

FEDERAL NATIONAL MORTGAGE ASSOCIATION FANNIE MAE

Form 10-K

May 02, 2007

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

Form 10-K

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

For the fiscal year ended December 31, 2005

Commission File No.: 0-50231

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

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

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

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

20016
(Zip Code)

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

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

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

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

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

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

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

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

Large accelerated filer Accelerated filer Non-accelerated filer

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

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

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

DOCUMENTS INCORPORATED BY REFERENCE

None.

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PART I

Item 1. Business

EXPLANATORY NOTE ABOUT THIS REPORT

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

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

OVERVIEW

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

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

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

RECENT SIGNIFICANT EVENTS

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

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

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

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

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

RESIDENTIAL MORTGAGE MARKET OVERVIEW

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

Residential Mortgage Market

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

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

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

Housing Market Data

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

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

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

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

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

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

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

Our Role in the Secondary Mortgage Market

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

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

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

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

BUSINESS SEGMENTS

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

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

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

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

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

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

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

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

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

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

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

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

Business Segment Summary Financial Information

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

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

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

⁽¹⁾ Includes interest income, guaranty fee income, and fee and other income.

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

Single-Family Credit Guaranty

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

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

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

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

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

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

Guaranty Services

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

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

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

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

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

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

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

Guaranty Fees

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

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

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

Our Customers

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

TBA Market

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

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

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

Credit Risk Management

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

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

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

Housing and Community Development

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

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

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

Multifamily Group

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

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

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

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

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

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

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

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

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

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

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

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

Community Investment Group

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

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

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

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

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

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

Community Lending Group

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

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

acquiring small multifamily loans from a variety of lending institutions that do not participate in our DUStm program;

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

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

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

Capital Markets

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

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

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

Mortgage Investments

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

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

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

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

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

Investment Activities and Objectives

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

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

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

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

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

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

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

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

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

Customer Transactions and Services

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

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

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

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

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

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

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

Mortgage Innovation

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

Housing Goals

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

ability to meet our housing goals.

Funding of Our Investments

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

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

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

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

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

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

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

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

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

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

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

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

Securitization Activities

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

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

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

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

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

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

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

Interest Rate Risk Management

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

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

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

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

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

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

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

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

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

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

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

COMPETITION

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

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

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

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

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

OUR CHARTER AND REGULATION OF OUR ACTIVITIES

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

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Charter Act

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

provide stability in the secondary market for residential mortgages;

respond appropriately to the private capital market;

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

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

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

Loan Standards

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

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

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

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

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

Other Charter Act Limitations and Requirements

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

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

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

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

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

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

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

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

Regulation and Oversight of Our Activities

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

HUD Regulation

Program Approval

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

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

Housing Goals

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

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

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

Housing Goals and Subgoals

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

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

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

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

Housing Goals and Subgoals Performance

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

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

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

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

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

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

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

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

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

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

OFHEO Regulation

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

OFHEO Consent Order

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

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

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

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

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

Capital Requirements

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

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

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

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

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

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

Dividend Restrictions

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

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

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

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

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

Recent Legislative Developments and Possible Changes in Our Regulations

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

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

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

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

changing the method for enforcing compliance with housing goals; and

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

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

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

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

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

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

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

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

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

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

EMPLOYEES

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

WHERE YOU CAN FIND ADDITIONAL INFORMATION

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

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

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

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

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

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

FORWARD-LOOKING STATEMENTS

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

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

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

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

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

average home prices could go down in 2007;

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

our intent to hold certain temporarily impaired securities until recovery;

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

GLOSSARY OF TERMS USED IN THIS REPORT

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

HUD refers to the Department of Housing and Urban Development.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

mortgage assets.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Item 1A. Risk Factors

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

COMPANY RISKS

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

and reputational damage as a result of mortgage fraud.

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

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

Item 7 MD&A Risk Management Operational Risk Management.

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

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

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

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

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

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

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

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

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

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

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

- changing the method for enforcing compliance with housing goals; and

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

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

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

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

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

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

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

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

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

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

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

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

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

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

estimating the fair value of financial instruments;

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

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

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

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

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

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

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

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

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

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

RISKS RELATING TO OUR INDUSTRY

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

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

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

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

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

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

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

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

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

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

Item 1B. Unresolved Staff Comments

None.

Item 2. Properties

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

Item 3. Legal Proceedings

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

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

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

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

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

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

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

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

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

RESTATEMENT-RELATED MATTERS

Securities Class Action Lawsuits

In re Fannie Mae Securities Litigation

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

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

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

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

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

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

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

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

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

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

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

Shareholder Derivative Lawsuits

In re Fannie Mae Shareholder Derivative Litigation

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

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

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

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

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

ERISA Action

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

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

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

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

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Department of Labor ESOP Investigation

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

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

U.S. Attorney s Office Investigation

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

OFHEO and SEC Settlements

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

OFHEO Special Examination and Settlement

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

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

SEC Investigation and Settlement

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

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

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

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

OTHER LEGAL PROCEEDINGS

Former CEO Arbitration

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

Antitrust Lawsuits

In re G-Fees Antitrust Litigation

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

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

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

Escrow Litigation

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

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

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

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

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

KPMG Litigation

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

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

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

None.

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

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

Common Stock Data

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

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

Holder

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

Dividends

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

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

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

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

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

Securities Authorized for Issuance under Equity Compensation Plans

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

Recent Sales of Unregistered Securities

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

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

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

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

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

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

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

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

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

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

	2005	As of December 31,		2002
		2004	2003	
	(Dollars in millions, except per share amounts)			
<u>Income Statement Data:</u>				
Net interest income	\$ 11,505	\$ 18,081	\$ 19,477	\$ 18,426
Guaranty fee income	3,779	3,604	3,281	2,516
Derivative fair value losses, net	(4,196)	(12,256)	(6,289)	(12,919)
Other income (loss) ⁽¹⁾	(725)	(812)	(4,220)	(1,735)
Income before extraordinary gains (losses) and cumulative effect of change in accounting principle	\$ 6,294	\$ 4,975	\$ 7,852	\$ 3,914
Extraordinary gains (losses), net of tax effect	53	(8)	195	
Cumulative effect of change in accounting principle, net of tax effect			34	
Net income	6,347	4,967	8,081	3,914
Preferred stock dividends and issuance costs at redemption	(486)	(165)	(150)	(111)
Net income available to common stockholders	\$ 5,861	\$ 4,802	\$ 7,931	\$ 3,803
<u>Per Common Share Data:</u>				
Earnings per share before extraordinary gains (losses) and cumulative effect of change in accounting principle				
Basic	\$ 5.99	\$ 4.96	\$ 7.88	\$ 3.83
Diluted	5.96	4.94	7.85	3.81
Earnings per share after extraordinary gains (losses) and cumulative effect of change in accounting principle				
Basic	\$ 6.04	\$ 4.95	\$ 8.12	\$ 3.83
Diluted	6.01	4.94	8.08	3.81
Weighted-average common shares outstanding:				

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Basic	970	970	977	992
Diluted	998	973	981	998
Cash dividends declared per share	\$ 1.04	\$ 2.08	\$ 1.68	\$ 1.32

New Business Acquisition Data:

Fannie Mae MBS issues acquired by third parties ⁽²⁾	\$ 465,632	\$ 462,542	\$ 850,204	\$ 478,260
Mortgage portfolio purchases ⁽³⁾	146,640	262,647	572,852	370,641
New business acquisitions	\$ 612,272	\$ 725,189	\$ 1,423,056	\$ 848,901

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	2005	2004	As of December 31, 2003	2002	2001
	(Dollars in millions)				
Balance Sheet Data:					
Investments in securities:					
Trading ⁽⁴⁾	\$ 15,110	\$ 35,287	\$ 43,798	\$ 14,909	\$ (45)
Available-for-sale	390,964	532,095	523,272	520,176	503,381
Mortgage loans:					
Loans held for sale	5,064	11,721	13,596	20,192	11,327
Loans held for investment, net of allowance	362,479	389,651	385,465	304,178	267,510
Total assets	834,168	1,020,934	1,022,275	904,739	814,561
Short-term debt	173,186	320,280	343,662	293,538	280,848
Long-term debt	590,824	632,831	617,618	547,755	484,182
Total liabilities	794,745	981,956	990,002	872,840	791,305
Preferred stock	9,108	9,108	4,108	2,678	2,303
Total stockholders' equity	39,302	38,902	32,268	31,899	23,256

Regulatory Capital Data:

Core capital ⁽⁵⁾	\$ 39,433	\$ 34,514	\$ 26,953	\$ 20,431	\$ 18,234
Total capital ⁽⁶⁾	40,091	35,196	27,487	20,831	18,500

Mortgage Credit Book of Business**Data:**

Mortgage portfolio ⁽⁷⁾	\$ 737,889	\$ 917,209	\$ 908,868	\$ 799,779	\$ 715,953
Fannie Mae MBS held by third parties ⁽⁸⁾	1,598,918	1,408,047	1,300,520	1,040,439	878,039
Other guarantees ⁽⁹⁾	19,152	14,825	13,168	12,027	16,421
Mortgage credit book of business	\$ 2,355,959	\$ 2,340,081	\$ 2,222,556	\$ 1,852,245	\$ 1,610,413

	2005	2004	2003	2002
Ratios:				
Return on assets ratio ^{(10)*}	0.63%	0.47%	0.82%	0.44%
Return on equity ratio ^{(11)*}	19.5	16.6	27.6	15.2
Equity to assets ratio ^{(12)*}	4.2	3.5	3.3	3.2
Dividend payout ratio ^{(13)*}	17.2	42.1	20.8	34.5
Average effective guaranty fee rate (in basis points) ^{(14)*}	21.0bp	20.8bp	21.0bp	19.3bp
Credit loss ratio (in basis points) ^{(15)*}	1.9bp	1.0bp	0.9bp	0.8bp
Earnings to combined fixed charges and preferred stock dividends and issuance costs at redemption ratio ⁽¹⁶⁾	1.23:1	1.22:1	1.36:1	1.16:1

- (1) Includes investment losses, net; debt extinguishment losses, net; loss from partnership investments; and fee and other income.
- (2) Unpaid principal balance of MBS issued and guaranteed by us and acquired by third-party investors during the reporting period. Excludes securitizations of mortgage loans held in our portfolio.
- (3) Unpaid principal balance of mortgage loans and mortgage-related securities we purchased for our investment portfolio. Includes advances to lenders and mortgage-related securities acquired through the extinguishment of debt.
- (4) Balance as of December 31, 2001 primarily represents the fair value of forward purchases of TBA mortgage securities that were in a loss position.
- (5) The sum of (a) the stated value of outstanding common stock (common stock less treasury stock); (b) the stated value of outstanding non-cumulative perpetual preferred stock; (c) paid-in-capital; and (d) retained earnings. Core capital excludes accumulated other comprehensive income.

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- (6) The sum of (a) core capital and (b) the total allowance for loan losses and reserve for guaranty losses, less (c) the specific loss allowance (that is, the allowance required on individually-impaired loans).
- (7) Unpaid principal balance of mortgage loans and mortgage-related securities held in our portfolio.
- (8) Unpaid principal balance of Fannie Mae MBS held by third-party investors. The principal balance of resecuritized Fannie Mae MBS is included only once.
- (9) Includes additional credit enhancements that we provide not otherwise reflected in the table.
- (10) Net income available to common stockholders divided by average total assets.
- (11) Net income available to common stockholders divided by average outstanding common equity.
- (12) Average stockholders' equity divided by average total assets.
- (13) Common dividend payments divided by net income available to common stockholders.
- (14) Guaranty fee income as a percentage of average outstanding Fannie Mae MBS and other guaranties.
- (15) Charge-offs, net of recoveries and foreclosed property expense (income), as a percentage of the average mortgage credit book of business.
- (16) Earnings includes reported income before extraordinary gains (losses), net of tax effect and cumulative effect of change in accounting principle, net of tax effect plus (a) provision for federal income taxes, minority interest in earnings of consolidated subsidiaries, loss from partnership investments, capitalized interest and total interest expense. Combined fixed charges and preferred stock dividends and issuance costs at redemption includes (a) fixed charges (b) preferred stock dividends and issuance costs on redemptions of preferred stock, defined as pretax earnings required to pay dividends on outstanding preferred stock using our effective income tax rate for the relevant periods. Fixed charges represent total interest expense and capitalized interest.

Note:

* Average balances for purposes of the ratio calculations are based on beginning and end of year balances.

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Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

ORGANIZATION OF MD&A

We intend for our MD&A to provide information that will assist the reader in better understanding our consolidated financial statements. Our MD&A explains the changes in certain key items in our consolidated financial statements from year to year, the primary factors driving those changes, our risk management processes and results, any known trends or uncertainties of which we are aware that we believe may have a material effect on our future performance, as well as how certain accounting principles affect our consolidated financial statements. Our MD&A also provides information about our three complementary business segments in order to explain how the activities of each segment impact our results of operations and financial condition. This discussion should be read in conjunction with our consolidated financial statements as of December 31, 2005 and the notes accompanying those consolidated financial statements. Readers should also review carefully Item 1 Business Forward-Looking Statements and Item 1A Risk Factors for a description of the forward-looking statements in this report and a discussion of the factors that might cause our actual results to differ, perhaps materially, from these forward-looking statements. Please refer to Item 1 Business Glossary of Terms Used in this Report for an explanation of key terms used throughout this discussion.

Our MD&A is organized as follows:

Executive Summary

Critical Accounting Policies and Estimates

Consolidated Results of Operations

Business Segment Results

Supplemental Non-GAAP Information Fair Value Balance Sheet

Risk Management

Liquidity and Capital Management

Off-Balance Sheet Arrangements and Variable Interest Entities

Impact of Future Adoption of New Accounting Pronouncements

2005 Quarterly Review

EXECUTIVE SUMMARY

Our Mission and Business

Fannie Mae is a mission-driven company, owned by private shareholders (NYSE: FNM) and chartered by Congress to support liquidity and stability in the secondary mortgage market. Our business includes three integrated business segments Single-Family Credit Guaranty, Housing and Community Development and Capital Markets that work together to provide services, products and solutions to our lender customers and a broad range of housing partners.

Together, our business segments contribute to our chartered mission objectives, helping to increase the total amount of funds available to finance housing in the United States and to make homeownership more available and affordable for low-, moderate- and middle-income Americans. We also work with our customers and partners to increase the availability and affordability of rental housing.

We view our mission as a key point of distinction and a fundamental element of our value proposition. By growing our earnings over time and providing investors with attractive returns, we grow capital. Growing our capital enables us to grow our business. As our business grows, so can the benefits that we provide to our customers and housing partners, who in turn can pass those benefits to the American homebuyer in the form of lower mortgage costs and product innovation. Our mission and the interests of our shareholders are aligned and complementary in our business model.

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Key 2005 Priorities

We entered 2005 facing some of the most significant challenges in our company's history. In September 2004, OFHEO identified serious deficiencies in our accounting, controls and financial reporting in an interim report of its special examination. In December 2004, the SEC determined that we had misapplied generally accepted accounting principles and directed us to restate previously issued financial statements. Accordingly, in addition to our primary business and mission objectives, in 2005 we focused on a number of key corporate priorities to address identified issues and to build a fundamentally stronger and sounder company going forward. These priorities included the following:

Restoring capital: Rebuilding our capital position, and achieving the 30% surplus over required minimum capital levels in accordance with our agreement with OFHEO, was our most immediate and important corporate objective in 2005. OFHEO determined that we achieved the 30% surplus requirement at September 30, 2005. Since that time, we have increased our capital position, and we were able to begin the process of returning capital to shareholders by increasing our dividend in the fourth quarter of 2006 and again in the second quarter of 2007, and by redeeming expensive series of preferred shares.

Progress on the restatement of our financials: We devoted substantial resources in 2005 and 2006 toward our restatement effort. On December 6, 2006, we filed our 2004 Form 10-K, including restated results for previous periods. We previously announced that we expect to file our 2006 Form 10-K by the end of 2007. We are assessing how the timing of the filing of this 2005 Form 10-K will impact the timing of our 2006 Form 10-K. Becoming a current filer remains a primary corporate priority.

Rebuilding relationships: We have focused on reshaping the culture of Fannie Mae to fully reflect the levels of service, engagement, accountability and effective management that we believe should characterize a company privileged to serve such an important role in a large and vital market. This continues to be a priority of the company.

We maintained our business focus as we addressed and devoted resources to issues outside our normal business operations. We believe that our business results, described below, indicate that we were successful in running our businesses effectively and addressing the key corporate priorities described above.

Market and Economic Factors Affecting Our Business

Our business is significantly affected by the dynamics of the U.S. residential mortgage market, including the total amount of residential mortgage debt outstanding, the volume and composition of mortgage originations and the level of competition for mortgage assets generally among investors.

The Federal Open Market Committee of the Federal Reserve increased the federal funds target rate by 25 basis points at each of its eight meetings in 2005, for a cumulative gain of 200 basis points. The target rate ended the year at 4.25%, its highest level since April 2001. However, the impact on long-term rates was muted, with the ten-year constant maturity Treasury yield closing the year approximately only ten basis points higher than at the start of the year. Mortgage rates in 2005 generally tracked these dynamics. The average rate on short-term Treasury-indexed adjustable-rate mortgages rose significantly over the course of the year, while the yearly average rate for 30-year fixed-rate mortgages increased by considerably less. Relative movements in short- and long-term mortgage rates resulted in a sharp narrowing of the spread between fixed-rate mortgages and ARMs during the course of the year.

For the years 2004 and 2005, home price appreciation and growth in U.S. residential mortgage debt outstanding were particularly strong, as detailed in Item 1 Business Residential Mortgage Market Overview.

Affordability issues were the primary catalyst for a dramatic shift in the composition of mortgage originations between 2003 and 2006. Based on data from LoanPerformance, we estimate that during this period, with regard to prime conventional conforming originations, the ARM share rose from 11% to 23%, the negative-amortizing share rose from 1% to 5%, and the low documentation share rose from 15% to 27%. In

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addition, subprime, Alt-A and investor borrowing grew significantly with the majority of these borrowers selecting ARMs.

In 2006, growth in U.S. residential mortgage debt outstanding and home price appreciation slowed from recent high levels, especially in the second half of the year. However, the volume of non-traditional mortgage products remained high as consumers continued to struggle with affordability issues and the investor share of home purchases remained above historical norms. Additionally, the subprime and Alt-A mortgage originations continued to represent an elevated level of originations by historical standards.

Over the next decade, we expect demographic demand (primarily from stable household formation rates, a positive age structure of the population for homebuying and rising homeownership rates due to the high level of immigration over the past 25 years) to be at a level that should maintain a fundamentally strong mortgage market. We believe that these and other underlying demographic factors will support continued long-term demand for new capital to finance the substantial and sustained housing finance needs of American homebuyers.

In the secondary mortgage market, competition for mortgage assets among a broad range of investors was intense in 2005, resulting in extremely narrow spreads between the cost of our funding and the yields we would expect to generate on many mortgage assets available for purchase. The intensity of competition for mortgage assets remained heightened in 2006 and the first quarter of 2007. Additionally, in our estimation, compensation for credit risk in the marketplace, particularly for higher risk mortgage assets, did not reflect adequate returns in 2005, and remained so through 2006. This dynamic was at least partly attributable to high levels of investment capital among a broad range of global investors seeking higher yields. We believe many investors sought out higher-yielding and higher-risk tranches of mortgage-related securities under the assumption that continued home price appreciation would provide insulation from credit losses.

Summary of Our Financial Results

Net income and diluted earnings per share totaled \$6.3 billion and \$6.01, respectively, in 2005, compared with \$5.0 billion and \$4.94 in 2004, and \$8.1 billion and \$8.08 in 2003.

Total stockholders' equity increased to \$39.3 billion as of December 31, 2005 from \$38.9 billion as of December 31, 2004 and \$32.3 billion as of December 31, 2003. The estimated fair value of our net assets (net of tax effect), a non-GAAP measure that we refer to as the fair value of our net assets, increased to \$42.2 billion as of December 31, 2005 from \$40.1 billion and \$28.4 billion as of year-end 2004 and 2003, respectively. Refer to Supplemental Non-GAAP Information Fair Value Balance Sheet for information on the fair value of our net assets.

Below are additional comparative highlights of our performance.

2005 versus 2004

New business acquisitions down 16% from 2004
 1% growth in our mortgage credit book of business
 36% decrease in net interest income to \$11.5 billion
 55 basis points decrease in net interest yield to 1.31%
 5% increase in guaranty fee income to \$3.8 billion
 Derivative fair value losses of \$4.2 billion, compared with derivative fair value losses of \$12.3 billion in 2004

2004 versus 2003

New business acquisitions down 49% from record level of \$1.4 trillion in 2003
 5% growth in our mortgage credit book of business
 7% decrease in net interest income to \$18.1 billion
 26 basis points decrease in net interest yield to 1.86%
 10% increase in guaranty fee income to \$3.6 billion
 Derivative fair value losses of \$12.3 billion, compared

Losses of \$68 million on debt extinguishments,
compared with losses of \$152 million in 2004

with derivative fair value losses of \$6.3 billion in 2003
Losses of \$152 million on debt extinguishments,
compared with losses of \$2.7 billion in 2003

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A detailed discussion of our results and key drivers of year-over-year changes can be found in Consolidated Results of Operations.

We expect our net income to decline in 2006, primarily due to further reductions in our net interest income and net interest yield in 2006 as a result of the decrease in our interest-earning assets and the decline in the spread between the average yield on these assets and our borrowing costs that we began experiencing at the end of 2004. Our administrative expenses also significantly increased in 2006, to an estimated \$3.1 billion, due to costs associated with the restatement process and related regulatory examinations, investigations and litigation defense, the preparation of our consolidated financial statements, control remediation activities and increased headcount to support these efforts. We also expect, however, continued strength in guaranty fee income, moderate increases in our provision for credit losses and somewhat lower derivative fair value losses as interest rates have generally trended up since the end of 2005 and remain at overall higher levels. We do not expect to be able to quantify the financial statement impact of these expected changes to our operating results and financial condition until we complete the preparation of our consolidated financial statements for the year ended December 31, 2006. We meet regularly with OFHEO to discuss our current capital position.

Both GAAP net income and the fair value of net assets are affected by our business activities, as well as changes in market conditions, including changes in the relative spread between our mortgage assets and debt, changes in interest rates and changes in implied interest rate volatility. A detailed discussion of the impact of these market variables on our financial performance can be found in Consolidated Results of Operations and Supplemental Non-GAAP Information-Fair Value Balance Sheet.

Our assets and liabilities consist predominately of financial instruments. We expect significant volatility from period to period in our results of operations and financial condition, due in part to the various ways in which we account for our financial instruments under GAAP. Specifically, under GAAP we measure and record some financial instruments at fair value, while other financial instruments are recorded at historical cost. In addition, as summarized below, changes in the carrying values of financial instruments that we report at fair value in our consolidated balance sheets under GAAP are recognized in our results of operations in a variety of ways depending on the nature of the asset or liability.

We record derivatives, mortgage commitments and trading securities at fair value in our consolidated balance sheets and recognize changes in the fair value of those financial instruments in net income.

We record available-for-sale (AFS) securities, retained interests and guaranty fee buy-ups at fair value in our consolidated balance sheets and recognize changes in the fair value of those financial instruments in accumulated other comprehensive income (AOCI), a component of stockholders' equity.

We record held-for-sale (HFS) mortgage loans at the lower of cost or market (LOCOM) in our consolidated balance sheets and recognize changes in the fair value (not to exceed the cost basis of these loans) in net income.

At the inception of a guaranty contract, we estimate the fair value of the guaranty asset and guaranty obligation and record each of those amounts in our consolidated balance sheet. In each subsequent period, we reduce the guaranty asset for guaranty fees received and any impairment. We amortize the guaranty obligation in proportion to the reduction of the guaranty asset and recognize the amortization as guaranty fee income in net income. We do not record subsequent changes in the fair value of the guaranty asset or guaranty obligation in our consolidated financial statements; however, we review guaranty assets for impairment.

We record debt instruments at amortized cost and recognize interest expense in net interest income.

As a result of the variety of ways in which we record financial instruments in our consolidated financial statements, we expect our earnings to vary, perhaps substantially, from period to period and also result in volatility in our stockholders' equity and regulatory capital. One of the major drivers of volatility in our financial performance measures, including GAAP net income, is the accounting treatment for derivatives used to manage interest rate risk in our mortgage portfolio. When we purchase mortgage assets, we use a

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combination of debt and derivatives to fund those assets and manage the interest rate risk inherent in our mortgage investments. Our net income reflects changes in the fair value of the derivatives we use to manage interest rate risk; however, it does not reflect offsetting changes in the fair value of the majority of our mortgage investments or in any of our debt obligations.

We do not evaluate or manage changes in the fair value of our various financial instruments on a stand-alone basis. Rather, we manage the interest rate exposure on our net assets, which includes all of our assets and liabilities, on an aggregate basis regardless of the manner in which changes in the fair value of different types of financial instruments are recorded in our consolidated financial statements. In Supplemental Non-GAAP Information Fair Value Balance Sheet, we provide a fair value balance sheet that presents all of our assets and liabilities on a comparable basis. Management uses the fair value balance sheet, in conjunction with other risk management measures, to assess our risk profile, evaluate the effectiveness of our risk management strategies and adjust our risk management decisions as necessary. Because the fair value of our net assets reflects the full impact of management's actions as well as current market conditions, management uses this information to assess performance and gauge how much management is adding to the long-term value of the company.

Single-Family Credit Guaranty Results

Our Single-Family Credit Guaranty business generated net income of \$2.9 billion, \$2.5 billion and \$2.5 billion in 2005, 2004 and 2003, respectively.

Our total issuance of single-family Fannie Mae MBS declined to \$500.7 billion in 2005 compared with \$545.4 billion in 2004. Guaranty fee income rose modestly to \$4.6 billion in 2005 from \$4.5 billion in 2004, as our average single-family mortgage credit book of business increased by 3% during 2005 and the average effective guaranty fees remained stable.

In 2005, we concluded that compensation for credit risk associated with many newly originated loans did not adequately reflect underlying, and often multi-layered, credit risks. Based on this assessment, we made a strategic decision not to pursue the guaranty of a significant subset of mortgage loans because they did not meet our risk and pricing criteria. As a result of this decision, we ceded market share of new single-family mortgage-related securities issuance to private-label issuers. Acquisitions that we did make in 2005 included a heightened proportion of adjustable-rate mortgage loans (ARMs), which peaked in April 2005 at nearly 35% of single-family mortgage applications.

While our market share declined in 2005 relative to private-label issuers, we remained the largest agency issuer of mortgage-related securities. This contributed to our leadership position in the overall market for outstanding mortgage-related securities, which benefited the liquidity and pricing of our MBS relative to securities issued by other market participants.

We believe that our approach to the management of credit risk in 2005 contributed to the maintenance of a credit book with strong credit characteristics, as measured by loan-to-value ratios, credit scores and other loan characteristics that reflect the effectiveness of our credit risk management strategy. A detailed discussion of our credit risk management strategies and results can be found in Risk Management Credit Risk Management.

A detailed discussion of the operations, results and factors impacting our Single-Family business can be found in Business Segment Results Single-Family Credit Guaranty Business.

HCD Results

Our HCD business generated net income of \$462 million, \$337 million and \$286 million in 2005, 2004 and 2003, respectively.

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Our HCD business segment participated in financing \$25.6 billion in multifamily rental housing in 2005, which included debt financing through lender partners and investments in low-income housing tax credits (LIHTC). This level of activity was supported by improved multifamily fundamentals, including a decline in overall apartment vacancies and increased rental rates. At the end of 2005, we estimate that we held or guaranteed approximately 18% of multifamily mortgage debt outstanding.

Our tax-advantaged investments, primarily LIHTC, continued to contribute significantly to net income by lowering our effective corporate tax rate. LIHTC investments totaled \$7.7 billion in 2005 compared with \$6.8 billion in 2004. The tax benefits associated with our LIHTC investments were the primary reasons for our 2005 effective corporate tax-rate being 17% versus the federal statutory rate of 35%.

A detailed discussion of the operations, results and factors impacting our HCD business can be found in *Business Segment Results HCD Business*.

Capital Markets Results

Our Capital Markets group generated net income of \$3.0 billion, \$2.1 billion and \$5.3 billion in 2005, 2004 and 2003, respectively.

Our Capital Markets group generates income primarily from the difference, or spread, between the yield on the mortgage assets we own and the cost of the debt we issue to fund these assets. Through our investment activities, we seek to maximize long-term total returns, subject to various constraints, while fulfilling our chartered liquidity function. In 2005, the portfolio activities of our Capital Markets group were also conducted within the context of our capital restoration plan, which was finalized with OFHEO in February 2005. The size of our net mortgage portfolio decreased by 20% in 2005 due to a significant increase in portfolio sales, normal liquidations and fewer portfolio purchases. The reduction of our mortgage portfolio helped enable the achievement of the 30% surplus requirement described above.

Because the vast majority of our assets had been reclassified as available-for-sale, we were able to capitalize on the intensity of competition for certain mortgage assets, selling highly valued assets on attractive economic terms. These sales contributed to our objectives of satisfying our capital requirement while supporting our primary liquidity function and, subject to various constraints, maximizing long-term total returns in our Capital Markets group.

The effective management of interest rate risk is fundamental to the overall management of our Capital Markets group. We accept a small amount of interest rate risk that is incidental to our investment activities, but we do not seek to generate significant returns from taking interest rate risk. We believe one measure of the general effectiveness of our interest rate risk management is reflected in our average monthly duration gap, which has not exceeded plus or minus one month in any month since October 2004.

A detailed discussion of the operations, results and factors impacting our Capital Markets group can be found in *Business Segment Results Capital Markets Group*.

Risk Management

Effectively managing risks credit risk, market risk, operational risk and liquidity risk is a principal focus of our organization, is a key determinant of our success in achieving our mission and business objectives, and is critical to our safety and soundness. Our corporate risk oversight function is led by a Chief Risk Officer who reports directly to our Chief Executive Officer and independently to the Risk Policy and Capital Committee of the Board of Directors.

Our businesses have responsibility for managing the day-to-day risks inherent in our business activities, principally credit risk in our Single-Family and HCD businesses and interest rate risk in our Capital Markets group. A detailed discussion of our risk management strategies, processes and measures is included in Risk Management.

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Current Corporate Priorities

We have adopted and are aggressively pursuing the following key corporate objectives in 2007, which we believe will contribute to the achievement of our mission and business objectives:

Grow Revenue: Fannie Mae's Chief Business Officer is leading a company-wide effort to explore additional opportunities to serve mortgage lenders, housing agencies and organizations, investors, shareholders, the housing finance market and the company's affordable housing mission.

Reduce Cost: Management is committed to keeping costs aligned with revenues, and to that end, has undertaken a company-wide effort to reduce its projected 2007 budget by \$200 million. For the longer-term, management intends to reduce the overall cost basis of the company through focused efforts to streamline operations and increase productivity.

Exceed Mission: In 2005, we fell short on one of our affordable housing subgoals. We have reported to HUD that we believe we achieved all of our housing goals for 2006, and await their final determination. Our objective is to exceed our housing goals, even as they continue to become more challenging. We intend to provide and expand, as far as possible, liquidity to the overall mortgage market.

Clean Up : This key objective refers to our commitment to complete and file our 2005, 2006 and 2007 financial statements and complete remediation of the company's operational and control weaknesses. Becoming a current and SOX-compliant filer is a top priority.

Operate in Real Time : We have set a longer-term goal of reengineering the company's business operations to make the enterprise more streamlined, efficient, productive and responsive to the market, lender customers and partners, and regulators. We have selected the Lean Six Sigma approach to improving our business operations. Early pilots of this approach have been encouraging, and we will focus on improving the operational platform across our entire organization.

Accelerate Culture Change: The need to strengthen our corporate culture remains a top corporate priority. Fannie Mae's culture change efforts are designed to foster professionalism, competitiveness, and humility through the attributes of service, engagement, accountability, and effective management.

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 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 1, Summary of Significant Accounting Policies.

We have identified four of our accounting policies that require significant estimates and judgments and have a significant impact on our financial condition and results of operations. These policies are considered critical because the estimated amounts are likely to fluctuate from period to period due to the significant judgments and assumptions about highly complex and inherently uncertain matters and because the use of different assumptions related to these estimates could have a material impact on our financial condition or results of operations. These four accounting policies are: (i) the fair value of financial instruments; (ii) the amortization of cost basis adjustments using the

effective interest method; (iii) the allowance for loan losses and reserve for guaranty losses; and (iv) the assessment of variable interest entities. 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. Management has discussed each of these significant accounting policies, the related estimates and its judgments with the Audit Committee of the Board of Directors.

Fair Value of Financial Instruments

The use of fair value to measure our financial instruments is fundamental to our financial statements and is our most critical accounting policy because a substantial portion of our assets and liabilities are recorded at estimated fair value. In certain circumstances, our valuation techniques may involve a high degree of

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management judgment. The principal assets and liabilities that we record at fair value, and the manner in which changes in fair value affect our earnings and stockholders' equity, are summarized below.

Derivatives initiated for risk management purposes and mortgage commitments: Recorded in the consolidated balance sheets at fair value with changes in fair value recognized in earnings;

Guaranty assets and guaranty obligations: Recorded in the consolidated balance sheets at fair value at inception of the guaranty obligation. The guaranty obligation affects earnings over time through amortization into income as we collect guaranty fees and reduce the related guaranty asset receivable;

Investments in AFS or trading securities: Recorded in the consolidated balance sheets at fair value. Unrealized gains and losses on trading securities are recognized in earnings. Unrealized gains and losses on AFS securities are deferred and recorded in stockholders' equity as a component of AOCI;

HFS loans: Recorded in the consolidated balance sheets at the lower of cost or market with changes in the fair value (not to exceed the cost basis of these loans) recognized in earnings; and

Retained interests in securitizations and guaranty fee buy-ups on Fannie Mae MBS: Recorded in the consolidated balance sheets at fair value with unrealized gains and losses recorded in stockholders' equity as a component of AOCI.

Fair value is defined as the amount at which a financial instrument could be exchanged in a current transaction between willing unrelated parties, other than in a forced or liquidation sale. We determine the fair value of these assets and obligations based on our judgment of appropriate valuation methods and assumptions. The degree of management judgment involved in determining the fair value of a financial instrument depends on the availability and reliability of relevant market data, such as quoted market prices. Financial instruments that are actively traded and have quoted market prices or readily available market data require minimal judgment in determining fair value. When observable market prices and data are not readily available or do not exist, management must make fair value estimates based on assumptions and judgments. In these cases, even minor changes in management's assumptions could result in significant changes in our estimate of fair value. These changes could increase or decrease the value of our assets, liabilities, stockholders' equity and net income. We estimate fair values using the following practices:

We use actual, observable market prices or market prices obtained from multiple third parties when available. Pricing information obtained from third parties is internally validated for reasonableness prior to use in the consolidated financial statements.

Where observable market prices are not readily available, we estimate the fair value using market data and model-based interpolations using standard models that are widely accepted within the industry. Market data includes prices of instruments with similar maturities and characteristics, duration, interest rate yield curves, measures of volatility and prepayment rates.

If market data used to estimate fair value as described above is not available, we estimate fair value using internally developed models that employ techniques such as a discounted cash flow approach. These models include market-based assumptions that are also derived from internally developed models for prepayment speeds, default rates and severity.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS 157), which establishes a framework for measuring fair value under GAAP. SFAS 157 provides a three-level fair value hierarchy for classifying the source of information used in fair value measures and requires increased disclosures about the sources and

measurements of fair value. SFAS 157 is required to be implemented on January 1, 2008. We are currently evaluating whether adoption of this standard will result in any changes to our valuation practices. See Item 7 MD&A Impact of Future Adoption of New Accounting Pronouncements for further discussion of SFAS 157.

Estimating fair value is also a critical part of our impairment evaluation process. When the fair value of an investment declines below the carrying value, we assess whether the impairment is other-than-temporary based on management's judgment. If management concludes that a security is other-than-temporarily impaired, we

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reduce the carrying value of the security and record a reduction in our net income. Factors that we consider in determining whether a decline in the fair value of an investment is other-than-temporary include the length of time and the extent to which fair value is less than its carrying amount and our intent and ability to hold the investment until its value recovers.

Fair Value of Derivatives

Of the financial instruments that we record at fair value in our consolidated balance sheets, changes in the fair value of our derivatives generally have the most significant impact on the variability of our earnings. The following table summarizes the estimated fair values of derivative assets and liabilities recorded in our consolidated balance sheets as of December 31, 2005 and 2004.

Table 1: Derivative Assets and Liabilities at Estimated Fair Value

	As of December 31,	
	2005	2004
	(Dollars in millions)	
Derivative assets at fair value	\$ 5,803	\$ 6,589
Derivative liabilities at fair value	(1,429)	(1,145)
Net derivative assets at fair value	\$ 4,374	\$ 5,444

We present the estimated fair values of our derivatives by the type of derivative instrument in Table 11 of

Consolidated Results of Operations Derivatives Fair Value Losses, Net. Our derivatives consist primarily of over-the-counter (OTC) contracts and commitments to purchase and sell mortgage assets. While exchange-traded derivatives can generally be valued using observable market prices or market parameters, OTC derivatives are generally valued using industry-standard models or model-based interpolations that utilize market inputs obtained from widely accepted third-party sources. The valuation models that we use to derive the fair values of our OTC derivatives require inputs such as the contractual terms, market prices, yield curves, and measures of volatility. A substantial majority of our OTC derivatives trade in liquid markets, such as generic forwards, interest rate swaps and options; in those cases, model selection and inputs do not involve significant judgments.

When internal pricing models are used to determine fair value, we use recently executed comparable transactions and other observable market data to validate the results of the model. Consistent with market practice, we have individually negotiated agreements with certain counterparties to exchange collateral based on the level of fair values of the derivative contracts they have executed. Through our derivatives collateral exchange process, one party or both parties to a derivative contract provides the other party with information about the fair value of the derivative contract to calculate the amount of collateral required. This sharing of fair value information provides additional support of the recorded fair value for relevant OTC derivative instruments. For more information regarding our derivative counterparty risk practices, see Risk Management Credit Risk Management Institutional Counterparty Credit Risk Management. In circumstances where we cannot verify the model with market transactions, it is possible that a different valuation model could produce a materially different estimate of fair value. As markets and products develop and the pricing for certain derivative products becomes more transparent, we continue to refine our valuation methodologies. For the year ended December 31, 2005, there were no changes to the quantitative models, or uses of such models, that resulted in a material adjustment to our consolidated statement of income.

See Risk Management for further discussion of the sensitivity of the fair value of our derivative assets and liabilities to changes in interest rates.

Amortization of Cost Basis Adjustments on Mortgage Loans and Mortgage-Related Securities

We amortize cost basis adjustments on mortgage loans and mortgage-related securities recorded in our consolidated balance sheets through earnings using the interest method by applying a constant effective yield. Cost basis adjustments include premiums, discounts and other adjustments to the original value of mortgage loans or mortgage-related securities that are generally incurred at the time of acquisition, which we historically

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referred to as deferred price adjustments. When we buy mortgage loans or mortgage-related securities, we may not pay the seller the exact amount of the unpaid principal balance. If we pay more than the unpaid principal balance, we record a premium that reduces the effective yield below the stated coupon amount. If we pay less than the unpaid principal balance, we record a discount that increases the effective yield above the stated coupon amount.

Pursuant to Statement of Financial Accounting Standards (SFAS) No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases (an amendment of FASB Statements No. 13, 60, and 65 and rescission of FASB Statement No. 17)* (SFAS 91), cost basis adjustments are amortized into interest income as an adjustment to the yield of the mortgage loan or mortgage-related security based on the contractual terms of the instrument. SFAS 91, however, permits the anticipation of prepayments of principal to shorten the term of the mortgage loan or mortgage-related security if we (i) hold a large number of similar loans for which prepayments are probable and (ii) the timing and amount of prepayments can be reasonably estimated. We meet both criteria on substantially all of the mortgage loans and mortgage-related securities held in our portfolio. For loans that meet both criteria, we use prepayment estimates to determine periodic amortization of the cost basis adjustments related to these loans. For loans that do not meet the criteria, we do not use prepayment estimates to calculate the rate of amortization. Instead, we assume no prepayment and use the contractual terms of the mortgage loans or mortgage-related securities and factor in actual prepayments that occurred during the relevant period in determining the amortization amount.

For mortgage loans and mortgage-related securities that meet the criteria allowing us to anticipate prepayments, we must make assumptions about borrower prepayment patterns in various interest rate environments that involve a significant degree of judgment. Typically, we use prepayment forecasts from independent third parties in estimating future prepayments. If actual prepayments differ from our estimated prepayments, it could increase or decrease current period interest income as well as future recognition of interest income. Refer to Table 2 below for an analysis of the potential impact of changes in our prepayment assumptions on our net interest income.

We calculate and apply an effective yield to determine the rate of amortization of cost basis adjustments into interest income over the estimated lives of the investments using the retrospective effective interest method to arrive at a constant effective yield. When appropriate, we group loans into pools or cohorts based on similar risk categories including origination year, coupon bands, acquisition period and product type. We update our amortization calculations based on changes in estimated prepayment rates and, if necessary, we record cumulative adjustments to reflect the updated constant effective yield as if it had been in effect since acquisition.

Sensitivity Analysis for Amortizable Cost Basis Adjustments

Interest rates are a key assumption used in our prepayment models. Table 2 shows the estimated effect on our net interest income of the amortization of cost basis adjustments for our investments in loans and securities using the retrospective effective interest method applying a constant effective yield assuming (i) a 100 basis point increase in interest rates and (ii) a 50 basis point decrease in interest rates as of December 31, 2005 and 2004. We based our sensitivity analysis on these hypothetical interest rate changes because we believe they reflect reasonably possible near-term outcomes as of December 31, 2005.

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	For the Year Ended December 31,	
	2005	2004
	(Dollars in millions)	
Unamortized cost basis adjustments	\$ 344	\$ 1,820
Reported net interest income	11,505	18,081
Decrease in net interest income from net amortization	(97)	(1,221)
Percentage effect on net interest income of change in interest rates: ⁽¹⁾		
100 basis point increase	1.6%	4.5%
50 basis point decrease	(2.2)	(4.9)

⁽¹⁾ Calculated based on an instantaneous change in interest rates.

As mortgage rates increase, expected prepayment rates generally decrease, which slows the amortization of cost basis adjustments. Conversely, as mortgage rates decrease, expected prepayment rates generally increase, which accelerates the amortization of cost basis adjustments.

Allowance for Loan Losses and Reserve for Guaranty Losses

The allowance for loan losses and the reserve for guaranty losses represent our estimate of probable credit losses arising from loans classified as held for investment in our mortgage portfolio as well as loans that back mortgage-related securities we guarantee. We use the same methodology to determine our allowance for loan losses and our reserve for guaranty losses as the relevant factors affecting credit risk are the same. Credit risk is the risk of loss to future earnings or future cash flows that may result from the failure of a borrower to make the payments required by his or her mortgage loan. We are exposed to credit risk because we own mortgage loans and have guaranteed to MBS trusts that we will supplement amounts received by those MBS trusts as required to permit timely payment of principal and interest on the related Fannie Mae MBS. We strive to mitigate our credit risk by, among other things, working with lender servicers, monitoring loan-to-value ratios and requiring mortgage insurance. See Risk Management Credit Risk Management below for further discussion of how we manage credit risk.

We employ a systematic methodology to determine our best estimate of incurred credit losses. This includes aggregating homogeneous loans into pools based on similar risk characteristics, using models to measure historical default and loss experience on the homogeneous loan populations, evaluating larger multifamily loans individually for impairment, monitoring observable data for key trends, as well as documenting the results of our estimation process.

Determining the adequacy of the allowance for loan losses and the reserve for guaranty losses is complex and requires significant judgment by management about the effect of matters that are inherently uncertain. When appropriate, our methodology involves grouping loans into pools or cohorts based on similar risk characteristics, including origination year, loan-to-value ratio, loan product type and credit rating. We use internally developed models that consider relevant factors historically affecting loan collectibility, such as default rates, severity of loss rates and adverse situations that may have occurred affecting the borrowers' ability to repay. Management also applies judgment in considering factors that have occurred but are not yet reflected in the loss factors, such as the estimated value of the

underlying collateral, other recoveries and external and economic factors. The methodology and the amount of our allowance for loan losses and reserve for guaranty losses are reviewed and approved on a quarterly basis by our Allowance for Loan Loss Oversight Committee, which is a committee chaired by the Chief Risk Officer or his designee and comprised of senior management from the Single-Family and HCD businesses, the Chief Risk Office and the finance organization.

