FEDERAL NATIONAL MORTGAGE ASSOCIATION FANNIE MAE
Form 10-K
August 16, 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, 2006

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 o No þ

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

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 o No þ

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. o

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 þ Accelerated filer o Non-accelerated filer o

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

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 29, 2007 (the last business day of the registrant s most recently completed second fiscal quarter) was approximately $63,724 million.

As of June 30, 2007, there were 973,451,598 shares of common stock of the registrant outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

None.

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MD&A TABLE REFERENCE

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PART I

Because of the complexity of our business and the financial services industry in which we operate, we have included in this Annual Report on Form 10-K a glossary under Item 7 MD&A Glossary of Terms Used in This Report beginning on page 152.

Item 1. Business

EXPLANATORY NOTE ABOUT THIS REPORT

We filed our Annual Report on Form 10-K for the year ended December 31, 2005 (2005 Form 10-K) on May 2, 2007, after filing our Annual Report on Form 10-K for the year ended December 31, 2004 (2004 Form 10-K) on December 6, 2006. The filing of these reports 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 the 2004 Form 10-K, the 2005 Form 10-K and this Annual Report on Form 10-K for the year ended December 31, 2006 (2006 Form 10-K) were delayed significantly as a result of the substantial time and effort devoted to ongoing controls remediation, and systems reengineering and development in order to complete the restatement of our financial results for 2003 and 2002, as presented in our 2004 Form 10-K. Because of the delay in our periodic reporting, where appropriate, the information contained in this report reflects more current information about our business, including information of the type we have included in previous Forms 12b-25 that we have filed with the Securities and Exchange Commission (SEC) to report the late filing of prior periodic reports. All amounts in this 2006 Form 10-K affected by the restatement adjustments reported in our 2004 Form 10-K reflect those amounts as restated.

In lieu of filing quarterly reports for 2006, we have included in this report substantially all of the information required to be included in quarterly reports. We have made significant progress in our efforts to remediate material weaknesses that have prevented us from reporting our financial results on a timely basis. On June 8, 2007, we announced that we plan to become a current filer by the end of February 2008 with the filing of our Annual Report on Form 10-K for the year ended December 31, 2007 (2007 Form 10-K) with the SEC. At this time, we are confirming our expectation that we will file our 2007 Form 10-K on a timely basis. In addition, we expect to file our Forms 10-Q for the first, second, and third quarters of 2007 by December 31, 2007.

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 SEC, and the Department of the Treasury.

Although we are a corporation chartered by the U.S. Congress, 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 (NYSE), and traded under the symbol FNM. Our debt securities are actively traded in the over-the-counter market.

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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. We discuss below 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 March 31, 2007, the latest date for which information was available, the amount of U.S. residential mortgage debt outstanding was estimated by the Federal Reserve to be approximately $11.2 trillion (including $10.4 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 $2.6 trillion as of March 31, 2007, 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.

The U.S. residential mortgage market has experienced strong long-term growth. According to Federal Reserve estimates, growth in U.S. residential mortgage debt outstanding averaged 10.6% per year from 1945 to 2006, 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 between 2001 and mid-2006 (with an average annualized growth rate of 12.8%). As indicated in the table below, which provides a comparison of overall housing and mortgage market statistics to our business activity, total U.S. residential mortgage debt outstanding grew at an even faster rate of approximately 14% in 2005. Growth in U.S. residential mortgage debt slowed to approximately 9% in 2006, and slowed further in early 2007, with an annualized first quarter growth rate of nearly 6%, the slowest rate of growth in almost 10 years.

Housing Market Data

				% Change from Prior Year	
	2006	**2005**	**2004**	**2006**	**2005**
Housing and mortgage market:[1]					
Home sales (units in thousands)	7,529	8,359	7,981	(10)%	5%
Home price appreciation[2]	9.1%	13.1%	10.7%		
Single-family mortgage originations (in billions)	$ 2,761	$ 3,034	$ 2,791	(9)	9
Purchase share	52.4%	49.8%	47.8%		
Refinance share	47.6%	50.2%	52.2%		
ARM share[3]	27.6%	31.4%	32.0%		
Fixed-rate mortgage share	72.4%	68.6%	68.0%		

Residential mortgage debt outstanding (in billions)	$ 11,017	$ 10,066	$ 8,866	9	14
Fannie Mae:					
New business acquisitions[4] (in billions)	$ 603	$ 612	$ 725	(2)	(16)
Mortgage credit book of business[5] (in billions)	$ 2,526	$ 2,356	$ 2,340	7	1
Interest rate risk market share[6]	6.6%	7.2%	10.2%		
Credit risk market share[7]	21.4%	21.8%	24.2%		

(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 based on July 2007 estimates from Fannie Mae s Economics & 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 truncated measure because it is based solely on loans from Fannie Mae and Freddie Mac. As a result, it excludes loans in excess of conventional loan amounts, or jumbo loans, and includes only a portion of total subprime and Alt-A loans outstanding in the overall market. 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 adjustable-rate mortgage share, or ARM share, is the ARM share of the number of mortgage applications reported in the Mortgage Bankers 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.

The unusually strong growth in U.S. residential mortgage debt outstanding between 2001 and mid-2006 was driven primarily by record home sales, strong home price appreciation and historically low interest rates. Also contributing to that growth 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. With even less housing activity and slower home price growth through June 2007, growth in total U.S. residential mortgage debt outstanding likely has slowed further. We expect this slower growth trend in U.S. residential mortgage debt outstanding to continue throughout 2007, and we believe average home prices are likely to continue to decline in 2007.

The amount of residential mortgage debt available for us to purchase or securitize and the mix of available mortgage 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, changes in depository institution requirements relating to allowable mortgage products in the primary market, 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. 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.

We operate in the secondary mortgage market where mortgages are bought and sold. We securitize mortgage loans originated by lenders in the primary mortgage 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 that offers them the flexibility to determine under what conditions they will hold or sell the MBS. By selling loans and mortgage-related securities to us, lenders replenish their funds and, consequently, are able to make additional loans. Under our charter, we may not lend money directly to consumers in the primary mortgage market.

OUR CUSTOMERS

Our principal customers are lenders that operate within the primary mortgage market where mortgage loans are originated and funds are loaned to borrowers. 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 mortgage market often sell them in the secondary mortgage market in the form of loans or in the form of mortgage-related securities.

Our lender customers supply mortgage loans both for securitization into Fannie Mae MBS and for purchase for our mortgage portfolio. During 2006, over 1,000 lenders delivered mortgage loans to us, either for securitization or for purchase. We acquire a significant portion of our single-family mortgage loans from several large mortgage lenders. During 2006, our top five lender customers, in the aggregate, accounted for approximately 51% of our single-family business volume compared with 49% in 2005. Our top customer, Countrywide Financial Corporation (through its subsidiaries), accounted for approximately 26% of our single-family business volume in 2006 compared with 25% in 2005. Due to increasing consolidation within the mortgage industry, we, as well as our competitors, seek business from a decreasing number of large mortgage lenders. See Item 1A Risk Factors for a discussion of the risks that this customer concentration poses to our business.

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 U.S. 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, as well as managing and pricing the credit risk of the single-family mortgage loans and single-family Fannie Mae MBS held in our own 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 works 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 investing in rental and for-sale housing projects, including rental housing that is eligible 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 managing and pricing the credit risk of the multifamily mortgage loans and multifamily Fannie Mae MBS held in 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

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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 rental housing projects eligible for the federal low-income housing tax credit 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 U.S. In addition, our Capital Markets group increases the liquidity of the mortgage market by maintaining a constant presence as an active investor in mortgage assets and in particular supports the liquidity and value of Fannie Mae MBS in a variety of market conditions. Our Capital Markets group has responsibility for managing the credit risk of the non-Fannie Mae mortgage-related securities in our portfolio and 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.

The table below displays net revenues, net income and total assets for each of our business segments for each of the three years during the period ended December 31, 2006.

Business Segment Summary Financial Information

	For the Year Ended December 31,		
	2006	2005	2004
	(Dollars in millions)		
Net revenues:[1]			
Single-Family Credit Guaranty	$ 6,073	$ 5,585	$ 5,007
Housing and Community Development	510	607	527
Capital Markets	5,202	10,764	16,666
Total	$ 11,785	$ 16,956	$ 22,200
Net income:			
Single-Family Credit Guaranty	$ 2,044	$ 2,623	$ 2,396
Housing and Community Development	338	503	425
Capital Markets	1,677	3,221	2,146
Total	$ 4,059	$ 6,347	$ 4,967

	As of December 31,	
	2006	2005
Total assets:		
Single-Family Credit Guaranty	$ 15,777	$ 14,450
Housing and Community Development	14,100	12,075
Capital Markets	814,059	807,643

Total	$ 843,936	$ 834,168

(1) Includes net 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, including capital and administrative costs, and to apply guaranty fees for managing credit risk, to the responsible operating segment. For a description of our allocation methodologies, see Notes to Consolidated Financial Statements Note 15, Segment Reporting. For further information on the results of operations and assets of our business segments, see Item 7 MD&A Business Segment Results.

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Single-Family Credit Guaranty

Our Single-Family business provides guaranty services principally 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. Mortgage lenders that operate in the primary mortgage market generally deliver pools of mortgage loans 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.

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

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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, our total outstanding single-family Fannie Mae MBS was $1.9 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.

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. The TBA feature of the mortgage market is unique in the fixed-income capital markets.

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; however, 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 and 30-year MBS and 15-year MBS settle on separate pre-arranged days each month. 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.

Housing and Community Development

Our HCD business is organized into three groups: the Multifamily Group, the Community Investment Group, and the Community Lending Group.

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. Our multifamily mortgage loans relate to properties with five or more residential units, which may be apartment communities, cooperative properties or manufactured housing communities. Our Multifamily Group generally creates multifamily Fannie Mae MBS in the same manner as our Single-Family business creates single-family Fannie Mae MBS. In recent years, the percentage of our multifamily business activity that has consisted of purchases for our investment portfolio has increased relative to our securitization activity.

Most of the multifamily loans we purchase or securitize are made by lenders that participate in our Delegated Underwriting and Servicing, or DUS®, program. Under the DUS program, we delegate the underwriting of loans to lenders that we approve for the program. As long as the lender is in good standing and represents and warrants that eligible loans meet our underwriting guidelines, we do not require the lender to obtain loan-by-loan approval before we acquire the loans.

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 is eligible for federal low-income housing tax credits, and the remainder are in conventional rental and primarily entry-level, for-sale housing. These investments are consistent with our focus on serving communities 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 as LIHTC partnerships) that directly or indirectly own an interest in rental housing developed or rehabilitated by the LIHTC partnerships. By renting a specified portion of the housing units to qualified low-income tenants over a 15-year period, the LIHTC partnerships become eligible for the federal low-income housing tax credit, which was enacted as part of the Tax Reform Act of 1986 to encourage investment by private developers and investors in low-income rental housing. 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 investments with third-party developers that, in turn, develop or rehabilitate the properties and then manage them. We invest in these partnerships as a limited partner or non-managing limited liability company member, with the fund manager acting as the general partner or managing member. We earn a return on our investments in LIHTC partnerships through reductions in our federal income tax liability that result from both our use of the tax credits for which the LIHTC partnerships qualify, and the deductibility of the LIHTC partnerships net operating losses.

In addition to investing in LIHTC partnerships, HCD s Community Investment Group makes equity investments in rental and for-sale housing, typically 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. Our equity investments in for-sale housing generally involve the acquisition, development and/or construction of entry-level homes or the conversion of existing housing to entry-level homes.

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:

- acquiring multifamily loans from a variety of lending institutions that do not participate in our DUS® program;
- helping to meet the financing needs of single-family and multifamily home builders by purchasing participation interests in acquisition, development and construction (AD&C) loans from lending institutions;
- providing loans to Community Development Financial Institution intermediaries to re-lend for community revitalization projects that expand the supply of affordable housing stock; and
- 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 finalized and implemented specified policies and procedures required to strengthen risk management practices related to this business. We have implemented these new policies and procedures and have also implemented new controls and reporting mechanisms relating to our AD&C business. We received approval from OFHEO on June 8, 2007 to re-enter the secured AD&C business in a graduated manner. However, OFHEO advised us not to re-enter the unsecured AD&C business until matters relating to our engagement in certain market activities and unsecured lending are resolved with HUD.

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.

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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. We refer to this spread as our net interest yield. 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 and trading securities we hold impact the net income reported by the Capital Markets group business segment.

Mortgage Investments

Our net mortgage portfolio totaled $726.1 billion and $736.5 billion as of December 31, 2006 and 2005, respectively. We estimate that the amount of our net mortgage portfolio was approximately $720.0 billion as of June 30, 2007. As part of our May 2006 consent order with OFHEO, we agreed not to increase our net mortgage portfolio assets above the amount shown in our minimum capital report as of December 31, 2005 ($727.75 billion), except in limited circumstances at OFHEO s discretion. Our net mortgage portfolio assets are defined as the unpaid principal balance of our mortgage assets, net of market valuation adjustments, allowance for loan losses, impairments, and unamortized premiums and discounts, excluding consolidated mortgage-related assets acquired through the assumption of debt. 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. We estimate that our net mortgage portfolio assets totaled approximately $714.9 billion and $719.6 billion as of June 30, 2007 and December 31, 2006, respectively. On August 1, 2007, we requested that OFHEO grant us a 10% increase in the limit on the amount of our net mortgage portfolio assets. On August 10, 2007, OFHEO advised us that, while it will keep under active consideration our request for this increase, it is not authorizing any significant changes at this time. For additional information on our capital requirements and regulations affecting the amount of our mortgage investments, see Our Charter and Regulation of Our Activities.

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 these types of loans. In addition, we purchase loans insured by the Federal Housing Authority (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 (for example, loans secured by second liens) and other mortgage-related securities. Most of these loans are prepayable at the option of the borrower. We make some of our investments in mortgage-related securities in the TBA market, which we describe above under Single-Family 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, such as the London Inter-Bank Offered Rate (LIBOR); however, the REMIC may be backed by fixed-rate mortgage loans. For information on the composition of our mortgage investment portfolio by product type, refer to Table 12 in Item 7 MD&A Consolidated Balance Sheet Analysis.

Investment Activities

Our Capital Markets group seeks to maximize long-term total returns while fulfilling our chartered liquidity function. The Capital Markets group s purchases and sales of mortgage assets in any given period generally has been 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.

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The spread between the amount we earn on mortgage assets available for purchase or sale and our funding 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. In normal market conditions, however, we expect our selling activity will represent a modest portion of the total change in the total portfolio for the year.

Customer Transactions and Services

Our Capital Markets group provides our lender customers and their affiliates with services that 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 by entering into options and forward contracts on mortgage-related securities, which we offset in the capital markets.

These activities provide a significant flow of assets for our mortgage portfolio, help to create a broader market for our customers and enhance liquidity in the secondary mortgage market.

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 when the lender delivers the loans to be pooled into mortgage-related securities.

Funding Our Investments

Our Capital Markets group funds its investments primarily through the issuance of debt securities, primarily short-term 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 satisfy our funding and risk management requirements, but also to access the capital markets in an orderly manner using 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.

Although we are a corporation chartered by the U.S. Congress, neither the U.S. government nor any instrumentality of the U.S. government guarantees any of our debt, and we are solely responsible for our debt obligations. 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 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 the single-family mortgage loans we purchase 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. In addition, the Capital Markets group issues structured, or multi-class, Fannie Mae MBS. 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 a structured Fannie Mae MBS we issue. This process is referred to as resecuritization. Our Capital Markets group earns transaction fees for issuing structured Fannie Mae MBS for third parties.

RISK MANAGEMENT

Risk is an inherent part of our business activities. Our risk management framework and governance structure is intended to provide comprehensive controls and ongoing management of the major risks inherent in our business activities. Our ability to properly identify, measure, monitor and report risk is critical to our soundness and profitability. 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, derivatives portfolio and liquid investment 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.

For a complete discussion of our methods for managing risk, refer to Item 7 MD&A Risk Management.

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, investment funds, and other investors.

We compete to purchase mortgage assets for our investment portfolio or to securitize them into Fannie Mae MBS. Our market share of mortgage assets 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. The decreased rate of growth in U.S. residential mortgage debt outstanding in 2006 and continuing into 2007 has decreased the supply of mortgage originations, available for purchase or securitization. Our market share is also affected by the mix of available mortgage loan products and the credit risk and prices associated with those loans.

