Final Transcript

FANNIE MAE: Investor Analyst Conference Call

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SPEAKERS

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Daniel H. Mudd – President and Chief Executive Officer
Stephen M. Swad – Executive Vice President and Chief Financial Officer
Michael A. Quinn – Senior Vice President, Single-Family Credit Risk Management
Thomas A. Lund – Executive Vice President, Single-Family Mortgage Business
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Beth A. Wilkinson – Executive Vice President, General Counsel, and Corporate Secretary

ANALYSTS

David Hochstim – Bear Stearns
Bruce Harting – Lehman Brothers
Howard Shapiro – Fox-Pitt, Kelton
George Sacco – JP Morgan
Fred Cannon – KBW
Eric Wasserstrom – UBS
Mark Patterson – NWQ Investment Management
Michael Cohen – Senova Capital
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PRESENTATION

Moderator: Ladies and gentlemen, thank you for standing by. Welcome to the Fannie Mae Investor Analyst conference call. At this time, all participants are in a listen-only mode. Later, we will conduct a question and answer session, and instructions will be given at that time. As a reminder, today's conference is being recorded. I would like to now turn the conference over to your host, Mary Lou Christy. Please go ahead.

M. Christy: Thank you. Good afternoon, and welcome to today's investor analyst conference call. I'm Mary Lou Christy, Senior Vice President of Investor Relations.

We will have three speakers this afternoon. Dan Mudd, Fannie Mae's President and Chief Executive Officer will lead off today's call. Then Steve Swad, Executive Vice President and Chief Financial Officer, and we will end with Mike Quinn.

A little information regarding Mike, he has been with Fannie Mae for over 15 years, and was in charge of loss mitigation efforts in the early '90's when we were dealing with credit losses in California and the Northeast. Currently, he is the Senior Vice President, Single-Family Risk Officer responsible for policy, underwriting standards, servicer oversights, and foreclosed property dispositions.

After Mike, a question and answer session will start, where we will be joined by other members of senior management.

In addition to the 2007 10-Qs and the press release, we posted to our Web site an investor summary, which provides a summary of our financial performance and key drivers for the period. We also provided a credit supplement that gives detailed information on our subprime and Alt-A exposure, single-family delinquencies by region, and REO levels in key states.

Please note that this conference call will include forward looking statements, including statements regarding our future plans, performance, capital position, expenses, credit losses, net interest yield, as well as future market opportunities, and industry trends. Future events may turn out to be very different from what is discussed in this call. Please see the risk factor section in our 2006 Form 10-K, and in our Form 10-Qs for description of issues that may lead to different results.

Now, I'd like to turn the call over to Dan Mudd.

D. Mudd

Thank you, Mary Lou, and thank you, everybody, for joining us today. We want to move relatively quickly. There is a lot of information we have put out for folks, and we want to do our best to make sure we're meeting your standards and our standards of transparency and clarity with all this.

As you know, we just filed our financial results for the first three quarters of 2007 on time. We are now a current filer, and we plan to file our 2007 10-K on time in February. That is the end of the process of catching up on our financials. However, as you know, the results we reported today reflect the correction in the housing and mortgage markets, what they're going through right now. Those results, as I said, show we are not immune to the current market conditions.

I think it's important to keep in mind, though, those market conditions are also creating opportunities for us, and you can see that in the results as well. Let me summarize the results as I see them, what we're focused on right now, and what we think the outlook is going forward.

Starting with the top line results as you saw in the filing this morning, net income fell $2.0 billion from $3.5 billion to $1.5 billion, mainly driven by a drop in net interest income, and an increase in credit cost. In parallel, EPS fell from $3.16 to $1.17 per share. At the same time, the market shifted back toward our segment, back toward the conventional conforming segment, and our mortgage credit book grew from $2.5 trillion to $2.8 trillion, which is 10 percent so far this year, and we're continuing to see that shift.

As the market share of single-family MBS issues has now reached 41 percent, which is, if you remember an earlier call that we did, that figure was 20 percent in April 2006, and now it's up to 40 percent.

We also brought administrative expenses down by over $200 million, which was exactly on the target we committed to hit, and to exit at a run rate around $2.0 billion. We're on track for that as well.

Overall, the estimated fair value of our net assets fell by 8.7 percent to $34.2 billion as of September 20, 2007, and that was also driven by credit market conditions.

In my view, the key drivers for these results, the net interest income drop was due to higher interest expense. We also moved $500 million from interest income into trust management income, and Steve will explain that move in more detail.

As our guarantee book and our market share grew, our guarantee fee income increased by 16 percent for a total increase of $482 million. That increase, unfortunately, was offset by a $1.6 billion increase in overall credit expenses, driven by higher charge-offs, foreclosed property costs mainly concentrated in the Midwest. Another big offset, was a rather complicated item; $857 million in losses on certain guarantee contracts, and Steve will also provide some structure and framework for thinking about that in a second here.

Given the impact of the market conditions on our business and results, I want to tell you what we're doing about it. First, let me start with the front end of the business. We've already tightened our underwriting and pricing going back to the early summer of 2007, where we began requiring higher down payments, more documentation, and higher credit scores. That came after the period where we made a specific decision not to get into some of the riskier segments of the market. Just this week, we have announced a nationwide increase in our single-family guarantee fee to make sure we're compensated for the risks we manage.

Moving from the front end to the back end, secondly, we're beefing up our risk management specifically in the area of loss mitigation. That goes to activities, such as giving our servicers more flexibility, and greater incentives to work our loans in these market conditions. Mike Quinn is going to talk about that in a moment.

Third point, we're working to free up capital. As you know in May 2006, our consent order with OFHEO imposed a 30 percent capital surcharge, as well as a limit on our mortgage portfolio as we worked through our issues.

Caps and capital, as you know, are basically the numerator and the denominator of the consent order limit on the business, and we need to address both. We now carry $11.4 billion in capital above the congressionally mandated minimum capital, and $2.3 billion above the OFHEO mandated 30 percent surcharge over that.