We adjust our estimate of the allowance for loan losses and reserve for guaranty losses based on period-to-period fluctuations in loss experience, economic conditions in areas of geographic concentration and profile of mortgage characteristics. Using different assumptions about default rates, severity and estimated deterioration in borrowers financial condition than those used in estimating our allowance for loan losses and reserve for guaranty losses could have a material effect on our net income.

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Given that a minimal change in any factor listed above that is used for calculation purposes would have a significant impact to the allowance and reserve liability and these factors have significant interdependencies, we do not believe a sensitivity analysis isolating one factor is meaningful. Therefore, the following example illustrates the impact to the allowance and reserve liability given changes to multiple assumptions used for these factors. For example, a natural disaster, such as a hurricane, might have an adverse impact on net income and our allowance for loan losses and reserve for guaranty losses. The damage to the properties that serve as collateral for the mortgages held in our portfolio and the mortgages underlying our mortgage-backed securities could increase our exposure to credit risk if the damage to the properties is not covered by hazard or flood insurance. Our estimate of probable credit losses related to a hurricane would involve considerable judgment and assumptions about the extent of the property damage, the impact on borrower default rates, the value of the collateral underlying the loans and the amount of insurance recoveries. In the case of Hurricane Katrina in 2005, we preliminarily estimated default rates, severity of loss rates, value of the underlying collateral, and other potential recoveries. As more information became available, we determined that the property damage was less extensive than had previously been estimated and the amount of insurance recoveries would be greater than previously expected. Accordingly, we revised our September 30, 2005 estimate of \$257 million after-tax, which was disclosed in November of 2005, to an estimate of \$106 million pre-tax for 2005.

Consolidation Variable Interest Entities

We are a party to various entities that are considered to be variable interest entities (VIEs) as defined in FASB Interpretation (FIN) No. 46 (revised December 2003), *Consolidation of Variable Interest Entities (an interpretation of ARB No. 51)* (FIN 46R). Generally, a VIE is a corporation, partnership, trust or any other legal structure that either does not have equity investors with substantive voting rights or has equity investors that do not provide sufficient financial resources for the entity to support its activities. We invest in securities issued by VIEs, including Fannie Mae MBS created as part of our securitization program, certain mortgage- and asset-backed securities that were not issued by us and interests in LIHTC partnerships and other limited partnerships. Our involvement with a VIE may also include providing a guaranty to the entity.

There is a significant amount of judgment required in interpreting the provisions of FIN 46R and applying them to specific transactions. FIN 46R indicates that if an entity is a VIE, either a qualitative or a quantitative assessment may be required to support the conclusion of which party, if any, is the primary beneficiary. The primary beneficiary is the party that will absorb a majority of the expected losses or a majority of the expected returns. If the entity is determined to be a VIE, and we either qualitatively or quantitatively determine that we are the primary beneficiary, we are required to consolidate the assets, liabilities and non-controlling interests of that entity.

To determine whether we are the primary beneficiary of an entity, we first perform a qualitative analysis, which requires certain subjective decisions regarding our assessment, including, but not limited to, the design of the entity, the variability that the entity was designed to create and pass along to its interest holders, the rights of the parties and the purpose of the arrangement. If we cannot conclude after qualitative analysis whether we are the primary beneficiary, we perform a quantitative analysis. Quantifying the variability of a VIE's assets is complex and subjective, requiring analysis of a significant number of possible future outcomes as well as the probability of each outcome occurring. The results of each possible outcome are allocated to the parties holding interests in the VIE and, based on the allocation, a calculation is performed to determine which, if any, is the primary beneficiary. The analysis is required when we first become involved with the VIE and on each subsequent date in which there is a reconsideration event (e.g., a purchase of additional beneficial interests).

We perform qualitative analyses on certain mortgage-backed and asset-backed investment trusts. These qualitative analyses consider whether the nature of our variable interests exposes us to credit or prepayment risk, the two primary

drivers of expected losses for these VIEs. For those mortgage-backed investment trusts that we evaluate using quantitative analyses, we use internal models to generate Monte Carlo simulations of cash flows associated with the different credit, interest rate and housing price environments. Material assumptions include our projections of interest rates and housing prices, as well as our expectations of prepayment, default and severity rates. The projection of future cash flows is a subjective process involving

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significant management judgment, primarily due to inherent uncertainties related to the interest rate and housing price environment, as well as the actual credit performance of the mortgage loans and securities that were held by each investment trust. If we determine that an investment trust meets the criteria of a VIE, we consolidate the investment trust when our models indicate that we are likely to absorb more than 50% of the variability in the expected losses or expected residual returns.

The following demonstrates the sensitivity of our FIN 46R modeling results. We considered the impact of different primary beneficiary conclusions for the trusts in which a change in the variability would have affected our primary beneficiary assessment and our consolidation determination at the time we adopted FIN 46R and at the time we applied FIN 46 to subsequent transactions:

If we changed our assumptions to cause our variability in trusts to increase from an amount between 40% and 50% to greater than 50%, our total assets and liabilities as of December 31, 2005 would increase by approximately \$380 million.

If we changed our assumptions to cause our variability in trusts to decrease from an amount between 60% and 50.1% to 50% or less, our total assets and liabilities as of December 31, 2005 would decrease by approximately \$400 million.

We also examine our LIHTC partnerships and other limited partnerships to determine if consolidation is required. We use internal cash flow models that are applied to a sample of the partnerships to qualitatively evaluate homogenous populations to determine if these entities are VIEs and, if so, whether we are the primary beneficiary. LIHTC partnerships are created by third parties to finance construction of property, giving rise to tax credits for these partnerships. Material assumptions we make in determining whether the partnerships are VIEs and, if so, whether we are the primary beneficiary, include the degree of development cost overruns related to the construction of the building, the probability of the lender foreclosing on the building, as well as an investor's ability to use the tax credits to offset taxable income. The projection of cash flows and probabilities related to these cash flows requires significant management judgment because of the inherent limitations that relate to the use of historical loss and cost overrun data for the projection of future events. Additionally, we apply similar assumptions and cash flow models to determine the VIE and primary beneficiary status of our other limited partnership investments.

We are exempt from applying FIN 46R to certain investment trusts if the investment trusts meet the criteria of a qualifying special purpose entity (QSPE), and if we do not have the unilateral ability to cause the trust to liquidate or change the trust's QSPE status. The QSPE requirements significantly limit the activities in which a QSPE may engage and the types of assets and liabilities it may hold. Management judgment is required to determine whether a trust's activities meet the QSPE requirements. To the extent any trust fails to meet these criteria, we would be required to consolidate its assets and liabilities if, based on the provisions of FIN 46R, we are determined to be the primary beneficiary of the entity.

The FASB currently is assessing further what activities a QSPE may perform. The outcome of these and future assessments may affect our interpretation of this guidance, and, consequently, the entities we consolidate in future periods.

CONSOLIDATED RESULTS OF OPERATIONS

The following discussion of our consolidated results of operations is based on our results for the years ended December 31, 2005, 2004 and 2003. Table 3 presents a condensed summary of our consolidated results of operations.

Table of Contents**Table 3: Condensed Consolidated Results of Operations**

	For the Year Ended December 31,			2005 vs. 2004		Variance 2004 vs. 2003	
	2005	2004	2003	\$	%	\$	%
	(Dollars in millions, except per share amounts)						
Net interest income	\$ 11,505	\$ 18,081	\$ 19,477	\$ (6,576)	(36)%	\$ (1,396)	(7)%
Guaranty fee income	3,779	3,604	3,281	175	5	323	10
Fee and other income	1,526	404	340	1,122	278	64	19
Investment losses, net	(1,334)	(362)	(1,231)	(972)	(269)	869	71
Derivatives fair value losses, net	(4,196)	(12,256)	(6,289)	8,060	66	(5,967)	(95)
Debt extinguishment losses, net	(68)	(152)	(2,692)	84	55	2,540	94
Loss from partnership investments	(849)	(702)	(637)	(147)	(21)	(65)	(10)
Provision for credit losses	(441)	(352)	(365)	(89)	(25)	13	4
Other non-interest expense	(2,351)	(2,266)	(1,598)	(85)	(4)	(668)	(42)
Income before federal income taxes, extraordinary gains (losses), and cumulative effect of change in accounting principle	7,571	5,999	10,286	1,572	26	(4,287)	(42)
Provision for federal income taxes	(1,277)	(1,024)	(2,434)	(253)	(25)	1,410	58
Extraordinary gains (losses), net of tax effect	53	(8)	195	61	763	(203)	(104)
Cumulative effect of change in accounting principle, net of tax effect			34			(34)	(100)
Net income	\$ 6,347	\$ 4,967	\$ 8,081	\$ 1,380	28%	\$ (3,114)	(39)%
Diluted earnings per common share	\$ 6.01	\$ 4.94	\$ 8.08	\$ 1.07	22%	\$ (3.14)	(39)%

Net income and diluted earnings per share (EPS) totaled \$6.3 billion and \$6.01, respectively, in 2005, compared with \$5.0 billion and \$4.94 in 2004, and \$8.1 billion and \$8.08 in 2003. We expect high levels of period-to-period volatility in our results of operations and financial condition as part of our normal business activities. This volatility is primarily due to changes in market conditions that result in periodic fluctuations in the estimated fair value of our derivative instruments, which we recognize in our consolidated statements of income as Derivatives fair value losses, net.

Although we use derivatives as economic hedges to help us manage interest rate risk and achieve our targeted interest rate risk profile, we do not meet the criteria for hedge accounting under SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities* (SFAS 133). Accordingly, we record our derivative instruments at fair value as assets or liabilities in our consolidated balance sheets and recognize the fair value gains and losses in our consolidated statements of income without consideration of offsetting changes in the fair value of the economically hedged exposure. The estimated fair value of our derivatives may fluctuate substantially from period to period because of changes in interest rates, expected interest rate volatility and our derivative activity. Based on the composition of our derivatives, we generally expect to report decreases in the aggregate fair value of our derivatives as interest rates decrease.

Our business segments generate revenues from three principal sources: net interest income, guaranty fee income, and fee and other income. Other significant factors affecting our net income include the timing and size of investment and debt repurchase gains and losses, equity investments, the provision for credit losses, and administrative expenses. We provide a comparative discussion of the impact of these items on our consolidated results of operations for the three-year period ended December 31, 2005 below. We also discuss other significant items presented in our consolidated statements of income.

Net Interest Income

Net interest income, which is the difference between interest income and interest expense, is a primary source of our revenue. Interest income consists of interest on our consolidated interest-earning assets, plus income from the amortization of discounts for assets acquired at prices below the principal value, less expense from

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the amortization of premiums for assets acquired at prices above principal value. Interest expense consists of contractual interest on our interest-bearing liabilities and amortization of any cost basis adjustments, including premiums and discounts, which arise in conjunction with the issuance of our debt. The amount of interest income and interest expense recognized in the consolidated statements of income is affected by our investment activity, debt activity, asset yields and our cost of debt. We expect net interest income 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 2005, 2004 and 2003.

As described below in *Derivatives Fair Value Losses, Net*, 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 *Derivatives Fair Value Losses, Net* for additional information.

Table 4: Analysis of Net Interest Income and Yield

	For the Year Ended December 31,								
	2005			2004			2003		
	Average ⁽¹⁾ Balance	Interest	Yield	Average ⁽¹⁾ Balance	Interest	Yield	Average ⁽¹⁾ Balance	Interest	Yield
(Dollars in millions)									
Interest-earning assets:									
Mortgage loans ⁽²⁾	\$ 384,869	\$ 20,688	5.38%	\$ 400,603	\$ 21,390	5.34%	\$ 362,002	\$ 21,370	5.90%
Mortgage securities	443,270	22,163	5.00	514,529	25,302	4.92	495,219	26,483	5.35
Non-mortgage securities ⁽³⁾	41,369	1,590	3.84	46,440	1,009	2.17	44,375	1,069	2.41
General funds sold and securities purchased under agreements to resell	6,415	299	4.66	8,308	84	1.01	6,509	32	0.49
Advances to lenders	4,468	104	2.33	4,773	33	0.69	12,613	110	0.87
Total interest-earning assets	\$ 880,391	\$ 44,844	5.09	\$ 974,653	\$ 47,818	4.91	\$ 920,718	\$ 49,064	5.33
Interest-bearing liabilities:									
Short-term debt	\$ 246,733	\$ 6,535	2.65%	\$ 331,971	\$ 4,380	1.32%	\$ 318,600	\$ 3,967	1.25
Long-term debt	611,827	26,777	4.38	625,225	25,338	4.05	582,686	25,575	4.39
General funds purchased and securities sold under agreements to repurchase	1,552	27	1.74	3,037	19	0.63	6,421	45	0.70
Total interest-bearing liabilities	\$ 860,112	\$ 33,339	3.88%	\$ 960,233	\$ 29,737	3.10%	\$ 907,707	\$ 29,587	3.26
Impact of net non-interest bearing funding	\$ 20,279		0.10%	\$ 14,420		0.05%	\$ 13,011		0.05
Net interest income and net interest yield ⁽⁴⁾		\$ 11,505	1.31%		\$ 18,081	1.86%		\$ 19,477	2.12

- (1) Average balances have been calculated based on beginning and end of year amortized cost.
- (2) Includes average balance on nonaccrual loans of \$7.4 billion, \$7.6 billion and \$6.8 billion for the years ended December 31, 2005, 2004 and 2003, respectively.
- (3) Includes cash equivalents.
- (4) Net interest yield is calculated based on net interest income divided by the average balance of total interest-earning assets.

Table 5 shows the changes in our net interest income between 2005 and 2004 and between 2004 and 2003 that are attributable to changes in the volume of our interest-earning assets and interest-bearing liabilities versus changes in interest rates.

Table of Contents**Table 5: Rate/Volume Analysis of Net Interest Income**

	2005 vs. 2004			2004 vs. 2003		
	Total Variance	Variance Due to: ⁽¹⁾ Volume	Rate	Total Variance	Variance Due to: ⁽¹⁾ Volume	Rate
(Dollars in millions)						
Interest income:						
Mortgage loans	\$ (702)	\$ (845)	\$ 143	\$ 20	\$ 2,164	\$ (2,144)
Mortgage securities	(3,139)	(3,557)	418	(1,181)	1,006	(2,187)
Non-mortgage securities	581	(121)	702	(60)	48	(108)
Federal funds sold and securities purchased under agreements to resell	215	(23)	238	52	11	41
Advances to lenders	71	(2)	73	(77)	(58)	(19)
Total interest income	(2,974)	(4,548)	1,574	(1,246)	3,171	(4,417)
Interest expense:						
Short-term debt	2,155	(1,355)	3,510	413	171	242
Long-term debt	1,439	(552)	1,991	(237)	1,797	(2,034)
Federal funds purchased and securities sold under agreements to repurchase	8	(13)	21	(26)	(22)	(4)
Total interest expense	3,602	(1,920)	5,522	150	1,946	(1,796)
Net interest income	\$ (6,576)	\$ (2,628)	\$ (3,948)	\$ (1,396)	\$ 1,225	\$ (2,621)

⁽¹⁾ Combined rate/volume variances are allocated to the rate and volume variances based on their relative size.

Net interest income of \$11.5 billion for 2005 decreased 36% from \$18.1 billion in 2004, driven by a 10% decrease in our average interest-earning assets and a 30% (55 basis points) decline in our net interest yield to 1.31%. The decrease in our average interest-earning assets was due to a lower volume of interest-earning assets attributable to liquidations and a significant increase in the sale of fixed-rate mortgage assets from our portfolio, coupled with a reduced level of mortgage purchases. While our overall debt funding needs declined in 2005, our net interest yield was compressed because of an increase in our debt funding costs that primarily resulted from a tightening of short-term interest rates by the Federal Reserve. The increased cost of our debt more than offset an increase in the average yields on our interest-earning assets.

Competition for mortgage assets during 2005 generally increased the number of economically attractive opportunities to sell certain mortgage assets, particularly 15-year and 30-year fixed-rate mortgage-related securities, resulting in a sizeable increase in portfolio sales to \$113.6 billion in 2005 compared with \$18.4 billion in 2004. These sales were aligned with our need to lower portfolio balances to achieve our capital plan objectives. While portfolio liquidations in 2005 were comparable to 2004, portfolio purchases were substantially lower in 2005 as compared with 2004 due to narrowing spreads on traditional fixed-rate products as the yield curve flattened, as well as our focus on managing the size of our balance sheet to achieve our capital plan objectives. Portfolio purchases totaled \$145.4 billion in 2005 compared with \$258.5 billion in 2004, and included a much lower proportion of 30-year fixed-rate assets than

historical norms. Sales, liquidations, and reduced purchases had the net effect of reducing our average interest-earning assets, as well as decreasing our mortgage portfolio, net balance by 20% to \$736.5 billion as of December 31, 2005 from \$924.8 billion as of December 31, 2004. Lower portfolio balances have the effect of reducing the net interest income generated by our portfolio.

The average yield on our interest-earning assets increased 18 basis points in 2005 to 5.09%, which was more than offset by an increase of 78 basis points in the average cost of our interest-bearing liabilities to 3.88%. As mortgage originations in our underlying market began to shift during 2004 to a higher share of ARM loans, the composition of our mortgage portfolio began to shift, a trend that continued throughout 2005. As we liquidated higher yielding fixed-rate mortgage assets, we partially replaced these assets in 2005 and 2004 by purchasing a greater proportion of floating-rate and ARM products. Although ARMs tend to earn lower initial yields than fixed-rate mortgage assets, we experienced an increase in our average yield during 2005 as interest

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rates increased and these floating-rate assets reset to higher interest rates. The flattening of the yield curve during 2005 resulted from a significant increase in short-term interest rates due to actions taken by the Federal Reserve to increase the Federal Funds target interest rate. As of December 31, 2005, the Federal Funds target rate was 4.25%, 200 basis points higher than at the start of the year and the highest level since 2001. The impact on long-term interest rates was much smaller, as the yield on the 10-year Treasury ended the year at 4.39%, 17 basis points higher than the end of 2004. Although we significantly reduced the level of our outstanding short-term debt during 2005, these interest rate changes had the effect of increasing the cost of short-term debt, which further reduced our net interest income and net interest yield. The increase in the cost of our long-term debt reflects the replacement of maturing lower-cost debt that we issued during the past few years to fund our portfolio investments when the yield curve was steep (*i.e.*, short- and medium-term interest rates were low relative to long-term interest rates). As the yield curve flattened during 2005 and we replaced this debt to fund our existing fixed-rate mortgage investments, we experienced an increase in our funding costs. At the same time, we experienced a significant decrease in the periodic net contractual interest expense accrued on our interest rate swaps during 2005, which is reflected in our consolidated statements of income as a component of Derivatives fair value losses, net.

Net interest income of \$18.1 billion for 2004 decreased 7% from \$19.5 billion in 2003, driven by a 6% increase in our average interest-earning assets that was more than offset by a 12% (26 basis points) decline in our net interest yield to 1.86%. The average yield on our interest-earning assets declined 42 basis points in 2004 to 4.91%, which exceeded the benefit we received from a decrease of 16 basis points in the average cost of our interest-bearing liabilities to 3.10%. During 2004, our mortgage asset purchases consisted of a greater proportion of lower-yielding, floating-rate assets. Partially offsetting this reduction in average yield on our mortgage investments was a slower rate of amortization of premiums in 2004 relative to 2003 due to slower prepayment rates. The yield on our total average debt decreased in 2004 due to the repurchase and call of a significant amount of higher cost long-term debt during 2003 and the issuance of new long-term debt at lower rates. However, as short-term interest rates began to increase in 2004, the cost of our short-term debt began to rise.

We expect the decrease in the volume of our interest-earning assets and the decline in the spread between the average yield on these assets and our borrowing costs that we began experiencing at the end of 2004 and that continued in 2005 to result in further reductions in our net interest income and net interest yield in the near future.

Guaranty Fee Income

Guaranty fee income primarily consists of contractual guaranty fees related to Fannie Mae MBS held in our portfolio and held by third-party investors, adjusted for the amortization of upfront fees and impairment of guaranty assets, net of a proportionate reduction in the related guaranty obligation and deferred profit, and impairment of buy-ups.

Guaranty fee income is primarily affected by the amount of outstanding Fannie Mae MBS and the compensation we receive for providing our guaranty on Fannie Mae MBS. The amount of compensation we receive and the form of payment varies depending on factors such as the risk profile of the securitized loans, the level of credit risk we assume and the negotiated payment arrangement with the lender. Our payment arrangements may be in the form of an upfront exchange of payments, an ongoing payment stream from the cash flows of the MBS trusts, or a combination. We typically negotiate a contractual guaranty fee with the lender and collect the fee on a monthly basis based on the contractual fee rate multiplied by the unpaid principal balance of loans underlying a Fannie Mae MBS issuance. In lieu of charging a higher contractual fee rate for loans with greater credit risk, we may require that the lender pay an upfront fee to compensate us for assuming the additional credit risk. We refer to this payment as a risk-based pricing adjustment. We also may 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 by making an upfront payment to the lender (buy-up) or receiving an upfront payment from the lender (buy-down).

As we receive monthly contractual payments for our guaranty obligation, we recognize guaranty fee income. We defer upfront risk-based pricing adjustments and buy-down payments that we receive from lenders and

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recognize these amounts as a component of guaranty fee income over the expected life of the underlying assets of the related MBS trusts. We record buy-up payments we make to lenders as an asset and reduce the recorded asset as cash flows are received over the expected life of the underlying assets of the related MBS trusts. We assess buy-ups for other-than-temporary impairment and include any impairment recognized as a component of guaranty fee income. The extent to which we amortize deferred payments into income depends on the rate of expected prepayments, which is affected by interest rates. In general, as interest rates decrease, expected prepayment rates increase, resulting in accelerated accretion into income of deferred fee amounts, which increases our guaranty fee income. Prepayment rates also affect the estimated fair value of buy-ups. Faster than expected prepayment rates shorten the average expected life of the underlying assets of the related MBS trusts, which reduces the value of our buy-up assets and may trigger the recognition of other-than temporary impairment.

The average effective guaranty fee rate reflects our average contractual guaranty fee rate adjusted for the impact of amortization of deferred amounts and buy-up impairment. Table 6 shows our guaranty fee income, including and excluding buy-up impairments, our average effective guaranty fee rate, and Fannie Mae MBS activity for 2005, 2004 and 2003.

Table 6: Analysis of Guaranty Fee Income and Average Effective Guaranty Fee Rate

	For the Year Ended December 31,						Variance	
	2005		2004		2003		2005 vs. 2004	2004 vs. 2003
	Amount	Rate ⁽¹⁾	Amount	Rate ⁽¹⁾	Amount	Rate ⁽¹⁾		
(Dollars in millions)								
Guaranty fee income and average effective guaranty fee rate, excluding impairment of buy-ups	\$ 3,828	21.3 bp	\$ 3,640	21.0 bp	\$ 3,474	22.2 bp	5%	5%
Impairment of buy-ups	(49)	(0.3)	(36)	(0.2)	(193)	(1.2)	36	(81)
Guaranty fee income and average effective guaranty fee rate	\$ 3,779	21.0 bp	\$ 3,604	20.8 bp	\$ 3,281	21.0 bp	5%	10%
Average outstanding Fannie Mae MBS and other	\$ 1,797,547		\$ 1,733,060		\$ 1,564,812		4%	11%

guaranties ⁽²⁾					
Fannie Mae					
MBS issues ⁽³⁾	510,138	552,482	1,220,066	(8)	(55)

- (1) Presented in basis points and calculated based on guaranty fee income components divided by average outstanding Fannie Mae MBS and other guaranties.
- (2) Other guaranties include \$19.2 billion, \$14.7 billion and \$12.8 billion as of December 31, 2005, 2004 and 2003, respectively, related to long-term standby commitments and credit enhancements.
- (3) Reflects unpaid principal balance of MBS issued and guaranteed by us, including mortgage loans held in our portfolio that we securitize and MBS issues during the period that we acquire for our portfolio.

Guaranty fee income of \$3.8 billion for 2005 was up approximately 5% over 2004, primarily due to a 4% increase in average outstanding Fannie Mae MBS and other guaranties. Guaranty fee income of \$3.6 billion for 2004 was up 10% over 2003, primarily due to an 11% increase in average outstanding Fannie Mae MBS and other guaranties. Our average effective guaranty fee rate, which includes the effect of buy-up impairments, remained essentially unchanged during the three-year period at 21.0 basis points in 2005, 20.8 basis points in 2004, and 21.0 basis points in 2003.

Growth in outstanding Fannie Mae MBS depends largely on the volume of mortgage assets made available for securitization and our assessment of the credit risk and pricing dynamics of these mortgage assets. Growth in outstanding Fannie Mae MBS slowed in 2004 and 2005 as compared to 2003, reflecting the impact of a decline in mortgage originations from the record level of \$3.9 trillion in 2003 that fueled growth in Fannie Mae MBS issuances to a record level of \$1.2 trillion. In addition, the product mix in the primary mortgage market began to shift in 2004 as the share of originations of lower credit quality loans, loans with reduced documentation and loans to fund investor properties increased. At the same time, originations of traditional mortgages, such as conventional fixed-rate loans, which historically have represented the majority of our business volume, decreased. Competition from private-label issuers, which have been a significant source of

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funding for these mortgage products, reduced our market share and level of MBS issuances. This trend continued in 2006; however, we began to increase our participation in these product types where we concluded that it would be economically advantageous or that it would contribute to our mission objectives.

Our average effective guaranty fee rate, excluding the effect of buy-up impairments, was 21.3 basis points in 2005, 21.0 basis points in 2004 and 22.2 basis points in 2003. Mortgage interest rates were higher in 2005 and 2004 relative to 2003, which reduced the rate of prepayments thereby increasing the average expected life of the underlying assets of outstanding Fannie Mae MBS. As a result, amortization of the deferred guaranty obligations into income slowed during 2005 and 2004, resulting in a reduced average effective guaranty fee rate compared with 2003. The increase in the average expected life of outstanding Fannie Mae MBS also caused the value of our buy-up assets to increase. Consequently, we recognized substantially less buy-up impairment in 2005 and 2004 than in 2003.

Fee and Other Income

Fee and other income includes transaction fees, technology fees, multifamily fees and foreign exchange gains and losses. Transaction and technology fees are largely driven by business volume, while foreign currency exchange gains and losses are driven by fluctuations in exchange rates on our foreign-denominated debt. Fee and other income totaled \$1.5 billion, \$404 million and \$340 million in 2005, 2004 and 2003, respectively. The increase in fee and other income in 2005 from 2004 was primarily due to exchange gains recorded in 2005 on our foreign-denominated debt that stemmed from a strengthening of the U.S. dollar relative to the Japanese yen. We recorded foreign currency exchange gains of \$625 million in 2005 versus losses of \$304 million in 2004 that were offset by corresponding net losses and gains on foreign currency swaps, which are recognized in our consolidated statements of income as a component of Derivatives fair value gains (losses), net. We eliminate our exposure to fluctuations in foreign exchange rates by entering into foreign currency swaps to convert foreign-denominated debt to U.S. dollars. The increase in fee and other income in 2004 from 2003 was primarily due to a reduction in net foreign currency exchange losses, which more than offset a decline in transaction and technology fees that resulted from reduced business volumes.

Investment Losses, Net

Investment losses, net includes other-than-temporary impairment on AFS securities, lower-of-cost-or-market adjustments on HFS loans, gains and losses recognized on the securitization of loans from our portfolio and the sale of securities, unrealized gains and losses on trading securities and other investment losses. Investment gains and losses may fluctuate significantly from period to period depending upon our portfolio investment and securitization activities, changes in market conditions that may result in fluctuations in the fair value of trading securities, and other-than-temporary impairment. Table 7 summarizes the components of investment gains and losses for 2005, 2004 and 2003.

Table 7: Investment Losses, Net

	For the Year Ended December 31,		
	2005	2004	2003
	(Dollars in millions)		
Other-than-temporary impairment on AFS securities ⁽¹⁾	\$ (1,246)	\$ (389)	\$ (733)
Lower-of-cost-or-market adjustments on HFS loans	(114)	(110)	(370)
Gains (losses) on Fannie Mae portfolio securitizations, net	259	(34)	(13)
Gains on sale of investment securities, net	225	185	87
Unrealized (losses) gains on trading securities, net	(415)	24	(97)

Other investment losses, net	(43)	(38)	(105)
Investment losses, net	\$ (1,334)	\$ (362)	\$ (1,231)

⁽¹⁾ Excludes other-than-temporary impairment on guaranty assets and buy-ups as these amounts are recognized as a component of guaranty fee income.

Table of Contents***Other-than-Temporary Impairment on Available-for-Sale Securities***

We periodically evaluate AFS securities for other-than-temporary impairment. Other-than-temporary impairment occurs when we determine that it is probable we will be unable to collect all of the contractual principal and interest payments of a security or if we do not have the ability and intent to hold the security until it recovers to its carrying amount. We consider many factors in assessing other-than-temporary impairment, including the severity and duration of the impairment, recent events specific to the issuer and/or the industry to which the issuer belongs, external credit ratings and recent downgrades, as well as our ability and intent to hold such securities until recovery. When we either decide to sell a security in an unrealized loss position and do not expect the fair value of the security to fully recover prior to the expected time of sale or determine that a security in an unrealized loss position may be sold in future periods prior to recovery of the impairment, we identify the security as other-than-temporarily impaired in the period that the decision to sell or determination that the security may be sold is made. For all other securities in an unrealized loss position resulting primarily from increases in interest rates, we have the positive intent and ability to hold such securities until the earlier of full recovery or maturity. We provide additional detail on our assessment of other-than-temporary impairment in Notes to Consolidated Financial Statements Note 1, Summary of Significant Accounting Policies.

We recognized other-than-temporary impairment on AFS securities totaling \$1.2 billion, \$389 million and \$733 million in 2005, 2004 and 2003, respectively, primarily related to our investments in mortgage-related securities held in our portfolio, interest-only securities, manufactured housing securities, and other non-mortgage investment securities. These impairment amounts are reflected in the results of our Capital Markets group and detailed below.

Other-than-temporary impairment on mortgage-related securities held in our portfolio totaled \$1.2 billion, \$285 million and \$23 million in 2005, 2004 and 2003, respectively. The rising interest rate environment in 2005 caused an overall decline in the fair value of our mortgage-related securities below the carrying value. We generally view changes in the fair value of our mortgage-related securities caused by movements in interest rates to be temporary. The \$1.2 billion in other-than-temporary impairment that we recognized in 2005 related to securities totaling approximately \$72.7 billion that we wrote down to fair value because we sold these securities before the interest rate impairments recovered. Of the \$72.7 billion in securities for which we recorded other-than-temporary impairment in 2005, we sold \$46.2 billion in 2005, \$12.8 billion in 2006 and \$13.7 billion in the first quarter of 2007. We did not recognize other-than-temporary impairment on the remaining mortgage-related securities in our portfolio that were in unrealized loss positions during 2005 because we have the intent and ability to hold these securities until the interest rate impairments recover. The continued upward trend in interest rates during 2006 caused a further decline in the fair value of our mortgage-related securities, which is likely to result in our recognition of material other-than-temporary impairment charges in 2006 for impaired securities that we sold prior to recovery of the impairment.

The other-than-temporary impairment on mortgage-related securities recognized in 2004 primarily related to certain securities with unrealized losses as of December 31, 2004 that we identified for possible sale in 2005 to comply with OFHEO's directive that we achieve a 30% surplus over our statutory minimum capital requirement by September 30, 2005.

We are required to write down the cost basis of our investments in interest-only securities to fair value when there is both a decline in fair value below the carrying amount and an adverse change in expected cash flows. We then recognize the write-down in earnings and establish a new cost basis for the security. Decreases in mortgage interest rates cause the expected lives of these securities to shorten, which decreases the expected cash flows and fair value of the securities. Mortgage interest rates reached historic lows in mid-2003 before beginning to increase during the second half of 2003 and 2004. While mortgage interest rates generally trended up in 2004 and 2005, they were

somewhat volatile with periodic declines over the course of each year. We recognized other-than-temporary impairment of \$19 million, \$49 million and \$78 million on mortgage-related interest-only securities in 2005, 2004 and 2003, respectively. The upward trend in interest rates in 2005 and 2004 resulted in lower impairment amounts during those years relative to 2003 when interest rates fell to

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historic lows. Periodic declines in interest rates could result in additional future impairments on our interest-only securities.

Beginning in 2002 and continuing in 2003, there was a significant weakening in the manufactured housing sector. As a result, certain manufactured housing servicers began to experience financial difficulties, triggering deterioration in the credit quality of certain securities as evidenced by credit downgrades and a considerable decline in fair value. Other-than-temporary impairment on our investments in manufactured housing securities totaled \$15 million, \$55 million and \$511 million in 2005, 2004 and 2003, respectively.

We recognized other-than-temporary impairment on non-mortgage investment securities totaling \$21 million, \$2 million and \$139 million in 2005, 2004 and 2003, respectively. The other-than-temporary impairment charge in 2005 related to corporate debt obligations. The other-than-temporary impairment charge in 2003 was largely attributable to our investments in certain aircraft lease securities, which suffered a decline in value due to the downturn in the airline industry. We completed the sale of all of our aircraft lease securities in 2005 and did not record any other-than-temporary impairment on these securities in 2005 or 2004.

We may subsequently recover other-than-temporary impairment amounts we record on securities if we collect all of the contractual principal and interest payments due or if we sell the security at an amount greater than the adjusted cost basis of the security.

Lower-of-Cost-or-Market Adjustments on Held-for-Sale Loans

We record loans classified as held for sale at the lower of cost or market, with any excess of cost over fair value reflected as a valuation allowance and changes in the valuation allowance recognized in income. The fair value of held for sale mortgage loans will fluctuate from period to period based primarily on changes in mortgage interest rates. As interest rates decline, the fair value of fixed-rate mortgage loans will generally increase, and as interest rates rise, the fair value of fixed-rate mortgage loans will generally decrease. In an environment of increasing interest rates or significant interest rate volatility, the LOCOM adjustment will typically increase.

We recorded losses related to LOCOM adjustments totaling \$114 million, \$110 million and \$370 million in 2005, 2004 and 2003, respectively. The slight increase in 2005 as compared to 2004 relates to higher interest rates during the period, which reduced the value of our HFS loans and resulted in higher LOCOM adjustments. In 2003, we purchased a significant volume of mortgage loans in response to the record level of mortgage originations in the primary market as mortgage interest rates reached record lows in the first half of 2003. An increase in interest rates in the second half of 2003 reduced the value of our HFS loans, resulting in a significantly higher amount of LOCOM adjustments in 2003 as compared with 2004.

Gains (Losses) on Fannie Mae Portfolio Securitizations, Net

Portfolio securitizations involve the transfer of mortgage loans or mortgage-related securities from our balance sheet to a trust to create Fannie Mae MBS (whether in the form of single-class Fannie Mae MBS, REMICs or other types of beneficial interests). We may retain an interest in the assets transferred to a trust in a portfolio securitization by receiving a portion of the resulting issued securities. If the transfer qualifies as a sale under SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (a replacement of FASB Statement No. 125)* (SFAS 140), we determine the gain (loss) on sale by allocating the carrying value of the financial assets sold and the interests retained based on their relative estimated fair values. The gain (loss) we recognize is the difference between the cash proceeds from the sale, net of any liabilities assumed, and the cost allocated to the financial assets sold. The timing of the recognition of the gain (loss) is dependent upon meeting specific accounting criteria. As a result, the gain (loss) on sale may be recorded in a different accounting period than

the period in which the securitization is completed. In addition, we may securitize financial assets in a different accounting period than the period in which the financial assets were purchased. See Notes to Consolidated Financial Statements Note 1, Summary of Significant Accounting Policies and Notes to Consolidated Financial Statements Note 6, Portfolio Securitizations for additional information on our accounting for Fannie Mae portfolio securitizations.

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Gains or losses on Fannie Mae portfolio securitizations in any given period are primarily affected by the level of securitization activity, the carrying amount of the financial assets sold, and changes in interest rates and prices from the time the financial assets are purchased until the completion of the securitization. We may record losses on portfolio securitizations because we are required to recognize a liability for the fair value of our guaranty obligation in determining the gain or loss on the sale. Cash proceeds from portfolio securitizations totaled \$55.0 billion, \$12.3 billion and \$7.2 billion in 2005, 2004 and 2003, respectively, and we recognized net gains on these transactions of \$259 million in 2005 and net losses of \$34 million and \$13 million in 2004 and 2003, respectively.

Gains on Sale of Investment Securities, Net

Gains and losses on the sale of investment securities in any given period are primarily affected by the volume of sales and changes in interest rates and prices from the time the securities are purchased until the time they are sold. We recorded net gains of \$225 million, \$185 million and \$87 million in 2005, 2004 and 2003, respectively, primarily related to the sale of securities totaling \$113.6 billion, \$18.4 billion and \$24.7 billion, respectively.

We began to increase the level of sales from our mortgage portfolio beginning in the latter part of 2004. Competition for mortgage assets during 2005 generally increased the number of economically attractive opportunities to sell certain mortgage assets, resulting in a sizeable increase in portfolio sales during 2005. These sales were aligned with our need to lower portfolio balances to achieve our capital plan objectives.

Unrealized Gains (Losses) on Trading Securities, Net

Trading securities are carried at fair value with unrealized gains and losses recorded in earnings. We expect unrealized gains and losses on trading securities to fluctuate each period with changes in volumes, interest rates and market prices. Generally, increases in medium- and long-term interest rates result in losses on mortgage-related securities classified as trading and decreases in interest rates result in gains. We recorded net unrealized losses on trading securities of \$415 million in 2005, net unrealized gains of \$24 million in 2004 and net unrealized losses of \$97 million in 2003. The increase in medium- and long-term interest rates during 2005 caused the fair value of our trading securities to decline, resulting in significant unrealized losses for the year. We experienced unrealized gains on trading securities during 2004 due to the modest decrease in long-term interest rates from the end of 2003 to the end of 2004. In 2003, an increase in interest rates in the second half of the year resulted in unrealized losses for the year.

Derivatives Fair Value Losses, Net

We record all derivatives as either assets or liabilities in the consolidated balance sheets at estimated fair value and recognize changes in fair value in our consolidated statements of income. Changes in the fair value of our derivatives, including mortgage commitments, resulted in losses of \$4.2 billion, \$12.3 billion and \$6.3 billion in 2005, 2004 and 2003, respectively. Included in these derivatives fair value loss amounts are net contractual interest expense accruals on interest rate swaps totaling \$1.3 billion, \$5.0 billion and \$6.4 billion in 2005, 2004 and 2003, respectively, which we consider to be part of the cost of funding our mortgage investments. Had we elected to fund our mortgage investments with long-term fixed-rate debt instead of a combination of short-term variable-rate debt and interest rate swaps, the expense related to our interest rate swap accruals would have been reflected as interest expense instead of as a component of our derivatives fair value losses.

To fully understand the derivatives fair value gains and losses recognized in our consolidated statements of income, it is important to examine the gains and losses in the context of our overall interest rate risk management objectives and strategy, including the economic objective in our use of various types of derivative instruments, the factors that drive changes in the fair value of our derivatives, how these factors affect changes in the fair value of other assets and

liabilities, and the differences in accounting for our derivatives and other financial instruments.

While we use debt instruments as the primary means to fund our mortgage investments and manage our interest rate risk exposure, we supplement our issuance of debt with interest rate-related derivatives to manage the prepayment and duration risk inherent in our mortgage investments. As an example, by combining a pay-

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fixed swap with short-term variable-rate debt, we can achieve the economic effect of converting short-term variable-rate debt into long-term fixed-rate debt. By combining a pay-fixed swaption with short-term variable-rate debt, we can achieve the economic effect of converting short-term variable-rate debt into long-term callable debt. The cost of derivatives used in our management of interest rate risk is an inherent part of the cost of funding and hedging our mortgage investments and is economically similar to the interest expense that we recognize on the debt we issue to fund our mortgage investments. However, because we do not apply hedge accounting to our derivatives, the fair value gains or losses on our derivatives, including the periodic net contractual interest expense accruals on our swaps, are reported as Derivatives fair value losses, net in our consolidated statements of income rather than as interest expense.

Our derivatives consist primarily of over-the-counter (OTC) contracts and commitments to purchase and sell mortgage assets that are valued using a variety of valuation models. The valuation model that we select to estimate the fair value of our derivatives requires assumptions and inputs, such as market prices, yield curves and measures of interest rate volatility, which may require judgment. Accordingly, we have identified the estimation of the fair value of our derivatives as a critical accounting policy, which we discuss further in Critical Accounting Policies and Estimates Fair Value of Financial Instruments Sensitivity Analysis for Risk Management Derivatives and Notes to Consolidated Financial Statements Note 18, Fair Value of Financial Instruments. The primary factors affecting changes in the fair value of our derivatives include the following:

Changes in the level of interest rates: Because our derivatives portfolio as of December 31, 2005, 2004 and 2003 predominately consisted of pay-fixed swaps, we typically reported declines in fair value as interest rates decreased and increases in fair value as interest rates increased. As part of our economic hedging strategy, these derivatives, in combination with our debt issuances, are intended to offset changes in the fair value of our mortgage assets, which tend to increase in value when interest rates decrease and, conversely, decrease in value when interest rates rise.

Implied interest rate volatility: We purchase option-based derivatives to economically hedge the embedded prepayment option in our mortgage investments. A key variable in estimating the fair value of option-based derivatives is implied volatility, which reflects the market's expectation about the future volatility of interest rates. Assuming all other factors are held equal, including interest rates, a decrease in implied volatility would reduce the fair value of our derivatives and an increase in implied volatility would increase the fair value. The time remaining until our option-based derivatives expire is another important factor that affects the fair value. As the remaining life of an option shortens, the time value decreases and becomes less sensitive to changes in implied interest rate volatility. Time value is the amount by which the price of the option exceeds its intrinsic value.

Changes in our derivative activity: As interest rates change, we are likely to take actions to rebalance our portfolio to manage our interest rate exposure. As interest rates decrease, expected mortgage prepayments are likely to increase, which reduces the duration of our mortgage investments. In this scenario, we generally will rebalance our existing portfolio to manage this risk by terminating pay-fixed swaps or adding receive-fixed swaps, which shortens the duration of our liabilities. Conversely, when interest rates increase and the duration of our mortgage assets increases, we are likely to rebalance our existing portfolio by adding pay-fixed swaps that have the effect of extending the duration of our liabilities. We also add derivatives in various interest rate environments to hedge the risk of incremental mortgage purchases that we are not able to accomplish solely through our issuance of debt securities.

The following tables show the impact of derivatives on our consolidated statements of income and consolidated balance sheets. Table 8 provides an analysis of changes in the estimated fair value of the net derivative asset (liability), excluding mortgage commitments, recorded in our consolidated balance sheets during the periods December 31, 2005, 2004 and 2003, including the components of the derivatives fair value gains (losses) recorded in our consolidated statements of income. As indicated in Table 8, we recorded a net derivative asset, excluding

mortgage commitments, of \$4.4 billion and \$5.4 billion in our consolidated balance sheets as of December 31, 2005 and 2004, respectively. The general effect on our consolidated financial

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statements of the changes in the estimated fair value of our derivatives shown in this table is described following the table.

Table 8: Changes in Risk Management Derivative Assets (Liabilities) at Fair Value, Net⁽¹⁾

	As of December 31,		
	2005	2004	2003
	(Dollars in millions)		
Beginning net derivative asset (liability) ⁽²⁾	\$ 5,432	\$ 3,988	\$ (3,365)
Effect of cash payments:			
Fair value at inception of contracts entered into during the period ⁽³⁾	846	2,998	5,221
Fair value at date of termination of contracts settled during the period ⁽⁴⁾	879	4,129	1,520
Periodic net cash contractual interest payments	1,632	6,526	5,365
Total cash payments	3,357	13,653	12,106
Income statement impact of recognized amounts:			
Periodic net contractual interest expense accruals on interest rate swaps	(1,325)	(4,981)	(6,363)
Net change in fair value during the period	(3,092)	(7,228)	1,610
Derivatives fair value losses, net ⁽⁵⁾	(4,417)	(12,209)	(4,753)
Ending derivative asset ⁽²⁾	\$ 4,372	\$ 5,432	\$ 3,988
Derivatives fair value gains (losses) attributable to:			
Periodic net contractual interest expense accruals on interest rate swaps	\$ (1,325)	\$ (4,981)	\$ (6,363)
Net change in fair value of terminated derivative contracts from end of prior year to date of termination	(1,434)	(4,096)	(1,103)
Net change in fair value of outstanding derivative contracts, including derivative contracts entered into during the period	(1,658)	(3,132)	2,713
Derivatives fair value losses, net ⁽⁵⁾	\$ (4,417)	\$ (12,209)	\$ (4,753)

(1) Excludes mortgage commitments.

(2) Represents the net of Derivative assets at fair value and Derivative liabilities at fair value recorded in our consolidated balance sheets, excluding mortgage commitments.