In addition, we compete for low-cost debt funding with institutions that hold mortgage portfolios, including Freddie Mac and the Federal Home Loan Banks.

We have been the largest 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, which has caused a decrease in our share of the market for new issuances of single-family mortgage-related securities. 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 and Ginnie Mae. Our estimated market share of new single-family mortgage-related securities issuance has fallen during the past several years, from 45.0% in 2003 to 23.7% in 2006, a slight increase from our estimated market share of 23.5% in 2005. We estimate that total single-family mortgage-related securities issued by all mortgage market participants, including Fannie Mae, during the quarter ended June 30, 2007 increased by approximately 6.9% to an estimated $530.9 billion, compared with an estimated $496.8 billion issued during the quarter ended December 31, 2006. In the quarter ended June 30, 2007, our estimated market share of new single-family mortgage-related securities issuance was 28.3%. Our estimates of market share are based on publicly available data and exclude previously securitized mortgages. Although we expect our market share to increase in 2007 compared to 2006, 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 through their use of commercial mortgage-backed securities (CMBS), which often package loans secured by multifamily residential property with higher yielding loans secured by commercial properties.

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.

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 the alignment of our overall strategy with these purposes, all of our business activities must be permissible under the Charter Act. Our charter authorizes us to, among other things, purchase, service, sell, lend on the security of, or otherwise deal in certain mortgage loans; issue debt obligations and mortgage-related securities; and do all things as are necessary or incidental to the proper management of [our] affairs and the proper conduct of [our] business.

Loan Standards

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 conventional mortgage loans (*i.e.*, loans that are not federally insured or guaranteed) secured by either a single-family or multifamily property. Single-family conventional mortgage loans are generally subject to maximum original principal balance limits. 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 2006 and 2007, the conforming loan limit for a one-family residence 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 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 either 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 generally requires credit enhancement on any conventional single-family mortgage loan that we purchase or securitize if it has a loan-to-value ratio over 80% at the time of purchase. 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 a seller-retained loan participation interest.

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.

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 U.S. nor any of its agencies guarantees our debt or mortgage-related securities or is obligated to finance our operations or assist us in any other manner.

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 under Section 12(g) of the Securities Exchange Act of 1934 (the Exchange Act). As a result, we are 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 current filer of our periodic reports on Form 10-K or Form 10-Q. We have issued or restated financial statements for 2002-2005, and with the filing of this 2006 Form 10-K, we are issuing financial statements for 2006. We are continuing to improve our accounting and internal control over financial reporting and are striving to become a current filer as soon as practicable. We are also required to file proxy statements with the SEC. We have not filed a proxy statement relating to an annual meeting of shareholders since 2004. On June 8, 2007, we announced plans to hold an annual meeting of shareholders on December 14, 2007. 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 Specified Taxes. 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. However, we are not exempt from the payment of federal corporate income taxes.

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 U.S., including the District of Columbia, the Commonwealth of Puerto Rico, and the territories and possessions of the U.S.

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 enactment of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (the 1992 Act). The Secretary of HUD 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.

HUD periodically conducts reviews of our activities to ensure compliance with the Charter Act and other regulatory requirements. 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 whether the outcome of this review may require us to modify our investment approach or restrict our current business activities.

Annual Housing Goals and Subgoals

For each calendar year, we are subject to housing goals and subgoals set by HUD. The goals, which are set as a percentage of the total number of dwelling units underlying our total mortgage purchases, are intended to expand housing opportunities (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. In addition, HUD has established three home purchase subgoals that are expressed as percentages of the total number of mortgages we purchase that finance the purchase of single-family, owner-occupied properties located in metropolitan areas, and a subgoal for multifamily special affordable housing that is expressed as a dollar amount. We report

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our progress toward achieving our housing goals to HUD on a quarterly basis, and we are required to submit a report to HUD and Congress on our performance in meeting our housing goals on an annual basis.

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 November 2004, HUD published a final regulation amending its housing goals rule, effective January 1, 2005. The regulation increased the housing goal levels for each year through 2008 and also created the three home purchase mortgage subgoals described above. These increasing housing goals and subgoals are designed to expand the amount of mortgage financing that we make available to those populations and geographic areas defined by the goals. The increased housing goals and subgoals for the period 2005-2008 are shown below.

Housing Goals and Subgoals

	2008	2007	2006	2005
Housing goals:(1)				
Low- and moderate-income housing	56.0%	55.0%	53.0%	52.0%
Underserved areas	39.0	38.0	38.0	37.0
Special affordable housing	27.0	25.0	23.0	22.0
Housing subgoals:				
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 special affordable housing subgoal ($ in billions)(3)	$ 5.49	$ 5.49	$ 5.49	$ 5.49

(1) A dwelling unit may be counted in more than one category of the goals. 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) that provide purchase money for owner-occupied single-family housing in metropolitan areas.

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

The following table compares our performance against the housing goals and subgoals for the years 2004 through 2006.

Housing Goals and Subgoals Performance

	2006		2005		2004	
	Result(1)	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%
Underserved areas	43.6	38.0	41.4	37.0	33.5	31.0
Special affordable housing	27.8	23.0	26.3	22.0	23.6	20.0
Housing subgoals:						
Home purchase subgoals:[4]						
Low- and moderate-income housing	46.9%	46.0%	44.6%	45.0%		
Underserved areas	34.5	33.0	32.6	32.0		
Special affordable housing	17.9	17.0	17.0	17.0		
Multifamily special affordable housing subgoal ($ in billions)[5]	$ 13.39	$ 5.49	$ 10.39	$ 5.49	$ 7.32	$ 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 and 2004. Actual results reflect the impact of provisions that allow us to estimate the affordability of units with missing income and rent data.

(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.

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

As shown by the table above, we were able to meet our housing goals and subgoals in 2006 and 2004. In 2005, we met all three of our housing goals and three of the four subgoals. We fell slightly short of the low- and moderate-income home purchase subgoal.

The housing goals are subject to enforcement by the Secretary of HUD. The subgoals, however, are treated differently. Pursuant to the 1992 Act, the low- and moderate-income housing subgoal and the underserved areas subgoal are not enforceable by HUD. However, HUD has taken the position that the special affordable subgoals are enforceable. HUD s regulations state that HUD shall require us to submit a housing plan if we fail to meet one or more 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 goal 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 the housing plan requirements are a cease-and-desist order and civil money penalties. Because the low- and moderate-income home purchase subgoal is not enforceable, there was no penalty for our failing to meet this subgoal in 2005.

We have made significant adjustments to our mortgage loan sourcing and purchase strategies in an effort to meet the increased housing goals and 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 further 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 continue to evaluate the cost of these activities.

Meeting the higher goals and subgoals for 2007 in the face of previous increases in home prices and, more recently, higher interest rates, which have reduced housing affordability during the past several years, is extremely challenging. Since HUD set the home purchase subgoals in 2004, the 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. In addition, because subprime mortgages tended to meet many of the HUD goals and subgoals, the recent disruption in the subprime market has further limited our ability to meet these goals. Our housing goals and subgoals continue to increase in 2007 and 2008. If our efforts to meet the housing goals and subgoals prove to be insufficient, we may become subject to a housing plan that could require us 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 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,

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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 Consent Order

In 2003, OFHEO began 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 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.

In the OFHEO consent order, we agreed to the following additional restrictions relating to our capital activity:

We must 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. For a discussion of the capital restoration plan, see Capital Adequacy Requirements Capital Restoration Plan and OFHEO-Directed Minimum Capital Requirement.

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

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 any or all of the following:

our capital;

market liquidity issues;

housing goals;

risk management improvements;

our 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 control over financial reporting is effective pursuant to section 404 of the Sarbanes-Oxley Act of 2002; or

other relevant information.

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 directed us to maintain compliance with the $727.75 billion portfolio cap. On August 10, 2007, in response to our request that OFHEO grant us a 10% increase in our $727.75 billion portfolio cap, OFHEO advised us to maintain compliance with the existing portfolio cap.

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

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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 whom had served on 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 that report.

In its Annual Report to Congress released April 10, 2007, OFHEO recognized that, as of December 31, 2006, we had complied with 67% of the requirements of the OFHEO consent order. We believe that we are making progress toward completing the OFHEO consent order requirements.

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 paid this civil penalty in full in 2006 and recorded an expense in our 2004 consolidated financial statements. This expense was not deductible for tax purposes.

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 a minimum capital requirement and a risk-based capital requirement. The minimum capital requirement is ratio-based, while the risk-based capital requirement is based on simulated stress test performance. The 1992 Act requires us to maintain sufficient capital to meet both of these requirements in order to be classified as adequately capitalized. OFHEO is permitted or required to take remedial action if we fail to meet our capital requirements, depending on which requirement we fail to meet. We are required to submit a capital restoration plan if OFHEO classifies us as significantly undercapitalized. 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.

The 1992 Act also 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, if our core capital is less than our required critical capital). OFHEO has discretion under its rules to appoint a conservator if we are significantly undercapitalized (that is, if 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 addition, under the OFHEO consent order, we are currently required to maintain a 30% capital surplus over our statutory minimum capital requirement. Consistent with OFHEO s disclosures, we refer to this requirement, which is described in more detail below under Capital Restoration Plan and OFHEO-Directed Minimum Capital Requirement, as the 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 statutory 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 U.S. generally accepted accounting principles (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, as part of its capital classification announcement, OFHEO publishes our standing relative to the statutory minimum capital requirement and the OFHEO-directed minimum capital requirement. For a description of the amounts by which our core capital exceeded our statutory minimum capital requirement as of March 31, 2007, December 31, 2006, and December 31, 2005, see Item 7 MD&A Liquidity and Capital Management Capital Management Capital Classification Measures.

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 without new business or active risk management action. In addition to this model-based amount, the risk-based capital requirement includes a 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 our 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, 2006 and 2005, see Item 7 MD&A Liquidity and Capital Management Capital Management Capital Classification Measures.

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. In December 2004, the SEC s Office of the Chief Accountant affirmed OFHEO s conclusion. We estimated that the disallowed hedge accounting treatments would result in a $9.0 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. On February 17, 2005, OFHEO accepted our capital restoration plan, which indicated our intention to achieve the OFHEO-directed minimum capital requirement by September 30, 2005.

We implemented the capital restoration plan by generating additional capital through retained earnings, significantly reducing the size of our investment portfolio, issuing $5.0 billion of non-cumulative preferred stock, reducing our dividend and implementing cost-cutting efforts. OFHEO announced on November 1, 2005 that, as of September 30, 2005, we had achieved the OFHEO-directed minimum capital requirement. OFHEO actively monitors our compliance with the capital restoration plan, pursuant to which we provide quarterly capital plan updates to OFHEO. We believe that we continue to be in compliance with the plan as of the date of this filing. For a description of the amounts by which our core capital exceeded the OFHEO-directed minimum capital requirement as of March 31, 2007, December 31, 2006 and 2005, see Item 7 MD&A Liquidity and Capital Management Capital Management Capital Classification Measures.

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.

For a description of the amounts by which our core capital exceeded our statutory critical capital requirement as of December 31, 2006 and 2005, see Item 7 MD&A Liquidity and Capital Management Capital Management Capital Classification Measures.

OFHEO Direction on Interagency Guidance on Nontraditional Mortgages and Subprime Lending

In September 2006, five federal financial regulatory agencies jointly issued Interagency Guidance on Nontraditional Mortgage Product Risks to address risks posed by mortgage products that allow borrowers to defer repayment of principal or interest, and the layering of risks that results from combining these product types with other features that may compound risk. In June 2007, the same financial regulatory agencies published the final Statement on Subprime Mortgage Lending, which addresses risks relating to certain subprime mortgages. Together, the agencies directed regulated financial institutions that originate nontraditional and subprime mortgage loans to follow prudent lending practices, including safe and sound underwriting practices and providing 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.

OFHEO directed us to apply the risk management, underwriting and consumer protection principles of the nontraditional and subprime mortgage guidances to mortgages we purchase or guarantee. In response to the guidance and OFHEO s directive, we are implementing changes to our Desktop Underwriter® automated underwriting system and have notified our lender customers of the dates by which we expect all loans sent to us to be in compliance with the guidances.

Recent Legislative Developments and Possible Changes in Our Regulations and Oversight

There is legislation pending before the U.S. Congress that would change the regulatory framework under which we, Freddie Mac and the Federal Home Loan Banks operate. On May 22, 2007, the House of Representatives 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.

As of the date of this filing, one GSE reform bill has been introduced in the Senate and another is expected. 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, see Item 1A Risk Factors.

EMPLOYEES

As of December 31, 2006, we employed approximately 6,600 personnel, including full-time and part-time employees, term employees and employees on leave. As of June 30, 2007, we employed approximately 6,400 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 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

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issue, are exempt from registration under the Securities Act of 1933 and are exempted 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, would, should, could, may, or similar words.

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, including those factors described in Item 1A Risk Factors.

Factors that could cause actual conditions, events or results to differ materially from those expressed in any forward-looking statements include, among others:

our expectation that we will file our 2007 Form 10-K on a timely basis, and that we will file our Forms 10-Q for the first, second, and third quarters of 2007 by December 31, 2007;

our ability to compete in the mortgage and financial services industry and to develop and implement strategies to adapt to changing industry trends;

our ability to achieve and maintain effective internal control over financial reporting;

our ability to become and remain current in our SEC financial reporting obligations;

our ability to overcome reputational harm and negative publicity;

our ability to continue to operate in compliance with the terms of the OFHEO consent order, including complying with the capital restoration plan provided for by the order;

changes in applicable legislative or regulatory requirements, including enactment of new oversight legislation, changes to our charter, housing goals, regulatory capital requirements, the exercise or assertion of regulatory or administrative authority beyond historical practice, or regulation of the subprime market;

the expiration of the limitation on our portfolio growth, or our ability to obtain relief from the limitation;

volatility in our financial results due to volatility in the fair value of our financial instruments;

our ability to manage credit risk successfully;

changes in our assumptions regarding interest rates, rates of growth of our business and spreads we expect to earn or required capital levels;

our ability to issue debt securities in sufficient quantity and at attractive rates to fund our investments;

our ability to maintain our current credit ratings;

failure of our institutional counterparties to perform their obligations;

changes in pricing or valuation methodologies, models, assumptions, estimates or other measurement techniques;

changes in general economic conditions, primarily the U.S. residential housing market;

borrower preferences for fixed-rate mortgages or ARMs;

investor preferences for mortgage loans and mortgage-backed securities rather than other instruments;

our estimates regarding our 2006 and 2007 business results and market share;

our belief that we met our 2006 housing goals and subgoals;

our expectation that meeting our housing goals in 2007 and 2008 will continue to present challenges;

our belief that home prices are likely to continue to decline in 2007;

our expectation that our credit loss ratio in 2007 will increase to what we believe represents our more normal historical range of 4 to 6 basis points;

our expectation that multifamily property vacancy rates will increase;

our expectation that losses on certain guaranty contracts will more than double in 2007 compared to 2006;

our expectation of continued increased investments in goals-targeted products in 2007;

our expectation that we will continue to invest in LIHTC partnerships;

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

our expectation that we will reduce our administrative expenses by $200 million in 2007 compared to 2006; and

our expectation that our ongoing daily operations costs will be reduced to approximately $2 billion in 2008.

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 except as required under the federal securities laws.

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. We believe that these risks represent the material risks relevant to us, our business and our industry, but new material risks to our business may emerge that we are currently unable to predict. 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.

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COMPANY RISKS

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

We are exposed to credit risk on our mortgage credit book of business because either we hold the mortgage assets in our portfolio, which consists of mortgage loans, Fannie Mae MBS and non-Fannie Mae mortgage-related securities, or we have issued a guaranty in connection with the creation of Fannie Mae MBS backed by mortgage assets. Borrowers of mortgage loans that we own or that back our Fannie Mae MBS or non-Fannie Mae mortgage-related securities may fail to make the required payments of principal and interest on those loans, exposing us to the risk of credit losses. Factors that affect the level of our risk of credit losses include the financial strength and credit profile of the borrower, the structure of the loan, the type and characteristics of the property securing the loan, and local, regional and national economic conditions.