Fourth action we're pushing on the mission through our HomeStay™ initiative, which we've talked about. We've provided about $8.6 billion in funding to refinance over 45,000 homeowners that had subprime loans, and can move into safer prime rate loans of the type that we specialize in.

Through our everyday business, we're also helping to stabilize the market by keeping liquidity flowing into the conventional conforming market, which as you see through the growth of our MBS securitization this year, our volume is up about 30 percent.

Looking ahead, we expect the current market trends to continue through next year. We see home prices falling by an average of 2 percent, or 3.3 percent nationwide over the entire year, and 4 percent next year. Again, that's driven mostly by the weak economy in the Midwest states and secondly by falling home prices in California, Nevada, Arizona, and Florida. We now believe home prices won't begin to stabilize until the end of 2009, as we work through what's now about a ten-month inventory nationally of unsold homes.

We also expect and are preparing for the subprime shakeout to continue to cause pockets of disruption in all the capital markets, as the market seeks a level of orderly pricing, and a more transparent view of credit. We've been through the disruption.

Now we're in a period of dislocation that has to stabilize at a new level, and as we find that new level, we would then expect a restoration of some growth in the market.

We expect additional foreclosures this year and next, because the ARM's that were originated in 2005 and 2006 reset in 2007 and 2008, and those resets will boost the payments for many individuals. A lot of those ARM's, as you know were originated just as home prices were peaking, so those homeowners that face the resets have comparatively little equity protection.

If there is any consolation in all of this, I should mention that I think a lot of the corrections in the mortgage market are happening pretty quickly. Housing starts came down quickly. Originations came down quickly. Risky products have gone away. And while all of this is painful, especially the foreclosures, the lack of credit for those that deserve it, and job losses in the housing industry itself where about 100,000 jobs have already been lost, I think those adjustments, if they're made and we get over them sooner, that means the recovery will also start sooner.

The correction is challenging for us, and I think you know, it's also challenging for other participants in the market. We previously said that our credit loss ratio would be in the range of four to six basis points this year, and that's still what we expect, so we're affirming that.

Going forward, projecting a 4 percent national decline in home prices, and a scenario where there's not a nationwide recession, we could see our credit loss ratio move into the range of eight to ten basis points next year. That's eight to ten basis points. In other scenarios, historically by way of reference, we've seen ranges like in the oil patch in the 1980's, we've seen that range hit 12 basis points.

At the same time, that correction is creating some opportunities for us, and that does not seem to be true for all the participants in the market. As you know, we held to the middle of the market, and now the market is returning to the middle. With the market coming back our way, the demand for our guarantee product is strong. We expect to see continued growth in our guarantee book, our market share, our charge fees, and our revenues, both on the single-family side, and on the multifamily side. For example, I will tell you, our most recent single-family acquisition fees, which cover the months of August, September, and October, our new business acquisition fees are exceeding 30 basis points.

New fees are exceeding 30 basis points. We see next year losses in the eight to ten basis point range, and we feel very good about the margins and the sustainability in that business. At the same time, we're also starting to see spreads widening for the capital markets business in the mortgage portfolio. We continue to see good opportunities to realize value in that business.

We did a lot of work this year to create the infrastructure and the capabilities in the business to help us serve both our shareholders and our mission. Just to recount quickly, we completed and filed financials for 2005, 2006 and now the three quarters of 2007, which brings us fully up-to-date. We've reduced administrative expenses. We've cut our head count. We're on track in terms of operating costs. We resolved nearly all the issues in our consent order, and other regulatory agreements. We're coming out of 2007 in an improving market position with share above 40 percent, and all of our risk tolerances well within their control limits.

With that as an overview of where we are, let me ask Steve to try to take you through a more detailed walk-through of what we think the principle items in the financials that will be of interest to you.

S. Swad — Thank you, Dan. I'll address three items today: First, how the current trends in the market have impacted our reported results. Second, our fair value balance sheet. And third, a summary of our exposures to securities backed by subprime and Alt-A loans.

Let me start with a high-level overview of how changes in the market have impacted our business and financial results. A higher demand for our traditional mortgage products has resulted in higher G-fee income. Next, higher delinquency rates and lower home prices resulted in higher charge-offs, and foreclosed property expenses. As you know, there has also been reduced liquidity and widening credit spreads, which has resulted in higher fair value write-downs on loans that we purchased out of trust, and higher losses on certain guarantee contracts.

Finally, in a relatively flat yield curve, our net interest income has reduced. All in all, these items contributed to a $2.0 billion decline in GAAP net income for the first nine months of 2007. There are lots of puts and takes that affected our results, so let me begin by walking you through the changes that had the biggest impact.

First, net interest income was $3.4 billion for the first nine months of 2007, down $1.5 billion after taking into account a $500 million reclassification, and to put 2006 on a comparable basis to 2007. The key driver of this decrease was a lower net interest yield, which dropped from 82 basis points last year to 57 for the first nine months of 2007. An important point here is we now believe that our yields have entered into a sustainable range after steady declines each year since 2002.

A second driver was higher guarantee fee income, which was $3.5 billion, up 16 percent over last year. This increase was driven by a 10 percent growth in our average book, and the steps we've taken to raise our fees on new business. Additionally, we saw a benefit from the amortization of losses on certain guarantee contracts, which I'll discuss in a moment.

A third driver was higher credit expenses, which totaled $2.0 billion for the nine-month period, up $1.6 billion over last year. Approximately 2/3 of this increase related to charge-offs, foreclosed property, and higher incremental provision for credit losses. We think of these as our actual realized credit losses, and they are the primary credit metrics that we focus on when evaluating the health of the company. These items totaled $1.3 billion at September 30, 2007, and were up $1.0 billion over last year.

In addition, our allowance at the end of the quarter was $1.4 billion, or roughly two times our annualized charge-offs.

The other portion of this increase was due to fair value losses on delinquent loans we purchased under terms of our guarantee. These losses have been significantly affected by recent market conditions, and are higher than what we expect our ultimate credit losses to be, even in light of our most recent experience. The mechanics of this accounting are described in more detail on Page ten of our Investor Summary, which is available on our Web site.