(3) Primarily includes upfront premiums paid on option contracts, which totaled \$853 million, \$3.0 billion and \$5.1 billion in 2005, 2004 and 2003, respectively. Also includes upfront cash paid or received on other derivative contracts. Additional detail on option premium payments provided in Table 9.

(4) Primarily represents cash paid upon termination of derivative contracts. The weighted average life in years at termination was approximately 15.5 years, 8.1 years and 6.7 years for contracts terminated in 2005, 2004 and 2003, respectively. The fair value at date of termination of contracts settled during 2002 totaled \$7.6 billion and

had a weighted average life at termination of approximately 5.2 years.

- (5) Reflects net derivatives fair value losses recognized in the consolidated statements of income, excluding mortgage commitments.

Amounts presented in Table 8 have the following effect on our consolidated financial statements:

Cash payments made to purchase options (purchased options premiums) increase the derivative asset recorded in the consolidated balance sheets.

Cash payments to terminate and/or sell derivative contracts reduce the derivative liability recorded in the consolidated balance sheets.

Periodic interest payments on our interest rate swap contracts also reduce the derivative liability as we accrue these amounts based on the contractual terms and recognize the accrual as an increase to the net derivative liability recorded in the consolidated balance sheets. The corresponding offsetting amount is recorded as expense and included as a component of derivatives fair value losses in the consolidated statements of income.

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Changes in the estimated fair value of our derivatives that result in a loss are recorded as an increase to the derivative liability or as a decrease to the derivative asset recorded in the consolidated balance sheets. The corresponding offsetting amount is recorded as a component of derivatives fair value losses in the consolidated statements of income.

Changes in the estimated fair value of our derivatives that result in a gain are recorded as a decrease to the derivative liability or as an increase to the derivative asset recorded in the consolidated balance sheets. The corresponding offsetting amount is recorded as a component of derivatives fair value gains in the consolidated statements of income.

The upfront premiums we pay to enter into option contracts primarily relate to swaption agreements, which give us the right to enter into a specific swap for a defined period of time at a specified rate. We can exercise the option up to the designated date. Table 9 below provides information on our option activity during 2005 and the amount of outstanding options as of December 31, 2005 based on the original premiums paid.

Table 9: Purchased Options Premiums⁽¹⁾

	Original Premium Payments	Original Weighted Average Life to Expiration (Dollars in millions)	Remaining Weighted Average Life
Outstanding options as of December 31, 2004	\$ 13,230	5.6 years	4.0 years
Purchases ⁽²⁾	853		
Exercises	(1,027)		
Expirations	(1,398)		
Outstanding options as of December 31, 2005	\$ 11,658	6.5 years	4.3 years

⁽¹⁾ As of December 31, 2003, the estimated amount of outstanding options based on the original premiums paid, the original weighted average life to expiration and the remaining weighted average life were \$12.5 billion, 4.8 years and 3.7 years, respectively. As of December 31, 2002, the estimated amount of outstanding options based on the original premiums paid, the original weighted average life to expiration and the remaining weighted average life were \$9.4 billion, 3.3 years and 2.8 years, respectively.

⁽²⁾ Amount of purchases is included in Table 8 as a component of the line item Fair value at inception of contracts entered into during the period. Purchases for 2004 and 2003 are included in Footnote 3 of Table 8.

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Table 10 provides additional detail on the derivatives fair value gains and losses recognized in our consolidated statements of income for 2005, 2004 and 2003 by type of derivative instrument. The 5-year interest rate swap rate, which is shown below in Table 10 as of the end of each quarter for the respective years, is a key reference interest rate affecting the estimated fair value of these derivatives.

Table 10: Derivatives Fair Value Gains (Losses), Net

	For the Year Ended December 31,		
	2005	2004	2003
	(Dollars in millions)		
Risk management derivatives:			
Swaps:			
Pay-fixed	\$ 549	\$ (10,640)	\$ (4,269)
Receive-fixed	(1,118)	3,917	1,849
Basis swaps	(2)	51	(1)
Foreign currency swaps	(673)	379	695
Swaptions:			
Pay-fixed	(1,393)	(3,841)	387
Receive-fixed	(2,071)	(1,913)	(3,047)
Interest rate caps	283	(140)	(339)
Other ⁽¹⁾	8	(22)	(28)
Risk management derivatives fair value losses, net	(4,417)	(12,209)	(4,753)
Mortgage commitment derivatives fair value gains (losses), net ⁽²⁾	221	(47)	(1,536)
Total derivatives fair value losses, net	\$ (4,196)	\$ (12,256)	\$ (6,289)
	2005	2004	2003
5-year swap rate:			
Quarter ended March 31	4.63%	3.17%	3.18%
Quarter ended June 30	4.15	4.30	2.76
Quarter ended September 30	4.66	3.81	3.24
Quarter ended December 31	4.88	4.02	3.64

(1) Includes MBS options, forward starting debt, forward purchase and sale agreements, swap credit enhancements, mortgage insurance contracts and exchange-traded futures.

(2) The subsequent recognition in our consolidated statements of income associated with cost basis adjustments that we record upon the settlement of mortgage commitments accounted for as derivatives resulted in expense of approximately \$870 million, \$541 million and \$883 million in 2005, 2004 and 2003, respectively. These amounts are reflected in our consolidated statements of income as a component of either Net interest income or Investment losses, net.

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Table 11 provides additional detail on the estimated fair value of derivatives recorded in our consolidated balance sheets and the related outstanding notional amount by derivative instrument type as of December 31, 2005 and 2004. We describe our risk management derivative activity in Risk Management Interest Rate Risk Management and Other Market Risks. We describe our credit exposure on our risk management derivatives in Risk Management Credit Risk Management Institutional Counterparty Credit Risk Management.

Table 11: Notional and Fair Value of Derivatives

	As of December 31,			
	2005	Estimated	2004	Estimated
	Notional	Fair	Notional	Fair
	Amount	Value ⁽¹⁾	Amount	Value ⁽¹⁾
	(Dollars in millions)			
Risk management derivatives:				
Swaps:				
Pay-fixed	\$ 188,787	\$ (2,954)	\$ 142,017	\$ (6,687)
Receive-fixed	123,907	(1,301)	81,193	479
Basis swaps	4,000	(2)	32,273	7
Foreign currency swaps	5,645	200	11,453	686
Swaptions:				
Pay-fixed	149,405	2,270	170,705	3,370
Receive-fixed	138,595	6,202	147,570	7,711
Interest rate caps	33,000	436	104,150	638
Other ⁽²⁾	776	69	733	84
Risk management derivatives excluding accrued interest	644,115	4,920	690,094	6,288
Accrued interest		(548)		(856)
Total risk management derivatives	\$ 644,115	\$ 4,372	\$ 690,094	\$ 5,432
Mortgage commitment derivatives:				
Mortgage commitments to purchase whole loans	\$ 2,081	\$ 6	\$ 2,118	\$ 4
Forward contracts to purchase mortgage-related securities	17,993	62	20,059	43
Forward contracts to sell mortgage-related securities	19,120	(66)	18,423	(35)
Total mortgage commitment derivatives	\$ 39,194	\$ 2	\$ 40,600	\$ 12

(1) Represents the net amount of Derivative assets at fair value and Derivative liabilities at fair value in the consolidated balance sheets.

(2) Includes MBS options, swap credit enhancements, forward starting debt and the fair value of mortgage insurance contracts that are accounted for as derivatives. These mortgage insurance contracts have payment

provisions that are not based on a notional amount.

As discussed above, because a significant portion of our derivatives consists of pay-fixed swaps, we expect the aggregate estimated fair value of our derivatives to decline and result in derivatives losses when interest rates decline because we are paying a higher fixed rate of interest relative to the current interest rate environment. The \$8.1 billion decrease in derivative losses in 2005 from 2004 was largely attributable to the increase in interest rates during 2005, which increased the aggregate fair value of interest rate swaps and resulted in a significant reduction in the net contractual interest expense recognized on our interest rate swaps. During 2005, we experienced a decrease in the fair value of our option-based derivatives primarily due to time decay of these options and a decrease in implied volatility during 2005. Interest rates have generally trended up since the end of 2005 and remained at overall higher levels through March 2007. As a result, we expect our derivative losses in 2006 to be lower than 2005.

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During 2004, there was a decrease in implied volatility that resulted in a decline in the estimated fair value of our option-based derivatives, including both our pay-fixed and receive-fixed swaptions. Although we recorded derivatives fair value losses of \$12.3 billion in our consolidated statements of income due to the decrease in the estimated fair value of our derivatives, as discussed in Supplemental Non-GAAP Information Fair Value Balance Sheet, the estimated fair value of our net assets (net of tax effect), excluding net capital transactions that included proceeds from the issuance of preferred stock and payment of dividends, increased by \$8.9 billion in 2004. This increase was driven in part by an increase in the estimated fair value of our mortgage assets that resulted from the decrease in implied volatility.

While changes in the estimated fair value of our derivatives resulted in net expense in each reported period, we incurred this expense as part of our overall interest rate risk management strategy to economically hedge the prepayment and duration risk of our mortgage investments. As more fully described in Risk Management Interest Rate Risk Management and Other Market Risks, we believe our duration gap, which is a measure of the difference between the estimated durations of our interest rate sensitive assets and liabilities, is a useful tool in assessing our interest rate exposure and our management thereof as it shows the extent to which changes in the fair value of our mortgage investments are offset by changes in the fair value of our debt and derivatives.

In 2003, we announced the implementation of new corporate financial disciplines that resulted in our taking less interest rate exposure, which had the effect of reducing the potential for economic losses resulting from changes in interest rates but also reducing the potential for economic gains. As part of these disciplines, we committed to managing the portfolio's duration gap within a target range of plus or minus six months substantially all of the time. Our duration gap has not exceeded plus or minus one month for any month since October 2004. We present our monthly duration gap for the period January 1, 2003 to December 31, 2005 in Risk Management Interest Rate Risk Management and Other Market Risks Measuring Interest Rate Risk. To maintain our duration gap within the tighter tolerances, we issue more callable debt, purchase more options and take rebalancing actions earlier and with greater frequency than we did prior to adopting this policy. However, the increased level of optionality provided by our callable debt and option-based derivatives generally reduces the magnitude of rebalancing actions needed for a given change in interest rates. The effects of our investment strategy, including our interest rate risk management, are reflected in changes in the estimated fair value of our net assets over time.

Debt Extinguishment Losses, Net

We call debt securities in order to reduce future debt costs as a part of our integrated interest rate risk management strategy. We also repurchase debt in order to enhance the liquidity of our debt. Debt extinguishment losses (and gains) are affected by the level of debt extinguishment activity and the price performance of our debt securities. Typically, the amount of debt repurchased has a greater impact on gains and losses recognized on debt extinguishments than the amount of debt called. Debt repurchases, unlike debt calls, may require the payment of a premium and therefore result in higher extinguishment costs. As a result, we historically have generally repurchased high interest rate debt at times (and in amounts) when we believed we had sufficient income available to absorb or offset those higher costs.

We recognized a pre-tax loss of \$68 million in 2005 from the repurchase of \$22.9 billion and call of \$28 billion of debt. In comparison, we recognized a pre-tax loss of \$152 million in 2004 from the repurchase of \$4.3 billion and call of \$155.6 billion of debt, and a pre-tax loss of \$2.7 billion in 2003 from the repurchase of \$19.8 billion and call of \$188.7 billion of debt. As interest rates began to rise in 2004, we began to curb our debt repurchase activity.

Loss from Partnership Investments

We make numerous investments in limited partnerships, which primarily include investments in LIHTC partnerships that sponsor affordable housing projects. These investments assist us in achieving our affordable housing mission and also provide a return on capital by generating tax credits and net operating losses that reduce our federal income tax liability. Our partnership investments totaled approximately \$9.3 billion and \$8.1 billion as of December 31, 2005 and 2004, respectively. In some cases, we consolidate these entities in

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our financial statements. In other cases, we account for these investments using the equity method and record our share of operating losses in the consolidated statements of income as Loss from partnership investments. Investments we accounted for under the equity method totaled \$4.5 billion and \$4.2 billion as of December 31, 2005 and 2004, respectively. We provide additional information about these investments and applicable accounting in Off-Balance Sheet Arrangements and Variable Interest Entities LIHTC Partnership Interests.

Loss from partnership investments, net, accounted for under the equity method totaled \$849 million, \$702 million and \$637 million in 2005, 2004 and 2003, respectively. The increase in losses in each year was primarily due to our increased level of LIHTC partnership investments. In March 2007, we sold a portfolio of investments in LIHTC partnerships totaling approximately \$676 million in LIHTC credits. These equity interests represented less than 10% of our overall LIHTC portfolio. We may sell LIHTC investments in the future if we believe that the economic return from the sale will be greater than the benefit we would receive from continuing to hold these investments. However, we view these investments as a significant channel for advancing our affordable housing mission and expect to continue to invest in LIHTC partnerships, which we expect will generate additional net operating losses and tax credits in the future. For more information on tax credits associated with our LIHTC investments, refer to Provision for Federal Income Taxes below.

Provision for Credit Losses

The provision for credit losses results from a detailed analysis estimating an appropriate allowance for loan losses for single-family and multifamily loans classified as held for investment in our mortgage portfolio and reserve for guaranty losses for credit-related losses associated with certain mortgage loans that back Fannie Mae MBS held in our portfolio and held by other investors. The provision for credit losses may reflect an increase or decrease, depending on whether we need to increase or decrease the allowance for loan losses and reserve for guaranty losses based on our estimate of incurred losses in our portfolio as of each balance sheet date.

The provision for credit losses increased to \$441 million in 2005, an increase of \$89 million, or 25%, from the provision in 2004. We recorded a provision for credit losses of \$106 million in 2005 for single-family and multifamily properties affected by Hurricane Katrina. We initially estimated for the Gulf Coast Hurricanes Katrina and Rita a range of after-tax losses of \$250 million to \$550 million (pre-tax range of \$385 million to \$846 million). However, as more information became available, we determined that property damage was less extensive than had been previously estimated, the amount of insurance recoveries were greater than previously expected, and Hurricane Rita did not have a significant impact on our credit losses. Because we had information regarding the probable amount of this existing loss contingency available to us prior to issuing our 2005 consolidated financial statements, we were required to record the most recent estimated loss amount of \$106 million in the period it arose based on information available at the time of the issuance of the consolidated financial statements. We also increased our provision for credit losses as a result of our adoption of Statement of Position 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer* (SOP 03-3). Under SOP 03-3, we are required to record loans we purchase from Fannie Mae MBS trusts due to default at fair value because these loans have deteriorated in credit quality since origination. The excess of the purchase price over the fair value, if any, is recorded as a charge to Reserve for guarantee losses in the consolidated balance sheet.

The provision for credit losses decreased slightly to \$352 million in 2004, down \$13 million, or 4%, from 2003. An observed trend of reduced levels of recourse proceeds from lenders on charged-off loans had the effect of increasing the provision for credit losses in 2004; however, lower than anticipated charge-offs more than offset this increase, leading to a slight reduction in the provision compared to 2003.

We provide additional detail on credit losses and factors affecting our allowance for loan losses and reserve for guaranty losses in Risk Management Credit Risk Management Mortgage Credit Risk Management and Critical

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Other Non-Interest Expense

Foreclosed Property Expense (Income)

Foreclosed property expense (income) includes gains and losses on the sale of acquired properties and valuation losses on REO properties held for sale. Foreclosed property expense (income) is affected by the level of foreclosures and the loss severity rate (average loss per case). Home price appreciation and credit enhancements generally reduce the severity of our losses.

We recorded foreclosed property income of \$13 million in 2005, expense of \$11 million in 2004 and income of \$12 million in 2003. The acceleration of home prices during this period helped to mitigate our foreclosure losses and resulted in gains on the sale of certain REO properties. The slowdown in the housing market during 2006 and the first quarter of 2007 has resulted in substantially lower home price appreciation and home price declines in some regions, which is likely to increase the level of foreclosures as well as our loss severity rates. As a result, we expect our credit losses to increase for 2006 and 2007. We provide additional detail on our management of credit losses, including foreclosed property expense, in Risk Management Credit Risk Management Mortgage Credit Risk Management.

Administrative Expenses

Administrative expenses include costs incurred to run our daily operations, such as salaries and employee benefits, professional services, occupancy expense and technology expenses. Administrative expenses totaled \$2.1 billion in 2005, up \$459 million, or 28%, over 2004, primarily related to costs associated with our restatement and related regulatory examinations, investigations and litigation defense, which totaled approximately \$570 million in 2005. Administrative expenses totaled \$1.7 billion in 2004, up \$202 million, or 14%, over 2003, primarily due to the write off of \$159 million of software that had been previously capitalized in conjunction with the reengineering of our core technology infrastructure.

Costs associated with the restatement process and related regulatory examinations, investigations and litigation defense also significantly increased our administrative expenses in 2006. Further increasing our administrative expenses in 2006 were costs attributable to or associated with the preparation of our consolidated financial statements and periodic SEC financial reports for periods through 2004, as well as control remediation activities and increased headcount to support these efforts. Administrative expenses totaled an estimated \$3.1 billion in 2006, of which approximately \$850 million was attributable to the restatement process and related regulatory examinations, investigations and litigation defense and approximately \$200 million was attributable to or associated with the preparation of our financial statements for periods subsequent to 2004. We anticipate that the costs associated with the preparation of our post-2004 consolidated financial statements and periodic SEC reports will continue to have a substantial impact on administrative expenses at least until we are current in filing our periodic financial reports with the SEC.

We have recently implemented cost-cutting measures in an effort to reduce our administrative expenses for future periods, which we expect will reduce our administrative expenses by approximately \$200 million for 2007 as compared with 2006. We also expect to reduce our administrative expenses, excluding costs associated with returning to timely financial reporting, to approximately \$2 billion per year in 2008. This amount is significantly higher than our historical level of administrative expenses because of the significant investment we have made to remediate material weaknesses in our internal controls by enhancing our organizational structure and systems.

Other Expenses

Other expenses include credit enhancement expenses that relate to costs associated with the purchase of additional mortgage insurance to protect against credit losses, regulatory penalties and other miscellaneous expenses. Other expenses totaled \$251 million, \$607 million and \$156 million in 2005, 2004 and 2003, respectively. The decrease in 2005 as well as the increase in 2004 over 2003 primarily stems from the recognition in 2004 of the \$400 million civil penalty that we paid to the U.S. Treasury in 2006 pursuant to our settlements with OFHEO and the SEC.

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Provision for Federal Income Taxes

The provision for federal income taxes includes deferred tax expense plus current tax expense. Deferred tax expense represents the net change in the deferred tax asset or liability balance during the year plus any change in a valuation allowance. The current tax expense represents the amount of tax currently payable to or receivable from tax authorities. The provision for income taxes does not include the tax effect related to adjustments recorded in AOCI.

Our effective income tax rate, excluding the provision for taxes related to extraordinary amounts and the cumulative effect of change in accounting principle, was reduced below the 35% statutory rate to 17%, 17% and 24% in 2005, 2004 and 2003, respectively. The difference between the statutory rate and our effective tax rate is primarily due to the tax benefits we receive from our investments in LIHTC partnerships that help in supporting our affordable housing mission. As disclosed in Notes to Consolidated Financial Statements Note 10, Income Taxes, our effective tax rate would have been 30%, 32% and 31% in 2005, 2004 and 2003, respectively, had we not received the tax benefits from our investments in LIHTC partnerships.

The variance in our effective income tax rate over the past three years is primarily due to the combined effect of fluctuations in our pre-tax income, which affects the relative tax benefit of tax-exempt income and tax credits, and an increase in the actual dollar amount of tax credits. Our effective income tax rate may vary from period to period, depending on, among other factors, our earnings and the level of tax credits. We expect tax credits resulting from our investments in LIHTC partnerships to grow in the future, which is likely to reduce our effective tax rate assuming we are able to use all of the tax credits generated. The extent to which we are able to use all of the tax credits generated by existing or future investments in housing tax credit partnerships to reduce our federal income tax liability will depend on the amount of our future federal income tax liability, which we cannot predict with certainty. In addition, our ability to use tax credits in any given year may be limited by the corporate alternative minimum tax rules, which ensure that corporations pay at least a minimum amount of federal income tax annually. For 2005, we were not able to use all the tax credits we received because our income tax liability, after applying all such credits, would have been reduced below the minimum tax amount. We were able to apply a portion of these unused credits to reduce our income tax liability for 2004. We expect to use the remainder in future years, to the extent permissible, and may evaluate selling any potential unusable tax credits if we determine that we can generate a greater economic return from selling versus holding certain LIHTC investments.

We recorded a net deferred tax asset of \$7.7 billion and \$6.1 billion as of December 31, 2005 and 2004, respectively. We have not recorded a valuation allowance against our net deferred tax asset as we anticipate it is more likely than not that the results of future operations will generate sufficient taxable income to realize the entire tax benefit.

Extraordinary Gains (Losses), Net of Tax Effect

When we determine that we are the primary beneficiary of a VIE under FIN 46R, we are required to consolidate the assets and liabilities of the VIE in our consolidated financial statements at fair value. Effective with the adoption of FIN 46R, any difference between the then fair value and the previous carrying amount of our interests in the VIE is recorded as an extraordinary gain (loss), net of tax effect, in our consolidated statements of income. As a result of our adoption of FIN 46R in 2003, we recorded an extraordinary gain, net of tax effect, of \$195 million due to the consolidation of VIEs.

Table of Contents**BUSINESS SEGMENT RESULTS**

Table 12 provides a summary of the financial results for each of our business segments for the years ended December 31, 2005, 2004 and 2003.

Table 12: Business Segment Results Summary

	For the Year Ended December 31,			Increase (Decrease)			
	2005	2004	2003	2005 vs. 2004		2004 vs. 2003	
				\$	%	\$	%
(Dollars in millions)							
Revenues: ⁽¹⁾							
Single-Family Credit Guaranty	\$ 5,805	\$ 5,153	\$ 4,994	\$ 652	13%	\$ 159	3%
Housing and Community Development	743	538	398	205	38	140	35
Capital Markets	43,601	46,135	47,293	(2,534)	(5)	(1,158)	(2)
Total	\$ 50,149	\$ 51,826	\$ 52,685	\$ (1,677)	(3)%	\$ (859)	(2)%
Net income:							
Single-Family Credit Guaranty	\$ 2,889	\$ 2,514	\$ 2,481	\$ 375	15%	\$ 33	1%
Housing and Community Development	462	337	286	125	37	51	18
Capital Markets	2,996	2,116	5,314	880	42	(3,198)	(60)
Total	\$ 6,347	\$ 4,967	\$ 8,081	\$ 1,380	28%	\$ (3,114)	(39)%

As of December 31,
2005 **2004**

Total assets:					
Single-Family Credit Guaranty	\$ 12,871	\$ 11,543		\$ 1,328	12%
Housing and Community Development	11,829	10,166		1,663	16
Capital Markets Group	809,468	999,225		(189,757)	(19)
Total	\$ 834,168	\$ 1,020,934		\$ (186,766)	(18)%

⁽¹⁾ Includes interest income, guaranty fee income, and fee and other income.

We use various methodologies to allocate certain balance sheet and income statement amounts between operating segments. For a description of our allocation methodologies and more financial detail on our business segments, see Notes to Consolidated Financial Statements Note 14, Segment Reporting. Following is an analysis and discussion of the performance of our business segments.

Single-Family Credit Guaranty Business

Our Single-Family Credit Guaranty business generated net income of \$2.9 billion, \$2.5 billion and \$2.5 billion in 2005, 2004 and 2003, respectively. The primary source of revenue for our Single-Family business is guaranty fee income. Other sources of revenue include technology and other fees and interest income. Expenses primarily include administrative expenses and credit-related expenses, including the provision for credit losses.

Net income for the Single-Family business segment increased by \$375 million or 15% in 2005 from 2004, primarily due to higher interest income and guaranty fee income offset by an increase in our provision for credit losses and administrative expenses. Interest income earned on cash flows from the date of the remittance by servicers to us until the date of distribution by us to MBS certificate holders, commonly referred to as float income, increased by \$282 million as a result of higher short-term interest rates throughout 2005. Guaranty fee income for 2005 increased slightly from 2004 as the average single-family mortgage credit book of business increased 3%. The average effective guaranty fee rate remained essentially unchanged from year to year.

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Expenses increased 13% in 2005 due in part to the segment's allocation of a portion of the costs associated with our restatement and related matters.

The provision for credit losses increased by 46% to \$454 million in 2005, primarily attributable to our provision for credit losses related to Hurricane Katrina and our implementation of SOP 03-3. The provision for credit losses includes \$105 million associated with Hurricane Katrina. As discussed further in Risk Management Mortgage Credit Risk Management Credit Losses, we have reduced and refined the initial estimate of the potential impact of Hurricane Katrina that we disclosed in 2005. This reduction results from several factors, including the liquidation of a number of the loans relating to flooded properties from our mortgage portfolio that resulted in no losses, the amount of insurance recoveries being greater than previously expected on the flooded properties and reduced delinquencies for affected loans within the flood-damaged areas.

Net income for the Single-Family business segment remained essentially unchanged in 2004 from 2003, with an increase in guaranty fee income offset by lower fee and other income, and higher expenses. Guaranty fee income increased by 6% in 2004 from 2003, primarily due to growth in average single-family mortgage credit book of business in 2004. The average effective guaranty fee rate on single-family Fannie Mae MBS remained essentially unchanged in 2004 as compared to 2003. This increase in guaranty fee income was offset primarily by an increase in other expenses in 2004 due to the allocation of a portion of the \$400 million civil penalty paid to the U.S. Treasury in connection with our settlements with the SEC and OFHEO; and a decline in fee and other income due to reduced fees from technology-related transactions resulting from reduced transaction volume.

Our credit losses remained low in 2005 and 2004. The rapid acceleration in home prices during the period from 1999 to 2005, combined with our use of credit enhancements, helped to mitigate our credit losses. Our conventional single-family serious delinquency rate increased to 0.79% in December 2005, compared with 0.63% in December 2004, as a result of Hurricane Katrina in 2005. Our conventional single-family serious delinquency rate subsequently improved as a result of the factors described above, dropping to 0.65% in December 2006. As a result of the significant slowdown in home price appreciation during 2006 and our belief that home prices could decline modestly in 2007, we expect credit losses will increase in future periods.

During 2005 and 2004, there was intense competition for the purchase of mortgage assets by a growing number of mortgage investors through a variety of investment vehicles and structures. During these years, in a steeper interest rate curve environment and with a variety of new mortgage products being introduced and accepted by investors, consumers took advantage of adjustable-rate mortgages, including non-traditional products such as interest-only ARMs, negative-amortizing ARMs and a variety of other product and risk combinations. The increased demand for floating-rate and subprime mortgage loans accelerated the growth of competing securitization options in the form of private-label mortgage-related securities. The demand for these products continued throughout 2006 and slowed in 2007.

Single-family mortgage originations posted the second strongest year in history at \$3.0 trillion (\$1.5 trillion for home purchase and \$1.5 trillion for refinancing) in 2005, up approximately 9% from 2004. However, based on our assessment of the underlying risk, we made a strategic decision to not pursue the guaranty of a significant portion of mortgage loan originations during 2004 and 2005. In doing so, we ceded market share of new single-family mortgage-related securities issuances to private-label issuers. Our estimated overall market share of new mortgage-related securities issuance declined to 23.5% in 2005, compared with 29.2% in 2004 and 45.0% in 2003. These estimates of market share are based on publicly available data and exclude previously securitized mortgages. In 2006, single-family mortgage originations fell to \$2.8 trillion and our market share remained essentially unchanged from 2005.

Our conventional single-family mortgage credit book of business remained relatively stable from 2004 to 2005. We believe that our assessment and approach to the management of credit risk during these years allowed us to maintain a conventional single-family mortgage credit book of business with strong credit risk characteristics. The weighted average original loan-to-value ratio and weighted average mark-to-market loan-to-value ratio for our conventional single-family mortgage credit book of business were 70% and 53%, respectively, as of December 31, 2005. The weighted average credit score for our conventional single-family

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mortgage credit book of business was 721 as of December 31, 2005. These credit risk characteristics were substantially the same as of December 31, 2006. We discuss the characteristics of our conventional single-family mortgage credit book of business in greater detail in Risk Management Mortgage Credit Risk Management Single-Family.

As discussed above, the demand for ARM products, including non-traditional products such as interest-only ARMs and negative-amortizing ARMs, remained higher than historical norms in 2004 and 2005, making up 33% and 32%, respectively, of conventional single-family mortgage originations. The popularity of ARMs declined in 2006, making up 29% of conventional single-family mortgage originations, and has continued to decline in 2007 as a result of the decline in interest rates on fixed-rate mortgages; the decrease in the spread, or difference, between interest rates on fixed-rate mortgages and ARMs; and improvements in housing affordability from the 20-year low recorded in July 2006. Additional factors that we believe may be contributing to the continued decline in the popularity of ARMs include heightened consumer awareness of the risks of certain non-traditional ARM product features, and lender approaches that may be evolving as a result of the interagency guidance on non-traditional mortgages. We believe that these factors may result in many homeowners choosing to refinance into fixed-rate mortgages in anticipation of future interest rate resets on ARMs. We estimate that approximately \$1.1 trillion in ARMs are scheduled to reset at least once during 2007, with approximately an additional \$300 billion scheduled to reset in 2008.

We are focused on understanding and serving our customers' needs, strengthening our relationships with key partners, and helping lenders reach and serve new, emerging and non-traditional markets by providing more flexible, low-cost mortgage options. We also continue to expand our mortgage options for borrowers with weaker credit histories.

HCD Business

Our Housing and Community Development business generated net income of \$462 million, \$337 million and \$286 million in 2005, 2004 and 2003, respectively. The primary sources of revenues for our HCD business are guaranty fee income and fee and other income. Expenses primarily include administrative expenses, credit-related expenses and losses associated with LIHTC and other partnership investments that are offset by the related tax benefits from these investments.

Net income for the HCD business segment increased by \$125 million, or 37%, in 2005 from 2004 as a result of increased tax benefits from tax-advantaged investments and higher fee and other income. HCD makes a variety of partnership investments in affordable housing. These investments include tax-advantaged investments (primarily LIHTC investments) where the economic benefits are primarily derived from tax credits, as well as other affordable housing investments that generate cash flow and equity appreciation. LIHTC investments, which totaled \$7.7 billion in 2005, compared to \$6.8 billion in 2004, comprised the largest proportion of investment activity in 2005. Losses from partnership investments increased by \$147 million as HCD increased its investment activity; however, these losses were more than offset by increased LIHTC tax benefits which were the primary reason for the reduction in our 2005 effective corporate tax rate to 17%. Guaranty fee income was down slightly as the 5% increase in the average multifamily mortgage credit book of business was offset by lower effective guaranty fee rates in 2005. Fee and other income doubled in 2005 to \$628 million primarily due to an increase in multifamily transaction fees caused by higher borrower refinancing activity in 2005 as compared to 2004. Expenses increased 28% in 2005 due to the segments allocation of a portion of the costs associated with our restatement and related matters.

Net income for the HCD business segment increased by 18% in 2004 from 2003, primarily due to an increase in tax benefits from tax-advantaged investments, guaranty fee income and fee and other income. These increases in revenues are partially offset by higher expenses. The increase in income tax benefits was largely attributable to growth in LIHTC and other partnership investment balances, reduced by a 10% increase in pre-tax losses from these partnership investments. Guaranty fee income increased by 25% in 2004, as a result of growth in the average multifamily

mortgage credit book of business in 2004 at stable effective guaranty fee rates. Growth in fee and other income was fueled by increases in multifamily transaction fees that resulted from substantially higher borrower refinancing activity in 2004 compared to 2003. Other expenses increased due to the allocation of a portion of the \$400 million civil penalty paid to the U.S. Treasury in connection

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with our settlements with the SEC and OFHEO, as well as increased direct and allocated costs. Net interest expense increased, reflecting higher internal funding costs due to our increased investment in LIHTC and other equity investments.

We expect tax credits resulting from our investments in LIHTC partnerships to grow in the future, which is likely to reduce our effective tax rate. The extent to which we are able to use all of the tax credits generated by existing or future investments in housing tax credit partnerships to reduce our federal income tax liability will depend on the amount of our future federal income tax liability, which we cannot predict with certainty. However, we may make a strategic decision to sell certain investments in the future as another means of realizing the benefits. In March 2007, we sold a portfolio of investments in LIHTC partnerships totaling approximately \$676 million in LIHTC credits. These equity interests represented less than 10% of our overall LIHTC portfolio. We may sell LIHTC investments in the future if we believe that the economic return from the sale will be greater than the benefit we would receive from continuing to hold these investments. However, we view these investments as a significant vehicle for advancing our affordable housing mission and expect to continue to invest in LIHTC partnerships.

HCD's Multifamily Group benefited from the improvement in multifamily real estate fundamentals during 2005. The two key drivers were an increase in the population of prime apartment renters and solid job growth throughout 2005. These factors contributed to a decline in overall apartment vacancies and an increase in monthly rental rates in 2005. These multifamily real estate fundamentals continued to improve during 2006.

Our multifamily serious delinquency rate increased to 0.32% in December 2005, compared with 0.11% in December 2004, as a result of Hurricane Katrina in 2005. Our multifamily serious delinquency rate subsequently improved, declining to 0.08% in December 2006. As discussed further in Risk Management Mortgage Credit Risk Management Credit Losses, we have reduced and refined our estimate of the potential impact of Hurricane Katrina due to our ongoing loss mitigation activities. We currently do not believe that we have credit concerns on multifamily properties related to the hurricanes.

We are one of the largest participants in the multifamily secondary market. HCD's multifamily business has been challenged in recent years. Competition has been fueled by private-label issuers of CMBS and aggressive bidding for multifamily debt among institutional investors, which reflects the high level of funds available for investment in the secondary mortgage market. We have responded to market challenges with an increased emphasis on serving partner needs with customized lending options and advanced a number of efficiency initiatives that will help make it quicker and easier to do business with us and at a lower cost. HCD continues to grow and diversify its business into new areas that expand the supply of affordable housing, such as increased investment in rental and for-sale housing projects, including LIHTC investments. HCD further enables the expansion of affordable housing stock by participating in specialized debt financing, acquiring mortgage loans from a variety of new public and private partners, and increasing other community lending activities.

Capital Markets Group

Our Capital Markets group generated net income of \$3.0 billion, \$2.1 billion and \$5.3 billion in 2005, 2004 and 2003, respectively. The primary sources of revenues for our Capital Markets group include net interest income and fee and other income. Derivatives fair value losses, investment gains and losses, and debt extinguishment gains and losses also have a significant impact on the financial performance of our Capital Markets group.

Net income for the Capital Markets group increased by \$880 million, or 42%, in 2005 from 2004. The reduction in net interest income and an increase in investment losses were almost completely offset by lower derivatives fair value losses. Net interest income decreased \$6.9 billion, or 39%, in 2005 from 2004 largely due to a 10% decline in the average mortgage portfolio balance resulting from a decrease in securities purchases and an increase in sales activity

throughout 2005. The majority of the portfolio sales and a large portion of portfolio liquidations were comprised of fixed-rate Fannie Mae MBS, which caused the product mix of the portfolio to shift slightly as floating-rate securities and adjustable-rate mortgage products increased as a

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percentage of our total mortgage portfolio. In addition, significant increases in short-term interest rates had the effect of increasing the cost of our short-term debt, which further reduced net interest income.

Investment losses increased from \$446 million in 2004 to \$1.5 billion in 2005 due to higher other-than-temporary impairment on AFS securities and unrealized losses on trading securities as the fair value of our mortgage assets declined due to rising interest rates. The \$1.2 billion in other-than-temporary impairment that we recognized in 2005 related to securities that were written down to fair value because we sold these securities before the interest rate impairment recovered. We did not recognize other-than-temporary impairment on the remaining mortgage-related securities in our portfolio that were in unrealized loss positions during 2005 because we have the intent and ability to hold these securities until full recovery.

Derivatives fair value losses dropped 66% to \$4.2 billion in 2005, reflecting a rise in interest rates that resulted in (i) the fair value of our interest rate derivatives to increase relative to 2004 and (ii) the spread between our pay-fixed and receive-variable swap positions to narrow causing our interest accruals on our interest rate swaps to decrease by \$3.7 billion. The significant increase in fee and other income was primarily attributable to foreign currency exchange gains on our foreign-denominated debt as the dollar strengthened against the Japanese yen in 2005 as compared to 2004. As discussed in Risk Management Interest Rate Risk Management and Other Market Risks , when we issue foreign-denominated debt, we swap out of the foreign currency completely at the time of the debt issue in order to minimize our exposure to currency risk. As such, the aforementioned gains are offset by losses on fair value of the related derivatives.

The \$3.2 billion, or 60%, decrease in the net income of our Capital Markets group in 2004 from 2003 was due to an increase in derivatives fair value losses and a decline in net interest income, partially offset by decreases in debt extinguishment losses, the provision for federal income taxes and investment losses. The \$6.0 billion increase in derivatives fair value losses recorded in 2004 primarily resulted from a decrease in implied volatility that reduced the fair value of our option-based derivatives. Net interest income declined by \$1.3 billion, or 7%, in 2004 from 2003, largely due to a decline in our net interest yield resulting from an increase in short-term interest rates and a shift in portfolio purchases to a greater percentage of adjustable-rate assets with lower initial spreads. Our Capital Markets group undertook a significantly lower level of debt repurchase activity during 2004 compared to 2003, resulting in a \$2.5 billion decrease in debt extinguishment losses. The provision for federal income taxes decreased 70% from 2003 due to significantly lower taxable income. Investment losses declined by \$861 million in 2004 due to a reduction in other-than-temporary impairments on certain assets as compared to 2003.

Table of Contents**Table 13: Mortgage Portfolio Activity⁽¹⁾**

	Purchases ⁽²⁾			Sales			Liquidations ⁽³⁾		
	2005	2004	2003	2005	2004	2003	2005	2004	2003
	(Dollars in millions)								
Mortgage loans:									
Fixed-rate:									
Term	\$ 60,267	\$ 53,305	\$ 98,474	\$ 1	\$ 8	\$ 8	\$ 55,427	\$ 69,182	\$ 135
Intermediate-term ⁽⁴⁾	18,824	23,470	56,591	9			38,603	31,446	37
Fixed-rate loans	79,091	76,775	155,065	10		8	94,030	100,628	172
Variable-rate	5,515	9,118	8,800	41	66		11,392	7,640	6
Mortgage loans	84,606	85,893	163,865	51	66	8	105,422	108,268	179
Mortgage securities:									
Fixed-rate:									
Term	13,630	58,412	292,675	93,910	14,691	18,079	83,861	107,309	257
Intermediate-term ⁽⁵⁾	832	4,834	37,499	12,117	3,460	5,350	6,670	8,097	12
Fixed-rate securities	14,462	63,246	330,174	106,027	18,151	23,429	90,531	115,406	270
Variable-rate	46,359	109,339	31,720	7,562	161	1,283	51,165	24,785	6
Mortgage securities	60,821	172,585	361,894	113,589	18,312	24,712	141,696	140,191	277
Mortgage portfolio	\$ 145,427	\$ 258,478	\$ 525,759	\$ 113,640	\$ 18,378	\$ 24,720	\$ 247,118	\$ 248,459	\$ 456
Liquidation							30.7%	27.9%	

(1) Excludes premiums, discounts and other cost basis adjustments.

(2) Excludes advances to lenders and mortgage-related securities acquired through the extinguishment of debt.

(3) Includes scheduled repayments, prepayments and foreclosures.

(4) Consists of mortgage loans with contractual maturities at purchase equal to or less than 15 years.

(5) Consists of mortgage securities with maturities of 15 years or less at issue date.

Mortgage Investment Activity

Our mortgage investment activities during 2005 were conducted within the context of our capital restoration plan, which was finalized with OFHEO in February 2005. The size of our net mortgage portfolio declined 20% during 2005 to \$736.5 billion as of December 31, 2005, due to a significant increase in portfolio sales, normal liquidations and fewer portfolio purchases. Lowering our net mortgage portfolio enabled us to achieve our capital objective. On November 1, 2005, OFHEO announced that we had achieved a 30% surplus over our statutory minimum capital requirement at September 30, 2005. OFHEO's requirement that we maintain a 30% capital surplus remains in effect at OFHEO's discretion.

Competition for mortgage assets during 2005 generally increased the number of economically attractive opportunities to sell certain mortgage assets, particularly 15-year and 30-year fixed-rate mortgage-related securities, resulting in a sizeable increase in portfolio sales to \$113.6 billion in 2005 compared with \$18.4 billion in 2004. These sales were aligned with our need to lower portfolio balances to achieve our capital plan objectives. While portfolio liquidations in 2005 were comparable to 2004, portfolio purchases were substantially lower in 2005 as compared with 2004 due to narrowing spreads on traditional fixed-rate products as the yield curve flattened, as well as our focus on managing the size of our balance sheet to achieve our capital plan objectives. Portfolio purchases totaled \$145.4 billion in 2005 compared with \$258.5 billion in 2004, and included a much lower proportion of 30-year fixed-rate assets than historical norms.

Our mortgage purchases in 2004 decreased by \$267.3 billion, or 51%, from our purchases in 2003. In 2004, spreads between our debt and mortgage assets were very narrow throughout the year, reflecting both strong investor demand for mortgage assets from banks, funds and other investors. Accordingly, because fewer

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available mortgage assets met our risk/return objectives in 2004 as compared to 2003, we purchased fewer mortgage assets in 2004. In addition, mortgage liquidations in 2004 decreased by \$207.7 billion, or 46%, from liquidations in 2003, due to higher prevailing mortgage rates in 2004, which reduced refinancing activity in 2004 as compared to 2003. Because liquidations of the mortgage assets in our portfolio in 2004 were roughly equal to our purchases of mortgage assets in 2004, our mortgage portfolio balance increased only slightly from 2003 to 2004.

We routinely enter into forward purchase commitments that lock in the future delivery of mortgage loans and mortgage-related securities at a fixed price or yield. Retained commitments are a leading indicator of future acquisition volume and a key driver of earnings growth in our Capital Markets group. Net retained commitments to purchase mortgage assets were \$35.5 billion and \$132.5 billion for year ended December 31, 2005 and December 31, 2006, respectively.

Recent Trends in Mortgage Investment Activity

During 2006 and through the first quarter of 2007, we continued to manage the size of our balance sheet to maintain a 30% capital surplus. Portfolio purchases and sales during 2006 were consistent with the primary objectives of our business model supporting liquidity in the secondary mortgage market and, subject to various constraints, maximizing long-term total returns from our investment activities. Portfolio purchases were higher in 2006 than in 2005. Portfolio sales and liquidations declined significantly in 2006 from 2005. The net impact of purchases, sales and liquidations in 2006 on our net mortgage portfolio balance as of December 31, 2006 was nominal, resulting in our 2006 balance staying essentially unchanged from the balance as of December 31, 2005.

Under our May 23, 2006 consent order with OFHEO, we agreed to continue to maintain a 30% capital surplus over our statutory minimum capital requirement until the Director of OFHEO, in his discretion, determines the requirement should be modified or allowed to expire, taking into account factors such as resolution of accounting and internal control issues. We also agreed not to increase the size of our net mortgage portfolio assets above the amount shown in the minimum capital report to OFHEO as of December 31, 2005 (\$727.75 billion), except in limited circumstances at OFHEO's discretion.

If market conditions change significantly, the limit on the size of our net mortgage portfolio assets could constrain our ability to capitalize fully on economically attractive opportunities to add mortgage portfolio assets to our portfolio. In addition to the portfolio limit, our ability to purchase and sell mortgage assets is also constrained by our risk parameters, operational limitations, regulatory limitations, and limitations related to our analysis of whether we will hold assets until a temporary impairment recovers.

We regularly meet with OFHEO to discuss current market conditions and our mortgage and capital markets activities. In addition, we will contact OFHEO if the market environment changes markedly and we determine that such changes could limit our ability to provide liquidity, meet our housing goals, or compete effectively in the secondary mortgage market while remaining within the portfolio limit prescribed by OFHEO.

On February 28, 2007, we submitted an updated business plan to OFHEO that included a report on our progress in remediating our internal control deficiencies, completing the requirements of the consent order and other matters. OFHEO reviewed our business plan and has directed us to maintain compliance with the \$727.75 billion portfolio cap. Until the Director of OFHEO has determined that modification or expiration of the limitation is appropriate, we will remain subject to this limitation on portfolio growth.

Table 14 shows the balance of our mortgage portfolio, which reflects the net impact of our purchases, sales and liquidations, and the composition of our mortgage portfolio by product type as of December 31, 2005, 2004, 2003, 2002 and 2001.

