with $1.6 billion in net fair value losses in the second quarter of 2011 driven by losses on risk management derivatives. In addition, we recognized foreclosed property expense of $733 million in the third quarter of 2011 compared with foreclosed property income of $478 million in the second quarter of 2011 because our estimate of amounts due to us related to outstanding repurchase requests remained relatively flat during the third quarter compared with a substantial increase in the second quarter of 2011. These losses and expenses were partially offset by a $2.4 billion decrease in our provision for credit losses primarily driven by a lower provision on individually impaired loans as the continued lower interest rate environment improved our expected cash flow projections on those loans, therefore reducing our estimated impairment.

Third Quarter 2011 vs. Third Quarter 2010. The $3.8 billion increase in our net loss was primarily due to $4.5 billion in net fair value losses in the third quarter of 2011 primarily driven by losses on our risk management derivatives due to a significant decline in swap interest rates during the quarter, compared with

$525 million in net fair value gains in the third quarter of 2010 primarily driven by gains on our trading securities. These losses were partially offset by a $677 million decrease in credit-related expenses which was primarily driven by a lower provision on individually impaired loans as the continued lower interest rate environment improved our expected cash flow projections on those loans, therefore reducing our estimated impairment. Additionally, there was a $410 million increase in net interest income primarily from lower interest expense on funding debt.

Nine Months of 2011 vs. Nine Months of 2010. Our net loss remained flat for the first nine months of 2011 compared with the first nine months of 2010. The key components of our net loss in both the first nine months of 2011 and the first nine months of 2010 were credit-related expenses and fair value losses, which were partially offset by net interest income.

See Consolidated Results of Operations for more information on our results.

Net Worth

Our net worth deficit of $7.8 billion as of September 30, 2011 reflects the recognition of our total comprehensive loss of $5.3 billion and our payment to Treasury of $2.5 billion in senior preferred stock dividends during the third quarter of 2011. The Acting Director of FHFA will submit a request to Treasury on our behalf for $7.8 billion to eliminate our net worth deficit.

In the third quarter of 2011, we received $5.1 billion in funds from Treasury to eliminate our net worth deficit as of June 30, 2011. Upon receipt of the additional funds requested to eliminate our net worth deficit as of September 30, 2011, the aggregate liquidation preference on the senior preferred stock will be $112.6 billion, which will require an annualized dividend payment of $11.3 billion. The amount of this dividend payment exceeds our reported annual net income for any year since our inception. Through September 30, 2011, we have paid an aggregate of $17.2 billion to Treasury in dividends on the senior preferred stock.

Table 1 below displays our senior preferred stock dividend payments to Treasury and Treasury draws since entering conservatorship on September 6, 2008.

Table 1: Treasury Dividend Payments and Draw

	2008	2009	2010	2011 to date (first nine months)	Cumulative Total
			(Dollars in billions)		
Senior preferred stock dividends[1]	$	$ 2.5	$ 7.7	$ 7.0	$ 17.2
Treasury draws[2][3]	15.2	60.0	15.0	21.4	111.6
Cumulative percentage of senior preferred stock dividends to Treasury draws	0.2%	3.3%	11.3%	15.4%	15.4%

(1) Represents total quarterly cash dividends paid to Treasury, during the periods presented, based on an annual rate of 10% per year on the aggregate liquidation preference of the senior preferred stock.

(2) Represents the total draws received from Treasury and / or currently requested based on our quarterly net worth deficits for the periods presented. Draw requests were funded in the quarter following each quarterly net worth

deficit.

(3) Treasury draws do not include the initial $1.0 billion liquidation preference of the senior preferred stock, for which we did not receive any cash proceeds.

Total Loss Reserves

Our total loss reserves, which reflect our estimate of the probable losses we have incurred in our guaranty book of business, increased to $75.6 billion as of September 30, 2011 from $74.8 billion as of June 30, 2011 and increased from $66.3 billion as of December 31, 2010. Our total loss reserve coverage to total nonperforming loans was 37.07% as of September 30, 2011, compared with 36.91% as of June 30, 2011 and 30.85% as of December 31, 2010. The continued stress on a broad segment of borrowers from continued high levels of unemployment and underemployment and the prolonged decline in home prices have caused our total loss reserves to remain high for the past few years. Further, the shift in our nonperforming loan balance from

loans in our collective reserve to loans that are individually impaired has caused our coverage ratio to increase.

Our Strong New Book of Business and Expected Losses on Our Legacy Book of Business

We refer to the single-family loans we have acquired since the beginning of 2009 as our new single-family book of business and the single-family loans we acquired prior to 2009 as our legacy book of business. In this section, we discuss our expectations regarding the profitability of our new single-family book of business, as well as the performance and credit profile of these loans to date. We also discuss our expectations regarding losses on the loans in our legacy book of business.