For example, loans that have unpaid principal balances that are high in relation to the value of the property, which are commonly referred to as loans with high loan-to-value (LTV) ratios, generally tend to have a higher risk of default and, if a default occurs, a greater risk that the amount of the gross loss will be high compared to loans with lower LTV ratios. The LTV ratio of an outstanding mortgage loan changes as the unpaid principal balance of the loan and the value of the property securing the loan change. Depending on the structure of the loan, the unpaid principal balance of the loan may increase or decrease over time. Similarly, depending on local, regional and national economic conditions, or the underlying supply and demand for housing, the value of the property securing the loan may increase or decrease over time. As of December 31, 2006, approximately 10% of our conventional single-family mortgage credit book of business consisted of loans with a mark-to-market estimated loan-to-value ratio greater than 80%.

The proportion of higher risk mortgage loans that were originated in the market between 2003 and mid-2006 increased significantly. As a result, our purchase and securitization of loans that pose a higher credit risk, such as negative-amortizing adjustable-rate mortgages (ARMs), interest-only loans and subprime mortgage loans, also increased, although to a lesser degree than many other institutions. In addition, we increased the proportion of reduced documentation loans that we purchased to hold or to back our Fannie Mae MBS.

For example, negative-amortizing 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, and approximately 7% as of June 30, 2007. 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, December 31, 2006, and June 30, 2007.

We also estimate that approximately 12% and 11% of our single-family mortgage credit book of business as of June 30, 2007 and December 31, 2006, respectively, consisted of Alt-A mortgage loans or structured Fannie Mae MBS backed by Alt-A mortgage loans, and approximately 1% of our single-family mortgage credit book of business consisted of private-label mortgage-related securities backed by Alt-A mortgage loans, including resecuritizations, as of both June 30, 2007 and December 31, 2006. We estimate that subprime loans represented approximately 2.2% of our single-family mortgage credit book of business as of both June 30, 2007 and 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, including resecuritizations.

We expect to experience increased delinquencies and credit losses in 2007 compared with 2006, and the increase in our exposure to credit risk resulting from our purchase or securitization of loans with higher credit risk may cause a further increase in the delinquencies and credit losses we experience. An increase in the delinquencies and credit losses we experience is likely to reduce our earnings during that period and also could adversely affect our financial condition.

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We depend on our institutional counterparties to provide services that are critical to our business, and our earnings and liquidity may be reduced if one or more of our institutional counterparties defaults in its obligations to us.

We face the risk that one or more of 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. In some cases, our business with institutional counterparties is heavily concentrated. As of December 31, 2006, our ten largest single-family mortgage servicers serviced 73% of our single-family mortgage credit book of business, and Countrywide Financial Corporation, which is our largest single-family mortgage servicer, serviced 22% of our single-family mortgage credit book of business. Also, as of December 31, 2006, we had outstanding transactions with 21 interest rate and foreign currency derivatives counterparties, of which seven counterparties accounted for approximately 78% of the total outstanding notional amount of our derivatives contracts. Each of these seven counterparties accounted for between approximately 6% and 16% of the year-end 2006 total outstanding notional amount. Further, as of December 31, 2006, our ten largest depository counterparties held 88% of the $34.5 billion in deposits held by all of our depository counterparties for scheduled MBS payments. In addition, we anticipate that consolidations may occur within the mortgage or other industries that are significant to our business, which would further increase our concentration risk to individual counterparties. Some of our counterparties also may become subject to serious liquidity problems affecting, either temporarily or permanently, the viability of their business plans due to mortgage repurchase obligations, margin calls, or lack of market access to regular sources of funding, which likely would adversely affect their ability to meet their obligations to us. 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 ability to conduct our operations efficiently and at cost-effective rates, which in turn could adversely affect our results of operations and our financial condition.

We have several key lender customers, and the loss of business volume from any one of these customers could adversely affect our business and result in a decrease in our market share and earnings.

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 mortgage loans from several large mortgage lenders. For 2006 and for the first six months of 2007, our top five lender customers of single-family mortgage loans accounted for approximately 51% and 57%, respectively, of our single-family business volume, and the top five lender customers of multifamily mortgage loans accounted for approximately 50% and 53%, respectively, of our multifamily business volume during those periods. In addition, during 2006 and during the first six months of 2007, our largest lender customer of single-family mortgage loans accounted for approximately 26% and 31%, respectively, of our single-family business volume, and our largest lender customer of multifamily mortgage loans accounted for approximately 16% and 20%, respectively, of our multifamily business volume during those periods. Accordingly, maintaining our current business relationships and business volumes with our top lender customers is critical to our business. During the recent disruption in the subprime market, a number of lenders began to originate fewer mortgage loans. 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 and result in a decrease in our market share and earnings. In addition, a significant reduction in the volume of mortgage loans that we securitize, whether resulting from a decrease in the volume of mortgage loans available to us from lenders or from our inability to purchase loans as a result of the limit on the size of our portfolio, could reduce the liquidity of Fannie Mae MBS, which in turn could have an adverse effect on their market value.

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Changes in option-adjusted spreads or interest rates, or our inability to manage interest rate risk successfully, 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. Changes in interest rates affect both the value of our mortgage assets and prepayment rates on our mortgage loans.

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. A widening, or increase, of the OAS of our net mortgage assets typically causes a decline in the fair value of the company. A narrowing, or decrease, 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, other than through asset monitoring and disposition.

Changes in interest rates could have a material adverse effect 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.

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

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;

competition from other issuers of AAA-rated agency debt;

general economic conditions in the U.S. and abroad; and

broader trade and political considerations among the U.S. and other countries.

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.

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, including our ability to issue securities that are responsive to the marketplace. We cannot predict whether the outcome of this review will materially impact our current business activities.

Our business is subject to laws and regulations that restrict our operations, that limit the amount of our net mortgage portfolio assets and that restrict our ability to compete optimally, any of which may adversely affect our profitability.

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. In addition, the policy, approach or regulatory philosophy of these agencies can materially affect our business.

Regulation by OFHEO could adversely affect our results of operations and financial condition. 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 made 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 the amount shown in our minimum capital report as of December 31, 2005 ($727.75 billion), except in limited circumstances at OFHEO s discretion. As of August 10, 2007, OFHEO has advised us that we should continue to comply with the $727.75 billion limit on our net mortgage portfolio assets. We anticipate that this limit on the size of our mortgage portfolio may restrict the growth of our net income or may cause it to decrease. This limitation on the size of our portfolio currently prevents us from purchasing assets that we would purchase if we were not subject to this limitation. In addition, to comply with our remediation obligations, we have incurred significant administrative expenses. Together, these changes contributed to a reduction in our earnings for the year ended December 31, 2006, as compared to the year ended December 31, 2005. We expect the limitation on the size of our mortgage portfolio will have, and the amount of our administrative expenses will continue to have, a negative impact on our earnings in 2007. Similarly, any new or additional regulations that OFHEO may adopt in the future could adversely affect our future earnings and financial condition.

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The consent order also prohibits our Board of Directors from increasing the dividend at any time if payment of the increased dividend would reduce our capital surplus to less than the OFHEO-directed minimum capital requirement. In addition, the OFHEO consent order requires us to provide OFHEO with prior notice of any planned dividend and a description of the rationale for its payment.

If we fail to comply with any of our agreements with OFHEO or with any OFHEO regulation, including those relating to our minimum, core, risk-based or OFHEO-directed capital, 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 could adversely affect our results of operations. HUD supervises our compliance with the Charter Act, which defines our permissible business activities. For example, we may not purchase single-family loans in excess of our conforming loan limits, which are set annually based on U.S. home prices. The conforming loan limit for a one-family mortgage loan in most geographic regions is currently $417,000. In addition, under the Charter Act, our business is limited to the U.S. housing finance sector. 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, our ability to respond quickly to changes in market conditions by offering new programs in response to these changes is subject to HUD s prior approval process. 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 reduce our market share, our earnings and our financial condition.

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 through 2008, and has created purchase money mortgage subgoals that also increase through 2008. These changes in our housing goals and subgoals and declining affordability have made it increasingly challenging to meet our housing goals and subgoals. If we do not meet any enforceable housing goal or subgoal, we may become subject to increased HUD oversight for the following year or be subject to civil money penalties.

Our efforts to meet 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 housing goals and subgoals, we have made 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 further increase our credit losses.

A decrease in our current credit ratings would have an adverse effect on our ability to issue debt on acceptable terms, which would reduce our liquidity and our earnings.

Our borrowing costs and our broad access to the debt capital markets depend in large part on our high credit ratings, particularly on our senior unsecured debt. Our 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.

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Material weaknesses and other control deficiencies relating to our internal control over financial reporting 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, 2006 identified eight material weaknesses in our internal control over financial reporting. As described in Item 9A Controls and Procedures Management s Report on Internal Control Over Financial Reporting Description of Material Weaknesses as of December 31, 2006, we have not yet remediated material weaknesses in our application of GAAP relating to our accounting for certain 2006 securities sold under agreements to repurchase and certain 2006 securities purchased under agreements to resell, our financial reporting process, our information technology applications and infrastructure access controls, and our 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 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 and have remediated all material weaknesses.

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.

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

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 (with lenders representing and warranting certain criteria) 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 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.

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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 financial condition and earnings.

We compete to acquire mortgage assets for our mortgage portfolio or to securitize mortgage assets into Fannie Mae MBS 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 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, increased consolidation within the financial services industry has created larger financial institutions, increasing pricing pressure. The recent decreased rate of growth in U.S. residential mortgage debt outstanding in 2006 and continuing into 2007 has also increased competition in the secondary mortgage market by decreasing the supply of new mortgage loans available for purchase.

We also expect private-label issuers to provide increased competition to our HCD business through their use of CMBS, which often package loans secured by multifamily residential property together with higher yielding loans secured by commercial properties.

This increased competition may adversely affect our business and financial condition and reduce our earnings.

Our ability to develop, enhance, and implement strategies to adapt to changing conditions in the mortgage industry and capital markets, may adversely affect our financial condition and earnings.

The manner in which we compete and the products for which we compete are affected by changing conditions which can take the form of trends or sudden changes to trends in our industry. If we do not effectively respond to these changes, or if our strategies to respond to these changes are not as successful as our prior business strategies, our earnings and liquidity may be reduced and our business and financial condition could be adversely affected. For example, in recent years, the proportion of single-family mortgage loan originations consisting of nontraditional mortgages has increased, and demand for traditional 30-year fixed-rate mortgages, which represents the largest portion of our business volume, decreased. We did not purchase or guarantee large amounts of these nontraditional mortgages in 2004, 2005 or 2006 and, as a result, our estimated share of the single-family mortgage market decreased substantially during this period.

Additionally, we may not be able to execute successfully any new or enhanced strategies that we adopt to address changing conditions. In addition, our strategies, even if fully implemented, may not increase our share of the secondary mortgage market, our revenues or our earnings due to factors beyond our control.

Legislation that would change the regulation of our business could, if enacted, reduce our competitiveness and adversely affect our liquidity, results of operations and financial condition.

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 May 22, 2007, the House of Representatives approved a bill, H.R. 1427, 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 establish standards by which it may limit the composition and growth of our mortgage investment portfolio;

- authorizing the regulator to increase the level of our required capital for safety and soundness;

authorizing the regulator to review new and existing products and activities for safety and soundness and mission compliance, and requiring prior regulatory approval for all new products;

restructuring the housing goals and changing the method for enforcing compliance;

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

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requiring us and Freddie Mac to contribute a percentage of our book of business the sponsor of the bill has estimated a total contribution by us and Freddie Mac combined of $500 million to $600 million per year to a fund to support affordable housing.

More recently, on July 31, 2007, the House Committee on Financial Services approved a bill to create an affordable housing trust fund (H.R. 2895). This bill creates an annually funded Trust Fund that does not seek to impose any new obligations on us that do not already exist under H.R. 1427, but is dependent upon passage of H.R. 1427 for funding.

As of the date of this filing, the only GSE reform bill that has been introduced in the Senate is S. 1100. This bill is substantially similar to a bill that was approved by the Senate Committee on Banking, Housing, and Urban Affairs in July 2005, and differs from H.R. 1427 in a number of respects. It is expected that a version of GSE reform legislation more similar to H.R. 1427 could be introduced in the Senate, 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 congressional legislation, or the impact that any enacted legislation could have on our financial condition or results of operations.

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 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.

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.

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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, including increased regulatory requirements and legislative and regulatory scrutiny.

We are subject to risks associated with 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 and the six months ended June 30, 2004, was the first periodic report we filed with the SEC since August 2004. Since that time, we have filed our 2005 Form 10-K and this 2006 Form 10-K. Our need to restate our historical financial statements, the delay in producing both restated and more current consolidated financial statements and related problems have had, and in the future may continue to have, an adverse effect on our business and reputation. In addition, we believe that the negative publicity to which we have been subject as a result of our restatement of prior period financial statements and related problems has further contributed to declines in the price of our common stock, an increase in the regulatory requirements to which we are subject, and in legislative and regulatory scrutiny of our business, and could increase our cost of funds and affect our customer relationships.

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 and two related individual securities actions filed by institutional investors; a consolidated shareholder derivative lawsuit; and a consolidated Employee Retirement Income Security Act of 1974 (ERISA)-based class action lawsuit. The consolidated shareholder derivative action was dismissed on May 31, 2007, but the plaintiffs have initiated an appeal with the U.S. Court of Appeals for the District of Columbia, and, in addition, two new derivative actions have been filed. 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, our results of operations and our cash flows. In addition, our current and former directors, officers and employees may be 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 20, Commitments and Contingencies.

The occurrence of a major natural or other disaster in the U.S. 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 U.S. 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.

The contingency plans and facilities that we have in place may be insufficient to prevent a disruption in the infrastructure that supports our business and the communities in which we are located from having an adverse effect on our ability to conduct business. 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.

RISKS RELATING TO OUR INDUSTRY

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

U.S. home prices rose significantly in recent years. This period of extraordinary home price appreciation has ended. By many measures, prices have declined in 2007, and we expect that they will continue to decline for the remainder of this year and in 2008. Declines in home prices are likely to result in increased delinquencies or defaults on the mortgage assets we own or that back our guaranteed Fannie Mae MBS. In addition, home price declines would reduce the fair value of our mortgage assets. Further, a significant portion of mortgage loans made in recent years contain adjustable-rate terms in which the interest rates are likely to increase periodically throughout the term of the loan or after an initial period in which the rates are fixed. Many ARMs are expected to reset during the remainder of 2007 and 2008 and are expected to require increases in monthly payments, which may lead to increased delinquencies or defaults. In addition, the prevalence of loans made based on limited or no credit or 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 reduce our earnings.

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 sharply in response to the reduced activity in the housing market and national declines in home prices. This trend could be exacerbated if recent increases in mortgage delinquencies and defaults continue. 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. In addition, spreads have expanded in all sectors of the mortgage market, including in the fixed-rate agency MBS market, resulting in at least some price deterioration. This, in turn, has affected the liquidity of many lenders, including lenders that primarily offered only prime mortgage loans. If liquidity issues continue, or increase, the amount of U.S. residential mortgage debt outstanding may decrease, perhaps significantly, which would adversely affect our earnings and could adversely affect the liquidity of our Fannie Mae MBS.

Changes in general market and economic conditions in the U.S. 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 U.S. and abroad. These conditions include short-term and long-term interest rates, the value of the U.S. dollar compared with the value of 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 in the U.S. and economies of other countries with investors that hold our debt. 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 U.S. 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 reduce 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, resulting in an increase in our liabilities and a reduction in our earnings.

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 407,038 square feet of office space at 4000 Wisconsin Avenue, NW, which is adjacent to our principal office. The present lease term for 4000 Wisconsin Avenue expires in April 2008. We have exercised the second of three 5-year renewal options that were included under the original lease terms and this will extend the lease through April 2013. We have one additional 5-year renewal option remaining under the original lease. We also lease an additional approximately 471,000 square feet of office space at seven 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 58 Fannie Mae Community Business Centers around the U.S., 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, 2006; (2) were terminated during the period from January 1, 2006 through the date of filing of this report; or (3) are pending as of the date of filing of this report. Accordingly, if applicable, the description of a matter will include developments that have occurred since December 31, 2006, as well as those that occurred during 2006.