Table of Contents**Table 14: Mortgage Portfolio Composition⁽¹⁾**

	2005	2004	As of December 31, 2003	2002	2001
	(Dollars in millions)				
Mortgage loans:					
Single-family: ⁽²⁾					
Government insured or guaranteed	\$ 15,036	\$ 10,112	\$ 7,284	\$ 6,404	\$ 6,381
Conventional:					
Long-term, fixed-rate	199,917	230,585	250,915	223,794	198,468
Intermediate-term, fixed-rate ⁽³⁾	61,517	76,640	85,130	59,521	45,018
Adjustable-rate	38,331	38,350	19,155	12,142	12,791
Total conventional single-family	299,765	345,575	355,200	295,457	256,277
Total single-family	314,801	355,687	362,484	301,861	262,658
Multifamily: ⁽²⁾					
Government insured or guaranteed	1,148	1,074	1,204	1,898	2,116
Conventional:					
Long-term, fixed-rate	3,619	3,133	3,010	3,165	2,991
Intermediate-term, fixed-rate ⁽³⁾	45,961	39,009	29,717	15,213	10,807
Adjustable-rate	1,151	1,254	1,218	1,107	962
Total conventional multifamily	50,731	43,396	33,945	19,485	14,760
Total multifamily	51,879	44,470	35,149	21,383	16,876
Total mortgage loans	366,680	400,157	397,633	323,244	279,534
Unamortized premiums (discounts) and cost basis adjustments, net	1,254	1,647	1,768	1,358	(493)
Lower of cost or market adjustments on loans held for sale	(89)	(83)	(50)	(16)	(36)
Allowance for loan losses for loans held for investment	(302)	(349)	(290)	(216)	(168)
Total mortgage loans, net	367,543	401,372	399,061	324,370	278,837
Mortgage-related securities:					
Fannie Mae single-class MBS	160,322	272,665	337,463	292,611	237,051
Non-Fannie Mae single-class mortgage securities	27,162	35,656	33,367	38,731	50,982
Fannie Mae structured MBS	74,129	71,739	68,459	87,772	90,147
	86,129	109,455	45,065	28,188	29,137

Non-Fannie Mae structured mortgage securities					
Mortgage revenue bonds	18,802	22,076	20,359	19,650	18,391
Other mortgage-related securities	4,665	5,461	6,522	9,583	10,711
Total mortgage-related securities	371,209	517,052	511,235	476,535	436,419
Market value adjustments ⁽⁴⁾	(789)	6,680	7,973	17,868	7,205
Other-than-temporary impairments	(553)	(432)	(412)	(204)	(22)
Unamortized premiums (discounts) and cost basis adjustments, net ⁽⁵⁾	(909)	173	1,442	1,842	(1,060)
Total mortgage-related securities, net	368,958	523,473	520,238	496,041	442,542
Mortgage portfolio, net	\$ 736,501	\$ 924,845	\$ 919,299	\$ 820,411	\$ 721,379

- (1) Mortgage loans and mortgage-related securities are reported at unpaid principal balance.
- (2) Mortgage loans include \$113.3 billion, \$152.7 billion, \$162.5 billion, \$135.8 billion and \$113.4 billion of mortgage-related securities that were consolidated in the consolidated balance sheets as loans as of December 31, 2005, 2004, 2003, 2002 and 2001, respectively.
- (3) Intermediate-term, fixed-rate consists of mortgage loans with contractual maturities at purchase equal to or less than 15 years.
- (4) Includes unrealized gains and losses on mortgage-related securities and securities commitments classified as trading and available-for-sale.
- (5) Includes the impact of other-than-temporary impairments of cost basis adjustments.

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The changing product mix of originations in our underlying market had a pronounced effect on the composition of mortgage assets purchased for our portfolio during 2005 and 2004. Due to a higher percentage of adjustable-rate mortgage originations in 2005 and 2004, a substantially larger proportion of our purchases in 2005 and 2004 consisted of ARMs and floating-rate mortgage-related securities than in previous years. In addition, higher sales of fixed-rate securities in 2005 contributed to the shift in the product mix of our portfolio.

Debt Funding and Derivatives

Total debt outstanding was \$764.7 billion as of December 31, 2005, compared with \$955.5 billion as of December 31, 2004. The 20% decline in our debt outstanding was directly correlated to the decline in our portfolio balances. During 2005, we reduced our total short-term debt by 46%, from \$322.7 billion as of December 31, 2004 to \$173.9 billion as of December 31, 2005, compared to a decrease of 7% our total long-term debt outstanding, from \$632.8 billion as of December 31, 2004 to \$590.8 billion as of December 31, 2005. Our total debt outstanding declined slightly during 2006 to approximately \$774.4 billion as of December 31, 2006.

The notional value of outstanding derivative instruments used to hedge interest rate risk in our portfolio declined to \$644.1 billion as of December 31, 2005 compared with \$690.1 billion as of December 31, 2004. We periodically terminate offsetting receive-fixed and pay-fixed swaps that result from our ongoing interest rate risk management process. The notional amount of derivatives also declines with maturing derivatives.

The total notional amount of our outstanding derivative instruments used to hedge interest rate risk in our portfolio increased in 2006 from 2005 by approximately 16%. The increase in the notional amount of our derivatives book at the end of 2006 reflects higher balances of both pay-fixed and receive-fixed swaps, partially offset by a reduction in interest rate swaptions. As interest rates during the first half of the year generally increased and the durations of our mortgage assets lengthened, we generally added to our net pay-fixed swap position. During the second half of 2006, when interest rates generally declined and the durations of our mortgage assets shortened, we added to our net receive-fixed swap position. These actions are consistent with our approach to interest rate risk management.

Non-Mortgage Investments

As discussed further in *Liquidity and Capital Management*, our Capital Markets group also purchases non-mortgage investments. Our non-mortgage investments consist primarily of high-quality securities that are readily marketable or have short-term maturities, such as commercial paper. As of December 31, 2005 and 2004, we had approximately \$52.2 billion and \$55.1 billion, respectively, in liquid assets, net of any cash and cash equivalents pledged as collateral. Our investments in non-mortgage securities, which account for the majority of our liquid assets, totaled \$37.1 billion and \$43.9 billion as of December 31, 2005 and 2004, respectively.

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Table 15 shows our investments in non-mortgage securities, which are presented at fair value as of December 31, 2005, 2004 and 2003.

Table 15: Non-Mortgage Investments

	As of December 31,		
	2005	2004	2003
	(Dollars in millions)		
Non-mortgage-related securities:			
Asset-backed securities	\$ 19,190	\$ 25,645	\$ 26,862
Corporate debt securities	11,840	15,098	16,432
Municipal bonds		863	1,203
Other non-mortgage-related securities ⁽¹⁾	6,086	2,303	2,335
Total non-mortgage-related securities	\$ 37,116	\$ 43,909	\$ 46,832

⁽¹⁾ Includes investments in commercial paper of \$5.1 billion, \$1.3 billion and \$1.3 billion as of December 31, 2005, 2004 and 2003, respectively.

Table 16 shows the amortized cost, maturity and weighted average yield of our investments in mortgage and non-mortgage securities as of December 31, 2005.

Table 16: Amortized Cost, Maturity and Average Yield of Investments in Available-for-Sale Securities

	As of December 31, 2005								
	Total Amortized Cost ⁽¹⁾	Total Fair Value	One Year or Less Amortized Cost ⁽¹⁾	One Year or Less Fair Value	After One Year Through Five Years Amortized Cost ⁽¹⁾	After One Year Through Five Years Fair Value	After Five Years Through Ten Years Amortized Cost ⁽¹⁾	After Five Years Through Ten Years Fair Value	After Ten Years or More Amortized Cost ⁽¹⁾
	(Dollars in millions)								
BS ⁽²⁾	\$ 144,193	\$ 143,742	\$ 1	\$ 1	\$ 651	\$ 666	\$ 2,148	\$ 2,206	\$ 141,393
ae									
ortgage	26,372	26,356			100	98	283	288	25,989
structured	74,452	74,102			54	55	384	388	74,014
ae									
tgage	86,273	86,006					37	37	86,236
ne bonds	18,836	19,178	98	97	319	317	695	702	17,724
	4,227	4,464		(2)					4,227

e-related

securities ⁽²⁾	19,197	19,190	4,725	4,724	12,089	12,083	1,218	1,217	1,165
securities	11,843	11,840	3,018	3,017	8,725	8,723	100	100	
related	6,032	6,086	5,679	5,733	353	353			
	\$ 391,425	\$ 390,964	\$ 13,521	\$ 13,570	\$ 22,291	\$ 22,295	\$ 4,865	\$ 4,938	\$ 350,748
	5.76%		4.23%		3.19%		5.56%		5.98%

- (1) Amortized cost includes unamortized premiums, discounts and other cost basis adjustments, as well as other-than-temporary impairment write downs.
- (2) Asset-backed securities, including mortgage-backed securities, are reported based on contractual maturities assuming no prepayments.
- (3) Includes commitments related to mortgage securities that are accounted for as securities.
- (4) Yields are determined by dividing interest income (including the amortization and accretion of premiums, discounts and other cost basis adjustments) by amortized cost balances as of year-end.

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SUPPLEMENTAL NON-GAAP INFORMATION FAIR VALUE BALANCE SHEET

Because our assets and liabilities consist predominately of financial instruments, we routinely use fair value measures to make investment decisions and to measure, monitor and manage our risk. The balance sheets presented in our consolidated financial statements reflect some financial assets measured and reported at fair value while other financial assets, along with most of our financial liabilities, are measured and reported at historical cost.

Each of the non-GAAP supplemental consolidated fair value balance sheets presented below in Table 17 reflects all of our assets and liabilities at estimated fair value. Estimated fair value is the amount at which an asset or liability could be exchanged between willing parties, other than in a forced or liquidation sale. We believe that the non-GAAP supplemental consolidated fair value balance sheets are useful to investors because they provide consistency in the measurement and reporting of all of our assets and liabilities. Management principally uses this information to gain a clearer picture of changes in our assets and liabilities from period to period and to understand how the overall value of the company is changing from period to period.

Our consolidated fair value balance sheets include the following non-GAAP financial measures:

- the estimated fair value of our other assets and our total assets;
- the estimated fair value of our other liabilities and our total liabilities; and
- the estimated fair value of our net assets (net of tax effect).

These measures are not defined terms within GAAP and may not be comparable to similarly titled measures reported by other companies. The estimated fair value of our net assets (net of tax effect) presented in the non-GAAP supplemental consolidated fair value balance sheets is not intended as a substitute for amounts reported in our consolidated financial statements prepared in accordance with GAAP. We believe, however, that the non-GAAP supplemental consolidated fair value balance sheets and the fair value of our net assets, when used in conjunction with our consolidated financial statements prepared in accordance with GAAP, can serve as valuable incremental tools for investors to assess changes in our overall value over time relative to changes in market conditions.

Cautionary Language Relating to Supplemental Non-GAAP Financial Measures

In reviewing our non-GAAP supplemental consolidated fair value balance sheets, there are a number of important factors and limitations to consider. The estimated fair value of our net assets is calculated as of a particular point in time based on our existing assets and liabilities and does not incorporate other factors that may have a significant impact on that value, most notably any value from future business activities in which we expect to engage. As a result, the estimated fair value of our net assets presented in our non-GAAP supplemental consolidated fair value balance sheets does not represent an estimate of our net realizable value, liquidation value or our market value as a whole. Amounts we ultimately realize from the disposition of assets or settlement of liabilities may vary significantly from the estimated fair values presented in our non-GAAP supplemental consolidated fair value balance sheets. Because temporary changes in market conditions can substantially affect the fair value of our net assets, we do not believe that short-term fluctuations in the fair value of our net assets attributable to mortgage-to-debt OAS or changes in the fair value of our net guaranty assets are necessarily representative of the effectiveness of our investment strategy or the long-term underlying value of our business. We believe the long-term value of our business depends primarily on our ability to acquire new assets and funding at attractive prices and to effectively manage the risks of these assets and liabilities over time. However, we believe that focusing on the factors that affect near-term changes in the estimated

fair value of our net assets helps us evaluate our long-term value and assess whether temporary market factors have caused our net assets to become overvalued or undervalued relative to the level of risk and expected long-term fundamentals of our business.

In addition, as discussed in Critical Accounting Policies and Estimates Fair Value of Financial Instruments, when quoted market prices or observable market data are not available, we rely on internally developed

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models that may require management judgment and assumptions to estimate fair value. Differences in assumptions used in our models could result in significant changes in our estimates of fair value.

Table 17: Non-GAAP Supplemental Consolidated Fair Value Balance Sheets

	As of December 31, 2005			As of December 31, 2004		
	Carrying Value	Fair Value Adjustment ⁽¹⁾	Estimated Fair Value	Carrying Value	Fair Value Adjustment ⁽¹⁾	Estimated Fair Value
(Dollars in millions)						
Assets:						
Cash and cash equivalents	\$ 3,575	\$	\$ 3,575 ⁽²⁾	\$ 3,701	\$	\$ 3,701 ⁽²⁾
Federal funds sold and securities purchased under agreements to resell	8,900		8,900 ⁽²⁾	3,930		3,930 ⁽²⁾
Trading securities	15,110		15,110 ⁽²⁾	35,287		35,287 ⁽²⁾
Available-for-sale securities	390,964		390,964 ⁽²⁾	532,095		532,095 ⁽²⁾
Mortgage loans held for sale	5,064	36	5,100 ⁽²⁾	11,721	131	11,852 ⁽²⁾
Mortgage loans held for investment, net of allowance for loan losses	362,479	(350)	362,129 ⁽²⁾	389,651	7,952	397,603 ⁽²⁾
Derivative assets at fair value	5,803		5,803 ⁽²⁾	6,589		6,589 ⁽²⁾
Guaranty assets and buy-ups	7,629	3,077	10,706 ⁽²⁾⁽³⁾	6,616	2,647	9,263 ⁽²⁾⁽³⁾
Total financial assets	799,524	2,763	802,287	989,590	10,730	1,000,320
Other assets	34,644	(861)	33,783 ⁽⁴⁾⁽⁵⁾	31,344	(23)	31,321 ⁽⁴⁾⁽⁵⁾
Total assets	\$ 834,168	\$ 1,902	\$ 836,070 ⁽⁶⁾	\$ 1,020,934	\$ 10,707	\$ 1,031,641 ⁽⁶⁾
Liabilities:						
Federal funds purchased and securities sold under agreements to repurchase	\$ 705	\$	\$ 705 ⁽²⁾	\$ 2,400	\$ (1)	\$ 2,399 ⁽²⁾
Short-term debt	173,186	(209)	172,977 ⁽²⁾	320,280	(567)	319,713 ⁽²⁾
Long-term debt	590,824	5,978	596,802 ⁽²⁾	632,831	15,445	648,276 ⁽²⁾
Derivative liabilities at fair value	1,429		1,429 ⁽²⁾	1,145		1,145 ⁽²⁾
Guaranty obligations	10,016	(4,848)	5,168 ⁽²⁾	8,784	(3,512)	5,272 ⁽²⁾
Total financial liabilities	776,160	921	777,081	965,440	11,365	976,805
Other liabilities	18,585	(1,916)	16,669 ⁽⁵⁾⁽⁷⁾	16,516	(1,850)	14,666 ⁽⁵⁾⁽⁷⁾
Total liabilities	794,745	(995)	793,750 ⁽⁸⁾	981,956	9,515	991,471 ⁽⁸⁾
	121		121	76		76

Minority interests in
consolidated subsidiaries

Net assets, net of tax effect (non-GAAP)	\$ 39,302	\$ 2,897	\$ 42,199 ⁽⁹⁾	\$ 38,902	\$ 1,192	\$ 40,094 ⁽⁹⁾
Fair value adjustments			(2,897)			(1,192)
Total stockholders' equity (GAAP)			\$ 39,302			\$ 38,902

Explanation and Reconciliation of Non-GAAP Measures to GAAP Measures

- (1) Each of the amounts listed as a fair value adjustment represents the difference between the carrying value reported in our GAAP consolidated balance sheets and our best judgment of the estimated fair value of the listed asset or liability.
- (2) The estimated fair value of each of these financial instruments has been computed in accordance with the GAAP fair value guidelines prescribed by SFAS No. 107, *Disclosures about Fair Value of Financial Instruments* (SFAS 107), as described in Notes to Consolidated Financial Statements Note 18, Fair Value of Financial Instruments. In Note 18, we also discuss the methodologies and assumptions we use in estimating the fair value of our financial instruments.
- (3) Represents the estimated fair value produced by combining the estimated fair value of our guaranty assets as of December 31, 2005 and 2004, respectively, with the estimated fair value of buy-ups. In our GAAP consolidated balance sheets, we report our guaranty assets as a separate line item and include all buy-ups associated with our guaranty assets in Other assets. As a result, the GAAP carrying value of our guaranty assets reflects only those arrangements entered into subsequent to our adoption of FIN 45 on January 1, 2003. On a GAAP basis, our guaranty assets totaled \$6.8 billion and \$5.9 billion as of December 31, 2005 and 2004, respectively, and the associated buy-ups totaled \$781 million and \$692 million as of December 31, 2005 and 2004, respectively.
- (4) In addition to the \$9.1 billion and \$7.1 billion of assets included in Other assets in the GAAP consolidated balance sheets as of December 31, 2005 and 2004, respectively, the assets included in the estimated fair value of our non-

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GAAP other assets consist primarily of the assets presented on five line items in our GAAP consolidated balance sheets, consisting of advances to lenders, accrued interest receivable, partnership investments, acquired property, net, and deferred tax assets, which together totaled \$26.4 billion and \$24.9 billion as of December 31, 2005 and 2004, respectively, in both the GAAP consolidated balance sheets and the non-GAAP supplemental consolidated balance sheets. In addition, we deduct the carrying value of the buy-ups associated with our guaranty obligation from our GAAP other assets because we combine the guaranty asset with the associated buy-ups when we determine the fair value of the asset.

- (5) Other assets and Other liabilities are reflected in each of the non-GAAP fair value balance sheets at their GAAP carrying values. With the exception of partnership investments and partnership liabilities, the GAAP carrying values of these other assets and other liabilities generally approximate fair value. The fair values of partnership investments and partnership liabilities are generally different from their GAAP carrying values, potentially materially. We have included partnership investments and partnership liabilities at their carrying value in each of the non-GAAP fair value balance sheets. We assume that other deferred assets and liabilities, consisting of prepaid expenses and deferred charges such as deferred debt issuance costs, have no fair value. We adjust the GAAP-basis deferred income taxes for purposes of each of our non-GAAP supplemental consolidated fair value balance sheets to include estimated income taxes on the difference between our non-GAAP supplemental consolidated fair value balance sheets net assets, including deferred taxes from the GAAP consolidated balance sheets, and our GAAP consolidated balance sheets stockholders' equity. Because our adjusted deferred income taxes are a net asset in each year, the amounts are included in our non-GAAP fair value balance sheets as a component of other assets.
- (6) Non-GAAP total assets represent the sum of the estimated fair value of (i) all financial instruments carried at fair value in our GAAP balance sheets, including all financial instruments that are not carried at fair value in our GAAP balance sheets but that are reported at fair value in accordance with SFAS 107 in Notes to Consolidated Financial Statements Note 18, Fair Value of Financial Instruments, (ii) non-GAAP other assets, which include all items listed in footnote 4 that are presented as separate line items in our GAAP consolidated balance sheets rather than being included in our GAAP other assets and (iii) the estimated fair value of credit enhancements, which are not included in Other assets in the consolidated balance sheets.
- (7) In addition to the \$8.1 billion and \$7.2 billion of liabilities included in Other liabilities in the GAAP consolidated balance sheets as of December 31, 2005 and 2004, respectively, the liabilities included in the estimated fair value of our non-GAAP other liabilities consist primarily of the liabilities presented on three line items on our GAAP consolidated balance sheets, consisting of accrued interest payable, reserve for guaranty losses and partnership liabilities, which together totaled \$10.5 billion and \$9.3 billion as of December 31, 2005 and 2004. As indicated above in footnote 5, these items are reported in our non-GAAP fair value balance sheets at their GAAP carrying values.
- (8) Non-GAAP total liabilities represent the sum of the estimated fair value of (i) all financial instruments that are carried at fair value in our GAAP balance sheets, including those financial instruments that are not carried at fair value in our GAAP balance sheets but that are reported at fair value in accordance with SFAS 107 in Notes to Consolidated Financial Statements Note 18, Fair Value of Financial Instruments, and (ii) non-GAAP other liabilities, which include all items listed in footnote 7 that are presented as separate line items in our GAAP consolidated balance sheets rather than being included in our GAAP other liabilities.
- (9) Represents the estimated fair value of total assets less the estimated fair value of total liabilities, which reconciles to total stockholders' equity (GAAP).

Key Drivers of Changes in the Estimated Fair Value of Net Assets (Non-GAAP)

We expect periodic fluctuations in the estimated fair value of our net assets due to our business activities, as well as due to changes in market conditions, including changes in interest rates, changes in relative spreads between our mortgage assets and debt, and changes in implied volatility. Following is a discussion of the effects these market conditions generally have on the fair value of our net assets and the factors we consider to be the principal drivers of changes in the estimated fair value of our net assets. We also disclose the sensitivity of the estimated fair value of our net assets to changes in interest rates in Risk Management Interest Rate Risk Management and Other Market Risks.

Capital Transactions, Net. Capital transactions include our issuances of common and preferred stock, our repurchases of stock and our payment of dividends. Cash we receive from the issuance of preferred and common stock results in an increase in the fair value of our net assets, while repurchases of stock and dividends we pay on our stock reduce the fair value of our net assets.

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Estimated Net Interest Income from OAS. OAS income represents the estimated net interest income generated during the current period that is attributable to the market spread between the yields on our mortgage-related assets and the yields on our debt during the period, calculated on an option-adjusted basis.

Guaranty Fees, Net. Guaranty fees, net, represent the net cash receipts during the reported period related to our guaranty business, and are generally calculated as the difference between the contractual guaranty fees we receive during the period and the expenses we incur during the period that are associated with our guaranty business. Changes in guaranty fees, net, result from changes in portfolio size and composition, changes in the credit quality of the underlying assets and changes in the market spreads for similar instruments.

Fee and Other Income and Other Expenses, Net. Fee and other income includes miscellaneous fees, such as resecuritization transaction fees and technology-related fees. Other expenses primarily include costs incurred during the period that are associated with the Capital Markets group.

Return on Risk Positions. Our investment activities expose us to market risks, including duration and convexity risks, yield curve risk, OAS risk and volatility risk. The return on risk positions represents the estimated net increase or decrease in the fair value of our net assets resulting from net exposures related to the market risks we actively manage. We actively manage, or hedge, interest rate risk related to our mortgage investments in order to maintain our interest rate risk exposure within prescribed limits. However, we do not actively manage certain other market risks. Specifically, we do not actively manage the mortgage-to-debt OAS or interest rate risk related to our guaranty business, as discussed below. Additional information about credit, market and operational risks and our strategies for managing these types of risks is included in Risk Management.

Mortgage-to-debt OAS. Funding mortgage investments with debt exposes us to mortgage-to-debt OAS risk, which represents basis risk. Basis risk is the risk that interest rates in different market sectors will not move in the same direction or amount at the same time. We generally hold our mortgage investments to generate a spread over our debt on a long-term basis. The fair value of our assets and liabilities can be significantly affected by periodic changes in the net OAS between the mortgage and agency debt sectors. The fair value impact of changes in mortgage-to-debt OAS for a given period represents an estimate of the net unrealized increase or decrease in the fair value of our net assets resulting from fluctuations during the reported period in the net OAS between our mortgage assets and our outstanding debt securities. When the mortgage-to-debt OAS on a given mortgage asset increases, or widens, the fair value of the asset will typically decline relative to the debt. The level of OAS and changes in OAS are model-dependent and differ among market participants depending on the prepayment and interest rate models used to measure OAS.

We work to manage the OAS risk that exists at the time we purchase mortgage assets through our asset selection process. We use our proprietary models to evaluate mortgage assets on the basis of yield-to-maturity, option-adjusted yield spread, historical valuations and embedded options. Our models also take into account risk factors such as credit quality, price volatility and prepayment experience. We purchase mortgage assets that appear economically attractive to us in the context of current market conditions and that fall within our OAS targets. Although a widening of mortgage-to-debt OAS during a period generally results in lower fair values of the mortgage assets relative to the debt during that period, it can provide us with better investment opportunities to purchase mortgage assets because a wider OAS is indicative of higher expected returns. We generally purchase mortgage assets when mortgage-to-debt OAS is relatively wide and restrict our purchase activity or sell mortgage assets when mortgage-to-debt OAS is relatively narrow. We do not, however, attempt to actively manage or hedge the impact of changes in mortgage-to-debt OAS after we purchase mortgage assets, other than through asset monitoring and disposition.

Change in the Fair Value of our Net Guaranty Assets. As described more fully in Notes to Consolidated Financial Statements Note 18, Fair Value of Financial Instruments, we calculate the estimated fair value of our existing guaranty business based on the difference between the estimated fair value of the guaranty

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fees we expect to receive and the estimated fair value of the guaranty obligations we assume. The fair value of both our guaranty assets and our guaranty obligations is highly sensitive to changes in interest rates and credit quality. Changes in interest rates can result in significant periodic fluctuations in the fair value of our net assets. For example, as interest rates decline, the expected prepayment rate on fixed-rate mortgages increases, which lowers the fair value of our existing guaranty business. We do not believe, however, that periodic changes in fair value are the best indication of the long-term value of our guaranty business because they do not take into account future guaranty business activity. Based on our historical experience, we expect that the guaranty fee income generated from future business activity will largely replace any guaranty fee income lost as a result of mortgage prepayments. Accordingly, we do not actively manage or hedge expected changes in the fair value of our net guaranty assets related to changes in interest rates. To assess the value of our underlying guaranty business, we focus primarily on changes in the fair value of our net guaranty assets resulting from business growth, changes in the credit quality of existing guaranty arrangements and changes in anticipated future credit performance.

Market Drivers of Changes in Fair Value

Selected relevant market information is shown below in Table 18. Our goal is to minimize the risk associated with changes in interest rates for our investments in mortgage assets. Accordingly, we do not expect changes in interest rates to have a significant impact on the fair value of our net mortgage assets. The market conditions that we expect to have the most significant impact on the fair value of our net assets include changes in implied volatility and relative changes between mortgage OAS and debt OAS. A decrease in implied volatility generally increases the estimated fair value of our mortgage assets and decreases the estimated fair value of our debt and derivatives, while an increase in implied volatility generally has the opposite effect. A tighter, or lower, mortgage OAS generally increases the estimated fair value of our mortgage assets, and a tighter debt OAS generally increases the fair value of our liabilities. Changes in interest rates, however, may have a significant impact on our guaranty business because we do not actively manage or hedge expected changes in the fair value of our net guaranty assets related to changes in interest rates. We have included the Lehman U.S. MBS Index OAS over the U.S. Treasury yield curve and over the LIBOR yield curve for each of 2004 and 2005. Mortgage market participants have generally moved from a Treasury basis to a LIBOR basis as the preferred way for measuring mortgage OAS. We use OAS to LIBOR as our primary basis for measuring both mortgage OAS and debt OAS.

Table 18: Selected Market Information⁽¹⁾

	As of December 31,			Change	
	2005	2004	2003	2005 vs. 2004	2004 vs. 2003
10-year U.S. Treasury note yield	4.39%	4.22%	4.25%	0.17%	(0.03)%
Implied volatility ⁽²⁾	19.5%	20.1%	22.9%	(0.6)%	(2.8)%
30-year Fannie Mae MBS par coupon rate	5.75%	5.21%	5.28%	0.54%	(0.07)%
Lehman U.S. MBS Index OAS (in basis points) over LIBOR yield curve	4.2bp	(11.5)bp	(3)	15.7bp	(3)
Lehman U.S. MBS Index OAS (in basis points) over U.S. Treasury yield curve	54.5bp	22.5bp	27.6bp	32.0bp	(5.1)bp
Lehman U.S. Agency Debt Index OAS (in basis points) over LIBOR yield curve	(11.0)bp	(6.3)bp	(3)	(4.7)bp	(3)
	35.5bp	32.2bp	36.9bp	3.3bp	(4.7)bp

Lehman U.S. Agency Debt Index OAS (in basis points) over U.S. Treasury yield curve

- (1) Information obtained from Lehman Live and Bloomberg.
- (2) Implied volatility for an interest rate swaption with a 3-year option on a 10-year final maturity.
- (3) Not available.

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The following table summarizes the change in the fair value of our net assets, as adjusted for capital transactions, for each of 2005 and 2004.

Table 19: Non-GAAP Estimated Fair Value of Net Assets (Net of Tax Effect)

	2005	2004
Balance as of January 1	\$ 40,094	\$ 28,393
Capital transactions: ⁽¹⁾		
Common dividends, share repurchases and issuances, net	(943)	(2,165)
Preferred dividends and share issuances, net	(486)	4,760
Capital transactions, net	(1,429)	2,595
Change in estimated fair value of net assets, net of capital transactions	3,534	9,106
Total change in estimated fair value of net assets	2,105	11,701
Balance as of December 31 ⁽²⁾	\$ 42,199	\$ 40,094

(1) Represents net capital transactions, which are reflected in the Consolidated Statements of Changes in Stockholders' Equity.

(2) Represents estimated fair value of net assets (net of tax effect) presented in Table 17: Non-GAAP Supplemental Consolidated Fair Value Balance Sheets.

Year Ended December 31, 2005 Compared to Year Ended December 31, 2004

As indicated above in Table 19, the estimated fair value of our net assets (net of tax effect) as of December 31, 2005 was \$42.2 billion, an increase of \$2.1 billion, or 5%, from December 31, 2004. The \$2.1 billion increase in 2005 included the effect of the payment of \$1.4 billion of dividends to holders of our common and preferred stock. The estimated fair value of our net guaranty assets increased by approximately \$1.5 billion. This increase in fair value is primarily due to higher interest rates and improvements in the credit quality of our book of business in 2005, which was driven primarily by the increase in home prices during the year. As displayed in Table 18 above, the 30-year Fannie Mae MBS par coupon rate and the 10-year U.S. Treasury note yield increased in 2005, which slowed the rate of expected prepayments and increased the fair value of our net guaranty assets.

As also indicated in Table 18, mortgage OAS based on the Lehman U.S. MBS Index to LIBOR increased by 15.7 basis points from minus 11.5 basis points as of year-end 2004, to 4.2 basis points as of year-end 2005. Debt OAS based on the Lehman U.S. Agency Debt Index to LIBOR decreased by 4.7 basis points from minus 6.3 basis points as of year-end 2004, to minus 11.0 basis points as of year-end 2005. This net increase in mortgage to debt OAS, a slight decline in interest rates and the flattening of the yield curve resulted in a decline in the fair value of our net mortgage assets. More than offsetting this decline were the cash inflows from our net mortgage assets and a slight decrease in implied volatility.

Year Ended December 31, 2004 Compared to Year Ended December 31, 2003

The estimated fair value of our net assets (net of tax effect) increased by \$11.7 billion, or 41%, to \$40.1 billion as of December 31, 2004 from the prior year end. Of the total \$11.7 billion increase in 2004, approximately \$2.8 billion was attributable to capital transactions, consisting primarily of \$5.0 billion of gross proceeds we received from a preferred stock offering in 2004, partially offset by the payment of \$2.2 billion of dividends to holders of our common and preferred stock. Net cash inflows generated by our Single-Family, HCD and Capital Markets businesses also contributed to the increase in fair value of our net assets (non-GAAP) in 2004. The remainder of the increase of \$9.1 billion in 2004 was largely attributable to changes in market conditions, primarily related to an increase in implied volatility, as explained below.

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Also as indicated in Table 18, implied volatility decreased considerably during 2004 compared to 2003. For example, the implied volatility of 3-year swaptions on 10-year underlying instruments declined by 280 basis points, to 20.1% as of December 31, 2004 from 22.9% as of December 31, 2003. As shown in Table 17, this decrease in implied volatility had the effect of increasing the estimated fair value of our mortgage assets more than it increased the estimated fair value of our debt and derivatives funding of those assets as shown above in Table 17. Changes in OAS had less of an impact on the fair value of our net assets over this period. According to the Lehman U.S. MBS Index, the OAS of mortgages to the U.S. Treasury yield curve decreased by 5.1 basis points to 22.5 basis points as of December 31, 2004, which contributed to an increase in the fair value of our mortgage assets. The OAS on debt securities included in the Lehman U.S. Agency Debt Index decreased by 4.7 basis points to 32.2 basis points as of December 31, 2004, which contributed to an increase in the fair value of our debt.

RISK MANAGEMENT

Overview

Our businesses expose us to the following four major categories of risk:

Credit Risk. Credit risk is the risk of financial loss resulting from the failure of a borrower or institutional counterparty to honor its contractual obligations to us and exists primarily in our mortgage credit book of business and derivatives portfolio.

Market Risk. Market risk represents the exposure to potential changes in the market value of our net assets from changes in prevailing market conditions. A significant market risk we face and actively manage is interest rate risk the risk of changes in our long-term earnings or in the value of our net assets due to changes in interest rates.

Operational Risk. Operational risk relates to the risk of loss resulting from inadequate or failed internal processes, people or systems, or from external events.

Liquidity Risk. Liquidity risk is the risk to our earnings and capital arising from an inability to meet our cash obligations in a timely manner.

We also are subject to a number of other risks that could adversely impact our business, financial condition, results of operations and cash flows, including legal and reputational risks that may arise due to a failure to comply with laws, regulations or ethical standards and codes of conduct applicable to our business activities and functions.

Effective management of risks is an integral part of our business and critical to our safety and soundness. In the following sections, we provide an overview of our corporate risk governance structure and risk management processes, which are intended to identify, measure, monitor and control the principal risks we assume in conducting our business activities in accordance with defined policies and procedures. Following the overview, we provide additional information on how we manage each of our four major categories of risk. In Item 1A Risk Factors, we identify other risk factors that may adversely affect our business.

Risk Governance Structure

We made significant organizational changes in 2005 and 2006 to enhance our risk governance structure and strengthen our internal controls due to identified material weaknesses. During 2005, we adopted an enhanced corporate risk framework to address weaknesses in our risk governance structure. This new framework is intended to ensure that people and processes are organized in a way that promotes a cross-functional approach to risk management and

controls are in place to better manage our risks. Basic tenets of our corporate risk framework include establishing corporate-wide policies for risk management, delegating to business units primary responsibility for the management of the day-to-day risks inherent in the activities of the business unit, and monitoring aggregate risks and compliance with risk policies at a corporate level.

Our corporate risk framework is supported by a governance structure encompassing the Board of Directors, an independent corporate risk oversight organization, business units, management-level risk committees and

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Internal Audit. As we continue in our efforts to build out our risk oversight organization, we are establishing clear lines of authority, clarifying roles and responsibilities, and enacting policies and procedures designed to ensure that we have an independent risk oversight function with appropriate checks and balances throughout our company.

Risk Policy and Capital Committee of the Board of Directors

The Board of Directors is responsible for approving our risk governance framework and providing capital and risk management oversight. The Board exercises its oversight of credit risk, market risk, operational risk and liquidity risk primarily through the Board's Risk Policy and Capital Committee. The responsibilities of the Risk Policy and Capital Committee include:

- recommending for Board approval enterprise risk governance policy and limits consistent with our mission, safety and soundness;

- overseeing the development of policies and procedures designed to: (i) define, measure, identify and report on credit, market, liquidity and operational risk; and (ii) establish and communicate risk management controls throughout the company;

- overseeing compliance with all enterprise-wide risk management policies;

- overseeing the Chief Risk Office; and

- reviewing the sufficiency of personnel, systems and other risk management capabilities.

In 2006, the Board of Directors adopted corporate risk principles that are being implemented to govern our risk activities. These principles include taking risks in an informed and disciplined manner and ensuring that we are adequately compensated for the risks we take, consistent with our mission goals.

Chief Risk Office

The Chief Risk Office is an independent risk oversight organization with responsibility for oversight of credit risk, market risk and operational risk. The Chief Risk Office is headed by a Chief Risk Officer who reports directly to the Chief Executive Officer and independently to the Risk Policy and Capital Committee of the Board of Directors. The Chief Risk Office and the position of Chief Risk Officer were established in 2005. The Chief Risk Office is responsible for formulating corporate risk policies and monitoring the company's aggregate risk profile. The Chief Risk Office works closely with our business units to ensure they have in place the structure and information systems necessary to adequately identify, measure, report, monitor and control their key business risks, consistent with corporate standards. The Chief Risk Office also is responsible for validation of risk models and for developing and implementing an economic risk capital framework.

The Chief Risk Officer is responsible for establishing our overall risk governance structure and providing independent evaluation and oversight of our risk management activities. In addition to directing the Chief Risk Office, the Chief Risk Officer oversees our management-level corporate risk committees. The Chief Risk Officer reports on a regular basis to our Board of Directors regarding our corporate risk profile, including our aggregate risk exposure, the level of risk by type of risk, performance relative to risk limits and any significant risk management issues. The Chief Risk Officer also reports to the Board of Directors annually on management's adherence to our corporate risk principles.

Risk Management Committees

At the end of 2006, we restructured our risk management committees to enhance our risk governance framework. We dissolved the Corporate Risk Management Committee, which had previously focused on both credit and market risk oversight, and formed two separate committees, the Credit Risk Committee and the Market Risk Committee. We now have three management-level risk committees that focus on our major categories of risk: (i) the Credit Risk Committee, which focuses on credit risk; (ii) the Market Risk

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Committee, which focuses on market, liquidity and model risk; and (iii) the Operational Risk Committee, which focuses on operational risk. Each committee is responsible for, among other things:

monitoring aggregated risk exposure;

discussing emerging risk issues;

reviewing key corporate risk limits and exposures;

reviewing the risk aspects of significant new business initiatives; and

reviewing and recommending risk policies with corporate-wide or significant business unit implications.

We also established two additional management-level risk committees that focus on other significant business risks: (i) the Capital Structure Committee, which focuses on capital management activities; and (ii) the Compliance Coordination Committee, which focuses on compliance with legal and regulatory requirements. Our Compliance Coordination Committee also is responsible for coordinating the legal and regulatory compliance risk governance functions with other control functions, such as Legal, Internal Audit and the Chief Risk Office.

The Management Executive Committee, which is chaired by the Chief Executive Officer and composed of principal executive officers of the company, has responsibility for reviewing and approving our enterprise-wide risk tolerance policy and our enterprise-wide risk framework, addressing issues referred to it by our risk committees, addressing matters that involve multiple types of risks and addressing other significant business and reputational risks. Where appropriate, the Management Executive Committee brings transactions of an extraordinary nature and significant potential new business activities to the Risk Policy and Capital Committee of the Board of Directors, as well as other relevant committees if necessary, for review and approval.

Business Units

Business unit managers execute company-wide risk policies set by the Chief Risk Officer, develop risk management strategies for their specific businesses, and establish and implement risk management policies and practices within their businesses. Each business unit is responsible for identifying, measuring and managing key credit risks within its business. In addition, each business unit has business unit risk managers who are responsible for ensuring that there are clear delineations of responsibility for managing credit risk, adequate systems for measuring credit risk, appropriately structured limits on risk taking, effective internal controls and a comprehensive risk reporting process. As part of our risk governance structure, we have established within each business unit risk committees that are responsible for decisions relating to risk strategy, policies and controls.

Internal Audit

Our Internal Audit group, under the direction of the Chief Audit Executive, provides an objective assessment of the design and execution of our internal control system, including our management systems, risk governance, and policies and procedures. The Chief Audit Executive reports directly and independently to the Audit Committee of the Board of Directors, and audit personnel are compensated on objectives set for the group by the Audit Committee rather than corporate financial results or goals. The Chief Audit Executive operates independently of management and may be removed only upon Board approval. Internal Audit activities are designed to provide reasonable assurance that resources are safeguarded; that significant financial, managerial and operating information is complete, accurate and reliable; and that employee actions comply with our policies and applicable laws and regulations.

Office of Compliance and Ethics

Our Office of Compliance and Ethics, under the direction of the Chief Compliance Officer, is responsible for developing and carrying out corporate policies related to compliance, ethics and investigations. The Office of Compliance and Ethics and the position of Chief Compliance Officer were established in 2005. The Chief Compliance Officer reports directly to the Chief Executive Officer and independently to the Compliance

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Committee of the Board of Directors. Office of Compliance and Ethics personnel are compensated on objectives set for the group by the Compliance Committee of the Board of Directors rather than corporate financial results or goals. The Chief Compliance Officer operates independently of management and may be removed only upon Board approval. The Chief Compliance Officer is responsible for overseeing our compliance activities; developing and promoting a code of ethical conduct; evaluating and investigating any allegations of misconduct; and overseeing and coordinating our OFHEO and HUD regulatory reporting and examinations.

Credit Risk Management

We assess, price and assume mortgage credit risk as a basic component of our business. We assume institutional counterparty credit risk in a variety of our business transactions, including transactions designed to mitigate mortgage credit risk and interest rate risk. The degree of credit risk to which we are exposed will vary based on many factors, including the risk profile of the borrower or counterparty, the contractual terms of the agreement, the amount of the transaction, repayment sources, the availability and quality of collateral and other factors relevant to current events, conditions and expectations. We evaluate these factors and actively manage, on an aggregate basis, the extent and nature of the credit risk we bear, with the objective of ensuring that we are adequately compensated for the credit risk we take, consistent with our mission goals.

Our Single-Family Credit Guaranty and HCD businesses are responsible for identifying, measuring, monitoring and managing credit risk subject to corporate risk policies and limits approved by the Chief Risk Office, which provides corporate oversight of the credit risk management process. The Credit Risk Committee, which focuses on credit risk, meets at least monthly to review our aggregate credit risk profile and monitor our exposure relative to credit risk limits.

Our credit-related losses during the period 2003 to 2005 reflect the high credit quality of our mortgage credit book of business, resulting from the effect of a combination of several factors, including strong home price appreciation during the period, the benefits we receive from credit enhancements and other risk-sharing strategies, and our loss mitigation efforts. Our credit-related losses during this period remained at what we consider to be low levels, not exceeding 0.02% of our mortgage credit book of business during any given year. Because the rapid acceleration of home prices during the period from 1999 to 2005 was a significant factor in helping to mitigate our credit losses over the past several years, we expect our credit losses to increase as a result of the significant slowdown in home price appreciation during 2006 and our belief that home prices could decline modestly in 2007.

Mortgage Credit Risk Management

Mortgage credit risk is the risk that a borrower will fail to make required mortgage payments. We are exposed to credit risk on our mortgage credit book of business because we either hold the mortgage assets or have issued a guaranty in connection with the creation of Fannie Mae MBS backed by mortgage assets. Our mortgage credit book of business consists of both on- and off-balance sheet arrangements, including single-family and multifamily mortgage loans held in our portfolio; Fannie Mae MBS and non-Fannie Mae mortgage-related securities held in our portfolio; Fannie Mae MBS held by third- party investors; and credit enhancements that we provide on mortgage assets. We provide additional information regarding our off-balance sheet arrangements in *Off-Balance Sheet Arrangements and Variable Interest Entities* below.

Factors affecting credit risk on loans in our single-family mortgage credit book of business include the borrower's financial strength and credit profile; the type of mortgage; the characteristics of the property and the value of the property securing the mortgage; and economic conditions, such as changes in home prices. Factors that affect credit risk on a multifamily loan include the structure of the financing; the type and location of the property; the condition and value of the property; the financial strength of the borrower and lender; market and sub-market trends and growth;

and the current and anticipated cash flows from the property. These and other factors affect both the amount of expected credit loss on a given loan and the sensitivity of that loss to changes in the economic environment.

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Table 20 displays the composition of our mortgage credit book of business as of December 31, 2005, 2004 and 2003. Our single-family mortgage credit book of business accounted for approximately 94% of our entire mortgage credit book of business as of December 31, 2005 and approximately 95% as of December 31, 2004 and 2003.