The fourth driver relates to $1.0 billion in losses on certain guarantee contracts, which are up over $800 million from last year. As we discussed with you on our last call, we are required to record a loss when we enter into a guarantee contract with a profit margin that is below our estimate of what a market participant would charge for the risk. The difference between our price and market pricing results in a loss. Due to the decline in home prices, and increased illiquidity in the market during 2007, the difference has become more pronounced, thereby causing the mark-to-market expense to increase. It's important to note, however, this loss is all timing. The loss is recorded at the beginning of the guarantee, and then comes back into income over the life of the guarantee. Also, the majority of this business, we expect revenues well in excess of expenses. This item is described in more detail, with examples on Page 11 of our Investor Summary.

Another key driver was our decline in administrative expenses. During the first three quarters of 2007, they were down $200 million, which is equal to the cost savings we set for the full year of 2007.

The last driver I want to address is one we've discussed extensively on past calls. We do not apply hedge accounting, so there's a one-sided mark-to-market of our derivatives book. This accounting treatment resulted in a loss of approximately $900 million for the first three quarters, and a lot of period-to-period volatility. We will continue to use derivatives to manage our portfolio and funding costs, and thus expect this volatility to be a continuing component of our earnings.

Now let me move to the fair value balance sheet. The fair value of our net assets decrease by $8.7 billion, which is consistent with what we're seeing in home prices, credit spreads, and the overall illiquidity in the marketplace. I would break down these charges into three buckets. First, there is a $1.8 billion bucket that relates to capital transactions, mostly dividends to our shareholders. Second, about $4.5 billion of the decrease relates to declines in the fair value of our net guarantee assets, inclusive of tax-related items. This decline is caused by the market's expectation of declines in home prices, and increases in credit spreads. As a long-term holder of this risk, we keep an eye on this fair value change, but we are most focused on minimizing realized losses in the form of actual charge-offs, and foreclosed property expenses. Accordingly, we are strengthening our loss mitigation procedures, narrowing the range of products we are guaranteeing, and increasing the price for the risk we are assuming.

Third, the remaining $2.5 billion decrease relates to the impact of a significant widening of option-adjusted spreads on our assets, offset in part by net economic earnings. During the first nine months of 2007, spreads widened causing losses of around $5.0 billion. This decrease was partially offset by net economic earnings of the corporation. Again, as long-term investors, we expect the value relating to changes in option-adjustment spreads to come back to us, as these securities are expected to mature at par. For a complete overview of the changes in our non-GAAP fair value balance sheet, please see table 15 in our 10-Q.

Now I would like to spend a few minutes addressing subprime and Alt-A securities that we own. We've included some expanded disclosure in our 10-Q, and in our credit supplement. As of September 30, 2007, we had total exposure to securities backed by subprime of around $42 billion.

First, some important distinctions between the securities we hold, and the securities behind a number of well publicized write-downs in recent weeks.

Our securities are back exclusively by conforming loans, have subordination of about 32 percent, and a weighted average life of between 2.5 years and 3 years. We have no exposure to CDO's. During the nine months ended September, the fair value of these securities dropped about $900 million or 2 percent, based on the prices we obtained from multiple vendors. Around $300 million of this loss was on trading securities, which is included in earnings. The remainder of the loss related to available for sale securities is included in other comprehensive income.

Since quarter end, we've seem some continued loss in fair value, but the prices we received from our pricing vendors on our AAA securities continue to be on average, in the high 90's.

We also have about $34 billion of Alt-A securities in our portfolio. They are all rated AAA, and none have been downgraded or placed on a watch list. Through September 30, 2007, we've seen these bonds lose about $400 million, or one percent of their value, with around $100 million of that loss going through the income statement as mark-to-market loss on trading securities. The remaining $300 million is recorded in comprehensive income. Through today, pricing from our vendors has stayed on average in the high 90's, and like our subprime securities, we have significant protection through subordination with a weighted average subordination of 21 percent. For more information on these positions, you can take a look at the credit supplement, which is also on our Web site.

To summarize, there are significant positive trends affecting our business, like share gains, and the improved ability to price for risk, but we are not immune to the current market trends around credit. We are laser focused on credit risk. Mike Quinn will address the strategies we are pursuing to manage our exposure and mitigate our losses.

I'd like to make one final point before turning over to Mike. I hope my comments have provided some context around the GAAP in finance and Fair Value financials. In connection with our next filing, our 2007 10-K, we plan to introduce a non-GAAP disclosure that will provide you additional information around key performance metrics that drive our business. With that, I'll pass it over to Mike.

M. Quinn Thank you, Steve. I want to take just a few minutes before we open it up to questions to brief you on three subjects: where are our credit loss is coming today, how we expect to see that shift in the coming periods, and third, what significant actions we've taken in the last six months to minimize those losses.

As Dan said, this is going to be a very challenging market for the next several years, even though the credit quality of our books is very good. If you look at the credit supplement on our Web site, which Mary Lou spoke about earlier, you can see on page three, that we have an average credit score of 721, with less than 5 percent having a credit score below 620. Eighty-eight percent of our mortgages are fixed-rate, and the average equity the borrower had in the house at origination was 29 percent. With appreciation and amortization, we estimate that increase to 41 percent today.

We, however, are not immune to the cycle as Steve and Dan have said. If you look at table 26 in the 10-Q, you can see our credit loss ratio year-to-date has increased to four basis points from 1.8 last year. As Dan said, we're still estimating we'll hit the four to six target of our previous guidance.

Let me give you three views of where our delinquencies are coming from, by state, by origination year, and product type.

We continue to see the majority of our losses in the Midwest: Michigan, Ohio, and Indiana. This area remains very economically depressed. Our delinquency rate has gone from 94 basis points in the last year to 114 this year, and the severity is increasing as home prices continue to decline. We expect losses from this area to be high for several more years.

As for the other areas of weakness, Arizona, California, Florida, and Nevada are the top of the list, as demand from investors in subprime borrowers drove up prices in home construction, resulting in an over-supply of houses.

On Page five and six of the credit supplement, you can see the year over year comparison of delinquency rates and foreclosures.