Factors that Could Cause Actual Results to be Materially Different from Our Estimates and Expectations

We present a number of estimates and expectations in this executive summary regarding the profitability of single-family loans we have acquired, our single-family credit losses and credit-related expenses, and our draws from and dividends to be paid to Treasury. These estimates and expectations are forward-looking statements based on our current assumptions regarding numerous factors, including future home prices and the future performance of our loans. Home prices are a key factor affecting the amount of credit losses and profitability we expect. As home prices decline, the loan-to-value ratios on our loans shift higher, and both the probability of default and the severity of loss increase. Furthermore, the level of regional variation in home price declines affects our results, as we will incur greater credit losses if home prices decline more significantly in regions where we have a greater concentration of loans. Our future estimates of our performance, as well as the actual amounts, may differ materially from our current estimates and expectations as a result of the timing, level and regional variation in home price changes, changes in interest rates, unemployment, other macroeconomic variables, direct and indirect consequences resulting from failures by servicers to follow proper procedures in the administration of foreclosure cases, government policy, changes in generally accepted accounting principles (GAAP), credit availability, social behaviors, the volume of loans we modify, the effectiveness of our loss mitigation strategies, management of our real-estate owned (REO) inventory and pursuit of contractual remedies, changes in the fair value of our assets and liabilities, impairments of our assets, and many other factors, including those discussed in Risk Factors, Forward-Looking Statements and elsewhere in this report and in Risk Factors in our 2010 Form 10-K. For example, if the economy were to enter a deep recession, we would expect actual outcomes to differ substantially from our current expectations.

Building a Strong New Single-Family Book of Business

Expected Profitability of Our Single-Family Acquisitions

Our new single-family book of business has a strong overall credit profile and is performing well. While it is too early to know how loans in our new single-family book of business will ultimately perform, given their strong credit risk profile, low levels of payment delinquencies shortly after acquisition, and low serious delinquency rates, we expect that, over their lifetime, these loans will be profitable, by which we mean our fee income on these loans will exceed our credit losses and administrative costs for them. Table 2 provides information about whether we expect loans we acquired in 1991 through the first nine months of 2011 to be profitable, and the percentage of our single-family guaranty book of business represented by these loans as of September 30, 2011. The expectations reflected in Table 2 are based on the credit risk profile of the loans we have acquired, which we discuss in more detail in Table 4: Credit Profile of Single-Family Conventional Loans Acquired and in Table 36: Risk Characteristics of Single-Family Conventional Business Volume and Guaranty Book of Business. These expectations are also based on numerous other assumptions, including our expectations regarding home price declines set forth in Outlook and other macroeconomic factors. As shown in Table 2, we expect loans we have acquired in 2009, 2010 and the first nine months of 2011 to be profitable over their lifetime. If future macroeconomic conditions turn out to be more adverse than our expectations, these loans could become unprofitable. For example, we believe that credit losses on these loans would exceed

guaranty fee revenue if home prices declined nationally by approximately 10% from their September 2011 levels over the next five years based on our home price index. See Outlook for our expectations regarding home price declines.

Table 2: Expected Lifetime Profitability of Single-Family Loans Acquired in 1991 through the First Nine Months of 2011

As Table 2 shows, the years in which we acquired single-family loans that we expect will be unprofitable are 2004 through 2008. A substantial majority of our realized credit losses since the beginning of 2009 were attributable to loans we acquired in 2005 through 2008. Although the 2004 vintage has been profitable to date, we currently believe that this vintage will not be profitable over its lifetime. While we previously believed the 2004 vintage would perform close to break-even, in 2011 our expectations for long-term home price changes have worsened, which has changed our expectation of future borrower behavior regarding these loans. We expect the 2005 through 2008 vintages to be significantly more unprofitable than the 2004 vintage. The loans we acquired in 2004 were originated under more conservative acquisition policies than loans we acquired from 2005 through 2008; however, because our 2004 acquisitions were made during a time when home prices were rapidly increasing, their performance is expected to suffer from the significant decline in home prices since 2006. The ultimate long-term performance and profitability of the 2004 vintage will depend on many factors, including changes in home prices, other economic conditions and borrower behavior.

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Loans we have acquired since the beginning of 2009 comprised 49% of our single-family guaranty book of business as of September 30, 2011. Our 2005 to 2008 acquisitions are becoming a smaller percentage of our single-family guaranty book of business, having decreased from 39% of our single-family guaranty book of business as of December 31, 2010 to 33% as of September 30, 2011. Our 2004 acquisitions constituted 5% of our single-family guaranty book of business as of September 30, 2011.