In addition to the matters specifically described in this item, we are involved in a number of legal and regulatory proceedings that arise in the ordinary course of business that do not have a material impact on our business.

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 20, Commitments and Contingencies.

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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 three federal district courts. 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 former officers 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. 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 unspecified 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 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. On August 14, 2006, the plaintiffs filed a second amended complaint adding KPMG LLP and Goldman, Sachs & Co. as additional defendants and adding allegations based on the May 2006 report issued by OFHEO and the February 2006 report issued by Paul, Weiss, Rifkind, Wharton & Garrison LLP. 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 a hearing on that motion was held on June 21, 2007.

On April 16, 2007, KPMG filed cross-claims against us in this action 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. Fannie Mae filed a motion to dismiss certain of KPMG s cross-claims. That motion was denied on June 27, 2007. We have separately filed a case against KPMG, which is discussed below under Other Legal Proceedings KPMG Litigation.

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 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. On April 27, 2007, KPMG also filed cross-claims against us in this action that are essentially identical to those it alleges in the consolidated class action case.

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 unspecified 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 adding additional allegations regarding improper accounting practices. The second amended complaints each added Radian Guaranty Inc. as a defendant. The court has consolidated these cases as part of the consolidated shareholder class action for pretrial purposes and possibly through final judgment. On July 31, 2007, the court dismissed all of the individual securities plaintiffs claims against 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, Leslie Rahl, and Radian Guaranty Inc. In addition, the court dismissed the individual securities plaintiffs state law claims and certain of their federal securities law claims against us, Franklin D. Raines, J. Timothy Howard, and Leanne Spencer. It also limited the individual securities plaintiffs insider trading claims against Franklin D. Raines, J. Timothy Howard and Leanne Spencer.

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 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 unspecified 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.

The plaintiffs filed an amended complaint on September 1, 2006. Among other things, the amended complaint added The Goldman Sachs Group, Inc., Goldman, Sachs & Co., Inc., Lehman Brothers, Inc., and Radian

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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 and on May 31, 2007, the court issued a Memorandum Opinion and Order dismissing plaintiffs derivative lawsuit for failing to make a demand on the Board of Directors or to plead specific facts demonstrating that such a demand was excused based upon futility. On June 27, 2007, plaintiffs filed a Notice of Appeal with the U.S. Court of Appeals for the District of Columbia.

On June 29, 2007, one of the original plaintiffs (James Kellmer) in the derivative action filed a new derivative action in the U.S. District Court for the District of Columbia. Mr. Kellmer had originally filed a shareholder derivative action on January 10, 2005, which was later consolidated into the main derivative case. Mr. Kellmer s new complaint alleges that he made a demand on the Board of Directors on September 24, 2004, and that his action should now be allowed to proceed independently. In addition to naming all of the defendants who were named in the amended consolidated complaint, Mr. Kellmer names the following new defendants: James Johnson, Lawrence Small, Jamie Gorelick, Victor Ashe, Molly Bordonaro, William Harvey, Taylor Segue, III, Manuel Justiz, Vincent Mai, Roger Birk, Stephen Friedman, Garry Mauro, Maynard Jackson, Esteban Torres, KPMG LLP and The Goldman Sachs Group, Inc.

The factual allegations in Mr. Kellmer s new complaint are largely duplicative of those in the amended consolidated complaint and it alleges causes of action against the current and former officers and directors based on theories of breach of fiduciary duty, indemnification, negligence, violations of the Sarbanes-Oxley Act of 2002 and unjust enrichment. The complaint seeks unspecified money damages, including legal fees and expenses, disgorgement and punitive damages, as well as injunctive relief.

In addition, another derivative action based on Mr. Kellmer s alleged September 24, 2004 demand was filed on July 6, 2007 by Arthur Middleton in the United States District Court for the District of Columbia. This complaint names the following current and former officers and directors as defendants: Franklin D. Raines, J. Timothy Howard, Daniel H. Mudd, Kenneth M. Duberstein, Stephen B. Ashley, Thomas P. Gerrity, Ann Korologos, Frederic V. Malek, Donald B. Marron, Joe K. Pickett, Leslie Rahl, H. Patrick Swygert, Anne M. Mulcahy, John K. Wulff, The Goldman Sachs Group, Inc., and Goldman, Sachs & Co. The allegations in this new complaint are essentially identical to the allegations in the amended consolidated complaint referenced above, and this plaintiff seeks the identical relief.

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. 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 and the other defendants filed motions to dismiss the consolidated complaint. These motions were denied on May 8, 2007.

We believe we have defenses to the claims in all of these restatement-related lawsuits and intend to defend these lawsuits vigorously.

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 THE 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 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 the 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).

Concurrent with OFHEO s release of its final report, we entered into comprehensive settlements that resolved open matters with the OFHEO special examination, as well as with the SEC s related investigation (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. 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. For a description of the OFHEO consent order, see Item 1 Business Our Charter and Regulation of Our Activities OFHEO Regulation OFHEO Consent Order.

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 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 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 s 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 s retirement was June 22, 2005, rather than December 21, 2004 (his final day of active employment). Under the arbitrator s decision, Mr. Raines s 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. On June 26, 2007, counsel for Mr. Raines notified the arbitrator that the parties have been unable to resolve the following issues: Mr. Raines s entitlement to additional shares of common stock under our performance share plan for the three-year performance share cycle that ended in 2003; Mr. Raines s entitlement to shares of common stock under our performance share plan for the three-year performance share cycles that ended in each of 2004, 2005 and 2006; and Mr. Raines s entitlement to additional compensation of approximately $140,000.

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. On June 12, 2007, we and Freddie Mac filed a supplemental memorandum in support of the October 11, 2005 motion to dismiss.

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)

A complaint was filed against us in the U.S. District Court for the Eastern District of Texas (Texarkana Division) on June 2, 2004, 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.

Our motions 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, which was fully briefed and remains pending.

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

KPMG Litigation

Fannie Mae v. KPMG LLP

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 our complaint, which was denied on June 13, 2007. On June 13, 2007, the court granted KPMG s motion to consolidate this action with *In re Fannie Mae Securities Litigation* for pretrial purposes.

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.

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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
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

Holders

As of June 30, 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 2005 through and including the fourth quarter of 2006.

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 1 Business Our Charter and Regulation of Our Activities OFHEO Regulation 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 and on May 1, 2007, the Board of Directors again increased the common stock dividend to $0.50 per share. 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 1 Business Our Charter and Regulation of Our Activities OFHEO Regulation Capital Adequacy Requirements 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 June 30, 2007. Quarterly dividends declared on the shares of our preferred stock outstanding totaled $243.6 million for the six months ended June 30, 2007. See Notes to Consolidated Financial Statements Note 17, Preferred Stock for detailed information on our preferred stock dividends.

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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 2006 was provided in Forms 8-K we filed on May 9, 2006, August 9, 2006, November 8, 2006, and February 27, 2007.

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 U.S. As a result, we do not file registration statements with the SEC with respect to offerings of our securities.

Purchases of Equity Securities by the Issuer

The following table shows shares of our common stock we repurchased from January 2006 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]	Maximum Number of Shares that May Yet be Purchased Under the Program[3][4]
	(Shares in thousands)			
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) 349,446 shares of common stock reacquired from employees to pay an aggregate of

approximately $18.9 million in withholding taxes due upon the vesting of restricted stock; (b) 73,181 shares of common stock reacquired from employees to pay an aggregate of approximately $4.3 million in withholding taxes due upon the exercise of stock options; (c) 418,847 shares of common stock repurchased from employees and members of our Board of Directors to pay an aggregate exercise price of approximately $24.4 million for stock options; and (d) 12,150 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 our shares of common stock from non-officer employees. On January 21, 2003, we publicly announced that the Board of Directors had approved a stock 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, 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.

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(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 13, 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) Amounts presented for 2006 do not reflect the determinations made by our Board of Directors in February 2007 and in June 2007 not to pay out certain shares expected to be issued under our plans. See Notes to Consolidated Financial Statements Note 13, Stock-Based Compensation Plans for a description of these shares.

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Item 6. Selected Financial Data

The selected consolidated financial data presented below is summarized from our results of operations for the five-year period ended December 31, 2006, as well as selected consolidated balance sheet data as of December 31, 2006, 2005, 2004, 2003, and 2002. The data presented below should be read in conjunction with the audited consolidated financial statements and related notes and with Item 7 MD&A included in this Annual Report on Form 10-K.

	For the Year Ended December 31,				
	2006	2005	2004	2003	2002
	(Dollars in millions, except per share amounts)				
Income Statement Data:					
Net interest income	$ 6,752	$ 11,505	$ 18,081	$ 19,477	$ 18,426
Guaranty fee income	4,174	3,925	3,715	3,376	2,516
Derivative fair value losses, net	(1,522)	(4,196)	(12,256)	(6,289)	(12,919)
Other income (loss)[1]	(927)	(871)	(923)	(4,315)	(1,735)
Income before extraordinary gains (losses) and cumulative effect of change in accounting principle	4,047	6,294	4,975	7,852	3,914
Extraordinary gains (losses), net of tax effect	12	53	(8)	195	
Cumulative effect of change in accounting principle, net of tax effect				34	
Net income	4,059	6,347	4,967	8,081	3,914
Preferred stock dividends and issuance costs at redemption	(511)	(486)	(165)	(150)	(111)
Net income available to common stockholders	3,548	5,861	4,802	7,931	3,803
Per Common Share Data:					
Earnings per share before extraordinary gains (losses) and cumulative effect of change in accounting principle:					
Basic	$ 3.64	$ 5.99	$ 4.96	$ 7.88	$ 3.83
Diluted	3.64	5.96	4.94	7.85	3.81
Earnings per share after extraordinary gains (losses) and cumulative effect of change in accounting principle:					
Basic	$ 3.65	$ 6.04	$ 4.95	$ 8.12	$ 3.83
Diluted	3.65	6.01	4.94	8.08	3.81
Weighted-average common shares outstanding:					
Basic	971	970	970	977	992
Diluted	972	998	973	981	998
Cash dividends declared per share	$ 1.18	$ 1.04	$ 2.08	$ 1.68	$ 1.32

New Business Acquisition Data:					
Fannie Mae MBS issues acquired by third parties[2]	$ 417,471	$ 465,632	$ 462,542	$ 850,204	$ 478,260
Mortgage portfolio purchases[3]	185,507	146,640	262,647	572,852	370,641
New business acquisitions	$ 602,978	$ 612,272	$ 725,189	$ 1,423,056	$ 848,901

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	As of December 31,				
	2006	2005	2004	2003	2002
	(Dollars in millions)				
Balance Sheet Data:					
Investments in securities:					
Trading	$ 11,514	$ 15,110	$ 35,287	$ 43,798	$ 14,909
Available-for-sale	378,598	390,964	532,095	523,272	520,176
Mortgage loans:					
Loans held for sale	4,868	5,064	11,721	13,596	20,192
Loans held for investment, net of allowance	378,687	362,479	389,651	385,465	304,178
Total assets	843,936	834,168	1,020,934	1,022,275	904,739
Short-term debt	165,810	173,186	320,280	343,662	293,538
Long-term debt	601,236	590,824	632,831	617,618	547,755
Total liabilities	802,294	794,745	981,956	990,002	872,840
Preferred stock	9,108	9,108	9,108	4,108	2,678
Total stockholders equity	41,506	39,302	38,902	32,268	31,899
Regulatory Capital Data:					
Core capital(4)	$ 41,950	$ 39,433	$ 34,514	$ 26,953	$ 20,431
Total capital(5)	42,703	40,091	35,196	27,487	20,831
Mortgage Credit Book of Business Data:					
Mortgage portfolio(6)	$ 728,932	$ 737,889	$ 917,209	$ 908,868	$ 799,779
Fannie Mae MBS held by third parties(7)	1,777,550	1,598,918	1,408,047	1,300,520	1,040,439
Other guarantees(8)	19,747	19,152	14,825	13,168	12,027
Mortgage credit book of business	$ 2,526,229	$ 2,355,959	$ 2,340,081	$ 2,222,556	$ 1,852,245

Ratios:	**2006**	**2005**	**2004**	**2003**	**2002**
Return on assets ratio(9)*	0.42%	0.63%	0.47%	0.82%	0.44%
Return on equity ratio(10)*	11.3	19.5	16.6	27.6	15.2
Equity to assets ratio(11)*	4.8	4.2	3.5	3.3	3.2
Dividend payout ratio(12)*	32.4	17.2	42.1	20.8	34.5
Average effective guaranty fee rate (in basis points)(13)*	21.8bp	21.8bp	21.4bp	21.6bp	19.3bp
Credit loss ratio (in basis points)(14)*	2.7bp	1.9bp	1.0bp	0.9bp	0.8bp
Earnings to combined fixed charges and preferred stock dividends and issuance costs at redemption ratio(15)	1.12:1	1.23:1	1.22:1	1.36:1	1.16:1

(1) Includes losses on certain guaranty contracts, investment losses, net; debt extinguishment gains (losses), net; losses 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) 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.

(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).

(6) Unpaid principal balance of mortgage loans and mortgage-related securities held in our portfolio.

(7) Unpaid principal balance of Fannie Mae MBS held by third-party investors. The principal balance of resecuritized Fannie Mae MBS is included only once.

(8) Includes additional credit enhancements that we provide not otherwise reflected in the table.

(9) Net income available to common stockholders divided by average total assets.

(10) Net income available to common stockholders divided by average outstanding common equity.

(11) Average stockholders equity divided by average total assets.

(12) Common dividend payments divided by net income available to common stockholders.

(13) Guaranty fee income as a percentage of average outstanding Fannie Mae MBS and other guaranties.

(14) Charge-offs, net of recoveries and foreclosed property expense (income), as a percentage of the average mortgage credit book of business.

(15) 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 (losses) of consolidated subsidiaries, losses 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.

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, 2006 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 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

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, HCD 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 U.S. 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.

Market and Economic Factors Affecting Our Business

Market Environment: 2001 to Mid-2006

Our business and financial performance are 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, the level of competition for mortgage assets generally among investors, and the mortgage credit environment.

Between 2001 and mid-2006, the housing and mortgage markets experienced a sustained period of growth due to a combination of factors, including low mortgage interest rates, positive demographic drivers such as household and immigration growth, and an increase in purchases of homes by investors all of which fueled extraordinary growth in home prices. As home prices climbed, decreasing affordability led to significant mortgage product innovation and rapid growth in mortgage products other than fully amortizing, fixed-rate, prime mortgage loans, especially between 2004 and mid-2006. Notably, there was rapid growth in interest-only and negative-amortizing loans, as well as adjustable rate mortgages with initial periods of low fixed rates. These types of loans generally required lower initial monthly payments either because the initial interest rates were lower or because they allowed borrowers to defer repayment of principal or interest. At the same time, there was a relaxation of credit underwriting standards, as the subprime and Alt-A sectors grew rapidly. The features of these new mortgage products allowed more borrowers to obtain mortgage loans, which contributed to continued growth in the housing market. As these products increased in popularity, the proportion of fully amortizing, fixed-rate mortgage originations, which historically have represented the majority of our mortgage credit book of business, decreased significantly.

Between 2001 and mid-2006, the substantial growth in mortgage originations and residential mortgage debt outstanding led to substantial growth in our mortgage credit book of business. In addition, we experienced historically low levels of credit losses due in part to the significant increase in home prices. As the composition of loan originations shifted from fixed-rate mortgages to a greater share of higher risk, less traditional mortgages, we concluded that the market s pricing of a significant portion of these loans did not appropriately reflect the underlying, and often layered, credit risks associated with these products. Based on this assessment, we made a strategic decision to forgo the guaranty of a significant proportion of mortgage loans because they did not meet our risk and pricing criteria. As a result of our decision to maintain a disciplined approach to managing our participation in the single-family mortgage market, we ceded significant market share of issuances of single-family mortgage-related securities to our competitors. We believe, however, that this decision has helped us maintain a mortgage credit book of business with strong credit characteristics overall.