Florida stands out, having increased from [37 basis points] to 99 basis points in one year. While California is at 30 basis points today, we expect that to increase substantially in the coming months.

From a year of origination perspective, the 2006 and early 2007 books are performing worse than other vintage, and this is driven by price decline.

From a product viewpoint, most of the increase in our delinquencies over the past year occurred in some of the higher risk products, including Alt-A, and various affordability products designed to meet our housing goals. In the case of Alt-A, we have significant credit enhancement. And on the affordability products, we have primary mortgage insurance since these loans are low down payments.

In light of the home prices, we've taken three significant steps in the last six months. First, we tightened underwriting standards and targeted segments that are producing a disproportionate share of delinquencies. Second, we meaningfully raised guarantee fees. And third, we're increasing the number of workouts. Let me just give you a little background on each.

On the underwriting side, we're requiring higher down payments, and higher credit scores for certain segments of the business. The segments excluded as a result of our recent tightening contributed 12 basis points to our September delinquency rates, and 25 percent of our foreclosures in September 2007.

On the pricing side, we began raising prices on our bulk business in the second quarter. On Tuesday of this week, we announced a meaningful across the board increase on loans having credit scores below 680 and LTV's above 70. These changes in underwriting and pricing will help control losses and maintain appropriate levels of profitability through this cycle.

The third part of this strategy is to increase the number of workouts. For the past six years, there has been very little need for servicers to have loss mitigation staff, because delinquent borrowers would cure their loans by selling their homes or refinancing. The speed of the downturn has surprised most people, and now servicers are in a sprint to hire more staff to do workouts. However, there is a shortage of experienced staff, and it will take time to hire and train. In the meantime, we have our staff on site at

20 major servicers to provide whatever support is needed, training, and approving workouts as needed.

As I said before, this is going to be a very challenging environment for the next several years. Although the credit quality of our book is very good, we'll have an increase in losses through the cycle. Borrowers won't be able to refinance or sell out of their trouble, especially in Florida, Arizona, Nevada, and California, as they will be competing against many sellers.

The upside is that the underwriting standards are much more prudent today, and higher prices better reflect the risk, which is good for the industry, and Fannie Mae, once the over-supply problem corrects.

Let me close by saying, this is not a new experience for us. We've faced very tough conditions before in the oil patch in the '80's in California and Northeast in the mid-'90's. We know what to do. We have a plan that we're executing against.

Let me turn it back to Dan.

D. Mudd — Yes. We'll go to the first question in a second here. I think the summary of all this is, the good news is, we're current. We're going to stay current. The good news is the market is coming back to us. The bad news is, we're subject to the big national trends, falling home prices, credit turmoil, and volatility in the capital markets. The other part of the summary is we're taking action in four areas that give us our biggest levers on how the company performs through this, adjusting underwriting and pricing, beefing up risk management, working to free up capital, and driving forward with the mission to provide the liquidity, and stability, and affordability this market so desperately needs. This company has been through some tough cycles before, as Mike said, we know how to deal with them, and I think when the cycle turns, we're going to be in a stronger, and stronger position.

With that, we're ready to turn it to the first question.

Moderator — Our first question will come from the line of David Hochstim with Bear Stearns. Please go ahead.

D. Hochstim — Thank you. Dan, could just repeat, did you say that guarantee fees on average in the third quarter were at 30 basis points? Is that what you were saying?

D. Mudd — Yes, and I can have Tom Lund who runs that business give you a little bit more color on that, David.

T. Lund — David, we have been able to adjust our pricing, as both Mike, and Dan talked about. We started both on the underwriting and the pricing side in the early part of the year. We made some early adjustments in some of the higher layered risk products in the flow business. When the bulk opportunities gave us the ability to re-price starting in the second quarter, we did that as the market gave us that opportunity. As Mike said, just this week, we announced a pretty significant pricing change on the flow business as well. As a result of those actions, over the course of the last three months, our guarantee fees on the new acquisitions in that period of time have been over 30 basis points in all three months.

D. Hochstim — Could you, or Mike, address the credit quality of the business that was put in the guarantee book in 2007? You've had these underwriting changes, but you did $500 billion of new securities this year. If you look at the disclosures in the credit supplement, you have a 7 percent delinquency rate on the low FICO and high LTV loans. It seems as though the stuff that was going into the private label market last year may have found its way into your

Expanded Approval™ business. I just wondered if you could give us a sense of how bad that stuff can be.

T. Lund — Let me start by saying, the market has moved back to us in a pretty significant way. A lot of the products that were being done in non-traditional products have gone and moved into a fixed-rate environment.

We began to see earlier in the year, some movement into some of the MyCommunityMortgage® expanded approval products. We took very aggressive actions at that point in time to make sure we were managing it appropriately and pricing it appropriately. We feel good about the actions we have taken, and where we are at against that.

The other thing that I would tell you is that across all of those products, we've had a tighter underwriting box than what was going on in the private label markets through that period of time. Consumers have begun to move back into those products, and into those tighter underwriting boxes.

D. Hochstim — Right, but historically, you were basically financing homeowners, not speculators. Typically, the borrowers you were involved with or guaranteeing, would behave well, or pay their mortgages until they lost their job, and then some. This year, we've seen in the last five months, a pretty significant increase in delinquencies when the only thing that really seems to have happened is home prices have declined. I wonder how much home price depreciation was masking credit problems for the past two years.

D. Mudd Yes, let me start, David, and then turn it back to these guys. I think what we have seen in the markets that are experiencing some distress, whether that's the Midwest, or it's Florida, California, and Nevada, those places, what it tends to be is not a single causal factor. There tends to be two things going on that impact the market at once.

The easiest example is the upper Midwest, where there actually has been, as you know, a long-term decline in home prices. But then you add to that, the macroeconomic effect of the job losses in Detroit, and so forth, you get an accelerating factor.

Across the broad scope of the business, I don't think the argument that says home prices were supporting the underwriting, because the underwriting standards on our side have always stayed fairly constant. But what has changed is that second factor kicking in.

With that, these guys might want to add a couple of additional points to it.

