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December 21, 2007

The Honorable Brian Montgomery  
Assistant Secretary for Housing  
Federal Housing Commissioner  
U.S. Department of Housing and Urban Development  
[Redacted]  
451 Seventh Street, SW  
Washington, DC 20410

Dear Mr. Assistant Secretary:

I am writing in response to your letter dated December 6, 2007. Your letter stated that, as provided in the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (“FHEFSSA”), the U.S. Department of Housing and Urban Development (“HUD”) has “determined that there is a substantial probability that Fannie Mae will fail to achieve the low- and moderate-income home purchase subgoal and the special affordable housing home purchase subgoal in 2007.”

As a result of this determination, the Secretary has initiated the statutorily-mandated process to evaluate whether the subgoals are feasible for 2007, taking into account market and economic conditions and the financial condition of Fannie Mae. As part of that process, Fannie Mae is authorized to submit written information regarding HUD’s determination and our views on the feasibility of achieving these two subgoals.

We view the regulatory goals and subgoals as an important part of our mission. Under difficult conditions, Fannie Mae has worked very hard this year to meet the housing goals and subgoals. However, as discussed below, Fannie Mae believes that the low- and moderate-income and special affordable subgoals are infeasible for 2007.

2007 Housing Goal Performance

Fannie Mae’s housing goals results through November are as follows:

<u>Housing Goals</u>	<u>Regulatory Targets</u>	<u>Fannie Mae Performance</u>
Low- and Moderate-Income	55%	55.18%
Underserved Areas	38%	42.90%
Special Affordable	25%	25.73%

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Fannie Mae remains comfortably ahead on the underserved areas goal and we have built a decent cushion above the special affordable housing goal. While our performance on the low- and moderate-income is ahead of the goal through November, our year-end estimates put us very close to the target. The market and economic conditions described below with respect to the subgoals have also made meeting this goal this year particularly challenging. While we are hopeful we will meet the low- and moderate-income goal when the final numbers are available, at this time we are not yet assured that we will make this goal.

### 2007 Subgoal Performance

Fannie Mae concurs with the determination of the Secretary that there is a substantial probability that Fannie Mae will not meet the low- and moderate-income and special affordable subgoals for 2007. Fannie Mae's performance on the subgoals through November is shown on the chart below.

<u>Home Purchase Subgoals</u>	<u>2007 Regulatory Targets</u>	<u>Fannie Mae Performance</u>
Low- and Moderate-Income	47%	42.38%
Underserved Areas	33%	33.38%
Special Affordable	18%	15.52%

In addition, we have provided \$16.68 billion of special affordable multifamily financing through November compared to the subgoal level of \$5.49 billion.

Fannie Mae has been – and will remain – focused on meeting the needs of low- and moderate-income borrowers. So far this year, Fannie Mae has financed nearly 50,000 more loans serving low- and moderate-income borrowers than we had by this time last year. Fannie Mae continues to offer *MyCommunityMortgage*<sup>™</sup> (“MCM”) as a preferred home financing solution for low- and moderate-income borrowers. Year-to-date 2007 deliveries for MCM are \$21.75 billion, compared with \$9.3 billion for all of 2006. In addition, the volume of mortgages purchased from housing finance agencies are \$3.77 billion compared to \$2.39 billion in 2006.

We continue to work closely with all our lender customers to increase their deliveries of eligible mortgages and to expand our relationships with housing finance agencies, manufactured housing lenders, and other specialized lenders who are able to deliver loans financing housing for low- and moderate-income borrowers and borrowers living in underserved areas. At this time, however, there are insufficient transactions in process that would increase performance on the above two subgoals in an amount that would raise the company's performance to subgoal levels.

### Market and Economic Conditions

Fannie Mae's subgoal performance for 2007 has been significantly affected by extraordinary market and economic conditions that could not have been foreseen when HUD set the goal and subgoal levels. These market conditions have had a negative impact on the market opportunities to purchase mortgages that satisfy the subgoal requirements. When it set the subgoals in 2004,

the Department relied almost exclusively on historical Home Mortgage Disclosure Act (“HMDA”) data and market estimates. Our review of currently available HMDA data shows that the percentages of the home purchase market represented by low- and moderate-income borrowers and borrowers who qualify for the special affordable subgoal fell significantly during the years following the publication of the current regulation. A subgoal should not be considered feasible if the goal does not reflect actual market opportunity. We do not believe the current market supports the subgoals set by HUD in 2004.