Change in Market Environment: Mid-2006 to Present

After five consecutive years of record home sales, however, the housing market slowed sharply in 2006, especially in the second half of the year. Housing starts fell by 13%; home sales fell by almost 10%; purchase originations fell for the first time this decade; and national home price appreciation slowed sharply in the second half of the year, with some regions of the country experiencing declines in home prices. Several factors contributed to this softening of the housing market, including: below-trend job growth; a decrease in the affordability of homes; and a decline in the share of mortgage originations made to investors and purchasers of second homes. In addition, as short-term interest rates climbed significantly during 2006 relative to long-term interest rates, the yield curve flattened, causing a continued narrowing of the spreads between the rates available for ARMs and fixed-rate mortgage loans. This change reduced the utility of ARM products as a means of increasing home price affordability for borrowers. As a result, for the first time in six years, residential mortgage debt outstanding grew at single-digit rates in 2006. During the first quarter of 2007, this growth rate declined to 6%, its lowest level in nearly 10 years.

As interest rates increased, many subprime loans (namely, ARMs with interest rates that were fixed for only two to three years) began to reset in 2006 from their below-market initial rates to higher interest rates, often at levels higher than then current market rates. The substantial increase in monthly mortgage payments resulting from the reset of the interest rates on these loans, along with increasing interest rates in the market generally and on all types of adjustable rate loans in particular, caused default rates to increase, particularly among subprime mortgages. The Mortgage Bankers Association reported in its June 2007 *National Delinquency Survey* that the serious delinquency rate on subprime loans had increased to 8.45% in the first quarter of 2007, compared with 6.32% in the first quarter of 2006. This increase in foreclosures and depressed home prices contributed to higher levels of unsold inventories during 2006 and into 2007. A number of subprime lenders exited the subprime market, and the federal financial regulatory agencies issued guidance tightening lending standards for nontraditional loans. As a result of these dynamics, the flow of capital for subprime lending has slowed substantially, which has affected the market for mortgage-related securities backed by subprime mortgages.

This combination of narrower spreads between the interest rates available for ARMs and the interest rates available for fixed-rate mortgage loans, increased scrutiny by federal regulators, reduced investor activity in the housing market and the subprime market disruption has led to a sharp decline in the prevalence of ARMs and nontraditional loans, an increase in fixed-rate mortgage originations, and wider spreads across all types of mortgage assets.

Impact of Subprime Market on Our Business

We believe that the limited scale and disciplined nature of our participation in the subprime market has helped to protect the company from a material adverse impact of the recent disruption in that market to date. We estimate that, as of June 30, 2007, subprime mortgage loans or structured Fannie Mae MBS backed by subprime mortgage loans represented approximately 0.2% of our single-family mortgage credit book of business. As of June 30, 2007, we had invested in private-label securities backed by subprime mortgage loans totaling $47.2 billion, which represented approximately 2% of our single-family mortgage credit book of business. Of this $47.2 billion, approximately $46.9 billion was rated AAA or the equivalent by two nationally recognized statistical rating agencies, with an overall weighted average credit enhancement of 32% and a minimum credit enhancement of 13%. As of the close of business on August 15, 2007, the day before this filing, none of our $47.2 billion of subprime-backed securities had been the subject of a credit ratings downgrade, and none had been placed on negative watch by the ratings agencies.

While we have not suffered significant losses from our investments in subprime mortgage-related securities as of the date of this filing the subprime market disruption has contributed to the overall decline in home prices and to the increased inventory of unsold properties. We expect the overall erosion of property values and excess inventories to slow the sale and reduce the sales price of our foreclosed properties. As a result, we expect higher loss severities on our foreclosed properties in 2007.

Summary of Our Financial Results

Consolidated Results

Net income and diluted earnings per share totaled $4.1 billion and $3.65, respectively, in 2006, compared with $6.3 billion and $6.01 in 2005, and $5.0 billion and $4.94 in 2004. The primary drivers of the decrease in net income in 2006 were substantially lower net interest income, higher administrative expenses, and higher credit-related expenses. The negative impact of these items was partially offset by a decrease in derivative fair value losses, lower investment losses, higher guaranty income and a decrease in our tax provision. Below are additional comparative highlights of our performance.

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2006 versus 2005

- New business acquisitions decreased 2% from 2005
- 7% growth in our mortgage credit book of business
- 41% decrease in net interest income to $6.8 billion
- 46 basis points decrease in net interest yield to 0.85%
- 6% increase in guaranty fee income to $4.2 billion
- Derivative fair value losses of $1.5 billion, compared with derivative fair value losses of $4.2 billion in 2005
- $961 million, or 45%, increase in administrative expenses to $3.1 billion
- 83% increase in credit-related expenses to $783 million
- $2.2 billion increase in stockholders equity to $41.5 billion
- $702 million increase in the non-GAAP estimated fair value of our net assets (net of tax effect) to $42.9 billion

2005 versus 2004

- New business acquisitions decreased 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%
- 6% increase in guaranty fee income to $3.9 billion
- Derivative fair value losses of $4.2 billion, compared with derivative fair value losses of $12.3 billion in 2004
- $459 million, or 28%, increase in administrative expenses to $2.1 billion
- 18% increase in credit-related expenses to $428 million
- $0.4 billion increase in stockholders equity to $39.3 billion
- $2.1 billion increase in the non-GAAP estimated fair value of our net assets (net of tax effect) to $42.2 billion

Both our 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 and other key drivers of year-over-year changes can be found in Consolidated Results of Operations and Supplemental Non-GAAP Information-Fair Value Balance Sheet.

Because our assets and liabilities consist predominately of financial instruments that are recorded in a variety of ways 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. Specifically, under GAAP we measure and record some financial instruments at fair value, while other financial instruments are recorded at historical cost. We discuss the manner in which we recognize various financial instruments in our financial statements in Critical Accounting Policies Fair Value of Financial Instruments.

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 combination of debt and derivatives to fund those assets and manage the inherent interest rate risk 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.

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Outlook

Industry trends that we believe will have a continued effect on our financial results during 2007 include the decline in the growth of mortgage debt outstanding, the decline in home prices, increasing mortgage interest rates and the disruption in the mortgage market. These factors have led to an increase in the inventory of unsold homes, which has contributed to slower home sales and reduced sale prices following a borrower default on a mortgage loan. As a result of these same factors, however, we expect the growth in our book of business to exceed growth of U.S. residential mortgage debt outstanding as borrowers refinance into the longer term fixed-rate mortgage loans that have always represented the substantial majority of our mortgage credit book of business.

As a result of the decrease in the volume of our interest-earning assets and further increases in the cost of our debt, we expect to experience a continued decline in our net interest income in 2007 at a rate somewhat below the rate of decline in 2006.

We anticipate that the losses we incur at inception of guaranty contracts will more than double in 2007 compared to 2006 as a result of the decline in home prices.

We anticipate a significant increase in our credit losses and credit-related expenses beginning in 2007 compared to the low, and often historically low, level of credit losses and credit-related expenses that we have experienced during the past few years. We expect that our credit loss ratio in 2007 will increase to what we believe represents our more normal historical range of 4 to 6 basis points, although this ratio may move outside that range depending on market factors and the risk profile of our mortgage credit book of business. Market factors that we believe will have a significant effect on our credit losses and credit-related expenses primarily include lack of job stability or growth, declines in home prices and increases in interest rates.

Based on historical housing market data, we believe that a downturn in the housing market is part of the normal industry cycle. We believe that underlying demographic factors, such as household formation rates, the portion of the population within the age ranges conducive to purchasing homes, and the increase in homeownership rates as a result of the high level of immigration during the past 25 years, will support continued long-term demand for new capital to finance the substantial and sustained housing finance needs of American homebuyers.

Business Segment Results

Single-Family Results

Our Single-Family business generated net income of $2.0 billion, $2.6 billion and $2.4 billion in 2006, 2005 and 2004, respectively. Guaranty fee income for our single-family business totaled $4.8 billion in 2006 and $4.5 billion in 2005, reflecting an increase in our total single-family mortgage credit book of business from $2.2 trillion in 2005 to $2.4 trillion in 2006, and an increase in the average effective guaranty fee rate on the book. The average effective guaranty fee rate is calculated as guaranty fee income as a percentage of the average single-family mortgage credit book of business and excludes losses on certain guaranty contracts.

Our total issuance of single-family Fannie Mae MBS declined by approximately 5% to $476.1 billion in 2006 compared with $500.7 billion in 2005. This decline was consistent with the decline in mortgage-related securities issued by all market participants in 2006. Our total issuance of single-family Fannie Mae MBS for the quarter and six months ended June 30, 2007 increased by approximately 26% and 22%, respectively, to an estimated $148.5 billion and $280.2 billion, compared with $117.7 billion and $229.9 billion for the quarter and six months ended June 30, 2006.

We estimate that our market share of single-family mortgage-related securities issuance increased in each quarter of 2006, reaching 24.7% in the fourth quarter. This trend continued into 2007 as we recorded estimated market shares of 25.0% and 28.3% in the first and second quarters, respectively. These estimates, which are based on publicly available data, exclude previously securitized mortgages and do not reflect purchases of single-family mortgage whole loans. We remained the largest issuer of mortgage-related securities in 2006 and the first two quarters of 2007. This contributed to our strong position in the overall

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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 during the past several years has contributed to our maintenance of a credit book with strong credit characteristics overall, as measured by loan-to-value ratios, credit scores and other loan characteristics that reflect the effectiveness of our credit risk management strategy. At the end of 2006, we estimate that we held or guaranteed approximately 22% of U.S. single-family mortgage debt outstanding. We anticipate that the nature of our credit book, along with our risk management strategies, will tend to reduce the impact on us of the current disruption in the mortgage market. 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 Business.

HCD Results

Our HCD business generated net income of $338 million, $503 million and $425 million in 2006, 2005 and 2004, respectively.

Our total issuance of multifamily Fannie Mae MBS declined by approximately 40% to $5.6 billion in 2006 compared with $9.4 billion in 2005 due, in part, to a decision to move more of our volume to portfolio purchases. Our total multifamily mortgage credit book of business increased to an estimated $141.5 billion as of December 31, 2006 compared with $131.7 billion as of December 31, 2005. For the six months ended June 30, 2007, our total issuance of multifamily Fannie Mae MBS totaled $2.1 billion and our total multifamily mortgage credit book of business increased to an estimated $158.8 billion as of June 30, 2007. At the end of 2006, we estimate that we held or guaranteed approximately 17% of U.S. multifamily mortgage debt outstanding.

Our tax-advantaged investments, primarily our LIHTC partnerships, continued to contribute significantly to net income by lowering our effective corporate tax rate. LIHTC investments totaled $8.8 billion in 2006 compared with $7.7 billion in 2005. The tax benefit associated with our LIHTC investments was the primary reason our 2006 effective corporate tax-rate was reduced from the federal statutory rate of 35% to approximately 4%.

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 $1.7 billion, $3.2 billion and $2.1 billion in 2006, 2005 and 2004, respectively.

Our gross mortgage portfolio balance as of December 31, 2006 was essentially unchanged from the balance as of December 31, 2005, decreasing by less than 1% to $724.4 billion. Net interest income decreased substantially in 2006 due to a lower average portfolio balance and a decline in the spread between the average yield on these assets and our borrowing costs. This decline was offset by a 92%, or $1.2 billion, decline in interest expense accruals on interest rate swaps, which we consider an important component of our cost of funding. Our gross mortgage portfolio balance decreased to $722.5 billion as of June 30, 2007, consisting of Fannie Mae MBS, loans, non-Fannie Mae agency securities, and non-Fannie Mae non-agency securities totaling $274.5 billion, $293.0 billion, $32.2 billion, and $122.8 billion, respectively. Our gross mortgage portfolio balance is calculated as the unpaid principal balances of our mortgage loans, and does not reflect, for example, market valuation adjustments, allowance for loan losses, impairments, unamortized premiums and discounts and the amortization of discounts, premiums, and issuance costs.

The effective management of interest rate risk is fundamental to the overall management of our Capital Markets group. 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. We believe one measure of the general effectiveness of our interest rate risk management is the estimated impact on our financial condition of changes in the level and slope of the yield curve. We discuss our interest rate risk management in Risk Management Interest Rate Risk and Other Market Risks.

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

Key 2006 Priorities

We evaluated our performance in 2006 based not only on our financial results, but also in terms of key non-financial priorities for the year. We entered 2006 focused on building a fundamentally stronger and more sound company while managing our businesses effectively in an extremely challenging competitive environment. We gained further clarity on areas of deficiency or weakness in our company in two reports issued during the course of 2006. In February 2006, the law firm of Paul, Weiss, Rifkind, Wharton & Garrison LLP issued a report which was the result of an extensive, independent investigation commissioned by our Board of Directors that reviewed matters related to our accounting, governance, structure and internal controls. In May 2006, OFHEO released the final report of its special examination. Our overriding objective, to effectively and expeditiously address matters raised in these reports while working to achieve our primary mission and business objectives, was reflected in the following corporate priorities, which were approved by our Board of Directors for 2006.

Stabilization: Completing the restatement of our financial statements, effectively managing our capital surplus, building strong and productive relationships with our regulators, and strengthening relationships with our shareholders and the investment community. These formed the key elements of our objective to stabilize our company.

We completed the restatement of our financial statements with the filing of our 2004 10-K on December 6, 2006. We achieved other milestones in our efforts to become a current filer when we filed our 2005 10-K on May 2, 2007, and with the filing of this 2006 10-K. We expect to become a current filer by the end of February 2008.

We made progress toward our stated objective of establishing a common stock dividend competitive with a peer group of large financial institutions by increasing our dividend in the fourth quarter of 2006 and again in the second quarter of 2007. Additionally, our efforts to effectively deploy excess capital have included the redemption of two expensive series of preferred shares.

We view our comprehensive settlements with OFHEO and the SEC, announced on May 23, 2006, as an important early step in building strong relationships with our regulators.

Build our businesses: Building on the existing strengths of our three businesses. This was a key objective for 2006. During the year, we introduced a number of initiatives focused on optimizing business operations, increasing profitability, identifying opportunities to expand sources of revenue within our charter and generating shareholder value. For example, our Capital Markets group teamed with our HCD business to add multifamily-only CMBS to the asset classes in which we invest. In our Single-Family business, we continued to work with our lender partners to support mortgage products across a broader range of the credit spectrum in ways that we believe will represent an attractive use of our shareholders capital.

Deliver on mission: Achieving our mission objectives, which we view as one of the primary measures of our company s success. In 2006, we took significant steps to address the challenges of meeting our liquidity mission and our HUD goals, including implementing enhancements to MyCommunityMortgage®, an affordable housing outreach program. In 2007, we introduced HomeStay[tm], a set of initiatives designed to help our lender partners protect borrowers and to provide some stability to the subprime mortgage market.

Instill operational discipline: Making continued progress in building out robust controls and instilling operational discipline into all of our functions. We have also made considerable progress in our efforts to remediate identified material weaknesses in our internal control over financial reporting. At December 31, 2005, we reported 20 material weaknesses. During 2006 and the first two quarters of 2007, we reduced the number of outstanding material weaknesses to five, and for each remaining material weakness, remediation plans are either underway or have been completed and await testing for effectiveness.

Focus on our customers and employees: Focusing on reshaping the culture of Fannie Mae to fully reflect the levels of service, engagement, accountability and good management that we believe should characterize a company privileged to serve such an important role in a large and vital market. This, including the ongoing renewal of our people strategy, continues to be a priority of the company.

Current Corporate Priorities

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

Grow Revenue: We are engaged in 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 with the goal of increasing our revenue base.

Reduce Costs: Management is committed to cost competitiveness and productivity, and, to that end, has undertaken a company-wide effort to reduce our projected ongoing daily operations costs in 2007 by $200 million compared to 2006. For the longer-term, management intends to reduce the overall cost basis of the company through focused efforts to streamline operations and increase productivity. Our stated objective is to reduce our ongoing daily operations costs, which excludes costs associated with our efforts to return to current financial reporting and various costs that we do not expect to incur on a regular basis, to approximately $2 billion in 2008.

Exceed Mission: In 2006, we achieved all of our housing goals and subgoals. Our objective is to continue to support the populations targeted by the housing goals by developing products to reach underserved populations and those with unique needs, such as residents of the Gulf Coast. We also intend to provide and expand, as far as possible, liquidity to the overall mortgage market.

Get Current : This key objective refers to our commitment to complete and file our 2006 and 2007 financial statements and remediation of the company s operational and control weaknesses. Becoming a current filer with effective internal controls 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.