T. Lund Sure. One of the things I would say is the 2006 and 2007 books are clearly not going to be the credit quality books we saw previously. You have to remember where we're coming from is a historic low in terms of credit losses. When we look at our projections moving forward, we take that into account.

The other thing I would tell you, you talked about the high LTV product coming. Virtually all of the high LTV product, lower FICO score product was purchase money product. It wasn't investor. It was owner-occupied, primary residence, many of it very, very much within the scope of what we are here to supply to. The other thing I would tell you is on a lot of that stuff as well, we have a significant amount of credit enhancement, and you'll begin to see some of those effects in the numbers as we move forward as well, that aren't as clear in the numbers today.

D. Hochstim Can you verify or have you started to verify, those loans you believed were purchase loans were, in fact, turned into a primary residence and it wasn't that the borrower then decided not to locate to the new home?

D. Mudd — That was the last one, David. We'll answer this one; you get a discount of two, next call.

D. Hochstim — Thank you.

M. Quinn — One of the processes we go through as these loans default is the fact that through the loss mitigation, there's a lot of calling, and information being gathered. And also, when a loan defaults, a lot of times, we pull the file and see exactly what happened. We haven't seen any trend yet. But like I said, as the loans go bad, we're pulling the files and seeing exactly what the circumstances are and talking to the borrower. It's too early to give you any information on it yet.

D. Hochstim — Thank you.

Moderator — Our next question comes from the line of Bruce Harting with Lehman Brothers. Please go ahead.

B. Harting — It doesn't sound like you're able to provide any guidance here. If we look at this third quarter provision number of 1.2, and I think roughly $340 million of that was for the purchasing of delinquent loans from the MBS trusts. I'll try to get a little guidance from you, but is that a run rate that we can look at for modeling the next three to five quarters? Part of that question is, is the repurchase of loans out of the MBS trusts, it says here, "after four or more consecutive monthly payments have not been made." Is SOP O3-3, is that just the fair value, or is that also taking a reserve for an assumed foreclosure? That also gets to the part of my question about guidance. Thank you.

D. Mudd Thank you, Bruce, it's a good question, and let me get Steve Swad to start off the answer, and then we'll go from there into a little more of the plumbing on 03-3.

S. Swad Bruce, the number for Q3 is roughly $600 million. Let me explain how 03-3 works. At a high level, what we do is we buy loans out of a trust, and we do that when they're delinquent as part of our normal guarantee business. We have models internally that are zip code specific, that estimate values on those loans, and historically, they've been quite accurate. Historically for accounting purposes, what you do is bring that loan on your books at its fair value. Historically, there has not been much of a difference between our own estimates of value of that loan and the market estimates.

Beginning principally in the third quarter, we saw the market move away from our own internal models, and we used the lower number, and that number was $600 million.

D. Mudd Sorry to interrupt for a second. The number is based on, think of it as an independent price verification we go to, to determine what a third party would require in order to step into our shoes, and earn a reasonable risk-adjusted return. If that number is worse than the number, we generate internally, we book the worst of those two numbers, even though our experience is we do much better than that. In fact, our current experience is that we're doing much better than that. Sorry to interrupt.

S. Swad I think that's right. Bruce, the only other thing I'd say is, we're not forecasting Q4.

B. Harting Okay.

Moderator Our next question comes from the line of Howard Shapiro with Fox-Pitt. Please go ahead.

H. Shapiro Hello, thank you very much. My questions are in terms of your marking methodology. There have been a lot of questions as to how people are exactly marking assets and liabilities across the financial services sector. I'm wondering if you can tell us for the $5.0 billion negative credit mark for fair value, what your reference points were. Were these model driven? Were these market driven? I assume you were not using the ABX, what would you have used in its place?

And then if I could just sneak in one other one, given the fact that durations have extended so much on your assets, how would we see the improved economics of your guarantee fee of manifested earnings?

D. Mudd — On the first part of your question, let me have Enrico Dallavecchia, the Chief Risk Officer, take you through the marking and modeling methodology. Then we'll move to your second question.

H. Shapiro — Thank you.

E. Dallavecchia — In our office, together with the finance group, we work on the verification of the independent marks. With regard to the PLS securities, it's quite important to note that nearly the totality of the securities we have priced for both the income statement purposes, as well as for OCI, have been marked by third party vendors. For the greatest majority of them, we also have more than one price from third party vendors.

I'll remind you of something Steve was alluding to with regard to the characteristics of the securities that we have. We have no CDO's, we do not have structure-financed securities. There are, we'll call them in my own terminology, plain vanilla ABS securities, and therefore, we have very straight marking capabilities through third party vendors.

D. Mudd I think your second question on duration GAGO impacts, and let me ask Peter Niculescu to pick up there, and we'll see if we hit it.

P. Niculescu Yes, sure, Howard. One of the things you said with the duration extension we're seeing going on in mortgages, does that have an impact, and you're absolutely right. What we're seeing is as home prices start to go down, people are moving less. This is certainly causing the duration of most of our assets that are sensitive to those payments to extend. That means, the book of business we put on historically will likely stick around for a little bit longer than what would otherwise be the case. That's really the driving principle, and it's going to show up throughout our results on the balance sheet, and off balance sheet as well. That really just means some stickiness to the book that was previously established. That's not necessarily a good thing for us, but I don't think it's a substantial negative either.

You also mentioned and Enrico touched on this, the question of pricing on private label securities, there's a duration issue there as well. You mentioned ABX. As Enrico pointed out, we are getting our price marks from vendors for all of our securities.

One point of confusion that's quite common out there is the duration question. The ABX index that people have been looking at is a typically somewhat longer spread direction index than the assets we have. We have assets that are more of the order of 2.5 to three years in spread duration. The ABX index is considerably longer than that, more like five to six years. That's one of the reasons I think that people are expecting to see and haven't seen, the sort of price markdowns in our book that you see on the ABX index.

H. Shapiro Thank you very much.

D. Mudd Thank you, Howard.

Moderator: Our next question comes from the line of George Sacco with JP Morgan. Please go ahead.