Table 20: Composition of Mortgage Credit Book of Business

	As of December 31, 2005					
	Single-Family		Multifamily		Total	
	Conventional ⁽¹⁾	Government ⁽²⁾	Conventional ⁽¹⁾	Government ⁽²⁾	Conventional ⁽¹⁾	Government ⁽²⁾
	(Dollars in millions)					
Mortgage portfolio: ⁽³⁾						
Mortgage loans ⁽⁴⁾	\$ 299,765	\$ 15,036	\$ 50,731	\$ 1,148	\$ 350,496	\$ 16,184
Fannie Mae MBS ⁽⁴⁾	232,574	1,001	404	472	232,978	1,473
Agency mortgage-related securities ⁽⁴⁾⁽⁵⁾	28,604	2,380		57	28,604	2,437
Mortgage revenue bonds	4,000	3,965	8,375	2,462	12,375	6,427
Other mortgage-related securities ⁽⁶⁾	85,698	1,174		43	85,698	1,217
Total mortgage portfolio	650,641	23,556	59,510	4,182	710,151	27,738
Fannie Mae MBS held by third parties ⁽⁷⁾	1,523,043	23,734	50,345	1,796	1,573,388	25,530
Other ⁽⁸⁾	3,291		15,718	143	19,009	143
Mortgage credit book of business	\$ 2,176,975	\$ 47,290	\$ 125,573	\$ 6,121	\$ 2,302,548	\$ 53,411

	As of December 31, 2004					
	Single-Family		Multifamily		Total	
	Conventional ⁽¹⁾	Government ⁽²⁾	Conventional ⁽¹⁾	Government ⁽²⁾	Conventional ⁽¹⁾	Government ⁽²⁾
	(Dollars in millions)					
Mortgage portfolio: ⁽³⁾						
Mortgage loans ⁽⁴⁾	\$ 345,575	\$ 10,112	\$ 43,396	\$ 1,074	\$ 388,971	\$ 11,186
Fannie Mae MBS ⁽⁴⁾	341,768	1,239	505	892	342,273	2,131
Agency mortgage-related securities ⁽⁴⁾⁽⁵⁾	37,422	4,273		68	37,422	4,341
Mortgage revenue bonds	6,344	4,951	8,037	2,744	14,381	7,695
Other mortgage-related securities ⁽⁶⁾	108,082	669	12	46	108,094	715
Total mortgage portfolio	839,191	21,244	51,950	4,824	891,141	26,068
Fannie Mae MBS held by third parties ⁽⁷⁾	1,319,066	32,337	54,639	2,005	1,373,705	34,342

Other ⁽⁸⁾	346		14,111	368	14,457	368
Mortgage credit book of business	\$ 2,158,603	\$ 53,581	\$ 120,700	\$ 7,197	\$ 2,279,303	\$ 60,778

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	As of December 31, 2003					
	Single-Family		Multifamily		Total	
	Conventional ⁽¹⁾	Government ⁽²⁾	Conventional ⁽¹⁾	Government ⁽²⁾	Conventional ⁽¹⁾	Government ⁽²⁾
	(Dollars in millions)					
Mortgage portfolio: ⁽³⁾						
Mortgage loans ⁽⁴⁾	\$ 355,200	\$ 7,284	\$ 33,945	\$ 1,204	\$ 389,145	\$ 8,488
Fannie Mae MBS ⁽⁴⁾	402,079	1,933	412	1,498	402,491	3,431
Agency mortgage-related securities ⁽⁴⁾⁽⁵⁾	30,672	7,235		68	30,672	7,303
Mortgage revenue bonds	6,242	5,983	5,828	2,306	12,070	8,289
Other mortgage-related securities ⁽⁶⁾	46,714	169	42	54	46,756	223
Total mortgage portfolio	840,907	22,604	40,227	5,130	881,134	27,734
Fannie Mae MBS held by third parties ⁽⁷⁾	1,200,222	38,487	59,403	2,408	1,259,625	40,895
Other ⁽⁸⁾	330		12,346	492	12,676	492
Total mortgage credit book of business	\$ 2,041,459	\$ 61,091	\$ 111,976	\$ 8,030	\$ 2,153,435	\$ 69,121

(1) Refers to mortgage loans and mortgage-related securities that are not guaranteed or insured by the U.S. government or any of its agencies.

(2) Refers to mortgage loans and mortgage-related securities guaranteed or insured by the U.S. government or one of its agencies.

(3) Mortgage portfolio data is reported based on unpaid principal balance.

(4) Mortgage loan data includes mortgage-related securities that were consolidated and reported in our consolidated balance sheets as loans of \$113.3 billion, \$152.7 billion and \$162.5 billion as of December 31, 2005, 2004 and 2003, respectively.

(5) Includes mortgage-related securities issued by Freddie Mac and Ginnie Mae. We held mortgage-related securities issued by Freddie Mac totaling \$28.7 billion as of December 31, 2005, which exceeded 10% of our stockholders equity as of that date.

(6) Includes mortgage-related securities issued by entities other than Fannie Mae, Freddie Mac or Ginnie Mae.

(7) Includes Fannie Mae MBS held by third-party investors. The principal balance of res securitized Fannie Mae MBS is included only once.

(8) Includes additional single-family and multifamily credit enhancements that we provide not otherwise reflected in the table.

Our strategy in managing mortgage credit risk consists of three primary components: (1) acquisition policy and standards; (2) portfolio diversification and monitoring; and (3) credit loss management. We use various metrics to evaluate credit performance in our mortgage credit book of business. We estimate incurred credit losses inherent in our mortgage credit book of business as of each balance sheet date and maintain a combined balance of allowance for loan losses and reserve for guaranty losses at a level we believe reflects these losses.

Acquisition Policy and Standards

Single-Family

Our Single-Family business is responsible for pricing and managing credit risk relating to the portion of our single-family mortgage credit book of business consisting of single-family mortgage loans and Fannie Mae MBS backed by single-family mortgage loans (whether held in our portfolio or held by third parties). This portion of our business, for which we have access to more detailed loan-level information, represented approximately 94%, 92% and 95% of our total conventional single-family mortgage credit book of business as of December 31, 2005, 2004 and 2003, respectively. Unless otherwise noted, the credit statistics we provide relate only to this specific portion of our conventional single-family mortgage credit book.

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We have established underwriting guidelines for these loans that are intended to provide a comprehensive analysis of borrowers and mortgage loans based upon known risk characteristics. We also have policies and various quality assurance efforts to review a sample of loans to measure compliance with our underwriting and eligibility criteria. We assess the characteristics and quality of a lender's loans and processes through a post-purchase loan review program, on-site reviews of lender operations and regular comparisons of actual loan performance to expected performance.

Lenders generally represent and warrant compliance with our asset acquisition requirements when they sell mortgage loans to us or deliver mortgage loans in exchange for Fannie Mae MBS. We may require the lender to repurchase a loan or we may seek another remedy if we identify any underwriting or eligibility deficiencies. We have developed a proprietary automated underwriting system, Desktop Underwriter[®], which measures default risk by assessing the primary risk factors of a mortgage, including the loan-to-value ratio, the borrower's credit profile, the type of mortgage, the loan purpose, and other mortgage and borrower characteristics. Subject to our review and approval, we also purchase and securitize mortgage loans that have been underwritten using other automated underwriting systems, as well as mortgage loans underwritten to agreed-upon standards that differ from our standard underwriting criteria.

The use of credit enhancements is an important part of our single-family acquisition policy and standards, although it also exposes us to institutional counterparty risk. Based on our current acquisition policy and standards, we may accept loans originated with loan-to-value ratios of up to 100%; however, from time to time, we may make an exception to these guidelines and acquire loans with a loan-to-value ratio greater than 100%. Our charter requires that conventional single-family mortgage loans that we purchase or that back Fannie Mae MBS with loan-to-value ratios above 80% at acquisition be covered by one or more of the following:

primary mortgage insurance;

a seller's agreement to repurchase or replace any mortgage loan in default (for such period and under such circumstances as we may require); or

retention by the seller of at least a 10% participation interest in the mortgage loans.

Primary mortgage insurance is the most common type of credit enhancement in our mortgage credit book of business and is typically provided on a loan-level basis. Primary mortgage insurance, which is typically provided by one of eight mortgage insurance companies, transfers varying portions of the credit risk associated with a mortgage loan to a third-party insurer. As discussed below in *Institutional Counterparty Credit Risk Management Mortgage Insurers*, these insurers are subject to our eligibility requirements. The amount of insurance we obtain on any mortgage loan depends on our requirements, which depend on our assessment of risk. In addition to the credit enhancement required by our charter, we may require or obtain supplemental credit enhancement for some mortgage loans, typically those with higher credit risk. Our use of discretionary credit enhancements depends on our view of the inherent credit risk, the price of the credit enhancement, and our risk versus return objective. The percentage of our conventional single-family mortgage credit book of business with credit enhancement, including primary mortgage, pool mortgage insurance, lender recourse and shared risk, was 18%, 19% and 21% as of December 31, 2005, 2004 and 2003, respectively. The percentage of our conventional single-family mortgage credit book of business with credit enhancement has not changed significantly since the end of 2005.

The remaining portion of our conventional single-family mortgage credit book of business consists of non-Fannie Mae mortgage-related securities backed by single-family mortgage loans and credit enhancements that we provide on single-family mortgage assets. Non-Fannie Mae mortgage-related securities held in our portfolio include Freddie Mac securities, Ginnie Mae securities, private-label mortgage-related securities, Fannie Mae MBS backed by private-label mortgage-related securities, and housing-related municipal revenue bonds. Our Capital Markets group prices and

manages credit risk related to this specific portion of our conventional single-family mortgage credit book. We may not have access to detailed loan-level data on these particular mortgage-related assets and therefore may not manage the credit performance of individual loans. However, a substantial majority of these securities benefit from significant forms of credit enhancement, including

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guarantees from Ginnie Mae or Freddie Mac, insurance policies, structured subordination and similar sources of credit protection. All non-Fannie Mae agency securities held in our portfolio as of December 31, 2006 were rated AAA/Aaa by Standard & Poor's and Moody's. Over 90% of non-agency mortgage-related securities held in our portfolio as of December 31, 2006 were rated AAA/Aaa by Standard & Poor's and Moody's.

Housing and Community Development

Our HCD business is responsible for managing the credit risk on multifamily mortgage loans we purchase and on Fannie Mae MBS backed by multifamily loans (whether held in our portfolio or held by third parties). HCD also makes equity investments in LIHTC limited partnerships that own an interest in rental housing that the partnerships have developed or rehabilitated. On a much smaller scale, our HCD business also makes investments in other rental or for-sale housing developments and provides loans and credit support to public entities and local banks to support affordable housing and community development. We have established credit and underwriting guidelines for these transactions. While the underwriting of single-family loans primarily focuses on an evaluation of the borrower's ability to repay the loan, the underwriting of multifamily loans focuses primarily on an evaluation of expected cash flows from the property for repayment. Our multifamily guidelines require a comprehensive analysis of the property value, the LTV ratio, the local market, the borrower and its investment in the property, the property's historical and projected financial performance, the property's physical condition and third-party reports, including appraisals and engineering and environmental reports. For multifamily equity investments, we also evaluate the strength of our investment sponsors and third-party asset managers.

Multifamily loans we purchase or that back Fannie Mae MBS are either underwritten by a Fannie Mae-approved lender or subject to our underwriting review prior to closing. Many of our agreements delegate the underwriting decisions to the lender, principally through our Delegated Underwriting and Servicing, or DUStm, program. Loans delivered to us by DUS lenders represented approximately 87% and 89% of our multifamily mortgage credit book of business as of December 31, 2005 and 2004, respectively. Lenders represent and warrant compliance with our underwriting requirements when they sell us mortgage loans, when they request securitization of their loans into Fannie Mae MBS or when they request that we provide credit enhancement in connection with an affordable housing bond transaction. In addition, we use proprietary models and analytical tools to price and measure credit risk at acquisition. After closing, we conduct a post-purchase review of certain loans based on the product type or risk profile of the loan, the lender's historical underwriting practices, the market and submarket conditions. If non-compliance issues are revealed during the review process, we may take a variety of actions, including increasing the lender credit loss sharing or requiring a lender to repurchase a loan, depending on the severity of the issues identified.

The use of credit enhancements is also an important part of our multifamily acquisition policy and standards. We use a variety of credit enhancement vehicles including lender risk sharing, lender repurchase agreements, pool insurance, subordinated participations in mortgage loans or structured pools, cash and letter of credit collateral agreements, and cross-collateralization/cross-default provisions. The most prevalent form of credit enhancement is lender risk sharing. Lenders in the DUS program typically share in loan-level credit losses in one of two ways. Generally, they either bear losses up to the first 5% of unpaid principal balance of the loan and share in remaining losses up to a prescribed limit, or they agree to share with us up to one-third of the credit losses on an equal basis. The percentage of our multifamily credit book of business with credit enhancement was 95% as of December 31, 2005, 2004 and 2003.

Portfolio Diversification and Monitoring

Single-Family

Our single-family mortgage credit book of business is diversified based on several factors that influence credit quality. We continually review the credit quality of our single-family mortgage credit book of business with a focus on a

variety of mortgage loan risk factors, including loan-to-value ratios, loan product type, property type, occupancy type, credit score, loan purpose, property location and age of loan. Table 21 presents our conventional single-family mortgage credit book of business as of December 31, 2005, 2004 and 2003, based on the key risk characteristics that we monitor closely to assess the sensitivity of our credit losses to economic

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changes. Table 22 presents our conventional single-family business volumes for 2005, 2004 and 2003 based on these risk characteristics. We typically obtain the data for these statistics from the sellers or servicers of the mortgage loans and receive representations and warranties as to the accuracy of the information. While we perform various quality assurance checks by sampling loans to assess compliance with our underwriting and eligibility criteria, we do not independently verify all reported information. As noted above, we generally have access to detailed loan-level statistics only on conventional single-family mortgage loans held in our portfolio and backing Fannie MBS (whether held in our portfolio or held by third parties).

Table 21: Risk Characteristics of Conventional Single-Family Mortgage Credit Book

	Percent of Book of Business ⁽¹⁾		
	As of December 31,		
	2005	2004	2003
Original loan-to-value ratio: ⁽²⁾			
<= 60.00	26%	26%	26%
60.01% to 70.00%	17	17	17
70.01% to 80.00%	41	40	39
80.01% to 90.00%	8	9	10
90.01% to 100.0%	8	8	8
Greater than 100%			
Total	100%	100%	100%
Weighted average	70%	70%	70%
Estimated mark-to-market loan-to-value ratio: ⁽²⁾			
<= 60.00	60%	53%	43%
60.01% to 70.00%	17	20	22
70.01% to 80.00%	16	18	24
80.01% to 90.00%	5	6	8
90.01% to 100.0%	2	3	3
Greater than 100%			
Total	100%	100%	100%
Weighted average	53%	57%	60%
Average loan amount	\$ 129,657	\$ 125,812	\$ 122,901
Product type: ⁽³⁾			
Fixed-rate:			
Long-term	65%	64%	64%
Intermediate-term	21	24	27
Interest-only			
Total fixed-rate	86	88	91
Adjustable-rate:			
Interest-only	4	2	1
Negative-amortizing	2	1	1
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Other ARMs	8	9	7
Total adjustable-rate	14	12	9
Total	100%	100%	100%
Number of property units:			
1 unit	96%	96%	96%
2-4 units	4	4	4
Total	100%	100%	100%
Property type:			
Single-family homes	92%	93%	93%
Condo/Co-op	8	7	7
Total	100%	100%	100%

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	Percent of Book of Business⁽¹⁾		
	As of December 31,		
	2005	2004	2003
Occupancy type:			
Primary residence	91%	92%	92%
Second/vacation home	4	3	3
Investor	5	5	5
Total	100%	100%	100%
Credit score:			
< 620	5%	5%	5%
620 to < 660	10	11	11
660 to < 700	18	18	18
700 to < 740	23	23	23
>= 740	43	41	40
Not available	1	2	3
Total	100%	100%	100%
Weighted average	721	719	717
Loan purpose:			
Purchase	34%	31%	28%
Cash-out refinance	31	30	30
Other refinance	35	39	42
Total	100%	100%	100%
Geographic concentration: ⁽⁴⁾			
Midwest	17%	17%	17%
Northeast	19	19	18
Southeast	23	22	22
Southwest	16	16	16
West	25	26	27
Total	100%	100%	100%
Origination year:			
<= 1995	2%	2%	5%
1996			1
1997		1	1
1998	2	2	3
1999	1	2	2
2000	1	1	1
2001	4	6	9
2002	12	17	25
2003	36	46	53

2004	21	23	
2005	21		
Total	100%	100%	100%

- (1) Percentages calculated based on unpaid principal balance of loans as of the end of each period.
- (2) Excludes loans for which this information is not readily available. The methodology used to estimate the mark-to-market loan-to-value ratio was implemented in 2004.
- (3) Long-term fixed-rate consists of mortgage loans with contractual maturities greater than 15 years.
Intermediate-term fixed-rate consists of mortgage loans with contractual maturities equal to or less than 15 years.
- (4) Midwest includes IL, IN, IA, MI, MN, NE, ND, OH, SD and WI. Northeast includes CT, DE, ME, MA, NH, NJ, NY, PA, PR, RI, VT and VI. Southeast includes AL, DC, FL, GA, KY, MD, MS, NC, SC, TN, VA and WV.
Southwest includes AZ, AR, CO, KS, LA, MO, NM, OK, TX and UT. West includes AK, CA, GU, HI, ID, MT, NV, OR, WA and WY.

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	Percent of Business Volume ⁽¹⁾		
	For the Year Ended December 31,		
	2005	2004	2003
Original loan-to-value ratio:			
<= 60.00	22%	23%	29%
60.01% to 70.00%	16	16	18
70.01% to 80.00%	46	43	38
80.01% to 90.00%	7	8	8
90.01% to 100.0%	9	10	7
Greater than 100%			
Total	100%	100%	100%
Weighted average	72%	71%	68%
Average loan amount	\$ 171,761	\$ 158,759	\$ 153,461
Product type: ⁽²⁾			
Fixed-rate:			
Long-term	69%	62%	63%
Intermediate-term	9	16	27
Interest-only	1		
Total fixed-rate	79	78	90
Adjustable-rate:			
Interest-only	9	5	1
Negative-amortizing	3	2	1
Other ARMs	9	15	8
Total adjustable-rate	21	22	10
Total	100%	100%	100%
Number of property units:			
1 unit	96%	96%	96%
2-4 units	4	4	4
Total	100%	100%	100%
Property type:			
Single-family detached	90%	91%	93%
Condo/Co-op	10	9	7
Total	100%	100%	100%

Occupancy type:			
Primary residence	89%	91%	93%
Second/vacation home	5	4	3
Investor	6	5	4
Total	100%	100%	100%

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	Percent of Business Volume⁽¹⁾		
	For the Year Ended December 31,		
	2005	2004	2003
Credit score:			
< 620	5%	6%	4%
620 to < 660	11	12	10
660 to < 700	19	19	18
700 to < 740	23	24	24
>= 740	42	39	44
Not available			
Total	100%	100%	100%
Weighted average	719	715	721
Loan purpose:			
Purchase	47%	43%	22%
Cash-out refinance	35	29	32
Other refinance	18	28	46
Total	100%	100%	100%
Geographic concentration: ⁽³⁾			
Midwest	16%	17%	18%
Northeast	18	19	18
Southeast	25	22	20
Southwest	16	14	14
West	25	28	30
Total	100%	100%	100%

(1) Percentages calculated based on unpaid principal balance of loans at time of acquisition.

(2) Long-term fixed-rate consists of mortgage loans with contractual maturities greater than 15 years.
Intermediate-term fixed-rate consists of mortgage loans with contractual maturities equal to or less than 15 years.

(3) See footnote 4 to Table 21 for states included in each geographic region.

The key elements of the above risk characteristics are as follows:

Loan-to-value (LTV) ratio. The LTV ratio is the ratio, at a given point in time, of the unpaid principal balance of a mortgage loan to the value of the property that serves as collateral for the loan (expressed as a percentage). LTV ratio is a strong predictor of credit performance. In most cases, the original LTV is based on the appraised property value reported to us at the time of acquisition of the loan and the original unpaid principal balance of the loan. The aggregate current or estimated mark-to-market LTV is based on the estimated current value of the property, calculated using an internal valuation model that estimates periodic changes in home value, and the

unpaid principal balance of the loan as of the date of each reported period. Assuming all other factors are equal, the likelihood of default and the gross severity of a loss in the event of default are typically lower as the LTV ratio decreases.

Product type. Product type is defined by the nature of the interest rate applicable to the mortgage (fixed for the duration of the loan or adjustable subject to contractual terms) and by the maturity of the loan. We generally divide our Single-Family business into three primary product types: long-term, fixed-rate mortgages with original terms of greater than 15 years; intermediate-term, fixed-rate mortgages with original terms of 15 years or less; and ARMs of any term. During 2004, 2005 and 2006, there was a proliferation of alternative product types, including negative-amortizing loans and interest-only loans. Negative-amortizing loans allow the borrower to make monthly payments that are less than the interest actually accrued for the period. The unpaid interest is added to the principal balance of the loan, which increases the outstanding loan balance. Negative-amortizing loans are typically adjustable-rate mortgage

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loans. Interest-only loans allow the borrower to pay only the monthly interest due, and none of the principal, for a fixed term. After the end of that term, usually five to ten years, the borrower can choose to refinance, pay the principal balance in a lump sum, or begin paying the monthly scheduled principal due on the loan, which results in a higher monthly payment at that time. Interest-only loans can be adjustable-rate or fixed-rate mortgage loans. While negative-amortizing and interest-only loans have been offered by lenders for some time, we began separately reporting and more closely monitoring them as their prevalence increased during 2004 to 2006.

Certain residential loan product types have features that may result in increased credit risk when compared to residential loans without those features. In general, 15-year fixed-rate mortgages exhibit the lowest default rate among the types of mortgage loans we securitize and purchase, due to the accelerated rate of principal amortization on these mortgages and the credit profiles of borrowers who use them. The next lowest rate of default is associated with 30-year fixed-rate mortgages. Balloon/reset mortgages and ARMs typically default at a higher rate than fixed-rate mortgages, although default rates for different types of ARMs may vary. While ARMs are typically originated with interest rates that are initially lower than those available for fixed-rate mortgages, the interest rates on ARMs change over time based on changes in an index or reference interest rate. As a result, the borrower's payments may rise or fall, within limits, as interest rates change. As payment amounts increase, the risk of default also increases. In the low interest rate environment experienced during 2006, 2005, 2004 and 2003, this industry trend was reversed with ARMs exhibiting lower default rates than fixed-rate mortgages. We expect loans that permit a borrower to defer the payment of principal or interest, such as negative-amortizing and interest-only loans, to default more often than traditional mortgage loans. We consider the risk of default in determining our guaranty fee and purchase price.

Number of units. We classify mortgages secured by housing with four or fewer living units as single-family. Mortgages on one-unit properties tend to have lower credit risk than mortgages on multiple-unit properties, such as duplexes, all other factors held equal. Over 95% of our conventional single-family mortgage credit book of business consists of loans secured by one-unit properties.

Property type. We evaluate the underlying type of property that secures a mortgage loan. Condominiums are generally considered to have higher credit risk than single-family detached properties. Condominiums are often more difficult to resell than single-family detached properties, and they historically have exhibited greater volatility in home price trends.

Occupancy type. Borrowers may purchase a home as a primary residence, a second or vacation home, or an investment property. Assuming all other factors are equal, mortgages on properties occupied by the borrower as a primary or secondary residence tend to have lower credit risk than mortgages on investment properties.

Credit score. Credit score is a measure often used by the financial services industry, including our company, to assess borrower credit quality. Credit scores are generated by credit repositories and calculated based on proprietary statistical models that evaluate many types of information on a borrower's credit report and predict the likelihood that a borrower will repay future obligations as expected. FICO® scores, developed by Fair Isaac Corporation, are commonly used credit scores. FICO scores, as reported by the credit repositories, may range from a low of 300 to a high of 850. Based on Fair Isaac Corporation statistical information, a higher FICO score typically indicates a lesser degree of credit risk.

We obtain borrower credit scores on the majority of single-family mortgage loans that we purchase or that back Fannie Mae MBS. We believe the average credit score within our single-family mortgage credit book of business is a strong indicator of default risk.

Loan purpose. Loan purpose indicates how the borrower intends to use the funds from a mortgage loan. We designate the loan purpose as purchase, cash-out refinance or other refinance. The funds in a purchase transaction

are used to acquire a property. In addition to paying off an existing first mortgage lien, the funds in a cash-out refinance transaction also may be used for other purposes, including paying off subordinate mortgage liens and providing unrestricted cash proceeds to the borrower. Cash-out

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refinancings have a higher risk of default. All other refinance transactions are defined as other re-financings. We also may disclose certain loans that were modified prior to our acquisition as refinanced loans.

Geographic concentration. Local economic conditions affect borrowers' ability to repay loans and the value of the collateral underlying a loan, if all other factors are equal. We analyze geographic exposure at a variety of levels of geographic aggregation, including at the regional level. Geographic diversification reduces mortgage credit risk.

Loan age. We monitor year of origination and loan age, which is defined as the number of years since origination. Statistically, the peak ages for default are currently from two to six years after origination.

The credit quality of the mortgage loans in our conventional single-family mortgage credit book of business remained high as of December 31, 2005 and 2004, as evidenced by weighted average loan-to-value ratios and weighted average credit scores. The weighted average original loan-to-value ratio was an estimated 70% as of both December 31, 2005 and 2004. The weighted average estimated mark-to-market loan-to-value ratio for our conventional single-family mortgage credit book of business decreased to 53% as of December 31, 2005, from 57% as of December 31, 2004. The weighted average credit score was 721 and 719 as of December 31, 2005 and 2004, respectively. As of December 31, 2006, the weighted average original loan-to-value ratio was an estimated 70% and the weighted average estimated mark-to-market loan-to-value ratio was an estimated 55%. The weighted average credit score remained at 721 as of December 31, 2006.

The most notable change in the overall risk profile of our single-family mortgage credit book of business in recent years has been in product types. As a result of the rise in home prices over the past several years, there has been a shift in the primary mortgage market to mortgage loans with features that make it easier for borrowers to qualify for a mortgage loan and that offer lower initial monthly payments by allowing the borrower to defer repayment of principal or interest. These products include interest-only mortgage loans that are available with both fixed-rate and adjustable-rate terms and ARMs that have the potential for negative amortization. In addition, there has been an increasing industry trend towards streamlining the mortgage loan underwriting process by reducing the documentation requirements for borrowers and accepting alternative or non-traditional documentation. Reduced documentation loans in some cases present higher credit risk than loans underwritten with full standard documentation. We have worked with our lender customers to support a broad range of mortgage products, including Alt-A and subprime products and other products with a higher level of credit risk, which have represented an increased proportion of mortgage originations in recent years. Although there is no uniform definition for Alt-A and subprime loans across the mortgage industry, Alt-A loans are generally defined as loans with lower or alternative documentation requirements, while subprime loans are generally defined as loans made to borrowers with weaker credit profiles. We have increased our participation in these types of products where we have concluded that it would be economically advantageous or that it would contribute to our mission objectives. We have worked to enhance our credit analytics and data to better understand, assess and price for the risks associated with these products to allow us to closely monitor credit risk and pricing dynamics across the full spectrum of mortgage product types.

The percentage of our single-family mortgage credit book of business consisting of subprime mortgage loans or structured Fannie Mae MBS backed by subprime mortgage loans was not material as of December 31, 2005. We estimate these loans represented approximately 0.2% of our single-family mortgage credit book of business as of December 31, 2006. To date, our purchases of subprime mortgage loans generally have been accompanied by the purchase of credit enhancements that materially reduce our exposure to credit losses on these mortgages. We estimate that approximately 2% of our single-family mortgage credit book of business as of December 31, 2006 consisted of private-label mortgage-related securities backed by subprime mortgage loans and, to a lesser extent, resecuritizations of private-label mortgage-related securities backed by subprime mortgage loans. We believe our credit exposure to the subprime mortgage loans underlying the private-label mortgage-related securities in our portfolio is limited because

we have focused our purchases to date on the highest-rated tranches of these securities.

Interest-only ARMs, which represented approximately 5% of our conventional single-family business volume in 2004, increased to approximately 9% of our conventional single-family business volume in both 2005 and

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2006. Most of the interest-only products we acquired during 2004 to 2006 had adjustable-rate terms. Approximately 43% of the interest-only products we acquired in 2006 had fixed-rate terms. Negative-amortizing ARMs represented approximately 2% of our conventional single-family business volume in 2004, compared with approximately 3% of our conventional single-family business volume in both 2005 and 2006. As a result of the shift in the product profile of new business in recent years, interest-only ARMs and negative-amortizing ARMs together represented approximately 6% of our conventional single-family mortgage credit book of business as of December 31, 2005 and 2006.

In September 2006, the federal financial regulatory agencies (The Board of Governors of the Federal Reserve System, the Office of Comptroller of the Currency, the Office of Thrift Supervision, the National Credit Union Administration, and the Federal Deposit Insurance Corporation) jointly issued *Interagency Guidance on Nontraditional Mortgage Product Risks* to address risks posed by interest-only loans and other mortgage products that allow borrowers to defer repayment of principal or interest. The guidance also addresses the layering of risks that results from combining these product types with other features that may compound risk, such as relying on reduced documentation to evaluate a borrower's creditworthiness. The guidance directs federally regulated financial institutions (which includes the bulk of our lender customers) originating these loans to maintain underwriting standards that are consistent with prudent lending practices, including analysis of a borrower's capacity to repay the full amount of credit that may be extended and to provide borrowers with clear and balanced information about the relative benefits and risks of these products sufficiently early in the process to enable them to make informed decisions.

In December 2006, OFHEO directed us to take immediate action to apply the risk management, underwriting and consumer disclosure principles of this guidance to mortgages we purchase or guarantee. In response to the guidance, we are implementing changes to our Desktop Underwriter[®] automated underwriting system relating to the calculation of qualifying ratios for certain non-traditional mortgage products. We are also making adjustments to our underwriting and eligibility standards to ensure our guidelines conform to the interagency guidance. We submitted a report to OFHEO in February 2007 on our progress in developing policies, credit quality standards and capital provisions in line with the guidance. OFHEO may require additional changes to our underwriting system and guidelines in connection with the interagency guidance, and we are currently discussing with OFHEO the actions we should take to implement the principles of this guidance, consistent with our role as a secondary mortgage market participant.

In addition to the shift in the product profile of new business described above, we have made, and continue to make, significant adjustments to our mortgage loan sourcing and purchase strategies in an effort to meet HUD's increased housing goals and new subgoals. These strategies include entering into some purchase and securitization transactions with lower expected economic returns than our typical transactions. We have also relaxed some of our underwriting criteria to obtain goals-qualifying mortgage loans and increased our investments in higher-risk mortgage loan products that are more likely to serve the borrowers targeted by HUD's goals and subgoals, which could increase our credit losses. See *Item 1 Business Our Charter and Regulation of Our Activities Regulation and Oversight of Our Activities HUD Regulation Housing Goals* for a description of our housing goals.

We use analytical tools to measure credit risk exposures, assess performance of our mortgage credit book of business, and evaluate risk management alternatives. We continually refine our methods of measuring credit risk, setting risk and return targets, and transferring risk to third parties. We use our analytical models to establish forecasts and expectations for the credit performance of loans in our mortgage credit book and compare actual performance to those expectations. Comparison of actual versus projected performance and changes in other key trends are monitored to identify changes in risk or return profiles and to provide the basis for revising policies, standards, guidelines, credit enhancements or guaranty fees for future business.

Housing and Community Development

Diversification within our multifamily mortgage credit book of business and LIHTC equity investments business by geographic concentration, term-to-maturity, interest rate structure, borrower concentration and credit enhancement arrangements is an important factor that influences credit quality and performance and helps reduce our credit risk.

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We monitor the performance and risk concentrations of multifamily loans and properties on an ongoing basis throughout the life cycle of the investment at the loan, property and portfolio level. We closely track the physical condition and financial performance of the property, the historical performance of the loan or property, the relevant local market economic conditions that may signal changing risk or return profiles and other risk factors. For example, we closely monitor rental payment trends and vacancy levels in local markets to identify loans meriting closer attention or loss mitigation actions. We also evaluate the servicers' submissions and may require the servicer to take certain actions to mitigate the likelihood of delinquency or default. For our investments in multifamily loans and properties, the primary asset management responsibilities are performed by our DUS lenders. For our LIHTC investments, the primary asset management responsibilities are performed by our LIHTC syndicator partners or third parties. These partners provide us with periodic construction status updates and property operating information. We compare the information received to our construction schedules, tax delivery schedules and industry standards to measure and grade project performance.

We use proprietary models and analytical tools to periodically re-evaluate our multifamily mortgage credit book of business, establish forecasts of credit performance and estimate future potential credit losses. Information derived from our analyses is used to identify changes in risks and provide the basis for revising policies, standards, pricing and credit enhancements.

We also have data on and manage multifamily mortgage credit risk at the loan level. We had loan-level data on approximately 90% of our total multifamily mortgage credit book as of December 31, 2005, 2004 and 2003. Unless otherwise noted, the credit statistics provided for our multifamily mortgage credit book generally include only mortgage loans in our portfolio, outstanding Fannie Mae MBS (excluding Fannie Mae MBS backed by non-Fannie Mae mortgage-related securities) and credit enhancements that we provide, where we have more detailed loan-level information.

Credit Loss Management

Single-Family

We manage problem loans to mitigate credit losses. If a mortgage loan does not perform, we work closely in partnership with the servicers of our loans to minimize the frequency of foreclosure as well as the severity of loss. We have developed detailed servicing guidelines and work closely with the loan servicers to ensure that they take appropriate loss mitigation steps on a timely basis. Our loan management strategy begins with payment collection and work-out guidelines designed to minimize the number of borrowers who fall behind on their obligations and to help borrowers who are delinquent from falling further behind on their payments. We seek alternative resolutions of problem loans to reduce the legal and management expenses associated with foreclosing on a home.

In our experience, early intervention is critical to controlling credit losses. We offer Risk Profilersm, an internally-developed default prediction model, to our single-family servicers to monitor the performance and risk of each loan and identify those loans that are most likely to default and require the most attention. Risk Profiler uses credit risk indicators such as mortgage payment records, updated borrower credit data, current property values and mortgage product characteristics to evaluate the risk of each loan. Most of the lenders that service loans we buy or that back Fannie Mae MBS use Risk Profiler or a similar default prediction model.

We require our single-family servicers to pursue various resolutions of problem loans as an alternative to foreclosure, including:

repayment plans in which borrowers repay past due principal and interest over a reasonable period of time through a temporarily higher monthly payment;

loan modifications in which past due interest amounts are added to the loan principal amount and recovered over the remaining life of the loan, and other loan adjustments;

long-term forbearances in which the lender agrees to suspend borrower payments for an extended period of time;

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accepting deeds in lieu of foreclosure whereby the borrower signs over title to the property without the added expense of a foreclosure proceeding; and

preforeclosure sales in which the borrower, working with the servicer, sells the home and pays off all or part of the outstanding loan, accrued interest and other expenses from the sale proceeds.

The objective of the repayment plan and loan modification strategies is to allow borrowers who have experienced temporary financial distress to remain in their homes and to avoid the losses associated with foreclosure. The objective of the deed in lieu and preforeclosure sale strategies is to minimize the extra costs associated with a traditional foreclosure by obtaining the borrower's cooperation in resolving the default. We use analytical models and work rules to determine which alternative resolution, if any, may be appropriate for each problem loan.

We track the ultimate performance of alternative resolutions in absolute terms and in relation to estimated losses in the event of a traditional single-family loan foreclosure. We adjust our loss mitigation policies as appropriate to be consistent with our risk management objectives. In the case of repayment plans and loan modifications, we focus in particular on the performance of the loans subsequent to our intervention. Of the conventional loans that recover through modifications, long-term forbearances and repayment plans, our performance experience after 36 months following the inception of all such plans, based on the period 1998 to 2002, has been that approximately 65% of these loans remain current or have been paid in full. Approximately 11% have terminated through foreclosure. The remaining loans once again reached a delinquent status.

In those cases when a foreclosure avoidance effort is not successful, we typically foreclose and acquire the property. Our property management and sales operation employs several strategies designed to shorten our holding time, minimize the impact on the neighborhood, maximize our recovery and mitigate credit losses. These strategies include prompt assessment of the property condition and partnering with qualified local real estate brokers to market and refurbish the property when economically feasible to appeal to the broadest market of homebuyers, particularly buyers who plan to live in the home.

The table below presents statistics on the resolution of conventional single-family problem loans for the years ended December 31, 2005, 2004 and 2003.

Table 23: Statistics on Conventional Single-Family Problem Loan Workouts

	For the Year Ended December 31,		
	2005	2004	2003
	(Number of loans)		
Modifications ⁽¹⁾	20,732	22,591	17,119
Repayment plans and long-term forbearances	47,641	39,225	37,271
Pre-foreclosure sales	2,478	2,575	2,052
Deeds in lieu of foreclosure	384	330	320
Total number of problem loan workouts ⁽²⁾	71,235	64,721	56,762

- (1) Modifications include troubled debt restructurings, which result in concessions to borrowers, and other modifications to the contractual terms of the loan that do not result in concessions to the borrower.
- (2) Represents approximately 0.5%, 0.4% and 0.4% of the total number of loans in our conventional single-family mortgage credit book for the years ended December 31, 2005, 2004 and 2003, respectively.

Housing and Community Development

When a multifamily loan does not perform, we work closely with our loan servicers to minimize the severity of loss by taking appropriate loss mitigation steps. We permit our multifamily servicers to pursue various options as an alternative to foreclosure, including modifying the terms of the loan, selling the loan, and preforeclosure sales. The resolution strategy depends in part on the borrower's level of cooperation, the performance of the market or submarket, the value of the property, the condition of the property, any remaining equity in the property and the borrower's ability to infuse additional equity into the property. The unpaid principal balance of modified multifamily loans totaled \$165 million, \$224 million and \$196 million

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for the years ended December 31, 2005, 2004, and 2003, respectively, which represented 0.13%, 0.18% and 0.16% of our total multifamily mortgage credit book of business as of the end of each respective period.

When a non-guaranteed LIHTC investment does not perform, we work closely with our syndicator partner. The resolution strategy depends on:

- the local general partner's ability to meet obligations;
- the value of the property;
- the ability to restructure the debt;
- the financial and workout capacity of the syndicator partner; and
- the strength of the market or submarket.

If a guaranteed LIHTC investment does not perform, the guarantor remits funds to us in an amount that provides us with the contractual underwritten return. Our risk in this situation is that the counterparty will not perform. Refer to Institutional Counterparty Credit Risk Management below for a discussion of how we manage the credit risk associated with our counterparties.

Mortgage Credit Book Performance

Key metrics used to measure credit risk in our mortgage credit book of business and evaluate credit performance include the serious delinquency rate, nonperforming loans and credit losses.

Serious Delinquency

The serious delinquency rate is an indicator of potential future foreclosures, although most loans that become seriously delinquent do not result in foreclosure. The rate at which new loans become seriously delinquent and the rate at which existing seriously delinquent loans are resolved significantly affect the level of future credit losses. Home price appreciation decreases the risk of default. A borrower with enough equity in a home can sell the home or draw on equity in the home to avoid foreclosure. A decline in home prices increases the risk of default. The presence of credit enhancements mitigates credit losses caused by defaults.

We classify single-family loans as seriously delinquent when a borrower has missed three or more consecutive monthly payments, and the loan has not been brought current or extinguished through foreclosure, payoff or other resolution. A loan referred to foreclosure but not yet foreclosed is also considered seriously delinquent. Loans that are subject to a repayment plan are classified as seriously delinquent until the borrower has missed fewer than three consecutive monthly payments. We calculate the single-family serious delinquency rate by dividing the number of seriously delinquent single-family loans by the total number of single-family loans outstanding. We include all of the conventional single-family loans that we own and that back Fannie Mae MBS in our single-family delinquency rate, including those with substantial credit enhancement. We distinguish between loans on which we have some form of credit enhancement and loans on which we do not have credit enhancement.

We classify multifamily loans as seriously delinquent when payment is 60 days or more past due. We calculate the multifamily serious delinquency rate by dividing the unpaid principal balance of seriously delinquent multifamily loans by the unpaid principal balance of all multifamily loans that we own or that back Fannie Mae MBS or housing authority bonds for which we provide credit enhancement. The table below compares the serious delinquency rates for

all conventional single-family loans and multifamily loans, in each case with credit enhancements and without credit enhancements.

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	As of December 31,					
	2005		2004		2003	
	Book	Serious	Book	Serious	Book	Serious
	Outstanding ⁽¹⁾	Delinquency	Outstanding ⁽¹⁾	Delinquency	Outstanding ⁽¹⁾	Delinquency
		Rate ⁽²⁾		Rate ⁽²⁾		Rate ⁽²⁾
Conventional single-family loans:						
Credit enhanced	18%	2.14%	19%	1.84%	21%	1.65%
Non-credit enhanced	82	0.47	81	0.33	79	0.30
Total conventional single-family loans	100%	0.79%	100%	0.63%	100%	0.60%
Multifamily loans:						
Credit enhanced	95%	0.34%	95%	0.11%	95%	0.29%
Non-credit enhanced	5	0.02	5	0.13	5	0.22
Total multifamily loans	100%	0.32%	100%	0.11%	100%	0.29%

(1) Reported based on unpaid principal balance of loans, where we have detailed loan-level information.

(2) Reported based on number of loans for single-family and unpaid principal balance for multifamily.

The aftermath of Hurricane Katrina during the fourth quarter of 2005 resulted in an increase in our single-family and multifamily serious delinquency rates to 0.79% and 0.32%, respectively, as of December 31, 2005, from 0.63% and 0.11%, respectively, as of December 31, 2004. Our serious delinquency rate for loans not impacted by Hurricane Katrina for single-family and multifamily was 0.64% and 0.12%, respectively, as of December 31, 2005.

The decline in the multifamily serious delinquency rate to 0.11% as of December 31, 2004 from 0.29% as of December 31, 2003 was primarily attributable to loans from two borrowers totaling \$137 million at the end of 2003, which were either restructured or were brought current during 2004.

Our conventional single-family serious delinquency rate decreased to 0.65% as of December 31, 2006, and our multifamily serious delinquency rate decreased to 0.08%. The decline in the delinquency rates during 2006 was due primarily to payoffs and the resolution of loans secured by properties in the Gulf Coast region. We expect serious delinquencies to increase in 2007 as a result of the significant slowdown in home price appreciation. As of December 31, 2006, approximately 10% of our conventional single-family mortgage credit book of business had an estimated mark-to-market loan-to-value ratio greater than 80%. Over 76% of these loans were covered by credit enhancement. The remaining loans, which would have required credit enhancement at acquisition if the original loan-to-value ratios were above 80%, were not covered by credit enhancement as of December 31, 2006 because of changes in home price appreciation over time and loan principal payments, which affected the estimated mark-to-market loan value ratio. In examining the geographic concentration of these high LTV loans, there was no

metropolitan statistical area with more than 5% of this segment of our conventional single-family mortgage credit book of business. The three largest metropolitan statistical area concentrations were in Atlanta, Detroit and Chicago.

Nonperforming Loans

We classify conventional single-family loans, including delinquent loans purchased from an MBS trust pursuant to the terms of the trust indenture, as nonperforming and place them on nonaccrual status at the earlier of when payment of principal and interest becomes three months or more past due according to the loan's contractual terms or when, in our opinion, collectibility of interest or principal is not reasonably assured. We classify conventional multifamily loans as nonperforming and place them on nonaccrual status at the earlier of when payment of principal and interest is three months or more past due according to the loan's contractual terms or when we determine that collectibility of all principal or interest is not reasonably assured based on an individual loan level assessment. We continue to accrue interest on nonperforming loans that are federally insured or guaranteed by the U.S. government. Table 25 provides statistics on nonperforming single-

Charge-offs, net of recoveries									
Foreclosed property expense (income)	(17)	4	(13)	(17)	28	11	(10)	(2)	(12)
Credit-related losses	\$ 420	\$ 29	\$ 449	\$ 172	\$ 49	\$ 221	\$ 186	\$ 3	\$ 189
Charge-off ratio (basis points) ⁽¹⁾	2.0 bp	1.9 bp	2.0 bp	0.9 bp	1.7 bp	0.9 bp	1.0bp	0.5bp	1.0 bp
Credit loss ratio (basis points) ⁽²⁾	1.9 bp	2.2 bp	1.9 bp	0.8 bp	4.0 bp	1.0bp	1.0bp	0.3bp	0.9 bp

(1) Represents charge-offs, net of recoveries, divided by average total mortgage credit book of business.

(2) Represents credit-related losses divided by average total mortgage credit book of business.

Interest forgone on nonperforming loans in our mortgage portfolio, which is presented in Table 25, reduces our net interest income but is not reflected in our credit loss total. Other-than-temporary impairment resulting from deterioration in credit quality of our mortgage-related securities is not included in credit-related losses. As shown in Table 26, our total credit-related losses for the years presented was less than 2.0 basis points, or 0.02%, of our average mortgage credit book of business over the periods presented. The rapid acceleration in home prices during the period from 1999 to 2005, combined with our use of credit enhancements, helped in mitigating our credit losses. As a result of the substantial slowdown in home price appreciation during 2006

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and economic indicators that suggest home prices are likely to decline modestly in 2007, we expect our credit losses to increase.