In determining the special affordable subgoal, HUD analyzed HMDA data for the years 1999-2003. The average share of special affordable home purchase loans originated during the time period ranged from 15.9 percent to 16.3 percent. Estimating that the market for special affordable loans would rise even further, HUD set the subgoals at 17 percent for 2005 and 2006 and at 18 percent for 2007 and 2008.

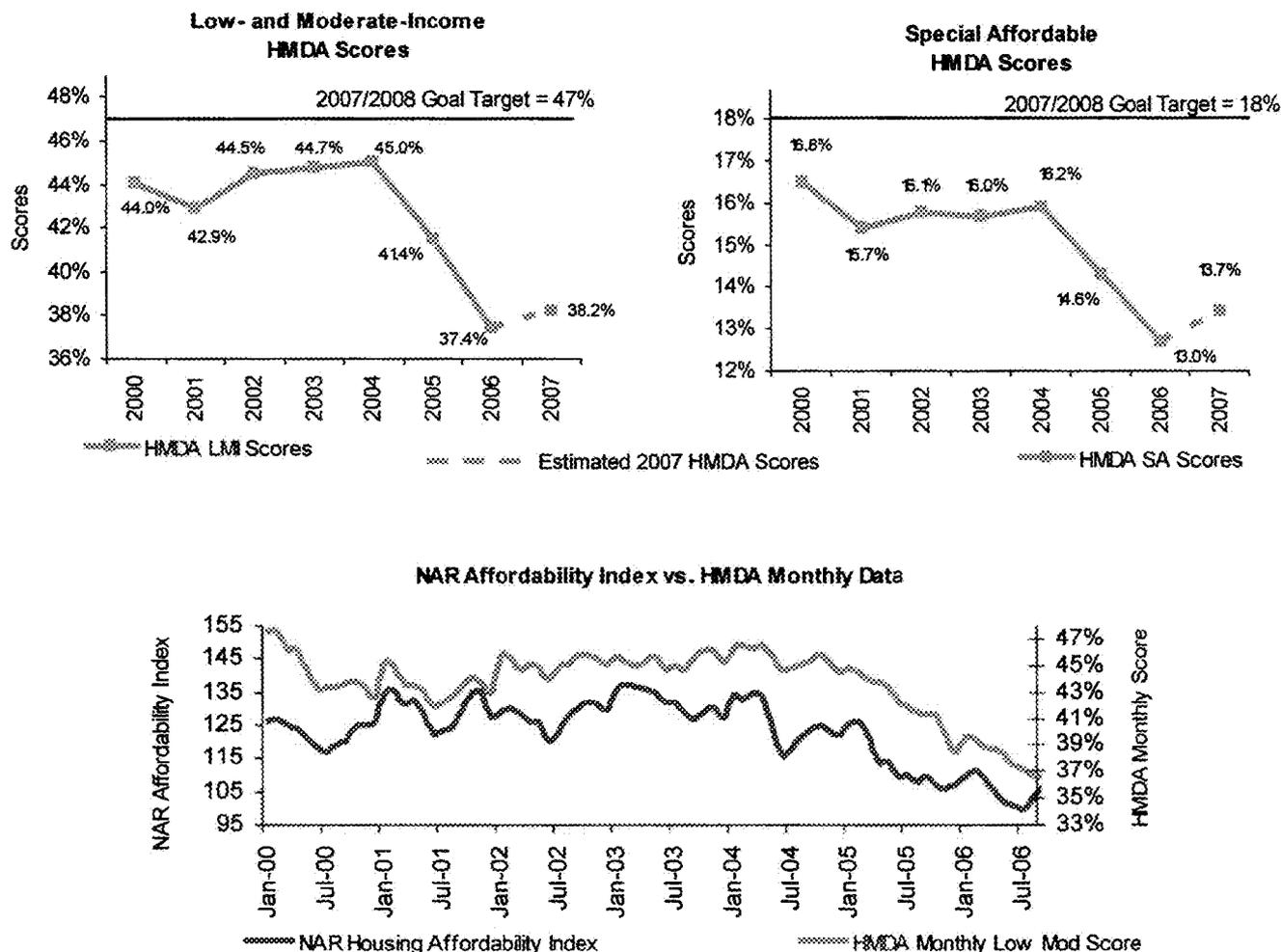
Similarly, HUD determined that the average low- and moderate-income share of the home purchase market ranged from 42.9 percent to 43.4 percent for the period 1999-2003. In the 2004 rulemaking, HUD set the subgoals to increase from 45 percent in 2005 to 47 percent in 2008. HUD stated that the subgoal levels were necessary for the enterprises to attain market leadership.