G. Sacco: Hello. To turn away from credit for a second and looking at your net interest margin, it looks like there was a lot of pressure on the funding costs. The cost of your MTM's was up a lot. I guess the question there, was that because you were doing more callable MTM's this quarter and this year? If I look at the short-term funding, the average rate that you disclose in your table that analyzes margin was significantly higher than the period end rates that you disclose later in the Q, and that gap was actually much wider than it has been in prior periods. What was the cause of that, and is that something that would come down in the next couple of quarters, depending on what caused it?

P. Niculescu: George, this is Peter again. One of the complexities of our income statements is going to relate to our net income and net interest on the balance sheet. It's unfortunate, but it's a fact of how a leveraged balance sheet like this works. Issues like the shape of the yield curve play an important role, the net amount of derivatives we have on the book play a very, very critical role, and they can be quite confusing as a result in the financial presentation.

What I can tell you on an economic basis how our funding has been developing in the third quarter, because it's a very interesting story. We have benefited to an extent from a flight to quality in funding. Through the end of September, we've seen our debt funding costs actually decline relative to benchmark swap rates. That decline was most pronounced in short-term discount notes, which typically we had priced at about LIBOR less 15 basis points, and which throughout the third quarter saw levels as good as LIBOR less 50 to 100 basis points, so a very substantial improvement in our funding costs relative to benchmarks.

We've also seen quite good volumes of callable debt, medium-term notes, at levels that we feel are quite attractive. Those are the incoming fundamentals, but unfortunately, the financial presentation can become complicated there. That doesn't make it very easy for you. I'm going to turn to Scott Blakely from our financial department to talk a little bit about those issues.

S. Blakely

Hello, George, thank you for the question. One of the things we saw in the third quarter that skews a little bit of our net interest margin in that period is as you know, we have premiums and discounts on some of our assets. The way the accounting statements work, you're required to amortize those under a method called FAS 91. FAS 91 causes you to book some cumulative effect catch-ups and true-ups in your amortization when you're seeing slowing or increasing pre-payment speeds. As we saw pre-payment speeds slowing in the third quarter, what we ended up doing is booking a cumulative effect catch-up to slow down the amortization we had booked. In the third quarter, there's about a $130 million catch-up adjustment, which really turned out to be about a six basis point reduction in the net interest margin in that period.

G. Sacco — That's on the asset side, though, not the funding. It's the funding I was trying to get more to, but that's okay.

S. Blakely — It's the overall impact of net interest margin.

G. Sacco — Okay, thank you.

D. Mudd — Thank you, George.

Moderator — Our next question comes from the line of Fred Cannon with KBW. Please go ahead.

F. Cannon — Thank you, and a lot of my questions have been asked, so I just have a general one. In your press release, you did discuss the fact that you would be talking to OFHEO about expanding your activities, and getting some of the constraints lifted. Also, I note yesterday, Federal Reserve Chairman Bernanke mentioned the concept in a question and answer period of the GSE's essentially having a formal Treasury guarantee on loans up to $1.0 million, and earning a fee on that. I was wondering if you could comment on the kinds of things that you would like to see moving forward, and if there's anything in Bernanke's comment we should think about in terms of policy.

D. Mudd Let me start, and I'll ask Beth Wilkinson, our General Counsel, to add anything that I miss. On the broad policy measure, you've seen during the course of the last four or five months, all of the changes and disruption we've talked about in the market, and that's starting to have an effect on the broader economy. A general recognition that this is going to take longer, not shorter, to work its way through the process, and I think that moves us back to some points that we and some others were making in the summer, which is it's a broad enough set of issues and challenges that all the institutions that are set up to address these problems need to be brought to bear.

On Fannie Mae's part, we've never said we're the only solution to this, but that we're part of the solution. And the banks are part of the solution, the Fed is part of the solution, the Federal Home Loan banks are part of the solution. I think there's an increasing recognition here in Washington, that a lot of folks can play a role in this.

What we do here is liquidity, affordability, and stability, and those are all things this market needs. With an increasingly clear recognition of what the problem is, there's developing some increasing consensus around that idea that more folks need to play a bigger role.

We don't have enough details in terms of Chairman Bernanke's specific idea to work it through. But we've continued to maintain the posture that says, we're willing to work to bring resources to bear. We have relatively dry powder and we can do so. With that, I'll ask Beth to pick up any other pieces.

B. Wilkinson — Fred, the only other thing I'd say is, we've been talking to our regulator on a regular basis about meeting all the requirements of the consent order. We're virtually there. And so we have started to discuss the capital relief and the CAP relief. And I believe our regulator understands our mission, especially at this time as we're trying to work with them constructively to get out from underneath the consent order, and do the things we were designed to do in a safe and sound manner.

F. Cannon — Can we think we might be able to get relief, or do you feel that there's even a possibility of relief prior to the 10-K and the full timeliness of the 10-K, getting the Q out on time, is that enough from your standpoint?

D. Mudd — It's a question best addressed between the regulatee and the regulator, and the public forum is not a constructive way to do it. The director does have discretion, cognizant of a lot of factors, and I think there's going to be an appropriate time to give you a definitive answer, but it's not yet.

F. Cannon — Thank you very much.

Moderator — Our next question comes from the line of Eric Wasserstrom with UBS. Please go ahead.

E. Wasserstrom — Thank you. Unfortunately, I'm losing my voice, so I'm going to try to croak my question out here. Can you give us a sense of how much one incremental percentage point decline in home prices means to charge-offs?

D. Mudd — Let me take the question on a broader basis, and start to talk you through the range of possibilities we've seen historically, and then have Enrico to take you into more. Some of these are tests we already disclosed, and I think you can extrapolate from those tests we disclosed where things are.

Again, as I said, historically, we've been in a range of about two basis points. We are moving into four to six. We're looking at extrapolating from a home price decline of 4 percent into eight to ten basis points, and historically, we've been up in the 12 range. Those are basis points, and those are out of what Tom Lund has already told you is now a 30 basis point price point to start that with.

With that, Enrico, you might want to refer folks to some of the disclosures.