Accelerate Culture Change: Strengthening 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, good 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 estimate 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 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 available-for-sale (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 accumulated other comprehensive income (AOCI);

Held-for-sale (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.

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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 Statement of Financial Accounting Standards (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 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, 2006 and 2005.

Table 1: Derivative Assets and Liabilities at Estimated Fair Value

	As of December 31,	
	2006	**2005**
	(Dollars in millions)	
Derivative assets at fair value	$ 4,931	$ 5,803
Derivative liabilities at fair value	(1,184)	(1,429)
Net derivative assets at fair value	$ 3,747	$ 4,374

We present the estimated fair values of our derivatives by the type of derivative instrument in Table 18 of Consolidated Balance Sheet Analysis Derivative Instruments. 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. 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 for the years ended December 31, 2006, 2005 and 2004.

See Risk Management Interest Rate Risk Management and Other Market Risks 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. 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 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 prepayment estimates. 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, 2006 and 2005. 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, 2006 and 2005.

Table 2: Amortization of Cost Basis Adjustments for Investments in Loans and Securities

	For the Year Ended December 31,	
	2006	2005
	(Dollars in millions)	
Unamortized cost basis adjustments	$ (140)	$ 344
Reported net interest income	6,752	11,505
Decrease in net interest income from net amortization	(120)	(97)
Percentage effect on net interest income of change in interest rates:[1]		
100 basis point increase	2.6%	1.6%
50 basis point decrease	(3.1)	(2.2)

(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 inherent in our portfolio of loans classified as held for investment in our mortgage portfolio, loans that back mortgage-related securities we guarantee, and loans that we have guaranteed under long-term standby commitments. 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. 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.

Estimating the allowance for loan losses and the reserve for guaranty losses is complex and requires judgment by management about the effect of matters that are inherently uncertain. We employ a systematic methodology to determine our best estimate of incurred credit losses. 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 Losses 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 the factors described above. Changes in assumptions used in estimating our allowance for loan losses and reserve for guaranty losses could have a material effect on our net income.

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 that these factors have significant interdependencies, we do not believe a sensitivity analysis isolating one factor is meaningful. Therefore, the following example loss event illustrates the impact to the allowance and reserve liability given changes to multiple assumptions used for these factors. For example, the occurrence of a natural disaster, such as a hurricane, may ultimately 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 initial September 30, 2005 estimate of $395 million pre-tax in credit losses to an estimate of $45 million pre-tax in credit losses by the end of 2006.

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 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.

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.

There is a significant amount of judgment required in interpreting the provisions of FIN 46R and applying them to specific transactions. 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 variability 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 home price environments. Material assumptions include our projections of interest rates and home prices, as well as our expectations of prepayment, default and severity rates. The projection of future cash flows is a subjective process involving significant management judgment, primarily due to inherent uncertainties related to the interest rate and home price environment, as well as the actual credit performance of the mortgage loans and securities that are 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.

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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. 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 the guidance for QSPEs, which may affect 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, 2006, 2005 and 2004. Table 3 presents a condensed summary of our consolidated results of operations for these periods.

Table 3: Condensed Consolidated Results of Operations

	For the Year Ended December 31,			Variance			
				2006 vs. 2005		2005 vs. 2004	
	2006	2005	2004	$	%	$	%
	(Dollars in millions, except per share amounts)						
Net interest income	$ 6,752	$ 11,505	$ 18,081	$ (4,753)	(41)%	$ (6,576)	(36)%
Guaranty fee income	4,174	3,925	3,715	249	6	210	6
Losses on certain guaranty contracts	(439)	(146)	(111)	(293)	(201)	(35)	(32)
Fee and other income	859	1,526	404	(667)	(44)	1,122	278
Investment losses, net	(683)	(1,334)	(362)	651	49	(972)	(269)
Derivatives fair value losses, net	(1,522)	(4,196)	(12,256)	2,674	64	8,060	66
Debt extinguishment gains (losses), net	201	(68)	(152)	269	396	84	55
Losses from partnership investments	(865)	(849)	(702)	(16)	(2)	(147)	(21)

Administrative expenses	(3,076)	(2,115)	(1,656)	(961)	(45)	(459)	(28)
Credit-related expenses[1]	(783)	(428)	(363)	(355)	(83)	(65)	(18)
Other non-interest expenses	(405)	(249)	(599)	(156)	(63)	350	58
Income before federal income taxes and extraordinary gains (losses)	4,213	7,571	5,999	(3,358)	(44)	1,572	26
Provision for federal income taxes	(166)	(1,277)	(1,024)	1,111	87	(253)	(25)
Extraordinary gains (losses), net of tax effect	12	53	(8)	(41)	(77)	61	763
Net income	$ 4,059	$ 6,347	$ 4,967	$ (2,288)	(36)%	$ 1,380	28%
Diluted earnings per common share	$ 3.65	$ 6.01	$ 4.94	$ (2.36)	(39)%	$ 1.07	22%

(1) Includes provision for credit losses and foreclosed property expense (income).

Our GAAP net income and diluted earnings per share totaled $4.1 billion and $3.65, respectively, in 2006, compared with $6.3 billion and $6.01 in 2005 and $5.0 billion and $4.94 in 2004. 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. 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 effect of our principal revenue sources and other listed items on our consolidated results of operations for the three-year period ended December 31, 2006 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 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 2006, 2005 and 2004.

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,								
	2006			2005			2004		
	Average Balance[1]	Interest Income/ Expense	Average Rates Earned/ Paid	Average Balance[1]	Interest Income/ Expense	Average Rates Earned/ Paid	Average Balance[1]	Interest Income/ Expense	Averag Rates Earned Paid
	(Dollars in millions)								
erest-earning assets:									
rtgage loans[2]	$ 376,016	$ 20,804	5.53%	$ 384,869	$ 20,688	5.38%	$ 400,603	$ 21,390	5.34
rtgage securities	356,872	19,313	5.41	443,270	22,163	5.00	514,529	25,302	4.92
n-mortgage securities[3]	45,138	2,734	6.06	41,369	1,590	3.84	46,440	1,009	2.17
leral funds sold and urities purchased under eements to resell	13,376	641	4.79	6,415	299	4.66	8,308	84	1.01
vances to lenders	5,365	135	2.52	4,468	104	2.33	4,773	33	0.69
al interest-earning assets	$ 796,767	$ 43,627	5.48%	$ 880,391	$ 44,844	5.09%	$ 974,653	$ 47,818	4.91
erest-bearing liabilities:									
ort-term debt	$ 164,566	$ 7,724	4.69%	$ 246,733	$ 6,535	2.65%	$ 331,971	$ 4,380	1.32
ng-term debt	604,555	29,139	4.82	611,827	26,777	4.38	625,225	25,338	4.05
leral funds purchased securities sold under eements to repurchase	320	12	3.75	1,552	27	1.74	3,037	19	0.63
al interest-bearing bilities	$ 769,441	$ 36,875	4.79%	$ 860,112	$ 33,339	3.88%	$ 960,233	$ 29,737	3.10
pact of net non-interest ring funding	$ 27,326		0.16%	$ 20,279		0.10%	$ 14,420		0.05
interest income/net erest yield[4]		$ 6,752	0.85%		$ 11,505	1.31%		$ 18,081	1.86

(1) Average balances for 2006 were calculated based on the average of the amortized cost amount at the beginning of the year and the amortized cost amount at the end of each respective quarter of the year. Average balances for 2005 and 2004 were calculated based on the average of the amortized cost amount at the beginning of each respective year and the amortized cost amount at the end of each respective year.

(2) Includes nonaccrual loans with an average balance totaling $6.7 billion, $7.4 billion and $7.6 billion for the years ended December 31, 2006, 2005 and 2004, respectively.

(3) Includes cash equivalents.

(4) We calculate our net interest yield by dividing our net interest income for the period by the average balance of our total interest-earning assets during the period.

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Table 5 presents the change, or variance, in our net interest income between 2006 and 2005 and between 2005 and 2004 that is attributable to changes in the volume of our interest-earning assets and interest-bearing liabilities and changes in interest rates.

Table 5: Rate/Volume Analysis of Net Interest Income

	2006 vs. 2005			2005 vs. 2004		
	Total Variance	Variance Due to:[1] Volume	Rate	Total Variance	Variance Due to:[1] Volume	Rate
	(Dollars in millions)					
Interest income:						
Mortgage loans	$ 116	$ (482)	$ 598	$ (702)	$ (845)	$ 143
Mortgage securities	(2,850)	(4,570)	1,720	(3,139)	(3,557)	418
Non-mortgage securities	1,144	156	988	581	(121)	702
Federal funds sold and securities purchased under agreements to resell	342	333	9	215	(23)	238
Advances to lenders	31	22	9	71	(2)	73
Total interest income	(1,217)	(4,541)	3,324	(2,974)	(4,548)	1,574
Interest expense:						
Short-term debt	1,189	(2,683)	3,872	2,155	(1,355)	3,510
Long-term debt	2,362	(322)	2,684	1,439	(552)	1,991
Federal funds purchased and securities sold under agreements to repurchase	(15)	(32)	17	8	(13)	21
Total interest expense	3,536	(3,037)	6,573	3,602	(1,920)	5,522
Net interest income	$ (4,753)	$ (1,504)	$ (3,249)	$ (6,576)	$ (2,628)	$ (3,948)

(1) Combined rate/volume variances are allocated to both rate and volume based on the relative size of each variance.

Net interest income of $6.8 billion for 2006 decreased 41% from $11.5 billion in 2005, driven by a 9% decrease in our average interest-earning assets and a 35% (46 basis points) decline in our net interest yield to 0.85%. The decrease in our average interest-earning assets was due to a lower level of mortgage asset purchases relative to the level of sales and liquidations during 2006. Sales, liquidations, and reduced purchases had the net effect of reducing our average interest-earning assets and resulted in a decrease of 1% in the balance of our net mortgage portfolio to $726.1 billion as of December 31, 2006. Lower portfolio balances have the effect of reducing the net interest income generated by our portfolio. We continued to experience compression in our net interest margin as the cost of our debt increased due to the interest rate environment. As the Federal Reserve raised the short-term Federal Funds target rate by 100 basis points to 5.25%, the highest level since 2001, the yield curve remained flat-to-inverted throughout 2006 and the cost of our short-term debt rose significantly. The overall increase in the average cost of our debt of 91 basis points more than offset a 39 basis point increase in the average yield on our interest-earning assets in 2006.

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. Sales, liquidations, and reduced purchases had the net effect of reducing our average interest-earning assets and resulted in a decrease of 20% in the balance of our net mortgage portfolio to $736.5 billion as of December 31, 2005. While our overall debt funding needs declined in 2005, our net interest yield was compressed because of a 78 basis point increase in our average debt funding costs in 2005 that primarily resulted from increases of short-term interest rates by the Federal Reserve of 200 basis points from year end 2004 to year end 2005 and a significant flattening of the yield curve. The increased cost of our debt more than offset an 18 basis point increase in the average yield on our interest-earning assets in 2005.

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Based on the decrease in the volume of our interest-earning assets and the decline in the spread between the average yield on those assets and our borrowing costs that we began to experience at the end of 2004 and that continued throughout 2006, we expect a continued downward trend in our net interest income and net interest yield in 2007, at a rate somewhat below the rate of decline in 2006.

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 our other guaranties and the compensation we receive for providing our guaranty on Fannie Mae MBS and for providing other guaranties. 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 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.

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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. Losses on certain guaranty contracts are excluded from the average effective guaranty fee rate. Table 6 shows our guaranty fee income, including and excluding buy-up impairment, our average effective guaranty fee rate, and Fannie Mae MBS activity for 2006, 2005 and 2004.

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

	For the Year Ended December 31,						% Change	
	2006		2005		2004		2006 vs. 2005	2005 vs. 2004
	Amount	Rate[1]	Amount	Rate[1]	Amount	Rate[1]		
	(Dollars in millions)							
Guaranty fee income/average effective guaranty fee rate, excluding buy-up impairment	$ 4,212	22.0bp	$ 3,974	22.1bp	$ 3,751	21.6bp	6%	6%
Buy-up impairment	(38)	(0.2)	(49)	(0.3)	(36)	(0.2)	(22)	36
Guaranty fee income/average effective guaranty fee rate[2]	$ 4,174	21.8bp	$ 3,925	21.8bp	$ 3,715	21.4bp	6%	6%
Average outstanding Fannie Mae MBS and other guaranties[3]	$ 1,915,457		$ 1,797,547		$ 1,733,060		7%	4%
Fannie Mae MBS issues[4]	481,704		510,138		552,482		(6)	(8)

(1) Presented in basis points and calculated based on guaranty fee income components divided by average outstanding Fannie Mae MBS and other guaranties for each respective year.

(2) Includes the effect of the reclassification from Guaranty fee income to Losses on certain guaranty contracts of $146 million and $111 million for 2005 and 2004, respectively.

(3) Other guaranties include $19.7 billion, $19.2 billion and $14.7 billion as of December 31, 2006, 2005 and 2004, respectively, related to long-term standby commitments we have issued and credit enhancements we have provided.

(4) Reflects unpaid principal balance of MBS issued and guaranteed by us, including mortgage loans held in our portfolio that we securitized during the period and MBS issued during the period that we acquired for our portfolio.

The 6% increase in guaranty fee income in 2006 from 2005 was driven by a 7% increase in average outstanding Fannie Mae MBS and other guaranties, due principally to slower liquidations than experienced in prior periods. The 6% increase in guaranty fee income in 2005 from 2004 was largely due to a 4% increase in average outstanding Fannie Mae MBS and other guaranties. Our average effective guaranty fee rate, which includes the effect of buy-up impairment and excludes losses on certain guaranty contracts, remained steady during the three-year period at 21.8 basis points for 2006 and 2005 and 21.4 basis points for 2004.

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. Our MBS issuances decreased in 2006; however, our outstanding Fannie Mae MBS grew because of the reduced level of liquidations in 2006. The decline in MBS issuances in 2006 continues the trend observed in 2005 and 2004. Originations of traditional mortgages, such as conventional fixed-rate loans, which historically have represented the majority of our business volume, began to decline during 2004. Originations of lower credit quality loans, loans with reduced documentation and loans to fund investor properties increased, resulting in a shift in the product mix in the primary mortgage market. Competition from private-label issuers, which have been a significant source of funding for these mortgage products, reduced our market share and level of MBS issuances. In 2006, 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, a trend that has continued in 2007.

Our average effective guaranty fee rate, excluding the effect of buy-up impairments and losses on certain guaranty contracts, was 22.0 basis points in 2006, 22.1 basis points in 2005 and 21.6 basis points in 2004. The decrease in 2006 was primarily due to slower prepayments. As prepayment speeds decrease, we recognize deferred guaranty income at a slower rate.

Losses on Certain Guaranty Contracts

While our guaranty fees are subject to competitive pressure and we may enter into transactions with lower expected economic returns than our typical transactions to achieve our housing goals or to maintain our market share, we expect the vast majority of our MBS guaranty transactions to generate positive economic returns over the lives of the related MBS. We negotiate guaranty contracts with our customers based upon our view of the overall economics of the transaction; however, the accounting for our guaranty-related assets and liabilities is not determined at the contract level. Instead, it is determined separately for each individual MBS issuance. We recognize an immediate loss in earnings on new credit guaranteed Fannie Mae MBS issuances where our modeled expectation of returns is below what we believe a market participant would require for that credit risk inclusive of a reasonable profit margin. Although we determine losses at an individual MBS issuance level, we largely price our credit guaranty business on an overall contract basis and establish a single guaranty fee for all the loans included in the contract. Accordingly, a guaranty transaction may result in some loan pools for which we recognize a loss immediately in earnings and other loan pools for which we record deferred profits that are recognized as a component of guaranty fee income over the life of the loans underlying the MBS issuance. We expect that we will subsequently recover the losses recognized at inception on certain guaranty contracts in our consolidated statements of income over time in proportion to our receipt of contractual guaranty fees on those guaranties.

The losses on guaranty transactions that we were required to recognize immediately in earnings totaled $439 million, $146 million and $111 million in 2006, 2005 and 2004, respectively. The increase in these losses in 2006 was driven primarily by the slowdown in home price appreciation in 2006, which resulted in an increase in our modeled expectation of credit risk and higher initial losses on some of our guaranty pools. In addition, our expanded efforts to increase the amount of mortgage financing that we make available to target populations and geographic areas to support our housing goals contributed to the increase in losses during 2006. Because of the likelihood that home prices will continue to decline in 2007, as well as our continued investment in loans that support our housing goals, we expect these losses to more than double in 2007 from 2006.