Serious Delinquency Rates by Year of Acquisition

In our experience, an early predictor of the ultimate performance of a portfolio of loans is the rate at which the loans become seriously delinquent (three or more months past due or in the foreclosure process) within a short period of time after acquisition. Loans we acquired in 2009 and 2010 have experienced historically low levels of delinquencies shortly after their acquisition. Table 3 shows, for single-family loans we acquired in each year from 2001 to 2010, the percentage that were seriously delinquent as of the end of the third quarter following the year of acquisition. Loans we acquired in 2011 are not included in this table because they were originated so recently that many of them could not yet have become seriously delinquent. As Table 3 shows, the percentage of our 2009 acquisitions that were seriously delinquent as of the end of the third quarter following their acquisition year was approximately nine times lower than the average comparable serious delinquency rate for loans acquired in 2005 through 2008. For loans originated in 2010, this percentage was approximately ten times lower than the average comparable rate for loans acquired in 2005 through 2008. Table 3 also shows serious delinquency rates for each year s acquisitions as of September 30, 2011. Except for 2008 acquisitions, whose performance has been affected by changes in underwriting and eligibility standards that became effective during the course of 2008, and more recent acquisition years, whose serious delinquency rates are likely lower than they will be after the loans have aged, Table 3 shows that the current serious delinquency rate generally tracks the trend of the serious delinquency rate as of the end of the third quarter following the year of acquisition. Below the table we provide information about the economic environment in which the loans were acquired, specifically home price appreciation and unemployment levels.

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Table 3: Single-Family Serious Delinquency Rates by Year of Acquisition

* For 2010, the serious delinquency rate as of September 30, 2011 is the same as the serious delinquency rate as of the end of the third quarter following the acquisition year.

(1) Based on Fannie Mae s Home Price Index (HPI), which measures average price changes based on repeat sales on the same properties. For 2011, the data show an initial estimate based on purchase transactions in Fannie-Freddie acquisition and public deed data available through the end of September 2011, supplemented by preliminary data available for October 2011. Previously reported data have been revised to reflect additional available historical data. Including subsequently available data may lead to materially different results. We recently enhanced our home price estimates to identify and exclude a greater portion of foreclosed home sales. As a result, some period to period comparisons of home prices differ from those indicated by our prior estimates.

(2) Based on the average national unemployment rates for each month reported in the labor force statistics current population survey (CPS), Bureau of Labor Statistics.

Credit Profile of Our Single-Family Acquisitions

Single-family loans we purchased or guaranteed from 2005 through 2008 were acquired during a period when home prices were rising rapidly, peaked, and then started to decline sharply, and underwriting and eligibility standards were more relaxed than they are now. These loans were characterized, on average and as discussed

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below, by higher loan-to-value (LTV) ratios and lower FICO credit scores than loans we have acquired since January 1, 2009. In addition, many of these loans were Alt-A loans or had other higher-risk loan attributes such as interest-only payment features. As a result of the sharp declines in home prices, 34% of the loans that we acquired from 2005 through 2008 had mark-to-market LTV ratios that were greater than 100% as of September 30, 2011, which means the principal balance of the borrower s primary mortgage exceeded the current market value of the borrower s home. This percentage is higher when second lien loans are included. The sharp decline in home prices, the severe economic recession that began in December 2007 and continued through June 2009, and continuing high unemployment and underemployment have significantly and adversely impacted the performance of loans we acquired from 2005 through 2008. We are continuing to take a number of actions to reduce our credit losses. We discuss these actions and our strategy in Reducing Credit Losses on Our Legacy Book of Business and Risk Management Credit Risk Management Single-Family Mortgage Credit Risk Management.

In 2009, we began to see the effect of actions we took, beginning in 2008, to significantly strengthen our underwriting and eligibility standards and change our pricing to promote sustainable homeownership and stability in the housing market. As a result of these changes and other market dynamics, we reduced our acquisitions of loans with higher-risk attributes. Compared with the loans we acquired in 2005 through 2008, the loans we have acquired since January 1, 2009 have had better overall credit risk profiles at the time we acquired them and their early performance has been strong. Our experience has been that loans with characteristics such as lower original LTV ratios (that is, more equity held by the borrowers in the underlying properties), higher FICO credit scores and more stable payments will perform better than loans with risk characteristics such as higher original LTV ratios, lower FICO credit scores, Alt-A underwriting and payments that may adjust over the term of the loan.

Table 4 shows the credit risk profile of the single-family loans we have acquired since January 1, 2009 compared to the loans we acquired from 2005 through 2008.

Table 4: Credit Profile of Single-Family Conventional Loans Acquired[1]

	Acquisitions from 2009 through the first nine months of 2011	**Acquisitions from 2005 through 2008**
Weighted average loan-to-value ratio at origination	68%	73%
Weighted average FICO credit score at origination	761	722
Fully amortizing, fixed-rate loans	95%	86%
Alt-A loans[2]	1%	14%
Interest-only	1%	12%
Original loan-to-value ratio > 90%	6%	11%
FICO credit score < 620	*	5%

* Represents less than 0.5% of the total acquisitions.

(1) Loans that meet more than one category are included in each applicable category.