Currently available HMDA data shows that HUD’s reliance on historical averages and market estimates did not result in subgoals that accurately reflect the state of the current market. In the 2006 HMDA data, we observed a significant drop in the market presence of low- and moderate-income home buyers and home buyers who qualify for the special affordable housing subgoal. The HMDA data that year showed 37.4 percent low- and moderate-income borrowers<sup>1</sup> compared to a current subgoal level of 47.0 percent and 13.0 percent special affordable home purchase loans compared to a current subgoal level of 18.0 percent.

Further, we expect affordability levels, which have been dropping steadily since 2005, to remain low relative to the subgoal targets. Fannie Mae expects that the 2007 HMDA data will show the low- and moderate-income and special affordable markets at or below 38.2 percent and 13.7 percent respectively in 2007. These estimates are based on a regression analysis comparing HMDA data to the National Association of REALTORS® Affordability Index, but do not consider the credit tightening occurring in the market. Fannie Mae expects that credit tightening will cause further downward pressure on affordability. Data illustrating these declines are shown in the following charts.

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<sup>1</sup> HMDA analysis is for owner-occupied home purchase mortgages in Metropolitan Statistical Areas, including 50 percent of subprime lender production and second liens.



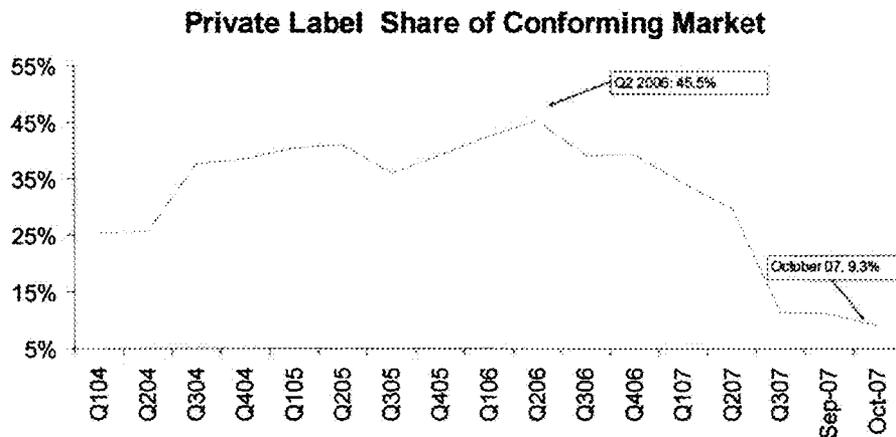
In addition to the decline in affordability, other market conditions have affected Fannie Mae's ability to meet the subgoals. The Mortgage Bankers Association ("MBA") recently released mortgage delinquency data for the third quarter of 2007. In the third quarter, 354,000 loans entered into foreclosure representing 0.78 percent of all loans being serviced - the highest rate recorded since the MBA began tracking these data in 1972, and a significant jump from 0.65 percent (seasonally-adjusted) in the second quarter. The prime conventional serious delinquency rate increased to 1.31 percent in the third quarter - a 52-basis point increase year-over-year, and the highest level ever reported. Fifty-two basis points represents a net increase of 204,000 loans that became seriously delinquent over the past year.<sup>2</sup>

Increasing delinquencies coupled with mounting credit losses led to a primary market credit crunch that is unprecedented in recent history. The uncertainty in investor demand for

<sup>2</sup> Fannie Mae's Weekly Economic Commentary - December 10, 2007

mortgages, particularly those with lower credit scores and higher loan-to-value ratios, has impacted lenders' willingness and ability to originate those loans. As a result, many lenders originating these loans were forced to exit the origination business. Since January 2007, Fannie Mae estimates \$640 billion of origination capacity and nearly 69,000 mortgage jobs have left the industry. Many lenders who remain have closed origination channels and tightened underwriting substantially. Even outside of these markets, lenders are pulling back from earlier underwriting advances in response to falling housing prices and increasing credit losses. Fannie Mae believes that fewer low income borrowers are able to purchase homes as tightened underwriting standards and the decline in the availability of non-traditional mortgage products exacerbate the already existing decline in housing affordability.