Losses from Hurricane Katrina increased our provision for credit losses in 2005. Our exposure to losses as a result of Hurricane Katrina arose primarily from Fannie Mae MBS backed by loans secured by properties in the affected areas, our portfolio holdings of mortgage loans and mortgage-related securities backed by loans secured by properties in the affected areas, and real estate that we own in the affected areas. We initially estimated that our after-tax losses associated with the Gulf Coast Hurricanes would be in a range of \$250 million to \$550 million, which included both single-family and multifamily properties. Based on our subsequent review and assessment, we recorded a provision for credit losses of \$106 million (after-tax loss of \$69 million) in the third quarter of 2005 to reflect our most recent estimate. This reduction was due to several factors, including our ongoing assessment, the liquidation of a number of the loans relating to flooded properties from our mortgage portfolio, the receipt of more insurance funds than previously expected on the flooded properties and reduced delinquencies for affected loans outside the flood-damaged areas. Further adjustments to this estimate are possible as we continue to monitor this issue.

We use internally developed models to assess our sensitivity to credit losses based on current data on home values, borrower payment patterns, non-mortgage consumer credit history and management's economic outlook. We closely examine a range of potential economic scenarios to monitor the sensitivity of credit losses. Our models indicate that home price movements are an important predictor of credit performance. Pursuant to the September 1, 2005 agreement with OFHEO, we agreed to provide quarterly assessments of the impact on our expected credit losses from an immediate 5% decline in single-family home prices for the entire United States, which we believe is a stressful scenario based on housing data from OFHEO. Historical statistics from OFHEO's house price index reports indicate the national average rate of home price appreciation over the last 20 years has been about 5.5%, while the lowest national average annual appreciation rate in any single year has been 0.3%. However, we believe that a modest decline in home prices is possible in 2007.

We develop a baseline scenario that estimates the present value of future credit losses over a ten-year period. We then calculate the present value of credit losses assuming an immediate 5% decline in the value of single-family properties securing mortgage loans we own or that back Fannie Mae MBS. Following this decline, we assume home prices will follow a statistically derived long-term path. The sensitivity of future credit losses represents the dollar difference between credit losses in the baseline scenario and credit losses assuming the immediate 5% home price decline. The estimated sensitivity of our expected future credit losses to an immediate 5% decline in home values for single-family mortgage loans as of December 31, 2005 and 2004 is disclosed in the following table. We disclose both the gross credit loss sensitivity prior to the receipt of private mortgage insurance claims or any other credit enhancements and the net credit loss sensitivity after consideration of these items.

Table of Contents**Table 27: Single-Family Credit Loss Sensitivity⁽¹⁾**

	As of December 31,	
	2005	2004
	(Dollars in millions)	
Gross credit loss sensitivity ⁽²⁾	\$ 2,310	\$ 2,266
Less: Projected credit risk sharing proceeds	(1,167)	(1,179)
Net credit loss sensitivity	\$ 1,143	\$ 1,087
Single-family whole loans and Fannie Mae MBS	\$ 2,035,704	\$ 1,980,789
Single-family net credit loss sensitivity as a percentage of single-family whole loans and Fannie Mae MBS	0.06%	0.05%

(1) Represents total economic credit losses, which include net charge-offs/recoveries, foreclosed property expenses, forgone interest and the cost of carrying foreclosed properties.

(2) Measures the gross sensitivity of our expected future credit losses to an immediate 5% decline in home values for first lien single-family whole loans we own or that back Fannie Mae MBS. After the initial shock, we estimate home price growth rates return to the rate projected by our credit pricing models.

The estimates in the preceding paragraphs are based on approximately 92% and 90% of our total single-family mortgage credit book of business as of December 31, 2005 and 2004, respectively. The mortgage loans and mortgage-related securities that are included in these estimates consist of single-family single-class Fannie Mae MBS (whether held in our portfolio or held by third parties) and single-family mortgage loans, excluding mortgages secured only by second liens and reverse mortgages. We expect the inclusion in our estimates of these excluded products may impact the estimated sensitivities set forth in the preceding paragraphs. The above estimated credit loss sensitivities are generated using the same models that we use to estimate fair value and impairment. We have made certain modifications to our models from those used to report previous credit loss sensitivities.

Foreclosure and REO activity affects the level of credit losses. The table below provides information on foreclosures for the years ended December 31, 2005, 2004 and 2003. In light of the continued weakness of economic fundamentals, such as employment levels and lack of home price appreciation in the Midwestern states, we expect increasing foreclosure and REO incidence and credit losses in that region. REO acquisitions in the Midwest increased to 16,000 units in 2006 from less than 12,000 units in 2005.

Table of Contents**Table 28: Single-Family and Multifamily Foreclosed Properties**

	For the Year Ended December 31,		
	2005	2004	2003
Single-family foreclosed properties (number of properties):			
Beginning inventory of single-family foreclosed properties (REO) ⁽¹⁾	18,361	13,749	9,975
Geographic analysis of acquisitions: ⁽²⁾			
Midwest	11,777	10,149	7,384
Northeast	2,405	2,318	1,997
Southeast	9,470	10,275	8,539
Southwest	8,099	8,422	6,640
West	809	1,739	2,235
Total properties acquired through foreclosure	32,560	32,903	26,795
Dispositions of REO	29,978	28,291	23,021
Ending inventory of single-family foreclosed properties (REO) ⁽¹⁾	20,943	18,361	13,749
Multifamily foreclosed properties:			
Ending inventory of multifamily foreclosed properties (REO)	8	18	20
Carrying value of multifamily foreclosed properties (dollars in millions)	\$ 51	\$ 131	\$ 98

(1) Includes deeds in lieu of foreclosure.

(2) See footnote 4 to Table 21 for states included in each geographic region.

Allowance for Loan Losses and Reserve for Guaranty Losses

We maintain a separate allowance for loan losses for single-family and multifamily loans classified as held for investment in our mortgage portfolio and a reserve for guaranty losses for credit-related losses associated with certain mortgage loans that back Fannie Mae MBS held in our portfolio and held by other investors. The allowance for loan losses and reserve for guaranty losses represent our estimate of incurred credit losses inherent in our loans held for investment and loans underlying Fannie Mae MBS, respectively, as of each balance sheet date. We use the same methodology to determine our allowance for loan losses and our reserve for guaranty losses because the relevant factors affecting credit risk are the same. We recognize credit losses and record a provision for credit losses when available information indicates that it is probable that a loss has been incurred and the amount of the loss can be reasonably estimated in accordance with SFAS No. 5, *Accounting for Contingencies*. We also evaluate certain single-family and multifamily loans on an individual basis to recognize and measure impairment and record an allowance for incurred losses in accordance with the provisions of SFAS No. 114, *Accounting by Creditors for Impairment of a Loan (an amendment of FASB Statement No. 5 and 15)* (SFAS 114). We provide additional information on the methodology used in developing our allowance for loan losses and reserve for guaranty losses in Notes to Consolidated Financial Statements Note 1, Summary of Significant Accounting Policies. Because of the

significant degree of judgment involved in estimating the allowance for loan losses and reserve for guaranty losses, we identify it as a critical accounting policy and discuss the assumptions involved in our estimation process in Critical Accounting Policies and Estimates Allowance for Loan Losses and Reserve for Guaranty Losses.

We report the allowance for loan losses and reserve for guaranty losses as separate line items in the consolidated balance sheets. The provision for credit losses is reported in the consolidated statements of income. Table 29 summarizes changes in our allowance for loan losses and reserve for guaranty losses for the years ended December 31, 2005, 2004, 2003 and 2002.

Table of Contents**Table 29: Allowance for Loan Losses and Reserve for Guaranty Losses**

	2005	As of December 31, 2004 2003		2002
		(Dollars in millions)		
Allowance for loan losses:				
Beginning balance	\$ 349	\$ 290	\$ 216	\$ 168
Provision	124	174	187	128
Charge-offs ⁽¹⁾	(267)	(321)	(270)	(175)
Recoveries	96	131	72	27
Increase from the reserve for guaranty losses ⁽²⁾		75	85	68
Ending balance	\$ 302	\$ 349	\$ 290	\$ 216
Reserve for guaranty losses:				
Beginning balance	\$ 396	\$ 313	\$ 223	\$ 138
Provision	317	178	178	156
Charge-offs ⁽³⁾	(302)	(24)	(7)	(11)
Recoveries	11	4	4	8
Decrease to the allowance for loan losses ⁽²⁾		(75)	(85)	(68)
Ending balance	\$ 422	\$ 396	\$ 313	\$ 223
Combined allowance for loan losses and reserve for guaranty losses:				
Beginning balance	\$ 745	\$ 603	\$ 439	\$ 306
Provision	441	352	365	284
Charge-offs ⁽¹⁾	(569)	(345)	(277)	(186)
Recoveries	107	135	76	35
Ending balance	\$ 724	\$ 745	\$ 603	\$ 439
Balance at end of each period attributable to:				
Single-family	\$ 647	\$ 644	\$ 516	\$ 374
Multifamily	77	101	87	65
Total	\$ 724	\$ 745	\$ 603	\$ 439
Percent of combined allowance and reserve in each category to related mortgage credit book of business: ⁽⁴⁾				
Single-family	0.03%	0.03%	0.02%	0.02%
Multifamily	0.06%	0.08%	0.07%	0.07%
Total	0.03%	0.03%	0.03%	0.02%

- (1) Includes accrued interest of \$24 million, \$29 million, \$29 million and \$24 million for the years ended December 31, 2005, 2004, 2003 and 2002, respectively.
- (2) Includes decrease in reserve for guaranty losses and increase in allowance for loan losses due to the purchase of delinquent loans from MBS pools. Effective with our adoption of SOP 03-3 on January 1, 2005, we record delinquent loans purchased from Fannie Mae MBS pools at fair value upon acquisition. We no longer record an increase in the allowance for loan losses and reduction in the reserve for guaranty losses when we purchase these loans.
- (3) Includes a \$251 million charge in 2005 for loans subject to SOP 03-3 where the acquisition price exceeded the fair value of the acquired loan.
- (4) Represents ratio of combined allowance and reserve balance by loan type to total mortgage credit book of business by loan type.

Our combined allowance for loan losses and reserve for guaranty losses totaled \$724 million as of December 31, 2005, compared with \$745 million, \$603 million and \$439 million as of December 31, 2004, 2003 and 2002, respectively. The increase in our combined allowance for loan losses and reserve for guaranty losses from 2002 to 2004 was primarily due to significant growth in our mortgage credit book of business during this period, combined with the effect of an observed reduction in subsequent recourse proceeds from lenders on certain charged-off loans and an increase in loans with higher risk characteristics. In the fourth quarter of 2004, we recorded an increase of \$142 million in our combined allowance for loan losses and reserve for guaranty losses due to the observed reduction in lender recourse proceeds. In 2005, we increased our combined allowance for loan losses and reserve for guaranty losses by \$67 million for estimated losses

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related to Hurricane Katrina, which reflects a reduction in the reserve for guaranty losses for loans acquired in the fourth quarter of 2005 under SOP 03-3. This increase was more than offset by a decrease in the allowance for loan losses and reserve for guaranty losses that resulted from the significant increase in home prices during 2005. The combined allowance for loan losses and reserve for guaranty losses as a percentage of our total mortgage credit book of business has remained relatively stable, averaging between 0.02% and 0.03%. This trend reflects our historically low average default rates and loss severity on foreclosed properties, which we expect to increase as a result of the substantial slowdown in home price appreciation starting in 2006.

Institutional Counterparty Credit Risk Management

Institutional counterparty risk is the risk that institutional counterparties may be unable to fulfill their contractual obligations to us. Our primary exposure to institutional counterparty risk exists with our lending partners and servicers, mortgage insurers, dealers who distribute our debt securities or who commit to sell mortgage pools or loans, issuers of investments included in our liquid investment portfolio, and derivatives counterparties.

Our overall objective in managing institutional counterparty credit risk is to maintain individual counterparty exposures within acceptable ranges based on our rating system. We achieve this objective through the following:

- establishment and observance of counterparty eligibility standards appropriate to each exposure type and level;
- establishment of credit limits;
- requiring collateralization of exposures where appropriate; and
- exposure monitoring and management.

Establishment and Observance of Counterparty Eligibility Standards. The institutions with which we do business vary in size and complexity from the largest international financial institutions to small, local lenders. Because of this, counterparty eligibility criteria vary depending upon the type and magnitude of the risk exposure incurred. We incorporate both the ratings provided by the rating agencies as well as internal ratings in determining eligibility. For significant exposures, we generally require that our counterparties have at least the equivalent of an investment grade rating (*i.e.*, a rating of BBB-/Baa3/BBB- or higher by Standard & Poor's, Moody's and Fitch, respectively.) Due to factors such as the nature, type and scope of counterparty exposure, requirements may be higher. For example, for mortgage insurance counterparties, we have generally required a minimum rating of AA-/Aa3/AA-, whereas we accept comparatively lower ratings for our risk sharing, recourse and mortgage servicing counterparties. In addition to ratings, factors including corporate or third-party support or guaranties, our knowledge of the counterparty, reputation, quality of operations, and experience are also important in determining the initial and continuing eligibility of a counterparty. Specific eligibility criteria are communicated through policies and procedures of the individual businesses or products.

Establishment of Credit Limits. All institutions are assigned a limit to ensure that the risk exposure is maintained at a level appropriate for the institution's rating and the time horizon for the exposure, as well as to diversify exposure so that no single counterparty exceeds a certain percentage of our regulatory capital. Limits are established for the institution as a whole as well as for individual subsidiaries or affiliates. A corporate limit is first established for the aggregate of all activity and then is allocated among individual business units. Our businesses may further allocate limits among products or activities.

Requiring Collateralization of Exposures. We may require collateral, letters of credit or investment agreements as a condition to approving exposure to a counterparty. We may also require that a counterparty post collateral in the event

of an adverse event such as a ratings downgrade.

Exposure Monitoring and Management. The risk management functions of the individual business units are responsible for managing the counterparty exposures associated with their activities within corporate limits. An oversight team within the Chief Risk Office is responsible for establishing and enforcing corporate policies and procedures regarding counterparties, establishing corporate limits, and aggregating and reporting

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institutional counterparty exposure. We calculate exposures by using current exposure information and applying stress scenarios to determine our loss exposure if a default occurs. The stress scenarios incorporate assumptions on shocks to interest rates, home prices or other variables appropriate for the type of risk. We regularly update exposure limits for individual institutions in our risk management system to communicate to business and credit staff throughout the company the capacity for further business activity. We regularly report exposures with our largest counterparties to the Risk Policy and Capital Committee of the Board of Directors.

Lenders with Risk Sharing

The primary risk associated with lenders providing risk sharing agreements is that they will fail to reimburse us for losses as required under these agreements. We had recourse to lenders for losses on single-family loans totaling an estimated \$55.0 billion and \$54.2 billion as of December 31, 2005 and 2004, respectively. The credit quality of these counterparties is generally high. Investment grade counterparties, based on the lower of Standard & Poor's and Moody's ratings, accounted for 55% and 60% of lender recourse obligations as of December 31, 2005 and 2004, respectively. Only 2% and less than 0.5% of these counterparties were rated by either Standard & Poor's or Moody's as below investment grade as of December 31, 2005 and 2004, respectively. The remaining counterparties were not rated by rating agencies, but were rated internally. In addition, we require some lenders to pledge collateral to secure their recourse obligations. We held \$61 million and \$66 million in collateral as of December 31, 2005 and 2004, respectively, to secure single-family recourse transactions. In addition, a portion of servicing fees on loans includes recourse to certain lenders, and the credit support for such lender recourse considers the value of the mortgage servicing assets for these counterparties.

We had full or partial recourse to lenders on multifamily loans totaling \$111.1 billion and \$107.1 billion as of December 31, 2005 and 2004, respectively. Our multifamily recourse obligations generally were partially or fully secured by reserves held in custodial accounts, insurance policies, letters of credit from investment grade counterparties rated A or better, or investment agreements.

Mortgage Servicers

The primary risk associated with mortgage servicers is that they will fail to fulfill their servicing obligations. Mortgage servicers collect mortgage and escrow payments from borrowers, pay taxes and insurance costs from escrow accounts, monitor and report delinquencies, and perform other required activities on our behalf. A servicing contract breach could result in credit losses for us or could cause us to incur the cost of finding a replacement servicer. We mitigate these risks in several ways, including the general maintenance of minimum servicing fees that would be available to compensate a replacement servicer in the event of a servicing contract breach; requiring servicers to follow specific servicing guidelines; monitoring the performance of each servicer using loan-level data; conducting selective on-site reviews to confirm compliance with servicing guidelines and mortgage servicing performance; and working on-site with nearly all of our major servicers to facilitate loan loss mitigation efforts and continuously improve the default management process.

Our ten largest single-family mortgage servicers serviced 72% and 71% of our single-family mortgage credit book of business, and the largest single-family mortgage servicer serviced 22% and 21% of our single-family mortgage credit book of business as of December 31, 2005 and 2004, respectively. Our ten largest multifamily servicers serviced 69% and 67% of our multifamily mortgage credit book of business as of December 31, 2005 and 2004, respectively. The largest multifamily mortgage servicer serviced 10% and 11% of our multifamily mortgage credit book of business as of December 31, 2005 and 2004, respectively.

Custodial Depository Institutions

Servicers deposit, in a depository institution of their choice, borrower payments of principal and interest they receive prior to the date they are scheduled to remit the payments to us. The depository institution serves as custodian of the funds. The primary risk associated with these depository institutions is that they may fail while holding remittances due to us, requiring us to replace the funds due to us and held by the depository institution in order to make payments to Fannie Mae MBS holders. We mitigate this risk by establishing

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qualifying standards for depository custodial institutions, including minimum credit ratings, and limiting depositories to federally regulated institutions that are classified as well capitalized by their regulator. In addition, we have the right to withdraw custodial funds at any time upon written demand or establish other controls, including requiring more frequent remittances or setting limits on aggregate deposits with a custodian.

A total of \$38.4 billion and \$45.0 billion in deposits for scheduled MBS payments were held by 371 and 402 custodial institutions as of December 31, 2005 and 2004, respectively. Of this amount, 91% and 76% were held by institutions rated as investment grade by both Standard & Poor's and Moody's as of December 31, 2005 and 2004, respectively. Our ten largest depository counterparties held 86% and 81% of these deposits as of December 31, 2005 and 2004, respectively.

Mortgage Insurers

The primary risk associated with mortgage insurers is that they will fail to fulfill their obligations to reimburse us for claims under insurance policies. We manage this risk by establishing eligibility requirements that an insurer must meet to become and remain a qualified mortgage insurer. Qualified mortgage insurers generally must obtain and maintain external ratings of claims paying ability, with a minimum acceptable level of Aa3 from Moody's and AA- from Standard & Poor's and Fitch. We regularly monitor our exposure to individual mortgage insurers and mortgage insurer credit ratings. We also perform periodic on-site reviews of mortgage insurers to confirm compliance with eligibility requirements and to evaluate their management and control practices.

Mortgage insurers may provide primary mortgage insurance or pool mortgage insurance. Primary mortgage insurance is insurance on an individual loan, while pool mortgage insurance is insurance that applies to a defined group of loans. Pool mortgage insurance benefits typically are based on actual loss incurred and are subject to an aggregate loss limit.

We were the beneficiary of primary mortgage insurance coverage on \$263.1 billion of single-family loans in our portfolio or underlying Fannie Mae MBS as of December 31, 2005, which represented approximately 13% of our single-family mortgage credit book of business, compared with \$285.4 billion, or approximately 13%, of our single-family mortgage credit book of business as of December 31, 2004. As of December 31, 2005, we were the beneficiary of pool mortgage insurance coverage on \$71.7 billion of single-family loans, including conventional and government loans, in our portfolio or underlying Fannie Mae MBS, compared with \$55.1 billion as of December 31, 2004. Seven mortgage insurance companies, all rated AA (or its equivalent) or higher by Standard & Poor's, Moody's or Fitch, provided approximately 99% of the total coverage as of December 31, 2005 and 2004.

On February 6, 2007, two major mortgage insurers, MGIC Investment Corporation and Radian Group Inc. announced an agreement to merge. The anticipated completion of this merger or any similar future consolidations within the mortgage industry will increase further our concentration risk to individual companies and may require us to take additional steps to mitigate this risk.

Debt Security and Mortgage Dealers

The primary credit risk associated with dealers who commit to place our debt securities is that they will fail to honor their contracts to take delivery of the debt, which could result in delayed issuance of the debt through another dealer. The primary credit risk associated with dealers who make forward commitments to deliver mortgage pools to us is that they may fail to deliver the agreed-upon loans to us at the agreed-upon date, which could result in our having to replace the mortgage pools at higher cost to meet a forward commitment to sell the MBS.

Mortgage Originators and Investors

We are routinely exposed to pre-settlement risk through the purchase, sale and financing of mortgage loans and mortgage-related securities with mortgage originators and mortgage investors. The risk is the possibility

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that the market moves against us at the same time the counterparty is unable or unwilling to either deliver mortgage assets or pay a pair-off fee. On average, the time between trade and settlement is about 35 days. We manage this risk by determining position limits with these counterparties, based upon our assessment of their creditworthiness, and we monitor and manage these exposures. Based upon this assessment, we may, in some cases, require counterparties to post collateral.

Liquid Investment Portfolio

The primary credit exposure associated with investments held in our liquid investment portfolio is that issuers will not repay principal and interest in accordance with the contractual terms. We believe the risk of default is low because we restrict these investments to high credit quality short- and medium-term instruments, such as commercial paper, asset-backed securities and corporate floating rate notes, which are broadly traded in the financial markets. Our non-mortgage securities, which account for the majority of our liquid assets, totaled \$37.1 billion and \$43.9 billion as of December 31, 2005 and 2004, respectively. Approximately 98% and 93% of our non-mortgage securities as of December 31, 2005 and 2004, respectively, had a credit rating of A (or its equivalent) or higher, based on the lowest of Standard & Poor's, Moody's or Fitch ratings. We monitor the fair value of these securities and periodically evaluate any impairment to assess whether the impairment is required to be recognized in earnings because it is considered other than temporary.

Derivatives Counterparties

The primary credit exposure that we have on a derivative transaction is that a counterparty will default on payments due, which could result in us having to acquire a replacement derivative from a different counterparty at a higher cost. Our derivative credit exposure relates principally to interest rate and foreign currency derivative contracts. Typically, we manage this exposure by contracting with experienced counterparties that are rated A (or its equivalent) or better. These counterparties consist of large banks, broker-dealers and other financial institutions that have a significant presence in the derivatives market, most of which are based in the United States. As an additional precaution, we have a conservative collateral management policy with provisions for requiring collateral on aggregate gain positions with each interest rate and foreign currency derivative counterparty. Also, we enter into master agreements that provide for netting of amounts due to us and amounts due to counterparties under those agreements. We monitor credit exposure on these derivative contracts daily and make collateral calls as appropriate based on the results of our internal models and dealer quotes. To date, we have never experienced a loss on a derivative transaction due to credit default by a counterparty.

Counterparties use the notional amounts of derivative instruments as the basis from which to calculate contractual cash flows to be exchanged. However, the notional amount is significantly greater than the potential market or credit loss that could result from such transactions and therefore does not represent our actual risk. Rather, we estimate our exposure to credit loss on derivative instruments by calculating the replacement cost, on a present value basis, to settle at current market prices all outstanding derivative contracts in a net gain position by counterparty where the right of legal offset exists, such as master netting agreements. Derivatives in a gain position are reported in the consolidated balance sheet as Derivative assets at fair value. Table 30 presents our assessment of our credit loss exposure by counterparty credit rating on outstanding risk management derivative contracts as of December 31, 2005 and 2004. We show the outstanding notional amount and activity for our risk management derivatives in Table 31.

Table of Contents**Table 30: Credit Loss Exposure of Derivative Instruments**

	As of December 31, 2005					
	AAA	Credit Rating ⁽¹⁾		Subtotal	Other ⁽²⁾	Total
		AA	A	(Dollars in millions)		
Credit loss exposure ⁽³⁾	\$	\$ 3,012	\$ 2,641	\$ 5,653	\$ 72	\$ 5,725
Less: Collateral held ⁽⁴⁾		2,515	2,476	4,991		4,991
Exposure net of collateral	\$	\$ 497	\$ 165	\$ 662	\$ 72	\$ 734
Additional information:						
Notional amount	\$ 775	\$ 323,141	\$ 319,423	\$ 643,339	\$ 776	\$ 644,115
Number of counterparties	1	14	6	21		

	As of December 31, 2004					
	AAA	Credit Rating ⁽¹⁾		Subtotal	Other ⁽²⁾	Total
		AA	A	(Dollars in millions)		
Credit loss exposure ⁽³⁾	\$ 57	\$ 3,200	\$ 3,182	\$ 6,439	\$ 88	\$ 6,527
Less: Collateral held ⁽⁴⁾		2,984	3,001	5,985		5,985
Exposure net of collateral	\$ 57	\$ 216	\$ 181	\$ 454	\$ 88	\$ 542
Additional information:						
Notional amount	\$ 842	\$ 327,895	\$ 360,625	\$ 689,362	\$ 732	\$ 690,094
Number of counterparties	3	12	8	23		

- (1) We manage collateral requirements based on the lower credit rating, as issued by Standard & Poor's and Moody's, of the legal entity. The credit rating reflects the equivalent Standard & Poor's rating for any ratings based on Moody's scale.
- (2) Includes MBS options, defined benefit mortgage insurance contracts, forward starting debt and swap credit enhancements accounted for as derivatives.
- (3) Represents the exposure to credit loss on derivative instruments, which is estimated by calculating the cost, on a present value basis, to replace all outstanding contracts in a gain position. Derivative gains and losses with the same counterparty are presented net where a legal right of offset exists under an enforceable master settlement agreement. This table excludes mortgage commitments accounted for as derivatives.
- (4) Represents the collateral amount held as of December 31, 2005 and 2004, adjusted for any collateral transferred subsequent to December 31, based on credit loss exposure limits on derivative instruments as of December 31,

2005 and 2004. The actual collateral settlement dates, which vary by counterparty, ranged from one to three business days after the December 31, 2005 and 2004 credit loss exposure valuation dates. The value of the collateral is reduced in accordance with counterparty agreements to help ensure recovery of any loss through the disposition of the collateral. We posted non-cash collateral of \$476 million and \$56 million related to our counterparties' credit exposure to us as of December 31, 2005 and 2004, respectively.

Our credit exposure on risk management derivatives, after consideration of the value of collateral held, was \$734 million and \$542 million as of December 31, 2005 and 2004, respectively. We expect the credit exposure on derivative contracts to fluctuate with changes in interest rates, implied volatility and the collateral thresholds of the counterparties. To reduce our credit risk concentration, we diversify our derivative contracts among different counterparties. We had 21 and 23 interest rate and foreign currency derivatives counterparties as of December 31, 2005 and 2004, respectively. Of the 21 counterparties as of December 31, 2005, seven counterparties accounted for approximately 79% of the total outstanding notional amount, and each of these seven counterparties accounted for between approximately 6% and 17% of the total outstanding notional amount. Each of the remaining counterparties accounted for less than 5% of the total outstanding notional amount as of December 31, 2005. In comparison, eight counterparties accounted for approximately 83% of the total outstanding notional amount as of December 31, 2004. Each of these eight counterparties accounted for between approximately 7% and 14% of the total outstanding notional amount, with each of the remaining counterparties accounting for less than 5% of the total outstanding notional amount.

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Approximately 68% of our net derivatives exposure of \$734 million as of December 31, 2005 was with 11 interest rate and foreign currency derivative counterparties rated AA- or better by Standard & Poor's and Aa3 or better by Moody's. In comparison, approximately 50% of our net derivatives exposure of \$542 million as of December 31, 2004 was with ten interest rate and foreign currency derivative counterparties rated AA- or better by Standard & Poor's and Aa3 or better by Moody's. The percentage of our net exposure with these counterparties ranged from approximately 0.6% to 12%, or approximately \$4 million to \$87 million, as of December 31, 2005, and from less than 0.1% to 13%, or less than \$1 million to \$70 million, as of December 31, 2004.

We mitigate our net exposure on interest rate and foreign currency derivative transactions through a collateral management policy, which consists of four primary components.

Minimum Collateral Threshold. Our derivatives counterparties are obligated to post collateral when exposure to credit losses exceeds agreed-upon thresholds that are based on credit ratings. The amount of collateral generally must equal the excess of exposure over the threshold amount.

Collateral Valuation Percentages. We require counterparties to post specific types of collateral to meet their collateral requirements. The collateral posted by our counterparties as of December 31, 2005 consisted of cash, U.S. Treasury securities, agency debt and agency mortgage-related securities. We assign each type of collateral a specific valuation percentage based on its relative risk. In cases where the valuation percentage for a certain type of collateral is less than 100%, we require counterparties to post an additional amount of collateral to meet their requirements.

Over-collateralization Based on Low Credit Ratings. We further reduce our net exposure on derivatives by generally requiring over-collateralization from counterparties whose credit ratings have dropped below predetermined levels. Counterparties with credit ratings falling below these levels must post collateral beyond the amounts previously noted to meet their overall requirements.

Daily Monitoring Procedures. On a daily basis, we value our derivative collateral positions for each counterparty using both internal and external pricing models, compare the exposure to counterparty limits, and determine whether additional collateral is required. We evaluate any additional exposure to a counterparty beyond our model tolerance level based on our corporate credit policy framework for managing counterparty risk.

Interest Rate Risk Management and Other Market Risks

Our most significant market risks are interest rate risk and spread risk, which arise primarily from the prepayment uncertainty associated with investing in mortgage-related assets with prepayment options and from the changing supply and demand for mortgage assets. The majority of our mortgage assets are intermediate-term or long-term fixed-rate loans that borrowers have the option to pay at any time before the scheduled maturity date or continue paying until the stated maturity. An inverse relationship exists between changes in interest rates and the value of fixed-rate investments, including mortgages. As interest rates decline, the value or price of fixed-rate mortgages held in our portfolio will generally increase because mortgage assets originated at the prevailing interest rates are likely to have lower yields and prices than the assets we currently hold in our portfolio. Conversely, an increase in interest rates tends to result in a reduction in the value of our assets. As interest rates decline prepayment rates tend to increase because more favorable financing is available to the borrower, which shortens the duration of our mortgage assets. The opposite effect occurs as interest rates increase.

One way of reducing the interest rate risk associated with investing in long-term, fixed-rate mortgages is to fund these investments with long-term debt with similar offsetting characteristics. This strategy is complicated by the fact that

most borrowers have the option of prepaying their mortgages at any time, a factor that is beyond our control and driven to a large extent by changes in interest rates. In addition, funding mortgage investments with debt results in mortgage-to-debt OAS risk, or basis risk, which is the risk that interest rates in different market sectors will not move in the same direction or amount at the same time.

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Our Capital Markets group is responsible for managing interest rate risk subject to corporate risk policies and limits. Our policies and procedures include interest rate risk dollar limits and requires escalation to senior management and the Board of Directors if risk limits are exceeded. The Chief Risk Officer provides corporate oversight of the interest rate risk management process and is responsible for measuring and monitoring interest rate risk and providing regular reports to senior management and the Board of Directors. The Market Risk Committee, which focuses on enterprise-wide market, liquidity and model risk management activities, meets at least monthly to review our aggregate market risk profile and monitor our exposure relative to market risk limits. The Capital Markets Investment Committee, a management-level business unit committee that includes senior officers in the Capital Markets group, meets weekly to review our current interest rate risk position relative to risk limits. The Capital Markets Investment Committee develops and monitors near-term strategies that comply with our risk objectives and policies. The Capital Markets Investment Committee reports interest rate risk measures on a weekly basis. As discussed in Supplemental Non-GAAP Information Fair Value Balance Sheet, we do not attempt to actively manage or hedge the impact of changes in mortgage-to-debt OAS after we purchase mortgage assets, other than through asset monitoring and disposition. We accept period-to-period volatility in our financial performance due to mortgage-to-debt OAS consistent with our corporate risk principles.

Interest Rate Risk Management Strategies

Our portfolio of interest rate-sensitive instruments includes our investments in mortgage loans and securities, the debt issued to fund those assets, and the derivatives we use to manage interest rate risk. These assets and liabilities have a variety of risk profiles and sensitivities. We employ an integrated interest rate risk management strategy that includes asset selection and structuring of our liabilities to match and offset the interest rate characteristics of our balance sheet assets and liabilities as much as possible. Our strategy consists of:

issuing a broad range of both callable and non-callable debt instruments to manage the duration and prepayment risk of expected cash flows of the mortgage assets we own;

supplementing our issuance of debt with derivative instruments to further reduce duration and prepayment risks; and

on-going monitoring of our risk positions and actively rebalancing our portfolio of interest rate-sensitive financial instruments to maintain a close match between the duration of our assets and liabilities.

Debt Instruments

The primary tool we use to manage the interest rate risk implicit in our mortgage assets is the variety of debt instruments we issue. Our ability to issue both short- and long-term debt helps in managing the duration risk associated with an investment in long-term fixed-rate assets. We issue callable debt to help us manage the prepayment risk associated with fixed-rate mortgage assets. The duration of callable debt changes when interest rates change in a manner similar to changes in the duration of mortgage assets. See Item 1 Business Business Segments Capital Markets Funding of Our Investments for additional information on our various types of debt securities and Liquidity and Capital Management Liquidity Debt Funding.

Derivative Instruments

Why We Use Derivatives

Derivatives also are an integral part of our strategy in managing interest rate risk. We use interest rate swaps and interest rate options, in combination with our issuance of debt securities, to better match both the duration and prepayment risk of our mortgages. We are generally an end user of derivatives and our principal purpose in using derivatives is to manage our aggregate interest rate risk profile within prescribed risk parameters. We generally only use derivatives that are highly liquid and relatively straightforward to value. We have derivative transaction policies and controls to minimize our derivative counterparty risk that are described in [Credit Risk](#)

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Management Institutional Counterparty Credit Risk Management Derivatives Counterparties. We use derivatives for three primary purposes:

(1) As a substitute for notes and bonds that we issue in the debt markets.

When we purchase mortgages, we fund the purchase with a combination of equity and debt. The debt we issue is a mix that typically consists of short- and long-term, non-callable debt and callable debt. The varied maturities and flexibility of these debt combinations help us in reducing the mismatch of cash flows between assets and liabilities.

We can use a mix of debt issuances and derivatives to achieve the same duration matching that would be achieved by issuing only debt securities. The primary types of derivatives used for this purpose include pay-fixed and receive-fixed interest rate swaps (used as substitutes for non-callable debt) and pay-fixed and receive-fixed swaptions (used as substitutes for callable debt).

Below are examples of equivalent funding alternatives for a mortgage purchase with funding derived solely from debt securities versus funding with a blend of debt securities and derivatives. As illustrated below, we can achieve similar economic results by funding our mortgage purchases with either debt securities or a combination of debt securities and derivatives, as follows:

Rather than issuing a ten-year non-callable fixed-rate note, we could issue short-term debt and enter into a ten-year interest rate swap with a highly rated counterparty. The derivative counterparty would pay a floating rate of interest to us on the swap that we would use to pay the interest expense on the short-term debt, which we would continue to reissue. We would pay the counterparty a fixed rate of interest on the swap, thus achieving the economics of a ten-year fixed-rate note issue. The combination of the pay-fixed interest rate swap and short-term debt serves as a substitute for non-callable fixed-rate debt.

Similarly, instead of issuing a ten-year fixed-rate note callable after three years, we could issue a ten-year non-callable fixed-rate note and enter into a receive-fixed swaption that would have the same economics as a ten-year callable note. If we want to call the debt after three years, the swaption would give us the option to enter into a swap agreement where we would receive a fixed rate of interest from the derivative counterparty over the remaining seven-year period that would offset the fixed-rate interest payments on the long-term debt. The combination of the receive-fixed swaption and ten-year non-callable note serves as a substitute for callable debt.

(2) To achieve risk management objectives not obtainable with debt market securities.

We sometimes have risk management objectives that cannot be fully accomplished by securities generally available in the debt markets. For example, we can use the derivative markets to purchase swaptions to add features to our debt not obtainable in the debt markets. Some of the features of the option embedded in a callable bond are dependent on the market environment at issuance and the par issuance price of the bond. Thus, in a callable bond we can not specify certain features, such as specifying an out-of-the-money option, which could allow us to more closely match the interest rate risk being hedged. We use option-based derivatives, such as swaptions, because they provide the added flexibility to fully specify the features of the option, thereby allowing us to more closely match the interest rate risk being hedged.

(3) To quickly and efficiently rebalance our portfolio.

We seek to keep our assets and liabilities matched within a duration tolerance of plus or minus six months. When interest rates are volatile, we often need to lengthen or shorten the average duration of our liabilities to keep them closely matched with our mortgage durations, which change as expected mortgage prepayments change.

While we have a number of rebalancing tools available to us, it is often most efficient for us to rebalance our portfolio by adding new derivatives or by terminating existing derivative positions. For example, when interest rates fall and mortgage durations shorten, we can shorten the duration of our debt by entering into receive-fixed interest rate swaps that convert longer-duration, fixed-term debt into shorter-duration, floating-rate debt or by terminating existing pay-fixed interest rate swaps. This use of derivatives helps increase our funding

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flexibility while maintaining our low risk tolerance. The types of derivative instruments we use most often to rebalance our portfolio include pay-fixed and receive-fixed interest rate swaps.

In addition to our three primary uses of derivatives, we may also use derivatives for the following purpose:

(4) To hedge foreign currency exposure.

We occasionally issue debt in a foreign currency. Because all of our assets are denominated in U.S. dollars, we enter into currency swaps to effectively convert the foreign-denominated debt into U.S. dollar-denominated debt. By swapping out of foreign currencies completely at the time of the debt issue, we minimize our exposure to any currency risk. Our foreign-denominated debt represents less than 1% of our total debt outstanding.

Types of Derivatives We Use

Derivative instruments may be privately negotiated contracts, which are often referred to as OTC derivatives, or they may be listed and traded on an exchange. Our derivatives consist primarily of OTC contracts that fall into three broad categories.

Interest rate swap contracts. An interest rate swap is a transaction between two parties in which each agrees to exchange payments tied to different interest rates or indices for a specified period of time, generally based on a notional amount of principal. The types of interest rate swaps we use include:

Pay-fixed, receive variable an agreement whereby we pay a predetermined fixed rate of interest based upon a set notional amount and receive a variable interest payment based upon a stated index, with the index resetting at regular intervals over a specified period of time. These contracts generally increase in value as interest rates rise.

Receive-fixed, pay variable an agreement whereby we make a variable interest payment based upon a stated index, with the index resetting at regular intervals, and receive a predetermined fixed rate of interest based upon a set notional amount and over a specified period of time. These contracts generally increase in value as interest rates fall.

Basis swap an agreement that provides for the exchange of variable interest payments, based on notional amounts, tied to two different underlying interest rate indices.

Interest rate option contracts. These contracts primarily include the following:

Pay-fixed swaptions an option that allows us to enter into a pay-fixed, receive variable interest rate swap at some point in the future. These contracts generally increase in value as interest rates rise.

Receive-fixed swaptions an option that allows us to enter into a receive-fixed, pay variable interest rate swap at some point in the future. These contracts generally increase in value as interest rates fall.

Interest rate caps although an interest rate cap is not an option it has option-like characteristics. It is a contract in which we receive money when a reference interest rate, typically LIBOR, exceeds an agreed-upon referenced strike price (cap). The value generally increases as reference interest rates rise.

Foreign currency swaps. Swaps that convert debt we issue in foreign-denominated currencies into U.S. dollars. We enter into foreign currency swaps only to the extent that we issue foreign currency debt.

Summary of Derivative Activity

The decisions to reposition our derivative portfolio are based upon current assessments of our interest rate risk profile and economic conditions, including the composition of our consolidated balance sheets and expected trends, the relative mix of our debt and derivative positions, and the interest rate environment. Table 31 presents our risk management derivative activity by type for the year ended December 31, 2005, along with the stated maturities of derivatives outstanding as of December 31, 2005. Table 31 does not include mortgage commitments that are accounted for as derivatives. We discuss our mortgage commitments in Business Segment Results Capital Markets Group.

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Table 31: Activity and Maturity Data for Risk Management Derivatives⁽¹⁾

	Pay-Fixed ⁽²⁾	Interest Rate Swaps Receive-Fixed ⁽³⁾	Basis	Foreign Currency	Interest Rate Swaps Pay-Fixed	Interest Rate Swaps Receive-Fixed	Interest Rate Caps	Other ⁽⁴⁾	Total
	(Dollars in millions)								
Balance									
As of 3/31/2019	\$ 364,377	\$ 201,229	\$ 32,303	\$ 5,195	\$ 163,980	\$ 141,195	\$ 130,350	\$ 379	\$ 1,038,528
As of 12/31/2018	138,442	207,269	33,700	13,650	31,575	49,145	17,800	5,243	1,038,528
Change ⁽⁵⁾	(360,802)	(327,305)	(33,730)	(7,392)	(24,850)	(42,770)	(44,000)	(4,889)	(0)
Balance									
As of 3/31/2019	\$ 142,017	\$ 81,193	\$ 32,273	\$ 11,453	\$ 170,705	\$ 147,570	\$ 104,150	\$ 733	\$ 639,921
As of 12/31/2018	141,775	156,475	1,300	9,147	14,750	25,250		7,409	639,921
Change ⁽⁵⁾	(95,005)	(113,761)	(29,573)	(14,955)	(36,050)	(34,225)	(71,150)	(7,366)	(0)
Balance									
As of 3/31/2019	\$ 188,787	\$ 123,907	\$ 4,000	\$ 5,645	\$ 149,405	\$ 138,595	\$ 33,000	\$ 776	\$ 613,010
As of 12/31/2018	188,787	123,907	4,000	5,645	149,405	138,595	33,000	776	613,010
Change ⁽⁵⁾	(0)	(0)	(0)	(0)	(0)	(0)	(0)	(0)	(0)
Maturities									
As of 3/31/2019	\$ 6,090	\$ 10,525	\$ 3,800	\$ 1,474	\$ 21,575	\$ 12,975	\$ 19,000	\$ 347	\$ 75,286
As of 12/31/2018	70,535	80,660	200	3,441	33,600	22,100	13,250	19	144,125
Change ⁽⁵⁾	(64,445)	(70,135)	(200)	(1,967)	(12,025)	(9,125)	(13,250)	(17)	(68,839)
As of 3/31/2019	\$ 76,260	\$ 27,557	\$ -	\$ -	\$ 86,430	\$ 85,420	\$ 750	\$ 410	\$ 166,877
As of 12/31/2018	35,902	5,165	-	730	7,800	18,100	-	-	67,697
Change ⁽⁵⁾	(40,358)	(22,388)	-	(730)	(78,630)	(67,320)	(750)	(410)	(98,780)
As of 3/31/2019	\$ 188,787	\$ 123,907	\$ 4,000	\$ 5,645	\$ 149,405	\$ 138,595	\$ 33,000	\$ 776	\$ 613,010
As of 12/31/2018	188,787	123,907	4,000	5,645	149,405	138,595	33,000	776	613,010
Change ⁽⁵⁾	(0)	(0)	(0)	(0)	(0)	(0)	(0)	(0)	(0)
Weighted-average rate as of 3/31/2019	5.02%	4.36%	4.04%		5.94%				
Weighted-average rate as of 12/31/2018	4.37%	4.38%	4.13%			5.03%		2.97%	

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ate

5.23%	2.13%	2.14%	5.73%		
2.39	2.84	2.32		5.16%	2.30%

- (1) Excludes mortgage commitments accounted for as derivatives. Dollars represent notional amounts that indicate only the amount on which payments are being calculated and do not represent the amount at risk of loss.
- (2) Notional amounts include swaps callable by Fannie Mae of \$14.3 billion as of December 31, 2005 and \$13.8 billion as of December 31, 2004.
- (3) Notional amounts include swaps callable by derivatives counterparties of \$3.6 billion as of December 31, 2005 and \$22.8 billion as of December 31, 2004.
- (4) Includes MBS options, forward starting debt and swap credit enhancements.
- (5) Includes matured, called, exercised, assigned and terminated amounts. Also includes changes due to foreign exchange rate movements.
- (6) Based on contractual maturities.

During 2005, we decreased the outstanding notional balance of our risk management derivatives by \$46.0 billion to \$644.1 billion as of December 31, 2005. The key driver of this decline was the termination of derivatives in connection with the elimination of debt that was used to fund mortgage assets that we sold. During 2004, we decreased the outstanding notional balance of our risk management derivatives by \$348.9 billion to \$690.1 billion as of December 31, 2004, primarily as a result of terminating pay-fixed and receive-fixed swaps that economically offset one another. We periodically review our derivatives portfolio and terminate offsetting derivative positions as market conditions permit.

The outstanding notional balance of our risk management derivatives increased to \$745.7 billion as of December 31, 2006. The \$101.6 billion increase during 2006 reflects higher balances of both pay-fixed and

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receive-fixed swaps, partially offset by a reduction in interest rate swaptions. In response to the general increase in interest rates during the first half of 2006, which lengthened the durations of our mortgage assets, we generally added to our net pay-fixed swap position. During the second half of the year, when interest rates generally declined and the durations of our mortgage assets shortened, we added to our net receive-fixed swap position.