E. Dallavecchia — Thank you, Dan. We try to run simulations similar to the one you are alluding to, Eric, but it is very difficult. The one percent decline in house prices is heavily loaded, depending on which part of the country that is, if it is nationwide, or if it is in conjunction with other increases in delinquencies, and so forth. Although we have tried a number of simulations, I don't feel comfortable that we can disclose any number that we have a sufficient comfort with.

There is one type of sensitivities that we publish in our 10-Q that does not directly answer your question, but gives you a sense of the overall fair value potential loss that Fannie Mae would have for a 5 percent decrease in house prices. It is on Page 56, I'm referring to the third quarter, it is table 27 on the single-family credit loss sensitivity. You can note that as of the end of September, we have a net credit loss in fair value for a 5 percent decline on house prices, net of the risk sharing and insurance that we get of about $2.4 billion for the Single-Family business. Again, I would caution you not to use the same number in terms of provisional credit losses, but simply in terms of overall changes in the fair value.

E. Wasserstrom If I could just get one point of clarity, the relationship though between HPA and charge-offs should be parabolic, as opposed to linear. Is that not correct?

E. Dallavecchia Parabolic is a little bit loaded, because it alludes to a huge increase in speed. I would just say that it is not the straight line linear, and I leave it with that.

Moderator Our next question comes from the line of Mark Patterson with NWQ Investment Management. Please go ahead.

M. Patterson Thank you. Given the recent trends in the markets and how it's affecting base interest rates, we'll get a 10-year treasury at 420 roughly today, offset a bit, obviously, by higher spreads. I'm curious about what you would think about the opportunity for a lot of mortgages that are sitting out there staring at rate reset issues that are sitting in more private label securities, to re-fi into agency-eligible business and home prices are down, so that would demand some credit enhancement through mortgage insurance, or something. I'm wondering if you're concerned about your own ability to handle potentially increased demand, and your thoughts on the ability for obtaining credit enhancement, if we were to get even lower rates and create an environment for a lot more agency flow.

D. Mudd Thank you, Mark. Let me start, and then a couple of the business guys will throw something into it. I think the opportunities are terrific. The business is scalable. As you see, we've managed, really without a hiccup, a doubling of our market share as this market has come back to us.

In my own view, they're pretty good investment opportunities. A lot of these securities are beaten down beyond a real point of rationality. And if you look at some of the independent price verification you do, where you used to be able to get at basically a liquid independent price verification from multiple sources, now, you're in a world where you have to beg to get one or two. That says that there are not a lot of bidders out there. And when there are not a lot of bidders out there, the folks who are long-term liquidity providers tend to do pretty well.

On both of those fronts, I think it looks pretty good, but you're absolutely right. It is a hazardous environment, and it's an environment where it makes an awful lot of sense to be conservative and to be careful. We have some data ability to do that, because we've been in this business for a long period of time. We have 60 million records we can look at and stress test, and see what they perform like, as Steve said, all the way down to the zip code level. We've built structures here, starting with Enrico's

Chief Risk organization and the risk officers in the businesses, to make sure we do that.

That said, if I knew how this was all going to end and when the trough was going to be and when the peak was going to be, we'd be having a different conversation now. There's a big uncertainty factor that plays into the market, and we're mindful of that.

Let me get a little perspective from the Single-Family business, and then the capital markets. Tom.

T. Lund Thank you for the question. Obviously, there is going to be a tremendous amount of demand, and we've already begun to see that demand move toward a more traditional fixed-rate, 30-year product. We've talked on this call in the past about our HomeStay™ initiative. Really, what that's about was trying to develop underwriting guidelines and products, and understanding of consumers and what their capabilities might be to get a more conforming like loan. We've talked about trying to bucket in thirds. We think that out of the gate, there were probably a third of consumers who got these loans that would potentially at the time have qualified for a standard, conforming kind of product. We think there's about a third of consumers who have made their payments up to the reset rates, and are probably now eligible in

having rehabilitated a lot of their credit, to get a more standard-like product. There's a third that probably don't have the equity in the home, and maybe shouldn't have gotten in it, and are going to have some difficulties figuring out what to do at the reset rate.
We're working very, very closely with our customers, trying to work with counselors, trying to get a lot of information out to the marketplace, as to what the capabilities are, and what we can provide to that marketplace.

I would also tell you, we are in constant communication with our MI partners to make sure the guidelines we have are prudent and make sense, and that we have risk sharing partners in this process through this opportunity, and we've been very closely working with them to make sure this does exist for us.

P. Niculescu Mark, this is Peter. You will see, the standard 30-year, 15-year long-term product pricing is holding up well in the securities market, and the demand remains solid. Though there's some fluctuation day-to-day, of course. We saw some widening earlier this week, late the week before for example, but by and large, this product is doing well. The demand is solid, and the 30-year remains good.

I think one of the lessons of the third quarter is just putting a Fannie Mae guarantee on products doesn't necessarily insure that it will trade equally well. If you look at some of the non-standard products, it has been more sensitive to market pricing, so you have seen more larger fluctuations there in some of the non-standard products. Looking at the Fed, the standard 30-year and 15-year product and even now, the agency hybrid ARM's, I think demand remains solid.

M. Patterson Great. If I might just ask one follow-up on the credit piece. You guys were sitting at one basis point of losses for multiple years when the housing market was kind of booming along. Now, you're talking about next year getting to the maybe eight to ten basis point credit loss rate. Do you look at your business as if anything has changed that over the cycle that you wouldn't be a two or three basis point credit loss expectation type of result?

D. Mudd Let me take that, and what we're going to do is do two more, and we'll try to be a little bit shorter on it. And then as we always do, we'll be happy to follow up with individuals or investors as time moves forward.

I think we were fairly consistent in terms of saying during the period where we were running at 1.2 percent to 1.8 percent, that we thought a more normalized range for the company was kind of in the 4 percent to 6 percent. And we think it looks like we're going to move through the 4 percent to 6 percent. I think typically through the cycle, given where the market is, given the expansion of the market, that middle range is probably about the right place for us to be. And it's a place where we can run a very attractive business from both the return, whether equity or capital, or what have you.

We'll try to do two more, fairly quickly, and then we'll wind up here.