Fee and Other Income

Fee and other income includes transaction fees, technology fees, multifamily fees and foreign currency exchange gains and losses. Transaction, technology and multifamily 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. Table 7 displays the components of fee and other income.

Table 7: Fee and Other Income

	For the Year Ended December 31,		
	2006	2005	2004
	(Dollars in millions)		
Transaction fees	$ 124	$ 136	$ 152
Technology fees	216	223	214
Multifamily fees	292	432	244
Foreign currency exchange gains (losses)	(230)	625	(304)
Other	457	110	98
Fee and other income	$ 859	$ 1,526	$ 404

The $667 million decrease in fee and other income in 2006 from 2005 was primarily due to a foreign currency exchange loss of $230 million in 2006, compared with a foreign currency exchange gain of $625 million in 2005. The $625 million foreign currency gain recorded in 2005 stemmed from a strengthening of the U.S. dollar relative to the Japanese yen. In addition, we experienced a $140 million decrease in multifamily fees due to a reduction in refinancing volumes, which were significantly higher in 2005 than in 2006 or 2004. These decreases were partially offset by a $347 million increase in other fee income, of which $191 million was due to the recognition of defeasance fees on consolidated multifamily loans and $111 million was due to the reclassification of float income. Float income is income that we earn on cash we hold during the period between when payments are received by us on Fannie Mae MBS and when we remit these payments to certificateholders. We previously recorded float income as a component of interest income. In November 2006, we made operational changes to segregate these funds from our corporate funds, and we began recording float income as a component of Fee and other income, instead of as a component of Interest income.

The $1.1 billion increase in fee and other income in 2005 over 2004 was primarily due to the foreign currency exchange gain of $625 million recorded in 2005, compared with a foreign currency exchange loss of $304 million recorded in 2004. In addition, we experienced a $188 million increase in multifamily fees due to a significant increase in refinancing volumes during 2005.

Our foreign currency exchange gains (losses) are offset by corresponding net losses (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 seek to eliminate our exposure to fluctuations in foreign exchange rates by entering into foreign currency swaps that effectively convert debt denominated in a foreign currency to debt denominated in U.S. dollars.

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. We recorded investment losses of $683 million, $1.3 billion and $362 million in 2006, 2005 and 2004, respectively. Table 8 details the components of investment gains and losses for each year.

Table 8: Investment Losses, Net

	For the Year Ended December 31,		
	2006	2005	2004
	(Dollars in millions)		
Other-than-temporary impairment on AFS securities[1]	$ (853)	$ (1,246)	$ (389)
Lower-of-cost-or-market adjustments on HFS loans	(47)	(114)	(110)
Gains (losses) on Fannie Mae portfolio securitizations, net	152	259	(34)
Gains on sale of investment securities, net	106	225	185
Unrealized gains (losses) on trading securities, net	8	(415)	24
Other investment losses, net	(49)	(43)	(38)
Investment losses, net	$ (683)	$ (1,334)	$ (362)

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

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. We generally view changes in the fair value of our AFS securities caused by movements in interest rates to be temporary. 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 the 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 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 its carrying value.

The $651 million decrease in investment losses, net in 2006 from 2005 was attributable to the following:

A decrease of $393 million in other-than-temporary impairment on AFS securities. We recognized other-than-temporary impairment of $853 million in 2006, compared with $1.2 billion in 2005. The other-than-temporary impairment of $853 million in 2006 resulted from continued interest rate increases in the first half of 2006, which caused the fair value of certain securities to decline below carrying value. Because we previously recognized significant other-than-temporary amounts on certain securities in 2005 that reduced the carrying value of these securities, the amount of other-than-temporary impairment recognized in 2006 declined relative to 2005.

A $423 million shift in unrealized amounts recognized on trading securities. We recorded unrealized gains of $8 million in 2006, compared with unrealized losses of $415 million in 2005. The unrealized gain in 2006 reflects an increase in the fair value of trading securities due to a decrease in implied volatility during the year. The vast majority of these unrealized gains, however, were offset by unrealized losses that resulted from the general increase in interest rates during the year. In 2005, we recorded an unrealized loss mainly due to fair value losses resulting from the increase in interest rates and the widening of option adjusted spreads.

The $1.0 billion increase in investment losses, net in 2005 from 2004 was attributable to the combined effect of the following:

An increase of $857 million in other-than-temporary impairment on AFS securities. We recognized other-than-temporary impairment of $1.2 billion in 2005 versus $389 million in 2004. The rising interest rate environment in 2005 caused an overall decline in the fair value of our mortgage-related securities below the carrying value. The increase in impairment was primarily due to the write down in 2005 of certain mortgage-related securities to fair value because we sold these securities before the interest rate impairments recovered.

An increase of $439 million in unrealized losses on trading securities. We recorded net unrealized losses on trading securities of $415 million in 2005, compared with net unrealized gains of $24 million in 2004. 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 during the year.

A net gain of $259 million in 2005 on Fannie Mae portfolio securitizations, compared with a net loss of $34 million in 2004. We experienced a significant increase in portfolio securitizations in 2005 relative to 2004. Cash proceeds from portfolio securitizations totaled $55.0 billion in 2005, compared with $12.3 billion in 2004.

On August 15, 2007, the Audit Committee of our Board of Directors reviewed and discussed, with our independent registered public accounting firm, 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 2006 Form 10-K for the year ended December 31, 2006. The Audit Committee affirmed that material impairments had occurred.

During the first six months of 2007, we increased our portfolio of trading securities to approximately $50 billion and have recorded losses on these securities. Changes in the fair value of our trading securities generally move inversely to changes in the fair value of our derivatives. Through the first half of the year, gains in the fair value of our derivatives more than offset the losses on our trading securities. In light of the market conditions as of the date of this filing and uncertainty about how long the markets will remain volatile, we may experience an increased level of volatility in the fair value of our trading securities for the remainder

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of 2007. Because the fair value of our trading securities is affected by market fluctuations that cannot be predicted, we cannot estimate the impact of changes in the fair value of our trading securities for the full year.

Derivatives Fair Value Losses, Net

Table 9 presents, by type of derivative instrument, the fair value gains and losses, net on our derivatives. Table 9 also includes an analysis of the components of derivatives fair value gains and losses attributable to net contractual interest expense accruals on our interest rate swaps, terminated derivative contracts and outstanding derivative contracts. The five-year interest rate swap rate is a key reference interest rate affecting the estimated fair value of our derivatives. We present this rate as of the end of each quarter of 2006, 2005 and 2004 in the table below.

Table 9: Derivatives Fair Value Gains (Losses), Net

	For the Year Ended December 31,		
	2006	2005	2004
	(Dollars in millions)		
Risk management derivatives:			
Swaps:			
Pay-fixed	$ 2,181	$ 549	$ (10,640)
Receive-fixed	(390)	(1,118)	3,917
Basis swaps	26	(2)	51
Foreign currency swaps[(1)]	105	(673)	379
Swaptions:			
Pay-fixed	(1,148)	(1,393)	(3,841)
Receive-fixed	(2,480)	(2,071)	(1,913)
Interest rate caps	100	283	(140)
Other[(2)]	6	8	(22)
Risk management derivatives fair value losses, net	(1,600)	(4,417)	(12,209)
Mortgage commitment derivatives fair value gains (losses), net[(3)]	78	221	(47)
Total derivatives fair value losses, net	$ (1,522)	$ (4,196)	$ (12,256)
Risk management derivatives fair value gains (losses) attributable to:			
Net contractual interest expense accruals on interest rate swaps	$ (111)	$ (1,325)	$ (4,981)
Net change in fair value of terminated derivative contracts from end of prior year to date of termination	(176)	(1,434)	(4,096)
Net change in fair value of outstanding derivative contracts, including derivative contracts entered into during the period	(1,313)	(1,658)	(3,132)
Risk management derivatives fair value losses, net[(4)]	$ (1,600)	$ (4,417)	$ (12,209)

	2006	2005	2004
5-year swap rate:			

Quarter ended March 31	5.31%	4.63%	3.17%
Quarter ended June 30	5.65	4.15	4.30
Quarter ended September 30	5.08	4.66	3.81
Quarter ended December 31	5.10	4.88	4.02

(1) Includes the effect of net contractual interest expense of approximately $71 million for 2006. The change in fair value of foreign currency swaps excluding this item resulted in a net gain of $176 million.

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

(3) 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 income of approximately $14 million in 2006 and expense of $870 million and $541 million in 2005 and 2004, respectively. These amounts are reflected in our consolidated statements of income as a component of either Net interest income or Investment losses, net.

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

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. Conversely, we expect the aggregate fair value to increase when interest rates rise. In addition, even when there is no change in interest rates or implied volatility, we generally would expect to record aggregate net fair value losses on our derivatives because we have a significant amount of purchased options where the time value of the upfront premium we pay for these options decreases due to the passage of time relative to the expiration date of these options.

As shown in Table 9 above, we recorded net contractual interest expense accruals on interest rate swaps totaling $111 million, $1.3 billion and $5.0 billion in 2006, 2005 and 2004, respectively. These amounts, which we consider to be part of the cost of funding our mortgage investments, are included in the derivatives fair value losses recognized in the consolidated statements of income. If we had 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, resulting in a reduction in our net interest income and net interest yield, instead of as a component of our derivatives fair value losses.

Interest rates have generally trended up since the end of 2004 and remained at overall higher levels through July 2007. The $2.7 billion and $8.1 billion decrease in derivative losses in 2006 and 2005, respectively, was largely attributable to the upward trend in interest rates. As a result, the aggregate fair value of our interest rate swaps increased and we experienced a significant reduction in the net contractual interest expense recognized on our interest rate swaps. This increase in fair value was partially offset by decreases in the fair value of our option-based derivatives during each year due to the combined effect of time decay of these options and decreases in implied volatility in each of these years. While we recorded fair value gains on our derivatives for the first six months of 2007, the financial markets have exhibited extraordinary volatility since mid-July 2007. In light of the market conditions as of the date of this filing and uncertainty about how long the markets will remain volatile, we may experience an increased level of volatility in the fair value of our derivatives for the remainder of 2007. Because the fair value of our derivatives is affected by market fluctuations that cannot be predicted, we cannot estimate the impact of changes in the fair value of our derivatives for the full year.

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. The derivatives fair value gains and losses recognized in our consolidated statements of income should be examined in the context of our overall interest rate risk management objectives and strategy, including the economic objective of 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. We provide additional information on our use of derivatives to manage interest rate risk and the effect on our consolidated financial statements in MD&A Consolidated Balance Sheet Analysis Derivative Instruments and MD&A Risk Management Interest Rate Risk Management and Other Market Risks.

Debt Extinguishment Gains (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. The gain or loss we recognize when we call or repurchase debt is based on the difference between the call price or fair value of the debt and the carrying value. 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 net gain of $201 million in 2006 from the repurchase of $15.5 billion and the call of $24.1 billion of outstanding debt. These gains resulted from our decision to take advantage of favorable funding spreads during 2006 relative to LIBOR to issue new debt and to repurchase outstanding debt trading at attractive prices. In comparison, we recognized a loss of $68 million in 2005 from the repurchase of $22.9 billion and the call of $28.0 billion of outstanding debt and a loss of $152 million in 2004 from the repurchase of $4.3 billion and the call of $155.6 billion of outstanding debt.

Losses from Partnership Investments

Our partnership investments totaled approximately $10.6 billion and $9.3 billion as of December 31, 2006 and 2005, respectively. In some cases, we consolidate these entities in 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 Losses from partnership investments. Investments we accounted for under the equity method totaled $4.9 billion and $4.5 billion as of December 31, 2006 and 2005, respectively. We provide additional information about these investments and applicable accounting in Off-Balance Sheet Arrangements and Variable Interest Entities LIHTC Partnership Interests.

Losses from partnership investments, net totaled $865 million, $849 million and $702 million in 2006, 2005 and 2004, respectively. These increased losses were primarily the result of continuing increases in the amount we invest in LIHTC partnerships. We consider these investments to be a significant channel for advancing our affordable housing mission. Accordingly, we expect to continue to invest in LIHTC partnerships, and we anticipate that these new investments will generate additional net operating losses and tax credits in the future. However, we recently sold two portfolios of LIHTC investments and expect that 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. In March 2007, we sold a portfolio of investments in LIHTC partnerships totaling approximately $676 million in potential future tax credits. In July 2007, we sold a second portfolio of investments in LIHTC partnerships totaling approximately $254 million in potential future tax credits. Together, these equity interests represented approximately 11% of our overall LIHTC portfolio. For more information on tax credits associated with our LIHTC investments, refer to Provision for Federal Income Taxes below.

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Administrative Expenses

Administrative expenses include costs incurred to run our daily operations, such as salaries and employee benefits, professional services, occupancy costs and technology expenses. Administrative expenses also include costs associated with our efforts to return to timely financial reporting and restructuring costs. Expenses included in our efforts to return to timely financial reporting include costs of restatement and related regulatory examinations, investigations and litigation and also include remediation costs. The table below details the components of these costs.

Table 10: Administrative Expenses

	For the Year Ended December 31,			% Change	
	2006	2005	2004	2006 vs. 2005	2005 vs. 2004
	(Dollars in millions)				
Ongoing daily operations costs	$ 2,013	$ 1,546	$ 1,656	30%	(7)%
Restatement and related regulatory expenses[1]	1,063	569	[2]	87	
Total administrative expenses	$ 3,076	$ 2,115	$ 1,656	45%	28%

(1) Includes costs of restatement and related regulatory examinations, investigations and litigation. Also includes remediation costs.

(2) Excludes the $400 million civil penalty that we paid to the U.S. Treasury in 2006 pursuant to our settlements with OFHEO and the SEC that we recognized in our consolidated income statement in 2004 as a component of Other expenses. However, we include this amount in the line item Restatement and related regulatory expenses for business segment reporting purposes.

The increases in administrative expenses in 2006 and in 2005 were primarily due to costs associated with our efforts to return to timely financial reporting. In addition, we experienced an increase in our ongoing daily operations costs during 2006 due to an increase in our hiring efforts and staffing levels, as we redesigned our organizational structure to enhance our risk governance framework and strengthen our internal controls. We anticipate that the costs associated with the preparation of our audited 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.

Beginning in January 2007, we undertook a thorough review of our costs as part of a broad reengineering initiative to increase productivity and lower administrative costs. We have previously disclosed that, while continuing to focus on core competencies and controls, we expect to reduce our administrative expenses by $200 million in 2007 compared with 2006, primarily through a reduction in employee and contract resources. In June 2007, we introduced a voluntary early retirement program that allowed eligible employees to elect to retire early and receive a severance package that included retirement benefits. We estimate that the costs of this early retirement program and various involuntary severance initiatives we have implemented or expect to implement during 2007 will total approximately $100 million in 2007. We continue to believe that we will be successful in reducing our total administrative expenses for 2007 by

$200 million compared with 2006.

As we have previously disclosed, we expect the level of our ongoing daily operations costs to exceed the level of these expenses for 2006 and prior years because of the significant investment we have made to remediate material weaknesses in our internal controls by enhancing our organizational structure and systems. We expect, however, that our 2007 productivity and cost reduction reengineering initiative will reduce our ongoing daily operations costs to approximately $2 billion in 2008. Our ongoing daily operations costs, or run rate, excludes costs associated with our efforts to return to current financial reporting and also excludes various costs, such as restructuring and litigation costs that we do not expect to incur on a regular basis. We, therefore, do not consider these expenses to be part of our run rate.

Administrative expenses totaled an estimated $659 million and $1.4 billion for the quarter and six months ended June 30, 2007, respectively, compared with $780 million and $1.5 billion for the quarter and six months ended June 30, 2006, respectively. Of these amounts, restatement and related regulatory expenses and restructuring costs totaled an estimated $152 million and $323 million for the quarter and six months ended

June 30, 2007, respectively, compared with $286 million and $573 million for the quarter and six months ended June 30, 2006, respectively.