Monitoring and Active Portfolio Rebalancing

Because single-family borrowers typically can prepay a mortgage at any time prior to maturity, the borrower's mortgage is economically similar to callable debt. By investing in mortgage assets, we assume this prepayment risk. As described above, we attempt to offset the prepayment risk and cover our short position either by issuing callable debt that we can redeem at our option or by purchasing option-based derivatives that we can exercise at our option. We also manage the prepayment risk of our assets relative to our funding through active portfolio rebalancing. We develop rebalancing actions based on a number of factors, including an assessment of key risk measures such as our duration gap and net asset fair value sensitivity, as well as analyses of additional risk measures and current market conditions.

Measuring Interest Rate Risk

Our Capital Markets group utilizes a wide range of risk measures and analyses to manage the interest rate risk inherent in the mortgage portfolio. We produce a series of daily, weekly, monthly and quarterly analyses of interest rate risk measures. Many of our projections of mortgage cash flows in our interest rate risk measures depend on our internally developed proprietary prepayment models. The models contain many assumptions, including those regarding borrower behavior in certain interest rate environments and borrower relocation rates. Other market inputs, such as interest rates, mortgage prices and interest rate volatility, are also critical components to our interest rate risk measures. The historical patterns that serve as inputs for our models may not continue in the future. We maintain a research program to constantly evaluate, update and enhance these assumptions, models and analytical tools as appropriate to reflect our best assessment of the environment.

Our primary interest rate risk measures include duration gap, convexity and net asset fair value sensitivity measures. On a daily basis, we calculate base duration and convexity gaps as well as the expected change in the value of our investments for relatively moderate changes in interest rates. On a weekly basis, we also calculate the expected change in the value of our investments for larger movements in interest rates and other factors such as implied volatility of option prices. We also perform other standard risk measures on our portfolio that are based on historical changes in key variables, such as value-at-risk measures and sensitivities to non-parallel changes in the yield curve.

Duration Gap

The duration gap is a measure of the difference between the estimated durations of our assets and liabilities (debt and risk management derivatives). Duration gap summarizes the extent to which estimated cash flows for assets and liabilities are matched, on average, over time and across interest rate scenarios. A positive duration gap signals a greater exposure to rising interest rates because it indicates that the duration of our assets exceeds the duration of our liabilities.

Because our duration gap does not incorporate projected future business activity, it is considered a run-off measure of interest rate risk. It reflects our existing mortgage portfolio, including priced asset, debt and derivatives commitments. We also include the interest rate risk impact of derivative instruments in calculating the duration of liabilities. Our reported duration gap for periods prior to November 2005 excludes non-mortgage investments. We began including non-mortgage investments in our duration gap calculation in November 2005. These incremental assets are primarily short-term, liquid investments included in our liquid investment portfolio. Based on our historical experience, we

expect that the guaranty fee income generated from future business activity will largely replace any guaranty fee income lost as a result of mortgage prepayments. Accordingly, we do not actively manage or hedge expected changes in the fair value of our net guaranty assets related to changes in interest rates. The fair values of our guaranty assets and guaranty obligations are presented in Table 17 in Supplemental Non-GAAP Information Fair Value Balance Sheet.

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Pursuant to the September 1, 2005 agreement with OFHEO, we agreed to provide periodic public disclosures regarding the monthly averages of our duration gap. We disclose the duration gap on a monthly basis in our Monthly Summary Report, which is available on our Web site and submitted to the SEC in a current report on Form 8-K. Our monthly duration gap, which is presented below for the period January 1, 2003 to December 31, 2005 reflects the estimate used contemporaneously by management as of the reported date to manage the interest rate risk of our portfolio. During 2006 and 2007 to date, our monthly duration gap has not exceeded plus or minus one month.

Month	2005	2004	2003
January	(1)	(1)	(3)
February	0	(1)	(5)
March	1	0	(2)
April	(1)	3	(2)
May	(1)	3	(5)
June	0	2	(1)
July	1	0	6
August	0	(2)	4
September	1	(2)	1
October	1	0	1
November	0	(1)	(1)
December	0	(1)	(1)

Convexity

Convexity reflects the degree to which the duration and price of our mortgage assets change in response to a given change in interest rates. Because of the prepayment option that exists in mortgage assets, they tend to exhibit negative convexity. Negative convexity refers to the tendency of fixed-rate mortgage assets to fall in price faster in periods of rising interest rates compared to the rate at which they appreciate in periods of falling interest rates. We use convexity measures to provide us with information on how quickly and by how much the portfolio's duration gap may change in different interest rate environments. Our primary strategy for managing convexity risk is to either issue callable debt or purchase option-based derivatives.

Interest Rate Sensitivity of Net Asset Fair Value

We perform various sensitivity analyses that quantify the impact of changes in interest rates on the estimated fair value of our interest rate sensitive assets and liabilities. Our analyses incorporate assumed changes in the interest rate environment, including selected hypothetical, instantaneous shifts in both the level and slope of the yield curve. Table 32 discloses the estimated fair value of our net assets as of December 31, 2005 and 2004, and the impact on the estimated fair value from a hypothetical instantaneous shock in interest rates of a 50 basis points decrease and a 100 basis points increase. We selected these interest rate changes because we believe they reflect reasonably possible near-term outcomes. We discuss how we derive the estimated fair value of our net assets, which serves as the base case for our sensitivity analysis, in Supplemental Non-GAAP Information Fair Value Balance Sheet.

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	As of December 31, 2005					
	Carrying Value	Estimated Fair Value	Effect on Estimated Fair Value			
			-50 Basis Points		+100 Basis Points	
			\$	%	\$	%
(Dollars in millions)						
Trading financial instruments ⁽¹⁾	\$ 15,110	\$ 15,110	\$ 262	1.73%	\$ (641)	(4.24)%
Non-trading mortgage assets and consolidated debt ⁽²⁾	760,586	760,187	9,315	1.23	(23,734)	(3.12)
Debt ⁽²⁾	(754,320)	(760,002)	(8,617)	1.13	17,640	(2.32)
Subtotal before derivatives	21,376	15,295	960	6.28	(6,735)	(44.03)
Derivative assets and liabilities, net	4,374	4,374	(1,577)	(36.05)	5,696	130.22
Subtotal after derivatives	25,750	19,669	(617)	(3.14)	(1,039)	(5.28)
Guaranty assets and guaranty obligations, net ⁽²⁾	(2,274)	7,860	(1,163)	(14.80)	1,791	22.79
Net market sensitive assets ⁽²⁾⁽³⁾	23,476	27,529	(1,780)	(6.47)	752	2.73
Other non-financial assets and liabilities, net ⁽⁴⁾	15,826	14,670	489	3.33	(397)	(2.71)
Net assets ⁽⁵⁾⁽⁶⁾	\$ 39,302	\$ 42,199	\$ (1,291)	(3.06)%	\$ 355	0.84%

	As of December 31, 2004					
	Carrying Value	Estimated Fair Value	Effect on Estimated Fair Value			
			-50 Basis Points		+100 Basis Points	
			\$	%	\$	%
(Dollars in millions)						
Trading financial instruments ⁽¹⁾	\$ 35,287	\$ 35,287	\$ 476	1.35%	\$ (1,417)	(4.02)%
Non-trading mortgage assets and consolidated debt ⁽²⁾	928,104	936,530	9,930	1.06	(28,596)	(3.05)
Debt ⁽²⁾	(943,017)	(958,237)	(9,215)	0.96	19,181	(2.00)
Subtotal before derivatives	20,374	13,580	1,191	8.77	(10,832)	(79.76)
Derivative assets and liabilities, net	5,444	5,444	(3,150)	(57.86)	8,525	156.59

Subtotal after derivatives	25,818	19,024	(1,959)	(10.30)	(2,307)	(12.13)
Guaranty assets and guaranty obligations, net ⁽²⁾	(1,826)	6,450	(1,499)	(23.24)	1,498	23.22
Net market sensitive assets ⁽²⁾⁽³⁾	23,992	25,474	(3,458)	(13.57)	(809)	(3.18)
Other non-financial assets and liabilities, net ⁽⁴⁾	14,910	14,620	1,210	8.28	283	1.94
Net assets ⁽⁵⁾⁽⁶⁾	\$ 38,902	\$ 40,094	\$ (2,248)	(5.61)%	\$ (526)	(1.31)%

- (1) Consists of securities classified in the consolidated balance sheets as trading and carried at fair estimated value.
- (2) Includes a reclassification of consolidated debt with a carrying value of \$10.4 billion and estimated fair value of \$10.5 billion as of December 31, 2005, respectively, and a carrying value of \$12.5 billion and estimated fair value of \$12.2 billion as of December 31, 2004, respectively. In addition, certain amounts have been reclassified from securities to Guaranty assets and guaranty obligations, net to reflect how the risk of these securities is managed by the business.
- (3) Includes net financial assets and financial liabilities reported in Notes to Consolidated Financial Statements Note 18, Fair Value of Financial Instruments and additional market sensitive instruments that consist of master servicing assets, master servicing liabilities and credit enhancements.
- (4) The sensitivity changes related to other non-financial assets and liabilities represent the tax effect on net assets under these scenarios and do not include any interest rate sensitivity related to these items.
- (5) The carrying value for net assets equals total stockholders equity as reported in the consolidated balance sheets.
- (6) The net asset sensitivities, excluding the sensitivity of the Guaranty assets and guaranty obligations, net, net of tax was (1.3)% for a -50 bp shock and (1.9)% for a +100 bp shock as of December 31, 2005, and (3.2)% for a -50 bp shock and (3.7)% for a +100 bp shock as of December 31, 2004.

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As discussed above, we structure our debt and derivatives to match and offset the interest rate risk of our mortgage investments as much as possible. The interest rate sensitivities presented in Table 32 convey the extent to which changes in the estimated fair value of our mortgage assets are offset by changes in the estimated fair value of our debt and derivatives. Based on our sensitivity analyses, as of December 31, 2005 we estimate that a 50 basis point instantaneous decrease in interest rates and a 100 basis point instantaneous increase in interest rates would reduce the estimated fair value of our net assets by approximately 3.1% and increase the estimated fair value of our net assets by 0.8%, respectively. We estimate that a 50 basis point instantaneous decrease in interest rates and a 100 basis point instantaneous increase in interest rates would reduce the estimated fair value of our net assets as of December 31, 2004 by approximately 5.6% and 1.3%, respectively. These sensitivities, which were relatively stable from the end of 2004 to the end of 2005, indicate a relatively low level of interest rate risk.

We also show in footnote 6 of Table 32 the sensitivity of the estimated fair value of our net assets, excluding the sensitivity of our guaranty assets and guaranty obligations, net (net of tax). We evaluate the sensitivity of the fair value of our net assets, excluding the sensitivity of our guaranty assets and guaranty obligations, because, as previously discussed, we do not actively manage the interest rate risk of our guaranty business.

These sensitivity analyses are limited in that they contemplate only certain movements in interest rates and are performed at a particular point in time based on the estimated fair values of our existing assets and liabilities. The sensitivity analyses do not incorporate other factors that may have a significant impact, most notably the value from expected future business activities and strategic actions that management may take to manage interest rate risk. Moreover, our sensitivity analyses require numerous assumptions, including prepayment factors and discount rates, which require management judgment. While we believe the assumptions and methodology used in our sensitivity analyses are reasonable, there is no standard methodology for estimating the sensitivity of net asset fair value and different assumptions could produce materially different sensitivity estimates.

In October 2000 we made a voluntary commitment to publicly disclose the results of interest rate risk sensitivity analyses on a monthly basis and began a monthly disclosure of net interest income at risk. Because our restatement affected net interest income at risk, we suspended this disclosure beginning in December 2004. Pursuant to our September 1, 2005 agreement with OFHEO, we have agreed to provide public disclosure of the estimated impact on our financial condition of a 50 basis point shift in rates and a 25 basis point change in the slope of the yield curve. We will begin providing this disclosure using data from the second quarter of 2007.

Operational Risk Management

Operational risk can manifest itself in many ways, including accounting or operational errors, business disruptions, fraud, technological failures and other operational challenges resulting from failed or inadequate internal controls. These events may potentially result in financial losses and other damage to our business, including reputational harm.

We currently manage operational risk through an enterprise-wide framework. In 2006, we established an independent Operational Risk Oversight (ORO) function within the Chief Risk Office with responsibility for oversight of the business units' operational risk management activities. In accordance with our Policy on Operational Risk Management established in October 2006, ORO regularly reports to senior management and the Board of Directors on the quality of our operational risk management and on identified operational risk exposures. The Operational Risk Committee, which provides a governance forum for the oversight of operational risk policies and programs of the company, meets at least four times annually to review the corporate operational risk position. ORO is also responsible for the design and implementation of operational risk management processes pertaining to capturing loss and near miss event data, risk and control assessments by the business units, key risk indicators, and analysis of scenarios representing significant potential losses to our business. To further strengthen our existing operational risk programs,

in 2006, we centralized oversight of our business continuity efforts, information security programs, fraud management and our corporate insurance program under this new operational risk oversight function. In 2007, we consolidated our SOX Finance Team as part of the operational risk oversight function, with accountability to both the Chief

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Risk Officer and the Chief Financial Officer. We continue to work on improving our internal controls and procedures relating to the management of operational risk.

Our business units have direct responsibility for the identification, assessment, control and mitigation of the operational risks associated with their business activities. The Division Risk Office has responsibility for the implementation and monitoring of operational risk management, SOX, and compliance programs throughout the company. ORO and the Division Risk Office work closely throughout the design and implementation effort to ensure that roles and responsibilities are properly identified and staffed, and that programs are effectively integrated into standard business practices. In addition, the ORO and Division Risk Office work closely with our Chief Compliance Officer to coordinate implementation efforts and reinforce new operational discipline frameworks within the company.

OFHEO's September 2004 interim report on its special examination concluded that we had experienced breakdowns in operational controls that contributed to our accounting failures and safety and soundness problems. Paul Weiss's independent investigation into the issues raised in OFHEO's interim report affirmed this conclusion. In 2005, we engaged an independent firm to assess our existing operational risk management capabilities and identify gaps in skill sets, processes and other elements. The results of this assessment identified several deficiencies in our operational risk management structure that we have been working to remediate. For a description of the material weaknesses in our internal control over financial reporting relating to our operational controls and operational risk management, see Item 9A Controls and Procedures.

To remedy the deficiencies in our operational risk management process, we have developed new policies for managing operational risks and an overall operational risk management framework to identify, measure, monitor and manage operational risks across the company. We are in the initial stage of a multi-year program to implement our new operational risk management framework. In November 2006, we submitted a detailed three-year plan on the design and implementation of this framework to OFHEO as required by our consent order with OFHEO. Our operational risk management framework is based on the Basel Committee guidance on sound practices for the management of operational risk broadly adopted by U.S. commercial banks comparable in size to Fannie Mae. The framework incorporates elements such as the monitoring of operational loss events, tracking of key risk indicators, use of common terminology to describe risks and self-assessments of risks and controls in place to mitigate operational risks. We have recently hired several new senior officers with significant expertise in operational risk management to implement this new framework.

In addition to the corporate operational risk oversight function, we also maintain programs for the management of our exposure to mortgage fraud, breaches in information security and external disruptions to business continuity, as outlined below.

Mortgage Fraud

We implemented a mortgage fraud policy and program in 2005. OFHEO issued a regulation in July 2005 on the detection and reporting of mortgage fraud that required us to establish adequate and efficient internal controls and procedures and an operational training program to assure an effective system to detect and report mortgage fraud or possible mortgage fraud. We have operated in compliance with this regulation since its effective date in August 2005.

As part of our mortgage fraud program, we assist our lender customers in preventing the origination of fraudulent loans, including through the use of a series of detection algorithms provided in conjunction with our automated underwriting technology that alerts lenders to possible fraud at loan origination. We maintain contracts with our lender customers that require them to represent and warrant that loans being sold meet the requirements of our selling and servicing guides, and to repurchase loans sold or delivered to us when misrepresentations are made that we determine

may involve mortgage fraud. We also carry insurance to provide further coverage in the event of failure of the lender to perform under fraudulent circumstances. We continue to work to improve our internal controls and procedures relating to the detection and reporting of mortgage fraud.

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Information Security

Recognizing the importance and sensitivity of our information assets, we have established an information security program designed to protect the security and privacy of confidential information, including non-public personal information and sensitive business data. Our current information security program was launched in late 2003 to address acknowledged industry-wide security concerns in areas such as access management, change management, secure application development and system monitoring.

Our security infrastructure is designed for the protection of sensitive information assets, and includes sophisticated network defenses and software designed to prevent hackers, spam, virus, phishing and other types of cyber attack, while our information security practices are intended to minimize risks due to process failure or misuse. We employ several firms specializing in information security assessment to uncover control gaps and risks to our information assets. We acknowledge the constant need to update and improve our defenses in response to changes in the threat environment.

We continue to work to improve our information security program, with the implementation of additional controls to protect our confidential data. These have included increased information security and privacy assessment and monitoring within our business units, a multi-year effort to improve access management, encryption of data on our employees' computers, as well as improved tools to monitor and block information loss from within our network, email and other communication systems.

Business Continuity and Crisis Management

Our ORO function has established business continuity and crisis management policies and programs, with execution of these programs implemented by our technology, operations, human resources and facilities functions in concert with the business units that are responsible for the affected processes and business applications. These policies and programs are designed to ensure that our critical business functions continue to operate under emergency conditions. Our business continuity program is subject to regulatory review by OFHEO.

We have installed redundant systems within each business critical system, as well as redundant systems in two geographically separate data centers. These redundant systems are designed to provide continuity of operations for up to one week without significant loss of service to constituents or significant loss of revenue. We also have developed longer-term recovery plans. In addition, we have implemented strategies for access to critical business systems by employees and staff, such as alternate work facilities in geographically diverse locations for our back office and wire transfer functions. We have also established redundant communications systems for external partners and customers. For staff functions that are considered most critical, such as cash wire operations and securities settlements, we have instituted multi-site, simultaneous operations from three separate locations. Dual-site market room activities are conducted on a quarterly basis for front office functions. We recently successfully completed a disaster recovery test of critical operations using a recently constructed alternate data center.

To enable recovery from large-scale, catastrophic events, we copy all production data to backup media on a real-time or nightly basis. The data is transported and stored in multiple locations, including an offsite storage facility located out of the region. In addition, a limited tertiary operating site is available out of the region. The tertiary site complies with the sound practices established by the Federal Reserve Board, Office of the Comptroller of the Currency, and the SEC for resiliency of key U.S. financial institutions, and is designed to enable us to fulfill our critical obligations until automated processing is able to resume.

LIQUIDITY AND CAPITAL MANAGEMENT

Liquidity is essential to our business. We actively manage our liquidity and capital position with the objective of preserving stable, reliable and cost-effective sources of cash to meet all of our current and future operating financial commitments and regulatory capital requirements. We obtain the funds we need to operate our business primarily from the proceeds we receive from the issuance of debt. We seek to maintain sufficient excess liquidity in the event that factors, whether internal or external to our business, temporarily prevent us from issuing debt in the capital markets.

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Liquidity

Liquidity Risk Management

Liquidity risk is the risk to our earnings and capital that would arise from an inability to meet our cash obligations in a timely manner. Because liquidity is essential to our business, we have adopted a comprehensive liquidity risk policy that is designed to provide us with sufficient flexibility to address both liquidity events specific to our business and market-wide liquidity events. Our liquidity risk policy governs our management of liquidity risk and outlines our methods for measuring and monitoring liquidity risk. Our liquidity risk policy, which has been approved by our Board of Directors, outlines the roles and responsibilities for managing liquidity risk within the company. Our Capital Markets group is responsible for monitoring and managing our liquidity risk, with oversight provided by the Chief Risk Office, several management-level committees and the Risk Policy and Capital Committee of the Board of Directors.

We conduct daily liquidity management activities to achieve the goals of our liquidity risk policy. The primary tools that we employ for liquidity management include the following:

- daily monitoring and reporting of our liquidity position;

- daily forecasting of our ability to meet our liquidity needs over a 90-day period without relying upon the issuance of unsecured debt;

- daily monitoring of market and economic factors that may impact our liquidity;

- a defined escalation process for bringing any liquidity issues or concerns that may arise to the attention of higher levels of our management;

- routine testing of our ability to rely upon identified sources of liquidity;

- periodic reporting to management and the Board of Directors regarding our liquidity position;

- periodic review and testing of our liquidity management controls by our Internal Audit department;

- maintaining unencumbered mortgage assets that are available as collateral for secured borrowings pursuant to repurchase agreements or for sale; and

- maintaining an investment portfolio of liquid non-mortgage assets that are readily marketable or have short-term maturities so that we can quickly and easily convert these assets into cash.

Sources and Uses of Cash

We manage our cash position on a daily basis.

Our primary source of cash is proceeds from the issuance of our debt securities. Our other sources of cash currently consist primarily of:

- principal and interest payments received on our mortgage portfolio assets;

principal and interest payments received on our liquid investments;

borrowings under secured and unsecured intraday funding lines of credit we have established with several large financial institutions;

sales of mortgage loans, mortgage-related securities and liquid assets;

borrowings against mortgage-related securities and other investment securities we hold pursuant to repurchase agreements and loan agreements;

guaranty fees earned on Fannie Mae MBS;

mortgage insurance counterparty payments; and

net receipts on derivative instruments.

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Our uses of cash currently consist primarily of:

- the repayment of matured, redeemed and repurchased debt;
- the purchase of mortgage loans, mortgage-related securities and other investments;
- the payment of interest payments on outstanding debt;
- net payments on derivative agreements;
- the pledging and delivery of cash and cash equivalents as collateral under derivative instruments;
- the payment of administrative expenses;
- the payment of federal income taxes;
- losses incurred in connection with our Fannie Mae MBS guaranty obligations; and
- the payment of dividends on our common and preferred stock.

Debt Funding

Because our primary source of cash is proceeds from the issuance of our debt securities, we depend on our continuing ability to issue debt securities in the capital markets to meet our cash requirements. We issue a variety of non-callable and callable debt securities in the domestic and international capital markets in a wide range of maturities to meet our large and continuous funding needs. Our Capital Markets group is responsible for the issuance of debt securities to meet our funding needs. Table 33 below provides a summary of our debt activity for the years ended December 31, 2005, 2004 and 2003. Table 34 below shows our outstanding short-term borrowings for the years ended December 31, 2005, 2004 and 2003.

Table 33: Debt Activity

	For the Year Ended December 31,		
	2005	2004	2003
	(Dollars in millions)		
Issued during the year: ⁽¹⁾			
Short-term: ⁽²⁾			
Amount: ⁽³⁾	\$ 2,795,854	\$ 2,055,759	\$ 2,234,000
Weighted average interest rate:	3.20%	1.50%	1.07%
Long-term:			
Amount: ⁽³⁾	\$ 156,437	\$ 252,658	\$ 348,112
Weighted average interest rate:	4.41%	2.90%	2.58%
Total issued:			
Amount: ⁽³⁾	\$ 2,952,291	\$ 2,308,417	\$ 2,582,112
Weighted average interest rate:	3.26%	1.66%	1.28%
Redeemed during the year: ⁽¹⁾⁽⁴⁾			

Short-term: ⁽²⁾			
Amount: ⁽³⁾	\$ 2,944,027	\$ 2,081,726	\$ 2,191,992
Weighted average interest rate:	3.03%	1.34%	1.12%
Long-term:			
Amount: ⁽³⁾	\$ 196,957	\$ 238,686	\$ 279,168
Weighted average interest rate:	3.51%	3.26%	3.66%
Total redeemed:			
Amount: ⁽³⁾	\$ 3,140,984	\$ 2,320,412	\$ 2,471,160
Weighted average interest rate:	3.06%	1.54%	1.41%

- (1) Excludes debt activity resulting from consolidations.
- (2) Includes Federal funds purchased and securities sold under agreements to repurchase.
- (3) Represents the face amount at issuance or redemption.
- (4) Represents all payments on debt, including regularly scheduled principal payments, payments at maturity, payments as the result of a call and payments for any other repurchases.

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	As of December 31,		2005 Average During the Year		Maximum Outstanding ⁽³⁾
	Outstanding	Weighted Average Interest Rate ⁽¹⁾	Outstanding ⁽²⁾ (Dollars in millions)	Weighted Average Interest Rate ⁽¹⁾	
Federal funds purchased and securities sold under agreements to repurchase	\$ 705	3.90%	\$ 2,202	2.88%	\$ 6,143
Fixed short-term debt					
U.S. discount notes	\$ 166,645	4.08%	\$ 205,152	3.15%	\$ 281,117
Foreign exchange discount notes	1,367	2.66	3,931	2.00	8,191
Other fixed short-term debt	941	3.75	1,429	3.03	3,570
Floating short-term debt	645	4.16	3,383	3.26	6,250
Debt from consolidations	3,588	4.25	4,394	3.25	4,891
Total short-term debt	\$ 173,186	4.07%			

	As of December 31,		2004 Average During the Year		Maximum Outstanding ⁽³⁾
	Outstanding	Weighted Average Interest Rate ⁽¹⁾	Outstanding ⁽²⁾ (Dollars in millions)	Weighted Average Interest Rate ⁽¹⁾	
Federal funds purchased and securities sold under agreements to repurchase	\$ 2,400	1.90%	\$ 2,704	0.80%	\$ 10,455
Fixed short-term debt					
U.S. discount notes	\$ 299,728	2.14%	\$ 306,539	1.42%	\$ 323,289
Foreign exchange discount notes	6,591	0.84	3,064	1.10	7,089
Other fixed short-term debt	3,724	1.59	3,236	1.43	3,779
Floating short-term debt	6,250	2.19	7,548	1.41	9,135
Debt from consolidations	3,987	2.20	2,989	1.54	3,987
Total short-term debt	\$ 320,280	2.11%			

	As of December 31,		2003 Average During the Year		Maximum
	Outstanding	Weighted Average Interest Rate ⁽¹⁾	Outstanding ⁽²⁾ (Dollars in millions)	Weighted Average Interest Rate ⁽¹⁾	Outstanding ⁽³⁾
Federal funds purchased and securities sold under agreements to repurchase	\$ 3,673	1.03%	\$ 7,276	0.58%	\$ 21,773
Fixed short-term debt					
U.S. discount notes	\$ 327,967	1.11%	\$ 320,987	1.20%	\$ 351,793
Foreign exchange discount notes	1,214	1.37	1,432	1.48	3,291
Other fixed short-term debt	1,863	1.53	726	1.13	2,250
Floating short-term debt	10,235	1.03	5,343	1.16	10,235
Debt from consolidations	2,383	1.14	1,360	1.23	2,383
Total short-term debt	\$ 343,662	1.11%			

(1) Includes discounts, premiums and other cost basis adjustments.

(2) Average amount outstanding during the year has been calculated using month-end balances.

(3) Maximum outstanding represents the highest month-end outstanding balance during the year.

For information regarding our outstanding long-term debt as of December 31, 2005 and 2004, refer to Notes to Consolidated Financial Statements Note 8, Short-term Borrowings and Long-term Debt.

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We are one of the world's largest issuers of unsecured debt securities. We issue debt on a regular basis in significant amounts in the capital markets and have a diversified funding base of domestic and international investors. Purchasers of our debt securities include fund managers, commercial banks, pension funds, insurance companies, foreign central banks, state and local governments, and retail investors. Purchasers of our debt securities are also geographically diversified, with a significant portion of our investors located in the United States, Europe and Asia. The diversity of our debt investors enhances our financial flexibility and limits our dependence on any one source of funding. Our status as a GSE and our current AAA (or its equivalent) senior long-term unsecured debt credit ratings are critical to our ability to continuously access the debt capital markets to borrow at attractive rates. The U.S. government does not guarantee our debt, directly or indirectly, and our debt does not constitute a debt or obligation of the U.S. government.

Our sources of liquidity have consistently been adequate to meet both our short-term and long-term funding needs, and we anticipate that they will remain adequate in the next year. Due to the reduction in the size of our mortgage portfolio subsequent to December 31, 2004 pursuant to our capital restoration plan, our debt funding requirements have been lower in 2005, 2006 and 2007 than in 2003 and 2004. As of December 31, 2005, we had total debt outstanding of \$764.7 billion, as compared to an estimated total debt outstanding of \$774.4 billion as of December 31, 2006. However, we remain an active issuer of short-term and long-term debt securities. Our short-term and long-term funding needs during 2007 and 2008 are generally expected to be consistent with our needs during 2005 and 2006, and with the uses of cash described above under Sources and Uses of Cash. As described below under Capital Management Capital Activity OFHEO Oversight of Our Capital Activity, pursuant to our May 2006 consent order with OFHEO, we are currently not permitted to increase our net mortgage portfolio assets above the amount shown in our minimum capital report to OFHEO as of December 31, 2005 (\$727.75 billion). We expect that, over the long term, our funding needs and sources of liquidity will remain relatively consistent with current needs and sources. We may increase our issuance of debt in future years if we decide to increase our purchase of mortgage assets following any modification or expiration of the current limitation on the size of our mortgage portfolio.

We have experienced no limitations on our ability to borrow funds through the issuance of debt securities in the capital markets and do not anticipate any change in our ability to do so in the foreseeable future. Significant changes in our current regulatory status, however, could adversely affect our access to some or all debt investors and lead to a reduction in our credit ratings, thereby potentially increasing our debt funding costs and reducing the amount of debt that we can issue at any given time. Other factors that could negatively impact our ability to issue debt securities at attractive rates include significant changes in interest rates, increased interest rate volatility, a significant adverse change in foreign exchange rates, a significant adverse change in our financial condition or financial results, significant events relating to our business or industry, a significant change in the public's perception of the risks to and financial prospects of our business or our industry, regulatory constraints, disruptions in the capital markets and general economic conditions in the United States or abroad. Refer to Item 1A Risk Factors for a discussion of the risks relating to our ability to issue debt in sufficient quantities and at attractive rates, the risks associated with a reduction in our current credit ratings and the risks associated with proposed changes in the regulation of our business. On June 13, 2006, the U.S. Department of the Treasury announced that it would undertake a review of its process for approving our issuances of debt, which could adversely impact our flexibility in issuing debt securities in the future. We cannot predict whether the outcome of this review will materially impact our current debt issuance activities.

Change in the Federal Reserve Board's Payments System Risk Policy

On July 20, 2006, the Federal Reserve Banks implemented changes to the Federal Reserve Board's Policy Statement on Payments System Risk. The changes pertain to the processing of principal and interest payments, via the Fedwire system, for securities issued by GSEs and certain international organizations, including us.

Prior to July 2006, the Federal Reserve Bank had exempted us from overdraft fees relating to the processing of interest and redemption payments on our debt and Fannie Mae MBS. We were permitted to overdraw our account at the Federal Reserve Bank for these payments and would make periodic payments throughout the

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business day until our account balance was zero. Since July 2006, we have been required to fund interest and redemption payments on our debt and Fannie Mae MBS before the Federal Reserve Banks, acting as our fiscal agent, will execute the payments on our behalf. We compensate the Federal Reserve Banks for this service.

Because we receive funds and make payments throughout each business day, we have implemented actions, including revising our funding strategies, to ensure that we will have access to funds to meet our payment obligations in a timely manner. We have established and periodically may use secured and unsecured intraday funding lines of credit with several large financial institutions. We are currently funding security holder payments on a daily basis and are fully compliant with the revised Federal Reserve policy.

Credit Ratings and Risk Ratings

Our ability to borrow at attractive rates is highly dependent upon our credit ratings. Our senior unsecured debt (both long-term and short-term), qualifying benchmark subordinated debt and preferred stock are rated and continuously monitored by Standard & Poor's, Moody's and Fitch, each of which is a nationally recognized statistical rating organization. Table 35 below sets forth the credit ratings issued by each of these rating agencies of our long-term and short-term senior unsecured debt, qualifying benchmark subordinated debt and preferred stock as of December 7, 2006.

Table 35: Fannie Mae Debt Credit Ratings

	Senior Long-Term Unsecured Debt	Senior Short-Term Unsecured Debt	Benchmark Subordinated Debt	Preferred Stock
Standard & Poor's	AAA	A-1+	AA-(1)	AA-(1)
Moody's Investors Service	Aaa	P-1	Aa2(2)	Aa3(2)
Fitch, Inc.	AAA	F1+	AA-(3)	AA-(4)

- (1) On September 23, 2004, Standard & Poor's placed our preferred stock and subordinated debt ratings on credit watch negative. On December 7, 2006, Standard & Poor's removed our preferred stock and subordinated debt ratings from credit watch negative and placed these ratings on a negative outlook.
- (2) On September 28, 2004, Moody's placed our preferred stock and subordinated debt ratings on a negative outlook. On December 15, 2005, Moody's confirmed our preferred stock and subordinated debt ratings with a stable outlook.
- (3) On September 29, 2004, Fitch downgraded our subordinated debt rating from AA to AA-. On December 23, 2004, Fitch placed our subordinated debt rating on rating watch negative. On December 7, 2006, Fitch removed our subordinated debt rating from rating watch negative and affirmed the AA- rating.
- (4) On September 29, 2004, Fitch downgraded our preferred stock rating from AA to AA-. On December 23, 2004, Fitch downgraded our preferred stock rating from AA- to A+ and placed our preferred stock rating on rating watch negative. On December 7, 2006, Fitch removed our preferred stock rating from rating watch negative and upgraded the rating from A+ to AA-.

Pursuant to our September 1, 2005 agreement with OFHEO, we agreed to seek to obtain a rating, which will be continuously monitored by at least one nationally recognized statistical rating organization, that assesses, among other things, the independent financial strength or risk to the government of Fannie Mae operating under its authorizing legislation but without assuming a cash infusion or extraordinary support of the government in the event of a financial crisis. We also agreed to provide periodic public disclosure of this rating.

Standard & Poor's risk to the government rating for us as of April 26, 2007 was AA- with a negative outlook. On December 7, 2006, Standard & Poor's removed this rating from credit watch negative and placed the rating on a negative outlook. Standard & Poor's continually monitors this rating.

Moody's Bank Financial Strength Rating for us as of April 26, 2007 was B+ with a stable outlook. This rating was downgraded from A- on March 28, 2005. Moody's continually monitors this rating.

We do not have any covenants in our existing debt agreements that would be violated by a downgrade in our credit ratings. To date, we have not experienced any limitations in our ability to access the capital markets due to a credit ratings downgrade. See Item 1A Risk Factors for a discussion of the risks associated with a reduction in our credit ratings.

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Liquidity Contingency Plan

Our Liquidity Risk Policy includes a contingency plan in the event that factors, whether internal or external to our business, temporarily compromise our ability to access capital through normal channels. Our contingency plan provides for alternative sources of liquidity that would allow us to meet all of our cash obligations for 90 days without relying upon the issuance of unsecured debt. If our access to the capital markets becomes impaired, our contingency plan designates our unencumbered mortgage portfolio as our primary source of liquidity. Our unencumbered mortgage portfolio consists of unencumbered mortgage loans and mortgage-related securities that could be pledged as collateral for borrowing in the market for mortgage repurchase agreements or sold to generate additional funds. As of December 31, 2005 and 2004, substantially all of our mortgage portfolio would have been eligible to be pledged as collateral under repurchase agreements. As of December 31, 2004, \$1.7 billion of the mortgage-related securities held in our portfolio had been pledged as collateral under repurchase agreements. As of December 31, 2005, we did not have any outstanding securities sold under agreements to repurchase, and therefore, we did not pledge any securities. We have not pledged any mortgage loans held in our portfolio as collateral under repurchase agreements.

Our liquid investment portfolio is also a source of liquidity in the event that we cannot access the capital markets. Our liquid investment portfolio consists primarily of high-quality non-mortgage investments that are readily marketable or have short-term maturities. As of December 31, 2005 and 2004, we had approximately \$52.2 billion and \$55.1 billion, respectively, in liquid assets, net of any cash and cash equivalents pledged as collateral. Our investments in non-mortgage securities, which account for the majority of our liquid assets, totaled \$37.1 billion and \$43.9 billion as of December 31, 2005 and 2004, respectively. Approximately 98% and 93% of our non-mortgage securities as of December 31, 2005 and 2004, respectively, had a credit rating of A (or its equivalent) or higher, based on the lowest of Standard & Poor's, Moody's or Fitch ratings.

OFHEO Supervision

Pursuant to its role as our safety and soundness regulator, OFHEO monitors our liquidity management practices and audits our liquidity position on a continuous basis. On September 1, 2005, we entered into an agreement with OFHEO that formalized and updated the voluntary initiatives that we announced in October 2000 to enhance market discipline, liquidity and capital. Pursuant to this agreement, we agreed to certain commitments pertaining to management of our liquidity, including:

complying with principles of sound liquidity management consistent with industry practice;

maintenance of a portfolio of highly liquid assets;

maintenance of a functional contingency plan providing for at least three months' liquidity without relying upon the issuance of unsecured debt; and

periodic testing of our contingency plan in consultation with an OFHEO examiner.

Each of these commitments is addressed in our Liquidity Risk Policy described above. We further agreed to periodic public disclosure regarding our compliance with the plan for maintaining three months' liquidity and meeting the commitment for periodic testing. We believe we were in compliance with our commitment to maintain and test our functional contingency plan as of March 31, 2007. We are currently in the process of revising our liquidity management policies in consultation with OFHEO. We expect that OFHEO will finalize its review of our implementation of our liquidity management commitments during the second quarter of 2007.

Table of Contents**Contractual Obligations**

Table 36 summarizes our expectation as to the effect of our minimum debt payments and other material noncancelable contractual obligations as of December 31, 2005 on our liquidity and cash flows in future periods. Our current contractual obligations as of the date of this report are different than the contractual obligations as of December 31, 2005 presented in the table below, primarily with respect to our debt obligations. As of December 31, 2005, we had total debt outstanding of \$764.7 billion, as compared to an estimated total debt outstanding of \$774.4 billion as of December 31, 2006.

Table 36: Contractual Obligations

	Payments Due by Period as of December 31, 2005				
	Total	Less than 1 Year	1 to 3 Years	3 to 5 Years	More than 5 Years
	(Dollars in millions)				
Long-term debt obligations ⁽¹⁾	\$ 584,017	\$ 129,138	\$ 197,438	\$ 105,754	\$ 151,687
Contractual interest on long-term debt obligations ⁽²⁾	135,478	24,005	35,596	22,541	53,336
Operating lease obligations ⁽³⁾	203	35	59	37	72
Purchase obligations:					
Mortgage commitments ⁽⁴⁾	23,673	23,636	37		
Other purchase obligations ⁽⁵⁾	95	51	44		
Other long-term liabilities reflected in the consolidated balance sheet: ⁽⁶⁾					
Government penalty ⁽⁷⁾	400	400			
Other ⁽⁸⁾	5,118	4,073	1,045		
Total contractual obligations	\$ 748,984	\$ 181,338	\$ 234,219	\$ 128,332	\$ 205,095

(1) Represents the carrying amount of our long-term debt assuming payments are made in full at maturity. Amounts exclude approximately \$6.8 billion in long-term debt from consolidations. Amounts include unamortized net premium and cost basis adjustments of approximately \$10.7 billion.

(2) Excludes contractual interest on long-term debt from consolidations.

(3) Includes certain premises and equipment leases.

(4) Includes on- and off-balance sheet commitments to purchase loans and mortgage-related securities.

(5) Includes only unconditional purchase obligations that are subject to a cancellation penalty for certain telecom services, software and computer services, and agreements. Excludes arrangements that may be cancelled without penalty.

(6)

Excludes risk management derivative transactions that may require cash settlement in future periods and our obligations to stand ready to perform under our guaranties relating to Fannie Mae MBS and other financial guaranties, because the amount and timing of payments under these arrangements are generally contingent upon the occurrence of future events. For a description of the amount of our on- and off-balance sheet Fannie Mae MBS and other financial guaranties as of December 31, 2005, see *Off-Balance Sheet Arrangements and Variable Interest Entities*.

- (7) Represents a \$400 million civil penalty to the U.S. government pursuant to May 23, 2006 settlements with the SEC and OFHEO. This penalty is included in the consolidated balance sheet under *Other Liabilities*.
- (8) Includes future cash payments due under our contractual obligations to fund LIHTC and other partnerships that are unconditional and legally binding, as well as cash received as collateral from derivative counterparties, which are included in the consolidated balance sheets under *Partnership liabilities* and *Other liabilities*, respectively. Amounts also include our obligation to fund partnerships that have been consolidated.

Cash Flows

Cash Flows for the Year Ended December 31, 2005

During the year ended December 31, 2005, cash and cash equivalents increased by \$165 million, or 6%, to \$2.8 billion as of December 31, 2005 as compared to the prior year.

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We generated net cash of \$78.1 billion in operating activities in 2005, primarily due to net income and a net decrease in trading securities. Our cash generated by operating activities was partially offset by purchases of HFS loans.

We generated net cash of \$139.4 billion in investing activities in 2005, primarily due to proceeds we received from sales and maturities of AFS securities and proceeds from the sale of held-for-investment (HFI) loans as we reduced our portfolio. The cash increases were partially offset by advances to lenders and purchases of AFS securities and HFI loans.

We used net cash of \$217.4 billion in financing activities in 2005, primarily for the net redemption of short-term and long-term debt.

Cash Flows for the Year Ended December 31, 2004

During the year ended December 31, 2004, cash and cash equivalents decreased by \$740 million, or 22%, to \$2.7 billion as of December 31, 2004 as compared to the prior year.

We generated net cash of \$41.6 billion in operating activities in 2004, primarily due to net income and a net decrease in trading securities. Our cash generated by operating activities was partially offset by purchases of HFS loans.

We used net cash of \$16.8 billion in investing activities in 2004, primarily due to advances to lenders and purchases of AFS securities and HFI loans. The cash we used in investing activities was partially offset by proceeds we received from maturities of AFS securities and repayments of HFI loans.

We used net cash of \$25.5 billion in financing activities in 2004, primarily for the redemption of short-term and long-term debt. The cash we used in financing activities was offset primarily by issuances of our short-term and long-term debt.

Cash Flows for the Year Ended December 31, 2003

During the year ended December 31, 2003, our cash and cash equivalents increased by \$1.7 billion, or 97%, to \$3.4 billion as of December 31, 2003 as compared to the prior year.

We generated net cash of \$58.2 billion in operating activities in 2003, primarily due to net income and a net decrease in trading securities. Our cash generated by operating activities was partially offset by purchases of HFS loans.

We used net cash of \$152.7 billion in investing activities in 2003, primarily due to advances to lenders and purchases of AFS securities and HFI loans. Our cash used in investing activities was partially offset by proceeds we received from maturities and sales of AFS securities and repayments of HFI loans.

We raised net cash of \$96.2 billion in financing activities in 2003, primarily by issuing short-term and long-term debt. Our cash provided by financing activities was partially offset primarily by redemption of short-term and long-term debt.

Capital Management

Our objective in managing capital is to maximize long-term stockholder value through the pursuit of business opportunities that provide attractive returns while maintaining capital at levels sufficient to ensure compliance with both regulatory and internal capital requirements.

Capital Adequacy Requirements

We are subject to capital adequacy requirements established by the 1992 Act. The statutory capital framework incorporates two different quantitative assessments of capital both a minimum capital requirement and a risk-based capital requirement. While the minimum capital requirement is ratio-based, the risk-based capital requirement is based on simulated stress test performance. Pursuant to the 1992 Act, we are required to maintain sufficient capital to meet both of these requirements in order to be classified as adequately capitalized. In addition, pursuant to our May 2006 consent order with OFHEO, we are currently required to maintain a 30% capital surplus over our statutory minimum capital requirement, which is referred to as the

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OFHEO-directed minimum capital requirement. We are subject to continuous examination by OFHEO to ensure that we meet these capital adequacy requirements on an ongoing basis.

Statutory Minimum Capital Requirement

OFHEO's ratio-based minimum capital standard ties our capital requirements to the size of our book of business. For purposes of the minimum capital requirement, we are in compliance if our core capital equals or exceeds our minimum capital requirement. Core capital is defined by statute as the sum of the stated value of outstanding common stock (common stock less treasury stock), the stated value of outstanding non-cumulative perpetual preferred stock, paid-in capital and retained earnings, as determined in accordance with GAAP. Our minimum capital requirement is generally equal to the sum of:

2.50% of on-balance sheet assets;

0.45% of the unpaid principal balance of outstanding Fannie Mae MBS held by third parties; and

up to 0.45% of other off-balance sheet obligations.

Each quarter, OFHEO publishes our standing relative to the statutory minimum capital requirement and, commencing for the quarter ended September 30, 2005, the OFHEO-directed minimum capital requirement as part of its capital classification announcement. For a description of the amounts by which our core capital exceeded or was less than our statutory minimum capital requirement as of December 31, 2005 and 2004, see Table 37 under **Capital Classification Measures** below.