Moderator Our next question comes from the line of Michael Cohen with Senova Capital. Please go ahead.

M. Cohen Hello, Fred actually asked my question, but congratulations, guys for hitting this milestone. I know that it's probably not under the best market conditions that you would have hoped, but I'm sure a lot of work went into it.

D. Mudd Thank you for that.

B. Wilkinson We'll take that.

D. Mudd Yes, we'll take that. I'm sorry that wasn't the last question. There would have been a lot of nice times to have the party about coming current. But I would stress it does put an important foundation under our business, and certainly increases the transparency with which we can talk to you.

M. Cohen Sure. Do you have any timeline, as to when you think you might have the conversations about capital and capital coming back?

D. Mudd Yes, I'd stick with where we are on it right now and instead of speculating about what might actually happen, come back to you when something actually has transpired. I'm happy to prognosticate on the things that are under my control, but things that have a lot of moving parts to them, it's probably better off coming back to you, so we'll do that.

Moderator Our last question comes from the line of Nandu Narayanan with Trident Investment Management. Please go ahead.

N. Narayanan Hello. My question relates overall to your assumption on losses, because I think you said earlier, you're expecting a 4 percent decline in home prices next year, and no real recession, and it seems like the odds of a recession are increasing. Also, looking at your book, correct me if I'm wrong, but you have about $2.8 trillion in guarantees, plus another $840 billion on your book, and it seems –

D. Mudd Actually, that would be net, it's not plus, it's net, but –

N. Narayanan Okay. But in terms of subprime and Alt-A, you seem to have roughly about $400 billion, give or take, in exposure to those areas. In terms of what we've seen in the overall markets, the losses in those areas have been colossal, at least in so far as market prices are concerned. Given your equity capital of $40 billion, and given that most people are saying this might be one of the worst housing markets since the Great Depression, because we've never had a national home price decline since the Great Depression. Given that with $40 billion capital, you have something in the order of $3 trillion of risk, what do you see as the prognosis? Obviously, the assumptions you make about recessionary impact of next year, and so on are really going to substantially change your loss factors and everything else. I'd like to get your perspective on what your assumptions are, because obviously, things could get a lot worse here.

D. Mudd

Okay, thank you for the question. Some of the numbers in your presumptions are a little bit cross wires with each other. But what I'll do is try to start with the notion, the question which is, we're in a tough market, we have some exposures. What if things get worse?

I start with the basic notion there is a fundamentally sound business model here, and what we're talking about is on the guarantee side of the book. Earning fees that are even on average across the book, north of 20 basis points, I think 22 basis points is the last figure. We're projecting increasing losses in the 8 percent to 10 percent basis point, but there's still a lot of margin in that sound business model to cover.

Do we plan for all kinds of scenarios? Yes. Do we plan for scenarios that might be significantly worse than what we're projecting? Yes. Is that what we hold capital against? Yes. Is our total capital more than our risk-based capital? Yes. Is this a time to be conservative from a capital standpoint? Yes, it is. Is this a time to take these issues and scenarios extremely seriously? Yes.

Is this a time to make sure we're beefing up all of our backend resources to manage loss mitigation and foreclosures? Yes. Are we doing that? Yes.

Do we know what's going to happen? No. That's when I finally have to give you a no answer. But are we prepared for scenarios that are somewhat ahistorical? Yes. Enrico can take you through a little bit in terms of how those look.

N. Narayanan Specifically, one of my concerns was to the extent you have credit insurance, or mortgage insurance on some of your products, it looks to us like a lot of the mortgage insurers will not survive, if any kind of bleak outcome comes to pass. To the extent that some of their risk may not be insurable by them if they're not in existence, it comes back on your books. There's clearly a much more complicated interlinked relationship you have with a number of other providers, which are all possibly at risk in this situation.

D. Mudd Okay, thank you, and we'll expand your question to also include risk mitigation and mortgage insurance, and I'll let Enrico take a crack at it.

N. Narayanan Thank you.

E. Dallavecchia I now have a complex question to answer, so let me start taking that in components. One is, what are the characteristics of our book? The core characteristics on an average of our book are 720 FICO, 71 percent regional activity. This is when the loan was created before the run-up in house prices, and a mark-to-market LTV, which is 59 percent, so there is a 40 percent protection in front of us.

The second part of my answer would be that doesn't seem that great if you're thinking about the subprime exposure. Our subprime exposure is composed basically of two large buckets. One bucket, which are the PLS securities, we have talked about the fact that they are conforming loans, that have over a 30 percent subordination, and average maturity of two years, so I won't spend more time on that.

The remaining bucket, which is really the loans that we own, which are subprime loans and that is about $7.0 billion of that. On those, I would point out to you that a good 55 percent are fixed-rate, and most of them are principle residence. So they are not loans we believe are owned by investors, that is what our underwriting has told us. For those loans, even in a worse market, the price drought, I think we are going to have losses. But it's very difficult to infer large losses for the whole company just based on how the very small amount of subprime loans we have, how the effect would be on that one.

With respect to the MI, despite the deterioration you have seen in their earnings in the market environment, we believe the MI industry will manage its capital position to meet the claims obligation they have. We monitor the exposure of the MI. We have a group of analysts that conduct stress analysis. We have our own models on the financial condition of the MI, so we don't rely for our point of view on rating agencies.

It's also important to know, the MI that are evaluated and regulated by state insurance agencies, which enforce statutory capital requirements, and our exposure to the MI industry is to this regulatory entity. I feel comfortable with the exposure we have to the MI industry at this stage.

M. Christy — Thank you so much, everyone. I'm sorry we won't be able to get to all of the other callers, but please feel free to call us in Investor Relations, we'll be happy to follow up, and answer the rest of your questions. Brian, will you do the conclusion?

Moderator: Certainly. A replay of this call will be available for two weeks, starting at 7:00 p.m. ET today, through Midnight, ET, November 23rd. The replay number for this call is 1.800.475.6701. For international callers, 320.365.3844, the confirmation code is 892836. That does conclude today's conference. We'd like to thank you for your participation, and for using AT&T Executive Teleconference Service. You may now disconnect.