One strategy that Fannie Mae has used in the past to meet the subgoals is the purchase of private label securities ("PLS"). In 2006, purchases of PLS contributed significantly to subgoals performance, increasing our scores by nearly two percentage points on the low- and moderate-income subgoal and 80 basis points on our special affordable subgoal. However, Fannie Mae's ability to source and purchase PLS that meet the goals has fallen off because the issuance of PLS has fallen significantly. Issuances of PLS declined markedly in the third quarter, particularly in the areas of subprime and Alt-A mortgages. In November, PLS issuances fell 23 percent month over month and 79 percent year over year to \$17.5 billion, the lowest level since July 2001. The resulting declines in PLS market share are shown in the graph below.



Source -- Inside MBS and ABS, Bond Buyer

Another factor affecting Fannie Mae's performance is the limited availability of seasoned loan pools. Since 2005, Fannie Mae has relied heavily on the availability of seasoned loans to meet the subgoals. However, Fannie Mae's efforts to meet the subgoals in 2005 and 2006 have significantly limited opportunities to purchase portfolios of seasoned affordable housing loans in 2007. In 2006, Fannie Mae purchased nearly \$7.8 billion of seasoned portfolios. In contrast, Fannie Mae expects to purchase about \$300 million of seasoned portfolios in 2007.

#### Financial Condition of the Enterprise

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As demonstrated above, current market conditions alone are sufficient to support a finding that the low- and moderate-income and special affordable home purchase subgoals are infeasible for 2007. FHEFSSA provides that HUD also consider the financial condition of the enterprise when determining the feasibility of the goals. Fannie Mae submits that the company took all reasonable actions to meet the subgoals that were both financially prudent and likely to contribute to achievement of the subgoals. HUD has stated that the enterprises should be able to meet higher goals "without compromising other business objectives and requirements." Other actions that the company could have taken would have substantially increased the company's potential for credit losses without increasing the likelihood that the company would meet the subgoals.

In 2006, Fannie Mae relaxed certain underwriting standards and purchased some higher risk mortgage loan products in an effort to meet the housing goals. The company continued to purchase higher risk loans into 2007, and believes that these efforts to acquire goals-rich loans are partially responsible for increasing credit losses. The impact of those purchases is reflected in the company's quarterly financial statements for 2007. Credit related expenses, including the provision for credit losses, rose \$1.6 billion to \$2.0 billion. Fannie Mae's credit losses, which had been at historic lows in the three years prior to 2007, rose \$477 million to \$799 million. The credit loss ratio – total credit losses as a percent of the mortgage credit book of business – rose to 0.04 percent for the nine months versus 0.018 percent in the same period of 2006.<sup>3</sup>

Fannie Mae's financial condition is dependent on the company's ability to balance the cost and risk of serving various sectors of the market. The company's experience this year, however, has been that market conditions have created substantial tension between Fannie Mae's regulatory obligations and its liquidity mission. Maintaining liquidity in the housing market is an important part of the company's mission and business. When, as now, the market is slow to originate mortgages affordable to low- and moderate-income and special affordable families, balancing compliance with the subgoals with fulfilling the liquidity mission becomes particularly challenging, and requires Fannie Mae to take on additional risk in other areas. In our view, acquiring additional higher-risk loans would have been inconsistent with both the objectives of FHEFSSA and HUD's requirements.

### Conclusion

HUD recognized in setting the goals and subgoals in 2004 that there are inherent difficulties in predicting the behavior of markets, particularly several years into the future. In fact, as described above, substantial changes in market conditions that were not foreseen at the time the goals were set have had a severe impact on Fannie Mae's ability to meet the low- and moderate-income and special affordable housing subgoals in 2007. Therefore, Fannie Mae requests that HUD find the low- and moderate-income home purchase subgoal and the special affordable home purchase subgoal infeasible for 2007.

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<sup>3</sup>See Fannie Mae News Release, November 9, 2007 at [www.fanniemae.com/newsreleases/](http://www.fanniemae.com/newsreleases/).

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I appreciate the opportunity to present these issues to you and look forward to your response. Please do not hesitate to contact me with any questions or if you need additional information.

Sincerely,

A handwritten signature in black ink, appearing to read 'Sandra Fostek', with a stylized flourish at the end.

cc: Sandra Fostek, Director  
Office of Government Sponsored Enterprises Oversight

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This letter has been marked to show that it contains information that is confidential and proprietary within the meaning of Exemption 4 of the Freedom of Information Act because it contains confidential business and financial information. Accordingly, Fannie Mae requests confidential treatment for this letter.

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