Statutory Risk-Based Capital Requirement

OFHEO's risk-based capital standard ties our capital requirements to the risk in our book of business, as measured by a stress test model. The stress test simulates our financial performance over a ten-year period of severe economic conditions characterized by both extreme interest rate movements and high mortgage default rates. Simulation results indicate the amount of capital required to survive this prolonged period of economic stress absent new business or active risk management action. In addition to this model-based amount, the risk-based capital requirement also includes an additional 30% surcharge to cover unspecified management and operations risks.

Our total capital base is used to meet our risk-based capital requirement. Total capital is defined by statute as the sum of core capital plus the total allowance for loan losses and reserve for guaranty losses in connection with Fannie Mae MBS, less the specific loss allowance (that is, the allowance required on individually-impaired loans). Each quarter, OFHEO runs a detailed profile of our book of business through the stress test simulation model. The model generates cash flows and financial statements to evaluate our risk and measure our capital adequacy during the ten-year stress horizon. As part of its quarterly capital classification announcement, OFHEO makes these stress test results publicly available. For a description of the amounts by which our total capital exceeded our statutory risk-based capital requirement as of December 31, 2005 and 2004, see Table 37 under **Capital Classification Measures** below.

Capital Restoration Plan and OFHEO-Directed Minimum Capital Requirement

OFHEO concluded in its September 2004 interim report on its special examination that we had misapplied GAAP relating to hedge accounting and the amortization of purchase premiums and discounts on securities and loans and on other deferred charges. The SEC's Office of the Chief Accountant affirmed OFHEO's conclusion and, on December 15, 2004, advised us that we should restate our financial statements filed with the SEC to eliminate the use of hedge accounting in order to be consistent with GAAP. At that time, we estimated that the disallowed hedge accounting

treatments resulted in a \$9 billion cumulative reduction in our core capital as of September 30, 2004. As a result, on December 21, 2004, OFHEO classified us as significantly undercapitalized as of September 30, 2004 and directed us to submit a capital restoration plan that would provide for compliance with our statutory minimum capital requirement plus a surplus of 30% over the statutory minimum capital requirement. Pursuant to OFHEO's directive, we submitted a capital restoration plan which indicated our intention to achieve a 30% capital surplus over our minimum capital requirement by September 30, 2005. The capital restoration plan was accepted by OFHEO on February 17, 2005.

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OFHEO announced on November 1, 2005 that we had achieved a 30% surplus over minimum capital requirement at September 30, 2005. In addition to generating capital through retained earnings, we achieved this capital surplus by taking the following actions pursuant to our capital restoration plan:

significantly reducing the size of our investment portfolio, through both normal mortgage liquidations and selected sales of mortgage assets, which reduced the amount of assets in the consolidated balance sheets and thereby reduced our overall minimum capital requirements;

issuing \$5.0 billion in non-cumulative preferred stock in December 2004;

reducing our quarterly dividend rate by 50% on January 18, 2005, from \$0.52 per share of common stock to \$0.26 per share of common stock; and

canceling our plans to build major new corporate facilities in Southwest Washington, DC and undertaking other cost-cutting efforts.

Under our May 23, 2006 consent order with OFHEO, we agreed to continue our commitment to maintain a 30% capital surplus over our statutory minimum capital requirement until such time as the Director of OFHEO determines that the requirement should be modified or allowed to expire, considering factors such as resolution of accounting and internal control issues. OFHEO actively monitors our compliance with the capital restoration plan. We believe that we continue to be in compliance with the plan as of the date of this filing.

Statutory Critical Capital Requirement

Our critical capital requirement is the amount of core capital below which we would be classified as critically undercapitalized and generally would be required to be placed in conservatorship. Our critical capital requirement is generally equal to the sum of:

1.25% of on-balance sheet assets;

0.25% of the unpaid principal balance of outstanding Fannie Mae MBS held by third parties; and

up to 0.25% of other off-balance sheet obligations.

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For a description of the amounts by which our core capital exceeded our statutory critical capital requirement as of December 31, 2005 and 2004, see Table 37 under Capital Classification Measures below.

Capital Classification Measures

The table below shows our core capital, total capital and other capital classification measures as of December 31, 2005 and 2004.

Table 37: Regulatory Capital Surplus

	As of December 31,	
	2005⁽¹⁾	2004
	(Dollars in millions)	
Core capital ⁽²⁾	\$ 39,433	\$ 34,514
Required minimum capital ⁽³⁾	28,233	32,121
Surplus of core capital over required minimum capital	11,200	\$ 2,393
Surplus of core capital percentage over required minimum capital ⁽⁴⁾	39.7%	7.4%
Total capital ⁽⁵⁾	\$ 40,091	\$ 35,196
Required risk-based capital ⁽⁶⁾	12,636	10,039
Surplus of total capital over required risk-based capital	\$ 27,455	\$ 25,157
Surplus of total capital percentage over required risk-based capital ⁽⁷⁾	217.3%	250.6%
Core capital ⁽²⁾	\$ 39,433	\$ 34,514
Required critical capital ⁽⁸⁾	14,536	16,435
Surplus of core capital over required critical capital	\$ 24,897	\$ 18,078
Surplus of core capital percentage over required critical capital ⁽⁹⁾	171.3%	110.0%

(1) Except for required risk-based capital amounts, all amounts represent estimates that will be resubmitted to OFHEO for their certification. Required risk-based capital amounts represent previously announced results by OFHEO. OFHEO may determine that results require restatement in the future based upon analysis provided by us.

(2) The sum of (a) the stated value of our outstanding common stock (common stock less treasury stock); (b) the stated value of our outstanding non-cumulative perpetual preferred stock; (c) our paid-in capital; and (d) our retained earnings. Core capital excludes AOCI.

(3) Generally, the sum of (a) 2.50% of on-balance sheet assets; (b) 0.45% of the unpaid principal balance of outstanding Fannie Mae MBS held by third parties; and (c) up to 0.45% of other off-balance sheet obligations, which may be adjusted by the Director of OFHEO under certain circumstances (See 12 CFR 1750.4 for existing adjustments made by the Director of OFHEO).

- (4) Defined as the surplus of core capital over required minimum capital expressed as a percentage of required minimum capital.
- (5) The sum of (a) core capital and (b) the total allowance for loan losses and reserve for guaranty losses, less (c) the specific loss allowance (that is, the allowance required on individually-impaired loans). The specific loss allowance totaled \$66 million and \$63 million as of December 31, 2005 and 2004, respectively.
- (6) Defined as the amount of total capital required to be held to absorb projected losses flowing from future adverse interest rate and credit risk conditions specified by statute (see 12 CFR 1750.13 for conditions), plus 30% mandated by statute to cover management and operations risk.
- (7) Defined as the surplus of total capital over required risk-based capital expressed as a percentage of risk-based capital.
- (8) Generally, the sum of (a) 1.25% of on-balance sheet assets; (b) 0.25% of the unpaid principal balance of outstanding Fannie Mae MBS held by third parties; and (c) up to 0.25% of other off-balance sheet obligations, which may be adjusted by the Director of OFHEO under certain circumstances.
- (9) Defined as the surplus of core capital over required critical capital, expressed as a percentage of required critical capital.

On May 19, 2005, OFHEO classified us as significantly undercapitalized as of December 31, 2004 and adequately capitalized as of March 31, 2005. For each subsequent quarter through December 31, 2006 (the most recent quarter for which OFHEO has published its capital classification), we have been classified by OFHEO as adequately capitalized. On March 30, 2007, OFHEO announced that we were classified as

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adequately capitalized as of December 31, 2006. Our core capital of \$42.3 billion as of December 31, 2006 exceeded our statutory minimum capital requirement by \$13.0 billion, or 44.2%, and our OFHEO-directed minimum capital requirement by \$4.2 billion, or 10.9%. Our total capital of \$43.0 billion as of December 31, 2006 exceeded our statutory risk-based capital requirement by \$16.2 billion, or 60.2%. Because we have not yet prepared audited consolidated financial statements for any periods after December 31, 2005, OFHEO's capital classifications for periods after December 31, 2005 are based on our estimates of our financial condition as of those periods and remain subject to revision.

Capital Management Framework

Our capital management practices are intended to ensure ongoing compliance with not only our regulatory capital requirements, but also internal economic capital requirements. Our internal economic capital requirements represent management's view of the capital required to support our risk posture and are used to guide capital deployment decisions to maximize long-term stockholder value. Our economic capital framework relies upon both stress test and value-at-risk analyses that measure capital solvency using long-term financial simulations and near-term market value shocks. We currently target a combined corporate economic capital requirement that is less than our regulatory capital requirements.

To ensure compliance with each of our regulatory capital requirements, we maintain different levels of capital surplus for each capital requirement. The optimal surplus amount for each capital measure is directly tied to the volatility of the capital requirement and related core capital base. Because it is explicitly tied to risk, the statutory risk-based capital requirement tends to be more volatile than the ratio-based minimum capital requirement. Quarterly changes in economic conditions (such as interest rates, spreads and home prices) can materially impact the calculated risk-based capital requirement. As a consequence, we generally seek to maintain a larger surplus over the risk-based capital requirement to ensure continued compliance.

While we are able to reasonably estimate the size of our book of business and therefore our minimum capital requirement, the amount of our reported core capital holdings at each period end is less certain without hedge accounting treatment. Changes in the fair value of our derivatives may result in significant fluctuations in our capital holdings from period to period. Accordingly, we target a surplus above the statutory minimum capital requirement and OFHEO-directed minimum capital requirement to accommodate a wide range of possible valuation changes that might adversely impact our core capital base.

Capital Activity

OFHEO Oversight of Our Capital Activity

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

In addition, in the May 2006 OFHEO consent order, we agreed to the following additional restrictions relating to our capital activity:

We must continue our commitment to maintain a 30% capital surplus over our statutory minimum capital requirement until such time as the Director of OFHEO determines that the requirement should be modified or allowed to expire, taking into account factors such as the resolution of accounting and internal control issues.

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

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

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We are not permitted to increase our net mortgage portfolio assets above the amount shown in our minimum capital report to OFHEO as of December 31, 2005 (\$727.75 billion), except in limited circumstances at the discretion of OFHEO. We will be subject to this limitation on portfolio growth until the Director of OFHEO has determined that expiration of the limitation is appropriate in light of information regarding: our capital; market liquidity issues; housing goals; risk management improvements; outside auditor's opinion that our consolidated financial statements present fairly in all material respects our financial condition; receipt of an unqualified opinion from an outside audit firm that our internal controls are effective pursuant to section 404 of the Sarbanes-Oxley Act of 2002; or other relevant information.

Pursuant to the capital restoration plan, we provide a quarterly capital plan update to OFHEO.

Common Stock

Shares of common stock outstanding, net of shares held in treasury, totaled approximately 972 million, 971 million and 969 million as of December 31, 2006, 2005 and 2004, respectively. During 2006, 2005 and 2004, we issued 1.6 million, 1.5 million and 5.8 million shares of common stock, respectively, from treasury for our employee benefit plans. We have not issued any common stock during 2004, 2005, 2006 and 2007 other than in accordance with these plans. Our ability to issue common stock will be limited until we have returned to timely financial reporting.

In January 2003, our Board of Directors approved a share repurchase program (the General Repurchase Authority) authorizing us to repurchase up to 5% of our shares of common stock outstanding as of December 31, 2002, as well as additional shares to offset stock issued, or expected to be issued, under our employee benefit plans. Under this General Repurchase Authority, which does not have a specified expiration date, we repurchased 7.2 million shares of common stock at a weighted average cost per share of \$73.67 in 2004. We have not repurchased any shares from the open market pursuant to this General Repurchase Authority since July 2004.

In November 2004, OFHEO agreed that our September 27, 2004 agreement with OFHEO did not impair our ability to repurchase shares from employees under certain employee benefit plan transactions, including reacquiring shares for: payment of withholding taxes on the vesting of restricted stock; payment of withholding taxes due upon the exercise of employee stock options; and payment of the exercise price on stock options. OFHEO also approved our request to repurchase shares from employees in limited circumstances relating to financial hardship.

Since April 2005, we have prohibited all of our employees from engaging in purchases or sales of our securities except in limited circumstances relating to financial hardship. In November 2005, our Board of Directors authorized the creation of a stock repurchase program that permits us to repurchase up to \$100 million of our shares from our non-officer employees, who are employees below the level of vice president. Under the program, we may repurchase shares weekly at fair market value only during the 30-trading day period following our quarterly filings on Form 12b-25 with the SEC. Officers and members of our Board of Directors are not permitted to participate in the program. On March 22, 2006, OFHEO advised us that it had no objection to our proceeding with the program on the terms described to OFHEO. We implemented the program in May 2006. From May 31, 2006 to February 28, 2007, we have purchased an aggregate of 47,440 shares of common stock from our employees under the program. The employee stock repurchase program does not have a specified expiration date.

Non-Cumulative Preferred Stock

In December 2004, we sold two issues of non-cumulative preferred stock to institutional investors for aggregate total proceeds of \$5.0 billion, which included \$2.5 billion in convertible preferred stock. These preferred stock issuances represent the largest capital placement we have ever undertaken and were a key component of our capital restoration

plan. We did not redeem any preferred stock during 2006, 2005 or 2004. We redeemed our Series J Preferred stock on February 28, 2007, and our Series K Preferred Stock on April 2, 2007. Our ability to issue preferred stock in the public market may be limited until we return to timely financial reporting. We have not issued preferred stock since December 31, 2004.

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Subordinated Debt

On September 1, 2005, we agreed with OFHEO to make specific commitments relating to the issuance of qualifying subordinated debt. These commitments replaced our October 2000 voluntary initiatives relating to the maintenance of qualifying subordinated debt. We agreed to issue qualifying subordinated debt, rated by at least two nationally recognized statistical rating organizations, in a quantity such that the sum of our total capital plus the outstanding balance of our qualifying subordinated debt equals or exceeds the sum of (1) outstanding Fannie Mae MBS held by third parties times 0.45% and (2) total on-balance sheet assets times 4%. We must also take reasonable steps to maintain sufficient outstanding subordinated debt to promote liquidity and reliable market quotes on market values. We also agreed to provide periodic public disclosure of our compliance with these commitments, including a comparison of the quantities of qualifying subordinated debt and total capital to the levels required by our agreement with OFHEO.

Every six months, commencing January 1, 2006, we are required to submit to OFHEO a subordinated debt management plan that includes any issuance plans for the upcoming six months. Although it is not a component of core capital, qualifying subordinated debt supplements our equity capital. It is designed to provide a risk-absorbing layer to supplement core capital for the benefit of senior debt holders. In addition, the spread between the trading prices of our qualifying subordinated debt and our senior debt serves as a market indicator to investors of the relative credit risk of our debt. A narrow spread between the trading prices of our qualifying subordinated debt and senior debt implies that the market perceives the credit risk of our debt to be relatively low. A wider spread between these prices implies that the market perceives our debt to have a higher relative credit risk.

The sum of our total capital plus the outstanding balance of our qualifying subordinated debt exceeded the sum of (1) outstanding Fannie Mae MBS held by third parties times 0.45% and (2) total on-balance sheet assets times 4% by an estimated \$8.9 billion, or 21.3%, as of December 31, 2006, and by an estimated \$8.3 billion, or 20.4%, as of December 31, 2005. Qualifying subordinated debt with a remaining maturity of less than five years receives only partial credit in this calculation. One-fifth of the outstanding amount is excluded each year during the instrument's last five years before maturity and, when the remaining maturity is less than one year, the instrument is entirely excluded.

Qualifying subordinated debt is defined as subordinated debt that contains an interest deferral feature that requires us to defer the payment of interest for up to five years if either:

our core capital is below 125% of our critical capital requirement; or

our core capital is below our minimum capital requirement, and the U.S. Secretary of the Treasury, acting on our request, exercises his or her discretionary authority pursuant to Section 304(c) of the Charter Act to purchase our debt obligations.

Core capital is defined by OFHEO and represents the sum of the stated value of our outstanding common stock (common stock less treasury stock), the stated value of our outstanding non-cumulative perpetual preferred stock, our paid-in capital and our retained earnings, as determined in accordance with GAAP.

During any period in which we defer payment of interest on qualifying subordinated debt, we may not declare or pay dividends on, or redeem, purchase or acquire, our common stock or preferred stock. To date, no triggering events have occurred that would require us to defer interest payments on our qualifying subordinated debt.

Prior to our September 1, 2005 agreement with OFHEO, pursuant to our voluntary initiatives, we sought to maintain sufficient qualifying subordinated debt to bring the sum of total capital and outstanding qualifying subordinated debt

to at least 4% of on-balance sheet assets, after providing adequate capital to support Fannie Mae MBS held by third parties that is not included in the consolidated balance sheets. We had qualifying subordinated debt with a carrying amount of \$12.5 billion as of both December 31, 2004 and 2003, which, together with our total capital, constituted 4.0% and 3.3% of our on-balance sheet assets as of December 31, 2004 and 2003, respectively. Under the voluntary initiatives, qualifying subordinated debt with a remaining maturity of less than five years did not receive a partial credit in this calculation.

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We issued \$4.0 billion of qualifying subordinated debt securities in 2003. We have not issued any subordinated debt securities since 2003. Under our agreement with OFHEO, we intend to resume the issuance of qualifying subordinated debt once we return to timely financial reporting. We had qualifying subordinated debt totaling \$1.5 billion and \$2.0 billion, based on redemption value, that matured in May 2006 and January 2007, respectively. As of the date of this filing, we have \$9.0 billion in outstanding qualifying subordinated debt.

Dividends

In January 2005, our Board of Directors reduced our quarterly dividend rate by 50%, from \$0.52 per share of common stock to \$0.26 per share of common stock. We reduced our common stock dividend rate in order to increase our capital surplus, which was a component of our capital restoration plan. In December 2006, the Board of Directors increased our quarterly dividend rate to \$0.40 per share of common stock, beginning in the fourth quarter of 2006, and increased our dividend rate again to \$0.50 per share of common stock, beginning in the second quarter of 2007.

We paid quarterly common stock dividends of:

\$0.52 per share for each quarter of 2004;

\$0.26 per share for each quarter of 2005 and for the first, second and third quarters of 2006; and

\$0.40 per share for the fourth quarter of 2006 and first quarter of 2007.

Our Board of Directors declared common stock dividends of \$0.50 per share which are payable on May 25, 2007. Our Board of Directors has also approved preferred stock dividends for periods commencing December 31, 2004, up to but excluding June 30, 2007. See Notes to Consolidated Financial Statements Note 16, Preferred Stock for detailed information on our preferred stock dividends.

OFF-BALANCE SHEET ARRANGEMENTS AND VARIABLE INTEREST ENTITIES

We enter into certain business arrangements to facilitate our statutory purpose of providing liquidity to the secondary mortgage market and to reduce our exposure to interest rate fluctuations. We form arrangements to meet the financial needs of our customers and manage our credit, market or liquidity risks. Some of these arrangements are not recorded in the consolidated balance sheets or may be recorded in amounts different from the full contract or notional amount of the transaction, depending on the nature or structure of, and accounting required to be applied to, the arrangement. These arrangements are commonly referred to as off-balance sheet arrangements, and expose us to potential losses in excess of the amounts recorded in the consolidated balance sheets.

The most significant off-balance sheet arrangements that we engage in result from the mortgage loan securitization and resecuritization transactions that we routinely enter into as part of the normal course of our business operations. Our Single-Family Credit Guaranty business generates most of its revenues through the guaranty fees earned from these securitization transactions. In addition, our HCD business generates a significant amount of its revenues through the guaranty fees earned from these securitization transactions. We also enter into other guaranty transactions and hold LIHTC partnership interests that may involve off-balance sheet arrangements.

Fannie Mae MBS Transactions and Other Financial Guaranties

As described in Item 1 Business, both our Single-Family Credit Guaranty business and our HCD business generate revenue through guaranty fees earned in connection with the issuance of Fannie Mae MBS. In a typical Fannie Mae

MBS transaction, we receive mortgage loans or mortgage-related securities from lenders and transfer the assets to a trust or special purpose entity. Upon creation of the trust, we deliver back beneficial interests in the trust to investors in the form of Fannie Mae MBS. In holding Fannie Mae MBS created from a pool of whole loans, an investor has securities that are generally more liquid than whole loans, which provides the investor with greater financial flexibility. In particular, by holding readily marketable Fannie Mae MBS, lenders increase their ability to replenish their funds for use in making additional loans.

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We guarantee to each MBS trust that we will supplement amounts received by the MBS trust as required to permit timely payments of principal and interest on the related Fannie Mae MBS, irrespective of the cash flows received from borrowers. In connection with our guaranties issued or modified on or after January 1, 2003, we record in the consolidated balance sheets a guaranty obligation based on an estimate of our non-contingent obligation to stand ready to perform under these guaranties. We also record in the consolidated balance sheets a reserve for guaranty losses based on an estimate of our incurred credit losses on all of our guaranties, irrespective of the issuance date.

While we hold some Fannie Mae MBS in our mortgage portfolio, the substantial majority of outstanding Fannie Mae MBS is held by third parties and therefore is generally not reflected in the consolidated balance sheets. Of the \$1.9 trillion in total Fannie Mae MBS outstanding as of December 31, 2005, \$234.5 billion was held in our portfolio and \$1.6 trillion was held by third-party investors. The \$234.5 billion in Fannie Mae MBS held in our portfolio is reflected in the consolidated balance sheets as Investments in securities. We consolidate certain Fannie Mae MBS trusts depending on the significance of our interest in those MBS trusts. Upon consolidation, we recognize the assets of the consolidated trust. As of December 31, 2005, we had recognized \$111.3 billion of assets as Mortgage loans in the consolidated balance sheets as a result of consolidating MBS trusts. Accordingly, as of December 31, 2005, there was approximately \$1.6 trillion in outstanding and unconsolidated Fannie Mae MBS held by third parties, which is not included in the consolidated balance sheets.

While our guaranties relating to Fannie Mae MBS represent the substantial majority of our guaranty activity, we also provide other financial guaranties. Our HCD business provides credit enhancements primarily for taxable and tax-exempt bonds issued by state and local governmental entities to finance multifamily housing for low- and moderate-income families. Under these credit enhancement arrangements, we guarantee to the trust that we will supplement proceeds as required to permit timely payment on the related bonds, which improves the bond ratings and thereby results in lower-cost financing for multifamily housing. Our HCD business generates revenue from the fees earned on these transactions. These transactions also contribute to our housing goals and help us meet other mission-related objectives.

Our maximum potential exposure to credit losses relating to our outstanding and unconsolidated Fannie Mae MBS held by third parties and our other financial guaranties is significantly higher than the carrying amount of the guaranty obligations and reserve for guaranty losses that are reflected in the consolidated balance sheets. In the case of outstanding and unconsolidated Fannie Mae MBS held by third parties, our maximum potential exposure arising from these guaranties is primarily represented by the unpaid principal balance of the mortgage loans underlying these Fannie Mae MBS, which was \$1.6 trillion as of December 31, 2005. In the case of our other financial guaranties, our maximum potential exposure is primarily represented by the unpaid principal balance of the underlying bonds and loans, which was \$19.2 billion as of December 31, 2005.

Based on our historical credit losses, which represent less than 0.02% of our mortgage credit book of business for each year from 2003 to 2005, we do not believe that the maximum exposure on our Fannie Mae MBS and other credit-related guaranties is representative of our actual credit exposure relating to these guaranties. In the event that we were required to make payments under these guaranties, we would pursue recovery of these payments by exercising our rights to the collateral backing the underlying loans or through available credit enhancements (which includes all recourse with third parties and mortgage insurance).

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The table below presents a summary of our on- and off-balance sheet Fannie Mae MBS and other guaranty obligations as of December 31, 2005 and 2004.

Table 38: On- and Off-Balance Sheet MBS and Other Guaranty Arrangements

	As of December 31,	
	2005	2004
	(Dollars in millions)	
Fannie Mae MBS and other guaranties outstanding ⁽¹⁾	\$ 1,852,521	\$ 1,767,276
Less: Fannie Mae MBS held in portfolio ⁽²⁾	234,451	344,404
Fannie Mae MBS held by third parties and other guaranties	\$ 1,618,070	\$ 1,422,872

(1) Includes \$19.2 billion and \$14.8 billion in unpaid principal balance of other guaranties as of December 31, 2005 and 2004, respectively. Excludes \$111.3 billion and \$150.1 billion in unpaid principal balance of consolidated Fannie Mae MBS as of December 31, 2005 and 2004, respectively.

(2) Amounts represent unpaid principal balance and are recorded in Investments in Securities in the consolidated balance sheets.

For more information on our securitization transactions, including the interests we retain in these transactions, cash flows from these transactions, and our accounting for these transactions, see Notes to Consolidated Financial Statements Note 6, Portfolio Securitizations, Notes to Consolidated Financial Statements Note 7, Financial Guaranties and Master Servicing and Notes to Consolidated Financial Statements Note 17, Concentrations of Credit Risk. For information on the revenues and expenses associated with our Single-Family Credit Guaranty and HCD businesses, refer to Business Segment Results.

LIHTC Partnership Interests

Our HCD business's Community Investment Group makes equity investments in numerous limited partnerships that sponsor affordable housing projects utilizing the low-income housing tax credit pursuant to Section 42 of the Internal Revenue Code. We invest in LIHTC partnerships in order to increase the supply of affordable housing in the United States and to serve communities in need. In addition, our investments in LIHTC partnerships generate both tax credits and net operating losses that reduce our federal income tax liability. The tax benefits associated with these LIHTC partnerships were the primary reasons for our effective tax rate in 2005 being 17% versus the federal statutory rate of 35%.

LIHTC partnerships own interests in rental housing that the partnerships have developed or rehabilitated. By renting a specified portion of the housing units to qualified low-income tenants over a 15-year period, the partnerships become eligible for the federal low-income housing tax credit. To qualify for this tax credit, among other requirements, the project owner must irrevocably elect that either (1) a minimum of 20% of the residential units will be rent-restricted and occupied by tenants whose income does not exceed 50% of the area median gross income, or (2) a minimum of 40% of the residential units will be rent-restricted and occupied by tenants whose income does not exceed 60% of the area median gross income. Failure to qualify as an affordable housing project over the entire 15-year period may result in the recapture of a portion of the tax credits. The LIHTC partnerships are generally organized by fund manager

sponsors who seek out investments with third-party developers who in turn develop or rehabilitate the properties, and subsequently manage them. We invest in these partnerships as a limited partner with the fund manager acting as the general partner. In making investments in these LIHTC partnerships, our HCD business's Community Investment Group identifies qualified sponsors and structures the terms of our investment.

In certain instances, we have been determined to be the primary beneficiary of these LIHTC partnership investments, and therefore all of the partnership assets and liabilities have been recorded in the consolidated balance sheets, and the portion of these investments owned by third parties is recorded in the consolidated balance sheets as an offsetting minority interest. In most instances, we are not the primary beneficiary of the investments, and therefore our consolidated balance sheets reflect only our investment in the partnership, rather than the full amount of the partnership's assets and liabilities. Our investments in LIHTC partnerships are recorded in the consolidated balance sheets as Partnership investments.

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In cases where we are not the primary beneficiary of these investments, we account for our investments in LIHTC partnerships by using the equity method of accounting or the effective yield method of accounting, as appropriate. In each case, we record in the consolidated financial statements our share of the income and losses of the partnerships, as well as our share of the tax credits and tax benefits of the partnerships. Our share of the operating losses generated by our LIHTC partnerships is recorded in the consolidated statements of income under Loss from partnership investments. The tax credits and benefits associated with any operating losses incurred by these LIHTC partnerships are recorded in the consolidated statements of income within our Provision for federal income taxes.

As of December 31, 2005, we had a recorded investment in these LIHTC partnerships of \$7.7 billion. Our risk exposure relating to these LIHTC partnerships is limited to the amount of our investment and the possible recapture of the tax benefits we have received from the partnership. Neither creditors of, nor equity investors in, these partnerships have any recourse to our general credit. To manage the risks associated with a partnership, we track compliance with the LIHTC requirements, as well as the property condition and financial performance of the underlying investment throughout the life of the investment. In addition, we evaluate the strength of the partnership's sponsor through periodic financial and operating assessments. Further, in some of our LIHTC partnership investments, our exposure to loss is further mitigated by our having a guaranteed economic return from an investment grade counterparty.

The table below provides information regarding our LIHTC partnership investments as of and for the year ended December 31, 2005:

Table 39: LIHTC Partnership Investments

	2005	
	Consolidated	Non-Consolidated
	(Dollars in millions)	
As of December 31:		
Obligation to fund LIHTC partnerships	\$ 833	\$ 1,698
For the year ended December 31:		
Tax credits from investments in LIHTC partnerships	\$ 366	\$ 467
Losses from investments in LIHTC partnerships	275	518
Tax benefits on credits and losses from investments in LIHTC partnerships	462	649
Contributions to LIHTC partnerships	484	743
Distributions from LIHTC partnerships	2	1

For more information on our off-balance sheet transactions, see Notes to Consolidated Financial Statements Note 17, Concentrations of Credit Risk.

IMPACT OF FUTURE ADOPTION OF NEW ACCOUNTING PRONOUNCEMENTS**SFAS No. 123R, Share-Based Payment and SAB No. 107**

In December 2004, the FASB issued SFAS No. 123(R), *Share-Based Payment* (SFAS 123R), which revises SFAS No. 123 and supersedes APB Opinion No. 25, and its related implementation guidance. SFAS 123R eliminates the alternative of applying the intrinsic value measurement provisions of APB 25 to stock compensation awards issued to employees. Rather, SFAS 123R requires measurement of the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. With respect to options, SFAS 123R

requires that they be measured at fair value using an option-pricing model that takes into account the options' unique characteristics and recognition of the cost as expense over the period the employee provides services to earn the award, which is generally the vesting period. Also, SFAS 123R requires that excess tax benefits be classified as a financing cash inflow in the consolidated statements of cash flows.

This standard includes measurement requirements for employee stock options that are similar to those under the fair-value-based method of SFAS 123; however, SFAS 123R requires initial and ongoing estimates of the

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amount of shares that will vest while SFAS 123 provided entities the option of assuming that all shares would vest and then recognizing actual forfeitures as they occur. SFAS 123R also clarifies and expands the guidance in SFAS 123 regarding classification of an award as equity or as a liability.

Additionally, SEC Staff Accounting Bulletin 107, Share-Based Payment, provides guidance related to the interaction between SFAS 123R and certain SEC rules and regulations, as well as the staff's views regarding the valuation of share-based payment arrangements.

SFAS 123R is effective for annual periods beginning after June 15, 2005 and allows use of the modified prospective application method to be applied to new awards, unvested awards and to awards modified, repurchased or cancelled after the effective date. We prospectively adopted the fair value expense recognition provisions of SFAS 123 effective January 1, 2003, using a model to estimate the fair value of the majority of our stock awards. We adopted SFAS 123R effective January 1, 2006 with no material impact to the consolidated financial statements.

SFAS No. 154, Accounting Changes and Error Corrections

In May 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections* (SFAS 154), which replaces APB Opinion No. 20, *Accounting Changes* (APB 20) and SFAS No. 3, *Reporting Accounting Changes in Interim Financial Statements*, and changes the requirements for the accounting for and reporting of a change in accounting principle. SFAS 154 applies to all voluntary changes in accounting principle and changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions.

APB 20 requires that the cumulative effect of most voluntary changes in accounting principles be included in net income in the period of adoption. The new statement requires retrospective application to prior periods' financial statements of a voluntary change in accounting principle, unless it is impracticable to determine either period-specific effects or the cumulative effect of the change. In addition, SFAS 154 requires that we account for a change in method of depreciation, amortization or depletion for long-lived, non-financial assets as a change in accounting estimate that is effected by a change in accounting principle. APB 20 previously required that we report such a change as a change in accounting principle.

SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The adoption of SFAS 154 effective January 1, 2006 had no impact on the consolidated financial statements.

SFAS No. 155, Accounting for Certain Hybrid Financial Instruments and DIG Issue No. B40, Embedded Derivatives: Application of Paragraph 13(b) to Securitized Interests in Prepayable Financial Assets

In February 2006, the FASB issued SFAS No. 155, *Accounting for Certain Hybrid Financial Instruments* (SFAS 155), an amendment of SFAS 133 and SFAS 140. This statement: (i) clarifies which interest-only strips and principal-only strips are not subject to SFAS 133; (ii) establishes a requirement to evaluate interests in securitized financial instruments that contain an embedded derivative requiring bifurcation; (iii) clarifies that concentration of credit risks in the form of subordination are not embedded derivatives; and (iv) permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation.

In January 2007, FASB issued Derivatives Implementation Group (DIG) Issue No. B40 (DIG B40). The objective of DIG B40 is to provide a narrow scope exception to certain provisions of SFAS 133 for securitized interests that contain only an embedded derivative that is tied to the prepayment risk of the underlying financial assets. SFAS 155 and DIG B40 are effective for all financial instruments acquired or issued after the beginning of the first fiscal year

that begins after September 15, 2006. We adopted SFAS 155 effective January 1, 2007 and elected fair value remeasurement for hybrid financial instruments that contain embedded derivatives that otherwise require bifurcation, which includes buy-ups and guaranty assets arising from portfolio securitization transactions. We also elected to classify investment securities that may contain embedded derivatives as trading securities under SFAS No. 115, *Accounting for Certain Investments in Debt*

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and Equity Securities. SFAS 155 is a prospective standard and had no impact on the consolidated financial statements on the date of adoption.

SFAS No. 156, Accounting for Servicing of Financial Assets

In March 2006, the FASB issued SFAS No. 156, *Accounting for Servicing of Financial Assets, an amendment of FASB Statement No. 133 and 140* (SFAS 156). SFAS 156 modifies SFAS 140 by requiring that mortgage servicing rights (MSR) be initially recognized at fair value and by providing the option to either (i) carry MSRs at fair value with changes in fair value recognized in earnings or (ii) continue recognizing periodic amortization expense and assess the MSRs for impairment as was originally required by SFAS 140. This option is available by class of servicing asset or liability. This statement also changes the calculation of the gain from the sale of financial assets by requiring that the fair value of servicing rights be considered part of the proceeds received in exchange for the sale of the assets.

SFAS 156 is effective for all separately recognized servicing assets and liabilities acquired or issued after the beginning of a fiscal year that begins after September 15, 2006, with early adoption permitted. We adopted SFAS 156 effective January 1, 2007, with no material impact to the consolidated financial statements. We do not believe SFAS 156 will have a material effect on the consolidated financial statements, because we do not intend to measure MSRs at fair value subsequent to their initial recognition.

FIN 48, Accounting for Uncertainty in Income Taxes

In July 2006, the FASB issued FIN No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48). FIN 48 supplements SFAS No. 109, *Accounting for Income Taxes* (SFAS 109), by defining a threshold for recognizing tax benefits in the consolidated financial statements.

FIN 48 provides a two-step approach to recognizing and measuring tax benefits when a benefit's realization is uncertain. First, we must determine whether the benefit is to be recognized and then the amount to be recognized. Income tax benefits should be recognized when, based on the technical merits of a tax position, we believe that if upon examination, including resolution of any appeals or litigation process, it is more likely than not (a probability of greater than 50%) that the tax position would be sustained as filed. The benefit recognized for a tax position that meets the more-likely-than-not criterion is measured based on the largest amount of tax benefit that is more than 50% likely to be realized upon ultimate settlement with the taxing authority, taking into consideration the amounts and probabilities of the outcomes upon settlement.

In March 2007, FSP FIN 48-a, *Definition of Settlement in FASB Interpretation 48* (FSP FIN 48-a), was proposed by the FASB. The objective of FSP FIN 48-a is to replace the term "ultimate settlement," originally introduced in FIN 48, with the term "effective settlement" and to provide guidance to determine whether or not a tax position is effectively settled for the purpose of recognizing previously unrecognized tax benefits. Final guidance of FSP FIN 48-a is expected in the second quarter of 2007 with an effective date that coincides with that of FIN 48.

FIN 48 is effective for consolidated financial statements beginning in the first quarter of 2007. The cumulative effect of applying the provisions of FIN 48 upon adoption will be reported as an adjustment to beginning retained earnings. We are evaluating the impact of the adoption of FIN 48 and FSP FIN 48-a on the consolidated financial statements.

SFAS No. 157, Fair Value Measurements

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurement* (SFAS 157). SFAS 157 provides enhanced guidance for using fair value to measure assets and liabilities and requires companies to provide expanded information about assets and liabilities measured at fair value, including the effect of fair value measurements on

earnings. This statement applies whenever other standards require (or permit) assets or liabilities to be measured at fair value, but does not expand the use of fair value in any new circumstances.

Under SFAS 157, fair value refers to the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants in the market in which the reporting entity transacts. This statement clarifies the principle that fair value should be based on the assumptions market

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participants would use when pricing the asset or liability. In support of this principle, this standard establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. The fair value hierarchy gives the highest priority to quoted prices in active markets and the lowest priority to unobservable data (for example, a company's own data). Under this statement, fair value measurements would be separately disclosed by level within the fair value hierarchy.

SFAS 157 is effective for consolidated financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. We intend to adopt SFAS 157 effective January 1, 2008 and are evaluating the impact of its adoption on the consolidated financial statements.

SFAS No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans

In September 2006, the FASB issued SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*, an amendment of FASB Statements No. 87, 88, 106, and 132(R) (SFAS 158). SFAS 158 requires the recognition of a plan's over-funded or under-funded status as an asset or liability and recognition of actuarial gains and losses and prior service costs and credits as an adjustment to AOCI, net of income tax. Additionally, it requires determination of benefit obligations and the fair values of a plan's assets at a company's year-end. SFAS 158 is effective as of the end of the fiscal year ending after December 15, 2006. We adopted SFAS 158 effective December 31, 2006 and reduced shareholders' equity by approximately \$100 million to record the underfunded status of our plans.

SFAS No. 159, Fair Value Option

In February 2007, the FASB issued SFAS No. 159, *Fair Value Option* (SFAS 159). SFAS 159 permits companies to make a one-time election to report certain financial instruments at fair value with the changes in fair value included in earnings. SFAS 159 is effective for consolidated financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. We do not plan to elect early adoption and are still evaluating how we will adopt SFAS 159. We have not yet determined the impact, if any, on the consolidated financial statements of adopting this standard.

2005 QUARTERLY REVIEW

We provide certain selected unaudited quarterly financial statement information for the year ended December 31, 2005 and 2004 in Notes to Consolidated Financial Statements Note 20, Selected Quarterly Financial Information (Unaudited). The selected financial information includes the following:

Condensed consolidated statements of income for the quarters ended March 31, 2005, June 30, 2005, September 30, 2005 and December 31, 2005.

Condensed consolidated statements of income for the quarters ended March 31, 2004, June 30, 2004, September 30, 2004 and December 31, 2004.

Condensed consolidated balance sheets as of March 31, 2005, June 30, 2005, September 30, 2005 and December 31, 2005.

Condensed business segment results of operations for the quarters ended March 31, 2005, June 30, 2005, September 30, 2005 and December 31, 2005.

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	For the Quarter Ended			
	March 31,	June 30,	September 30,	December 31,
	2005	2005	2005	2005
	(Dollars and shares in millions, except per share amounts)			
Net interest income	\$ 3,787	\$ 2,897	\$ 2,664	\$ 2,157
Guaranty fee income	870	1,208	832	869
Investment gains (losses), net	(1,454)	596	(169)	(307)
Derivatives fair value losses, net	(749)	(2,641)	(539)	(267)
Debt extinguishment gains (losses), net	(142)	18	86	(30)
Loss from partnership investments	(200)	(210)	(211)	(228)
Fee and other income	353	459	298	416
Administrative expenses	(363)	(507)	(567)	(678)
Provision for credit losses	(57)	(125)	(172)	(87)
Other expenses	(53)	(22)	(68)	(93)
Income before federal income taxes and extraordinary gains (losses)	1,992	1,673	2,154	1,752
Provision for federal income taxes	217	333	406	321
Income before extraordinary gains (losses)	1,775	1,340	1,748	1,431
Extraordinary gains (losses), net of tax effect	65	(2)	(3)	(7)
Net income	\$ 1,840	\$ 1,338	\$ 1,745	\$ 1,424
Preferred stock dividends	(121)	(122)	(122)	(121)
Net income available to common stockholders	\$ 1,719	\$ 1,216	\$ 1,623	\$ 1,303
Basic earnings (loss) per share:				
Earnings before extraordinary gains	\$ 1.71	\$ 1.25	\$ 1.68	\$ 1.35
Extraordinary gains (losses), net of tax effect	.06			(0.01)
Basic earnings per share	\$ 1.77	\$ 1.25	\$ 1.68	\$ 1.34
Diluted earnings (loss) per share:				
Earnings before extraordinary gains (losses)	\$ 1.70	\$ 1.25	\$ 1.66	\$ 1.35
Extraordinary gains (losses), net of tax effect	0.06			(0.01)
Diluted earnings per share	\$ 1.76	\$ 1.25	\$ 1.66	\$ 1.34
Weighted-average common shares outstanding:				
Basic	969	970	970	970

Diluted ⁽¹⁾	998	971	998	998
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(1) For the quarter ended June 30, 2005, diluted shares excludes the effect of our convertible preferred stock as inclusion would be antidilutive for that period.

Table of Contents**Table 41: 2004 Quarterly Condensed Consolidated Statements of Income**

	For the Quarter Ended			
	March 31,	June 30,	September 30,	December 31,
	2004	2004	2004	2004
	(Dollars and shares in millions, except per share amounts)			
Net interest income	\$ 5,062	\$ 4,836	\$ 4,000	\$ 4,183
Guaranty fee income	891	727	1,067	919
Investment gains (losses), net	525	(1,518)	887	(256)
Derivatives fair value gains (losses), net	(6,446)	2,269	(7,136)	(943)
Debt extinguishment gains (losses), net	(78)	(7)	(21)	(46)
Loss from partnership investments	(145)	(177)	(177)	(203)
Fee and other income	56	413	103	(168)
Administrative expenses	(406)	(372)	(367)	(511)
Provision for credit losses	(13)	(55)	(65)	(219)
Other expenses	(50)	(43)	(50)	(467)
Income (loss) before federal income taxes and extraordinary gains (losses)	(604)	6,073	(1,759)	2,289
Provision (benefit) for federal income taxes	(529)	1,753	(910)	710
Income (loss) before extraordinary gains (losses)	(75)	4,320	(849)	1,579
Extraordinary gains (losses), net of tax effect	10	(3)	(18)	3
Net income (loss)	\$ (65)	\$ 4,317	\$ (867)	\$ 1,582
Preferred stock dividends and issuance costs at redemption	(43)	(40)	(41)	(41)
Net income (loss) available to common stockholders	\$ (108)	\$ 4,277	\$ (908)	\$ 1,541
Basic earnings (loss) per share:				
Earnings before extraordinary gains (losses)	\$ (0.12)	\$ 4.41	\$ (0.92)	\$ 1.59
Extraordinary gains (losses), net of tax effect	0.01		(0.02)	
Basic earnings (loss) per share	\$ (0.11)	\$ 4.41	\$ (0.94)	\$ 1.59
Diluted earnings (loss) per share:				
Earnings before extraordinary gains (losses)	\$ (0.12)	\$ 4.40	\$ (0.92)	\$ 1.59
Extraordinary gains (losses), net of tax effect	0.01		(0.02)	
Diluted earnings (loss) per share	\$ (0.11)	\$ 4.40	\$ (0.94)	\$ 1.59
Weighted-average common shares outstanding:				

Basic	972	969	968	969
Diluted	972	973	968	972

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	March 31, 2005	June 30, 2005	As of September 30, 2005	December 31, 2005
	(Dollars in millions)			
Assets:				
Cash and cash equivalents	\$ 3,186	\$ 2,597	\$ 2,797	\$ 2,820
Investments in securities:				
Trading, at fair value	29,670	24,291	16,401	15,110
Available-for-sale, at fair value	496,591	466,045	391,503	390,964
Total investments	\$ 526,261	490,336	407,904	406,074
Mortgage loans:				
Loans held for sale, at lower of cost or market	10,587	7,654	5,973	5,064
Loans held for investment, at amortized cost	385,528	366,203	359,372	362,781
Allowance for loan losses	(302)	(312)	(319)	(302)
Total loans	395,813	373,545	365,026	367,543
Derivative assets at fair value	7,602	6,405	6,355	5,803
Guaranty assets	5,982	5,765	6,425	6,848
Deferred tax assets	7,053	5,039	6,099	7,684
Other assets	30,308	32,371	32,590	37,396
Total assets	\$ 976,205	\$ 916,058	\$ 827,196	\$ 834,168
Liabilities and Stockholders Equity:				
Liabilities:				
Short-term debt	\$ 284,776	\$ 219,837	\$ 151,906	\$ 173,186
Long-term debt	625,686	628,148		