Credit-Related Expenses

Credit-related expenses include the provision for credit losses and foreclosed property expense (income). Our credit-related expenses increased to $783 million in 2006, from $428 million in 2005 and $363 million in 2004. Following is a discussion of how changes in the provision for credit losses and foreclosed property expense (income) affected our credit-related expenses in each year.

Provision for Credit Losses

The level of the provision for loan losses in each period reflects our assessment of the combined allowance for loan losses and reserve for guaranty losses, taking into consideration factors such as loan product mix, current levels of non-performing loans, historical loss severity and default rate trends, and economic conditions as of the balance sheet date.

The provision for credit losses totaled $589 million in 2006, an increase of $148 million, or 34%, over 2005. This increase reflects the impact of a trend of higher charge-offs that began in the second half of 2006. We began to experience higher default rates and loan loss severities in 2006 due to the significant slowdown in home price appreciation and continued economic weakness in the Midwest.

The provision for credit losses totaled $441 million in 2005, an increase of $89 million, or 25%, from the provision in 2004. This increase primarily related to our recording a provision for credit losses of $106 million in 2005 for single-family and multifamily properties affected by Hurricane Katrina. In addition, we increased our provision for credit losses in 2005 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, increases our provision for credit losses because it is recorded as a charge to Reserve for guarantee losses in the consolidated balance sheet.

Based on the likelihood that home prices will continue to decline during 2007, we expect the level of foreclosures and the related expense to increase for 2007. As a result, we expect a significant increase in credit-related expenses and credit losses in 2007. 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 Accounting Policies and Estimates Allowance for Loan Losses and Reserve for Guaranty Losses.

Foreclosed Property Expense (Income)

Foreclosed property expense (income) is affected by the level of foreclosures and the effectiveness of our property management and sales operations, which employ strategies designed to shorten our holding time, maximize our recovery and mitigate credit losses. Home price appreciation trends and the level of credit enhancement on loans also have an impact on foreclosed property expense (income).

We recorded foreclosed property expense of $194 million in 2006, income of $13 million in 2005 and expense of $11 million in 2004. The accelerated rate of home price appreciation during 2005 and 2004 helped to mitigate our foreclosure losses and resulted in gains on the sale of certain REO properties. As the housing market began to soften in 2006 and the rate of home price appreciation slowed, we experienced an increase in the level of foreclosures, as well as losses on foreclosed properties, particularly in the Midwest, which accounted for a majority of the increase in foreclosed property expense in 2006. Based on the likelihood that home prices will continue to decline in 2007, we expect the level of foreclosures and the related expense to increase in 2007. As a result, we expect a significant increase in the amount of our credit losses in 2007.

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Other Non-Interest Expenses

Other Expenses

Other expenses include credit enhancement expenses that relate to the amortization of the credit enhancement asset we record at inception of certain guaranty contracts, costs associated with the purchase of additional mortgage insurance to protect against credit losses, regulatory penalties and other miscellaneous expenses. Other expenses totaled $395 million, $251 million and $607 million in 2006, 2005 and 2004, respectively.

The $144 million increase in other expenses in 2006 over 2005 was attributable to higher credit enhancement expense, due in part to our acquisition of insurance coverage related to our increased purchase of nontraditional mortgage products that we believe may present higher credit risk, such as Alt-A and subprime loans. In addition, we dissolved an MBS trust in 2006 for which we had a remaining unamortized credit enhancement asset as of the date of dissolution of $126 million. We were required to recognize this unamortized amount as credit enhancement expense in 2006. The $356 million decrease in other expenses in 2005 from 2004 was attributable to the $400 million civil penalty that we accrued in 2004 and paid to the U.S. Treasury in 2006 pursuant to our settlements with OFHEO and the SEC.

Provision for Federal Income Taxes

Our effective income tax rate, excluding the provision or benefit for taxes related to extraordinary amounts, was reduced below the 35% statutory rate to 4%, 17% and 17% in 2006, 2005 and 2004, 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 to support our affordable housing mission. As disclosed in Notes to Consolidated Financial Statements Note 11, Income Taxes, our effective tax rate would have been 29%, 30% and 32% in 2006, 2005 and 2004, respectively, if we had 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.

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. We were not able to use all the tax credits we received for 2006 and 2005 in the year the credits were generated 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 the 2005 unused credits to reduce our income tax liability for 2004 and expect to use the remainder for 2006. We expect to use the remaining credits generated in 2006 in future years, to the extent permissible. Because we plan to continue investing in LIHTC partnerships, we expect tax credits related to these investments to grow in the future, which is likely to significantly reduce our effective tax rate below the 35% statutory rate assuming we are able to use all of the tax credits generated. If we are limited in our use of the tax credits related to these investments and we conclude that the economic return from selling the investment is likely to be greater than the benefit we would receive from continuing to hold these investments, we may also sell certain LIHTC investments, as we did in 2007.

We recorded a net deferred tax asset of $8.5 billion and $7.7 billion as of December 31, 2006 and 2005, respectively, arising principally from differences in the timing of the recognition of derivatives fair value gains and losses for financial statement and income tax purposes. 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 allow us to realize the entire tax benefit.

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BUSINESS SEGMENT RESULTS

The table below displays net revenues, net income and total assets for each of our business segments for each of the three years in the period ended December 31, 2006. We use various methodologies to allocate certain balance sheet and income statement amounts between operating segments. For additional financial information on the underlying management allocation methodologies and adjustments to prior period segment results, see Notes to Consolidated Financial Statements Note 15, Segment Reporting. Following is an analysis and discussion of the performance of our business segments. We provide a more complete description of our business segments in Item 1 Business Business Segments.

Table 11: Business Segment Summary Financial Information

	For the Year Ended December 31,		
	2006	2005	2004
	(Dollars in millions)		
Net revenues:[1]			
Single-Family Credit Guaranty	$ 6,073	$ 5,585	$ 5,007
Housing and Community Development	510	607	527
Capital Markets	5,202	10,764	16,666
Total	$ 11,785	$ 16,956	$ 22,200
Net income:			
Single-Family Credit Guaranty	$ 2,044	$ 2,623	$ 2,396
Housing and Community Development	338	503	425
Capital Markets	1,677	3,221	2,146
Total	$ 4,059	$ 6,347	$ 4,967

	As of December 31,	
	2006	2005
Total assets:		
Single-Family Credit Guaranty	$ 15,777	$ 14,450
Housing and Community Development	14,100	12,075
Capital Markets	814,059	807,643
Total	$ 843,936	$ 834,168

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

Single-Family Business

Our Single-Family business generated net income of $2.0 billion, $2.6 billion and $2.4 billion in 2006, 2005 and 2004, respectively. The primary source of net revenues 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 decreased by $579 million, or 22%, in 2006 from 2005 reflecting a $488 million increase in net revenue during the period that was more than offset by a $308 million increase in losses on certain guaranty contracts, a $553 million increase in administrative expenses, a $123 million increase in the provision for credit losses, and an increase of $218 million of foreclosed property expense.

Net revenues increased in 2006 by 9% to $6.1 billion from $5.6 billion in 2005 primarily reflecting a $288 million, or 6%, increase in guaranty fee income and a $62 million increase in float income during the period. Guaranty fee income increased $288 million, or 6%, from $4.5 billion to $4.8 billion due to a 4%

growth in the average single-family mortgage credit book of business, and an increase in the average effective guaranty fee rate on the book. The average effective guaranty fee rate is calculated as guaranty fee income as a percentage of the average single-family mortgage credit book of business and excludes losses on certain guaranty contracts. Float income, the interest income that we earn on cash flows from the date of the remittance by servicers to us until the date of distribution by us to MBS certificate holders, increased by $62 million, or 12%, in 2006 from 2005 due to an increase in short-term interest rates during the year.

In 2006, losses on certain guaranty contracts increased by $308 million as compared to 2005. This loss is determined and recorded at an individual MBS issuance level and our credit guaranty business is largely priced on an overall contract basis where a single guaranty fee is established for all loans in a deal. The loans in that deal may be included in a single MBS issuance or in multiple MBS issuances. These losses are recorded on new credit guaranteed MBS issuances where our modeled expectation of returns is below what we believe a market participant would require for such credit risk inclusive of a reasonable profit margin. The increase in 2006 is attributable, in part, to our efforts to increase the amount of mortgage financing that we make available to target populations and geographic areas in support of housing goals. As home price appreciation slows, our modeled expectation of credit risk in such loans increases, resulting in higher losses.

Expenses increased by 76% in 2006 from 2005 due to an increase in the segment allocation of indirect corporate expenses during the period mostly driven by an increase in costs associated with our restatement and related matters, as well as an increase of $218 million of foreclosed property expense.

The provision for credit losses of $577 million in 2006, an increase of $123 million from 2005, was primarily attributable to a $221 million addition to the allowance for credit losses in the fourth quarter reflecting continued credit weakness in the Midwest region and a decline in home prices in some regions in the second half of the year which has an impact on the number of loans that will default and the amount of the charge off in the event of a default. The prior year provision for credit losses included the impact of Hurricane Katrina. While the credit environment was strong in the first half of 2006, the fundamentals that drive low credit losses, such as defaults and loss severity, began to weaken in the latter half of the year. This was evidenced by the steady growth in acquired properties and higher foreclosed property expense due to declining property values. Additionally, we recorded $201 million of foreclosed property expense in 2006, compared to gains of $17 million in 2005, due to the weakening home prices, particularly concentrated in the Midwest. We expect weakening home prices to continue to result in significantly higher credit losses in 2007.

Net income for the Single-Family business segment increased by $227 million or 9% in 2005 from 2004, primarily due to a $578 million increase in net revenues during the period that was offset by a $129 million increase in administrative expenses and $142 million increase in the provision for credit losses. Net revenues increased in 2005 by 12% to $5.6 billion as a result of higher guaranty fee income and float income. 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. Float income increased by $282 million in 2005 due to an increase in short-term interest rates during the year. Expenses increased by 13% in 2005 due to the increase in administrative expenses resulting from 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.

During the period 2004 to 2006, 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, affordability issues, combined with a variety of new mortgage products being introduced and accepted by investors, encouraged consumers to take advantage of adjustable-rate mortgages, including nontraditional 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 slowed in 2007.

Single-family mortgage originations in the primary mortgage market totaled $2.8 trillion, $3.0 trillion and $2.8 trillion in 2006, 2005 and 2004, respectively. The $3.0 trillion in originations in 2005 represented the second strongest year in history. 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, ceding market share of new single-family mortgage-related securities issuances to private-label issuers. While we maintained the same strategic approach in 2006, our market share did not decline significantly in 2006. Our estimated overall market share of new single-family mortgage-related securities issuance for 2006 was approximately 23.7% in 2006, compared with 23.5% in 2005 and 29.2% in 2004. We estimate that our market share will increase slightly in 2007 as the marketplace shifts towards more fixed-rate mortgage products. Our total single-family Fannie Mae MBS outstanding increased to $2.1 trillion as of June 30, 2007, from $1.9 trillion as of June 30, 2006. The market share estimates are based on publicly available data and exclude previously securitized mortgages.

Our conventional single-family mortgage credit book of business remained relatively strong from 2004 to 2006. 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 as evidenced by our credit losses, which remained low during the three-year period from 2004 to 2006.

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 nontraditional markets by providing more flexible mortgage options, including Alt-A and subprime products, which have represented an increased proportion of mortgage originations in recent years. We have increased our participation in these types of products where we have concluded that it would be economically advantageous and/or that it would contribute to our mission objectives. Our participation in these products reflects our assessment of anticipated guaranty fee income in light of our expectation for potentially higher credit losses. We continue to closely monitor credit risk and pricing dynamics across the full spectrum of mortgage product types. Our assessment of these dynamics will continue to determine the timing and level of our acquisitions of these types of mortgage products.

HCD Business

Our HCD business generated net income of $338 million, $503 million and $425 million in 2006, 2005 and 2004, respectively. The primary sources of net revenues for our HCD business are guaranty fee income and fee and other income. Expenses primarily include administrative expenses, credit-related expenses and our share of net operating losses associated with LIHTC investments that are offset by the related tax benefits from these investments.

Net income for the HCD business segment decreased by $165 million, or 33%, in 2006 from 2005 resulting from an increase in administrative expenses and credit enhancement expense and a decline in net revenues, which were partially offset by investment tax credits as HCD increased its investment activity. LIHTC investments, which comprise the largest proportion of investment activity for this segment, increased to $8.8 billion in 2006, compared to $7.7 billion in 2005, and generated tax benefits that were the primary driver in reducing our 2006 effective corporate tax rate to approximately 4%. Losses from partnership investments were $865 million in 2006, a slight increase as compared to 2005. Guaranty fee income remained essentially unchanged in 2006 from 2005. Expenses increased 46% in 2006 from 2005 primarily due to an increase in the segment allocation of indirect corporate expenses during the period mostly driven by an increase in costs associated with our restatement and related matters, and higher credit enhancement expenses associated with a large multifamily transaction that liquidated in 2006.

Net income for the HCD business segment increased by $78 million, or 18%, in 2005 from 2004 as a result of increased tax benefits from tax-advantaged investments and higher fee and other income, which were partially offset by an increase in administrative expenses. LIHTC investments totaled $7.7 billion in 2005 compared to $6.8 billion in 2004. Losses from partnership investments increased by $147 million as HCD increased its investment activity but were more than offset by increased LIHTC tax benefits. Guaranty fee income was up due to the 5% increase in the average multifamily mortgage credit book of business in 2005. Fee and other income was up $143 million in 2005 to

$347 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 an increase in the segment s allocation of a portion of the costs associated with our restatement and related matters.

We expect to maintain our LIHTC partnership investments strategy in the future, which is likely to continue to result in an effective tax rate significantly below the statutory rate of 35%. We view these investments as a significant vehicle for advancing our affordable housing mission and expect to continue to invest in LIHTC partnerships. In March 2007, we sold a portfolio of investments in LIHTC partnerships totaling approximately $676 million in LIHTC credits. In July 2007, we sold a second portfolio of investments in LIHTC partnerships totaling approximately $254 million in LIHTC credits. Together, these equity interests represented approximately 11% of our overall LIHTC portfolio. We may sell additional 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.

HCD s Multifamily Group continued to benefit from the improvement in multifamily real estate fundamentals during 2006. Rental unit vacancies declined to an estimated 5.3% nationally at year-end 2006 for institutional-type multifamily properties, compared to an estimated vacancy rate of approximately 6.1% at the end of 2005. However, the multifamily real estate sector is beginning to experience the effects of the overall slowdown in the housing market. We expect the vacancy rate for multifamily rental properties to increase in 2007 as a result of an increasing supply of new condominiums reverting to rental units. As of March 31, 2007, estimated vacancy rates were approximately 5.8%.

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 to make it quicker, easier and less expensive to do business with us.

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 $1.7 billion, $3.2 billion and $2.1 billion in 2006, 2005 and 2004, respectively. The primary sources of net 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 decreased by $1.5 billion or 48%, in 2006 from 2005, primarily due to a significant decline in net interest income, which was partially offset by a reduction in derivatives fair value losses, lower impairment expense and lower income tax expense.

Net interest income was $6.2 billion, $10.9 billion, and $17.8 billion in 2006, 2005 and 2004, respectively. The decrease in net interest income of $4.7 billion, or 44%, in 2006 from 2005 was driven by lower average balances of asset in 2006 versus 2005 and by the compression of the spread between interest earned on our assets and interest expense on our debt. In addition, our product mix shifted as floating-rate securities and adjustable-rate mortgage products increased as a percentage of our total mortgage portfolio. Increasing interest rates had the effect of increasing the cost of our debt, which further reduced net interest income. The decrease in fee and other income was primarily attributable to a foreign currency exchange loss of $230 million in 2006 compared with a foreign currency exchange gain of $625 million in 2005 on our foreign denominated debt. 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 a result, our foreign currency exchange losses are primarily offset by gains in fair value of the related derivatives.

Investment losses decreased by $723 million or 48%, due to a decrease in the amount of impairments recognized on AFS securities in 2006 as compared to 2005, combined with a decline in unrealized losses recognized on our trading securities. We recognized other-than-temporary impairment of $853 million in 2006 as compared to $1.2 billion in 2005. The decrease in other-than-temporary impairment in 2006 was due to the level of the change in interest rates in 2006 relative to 2005, coupled with impairment amounts recognized on these securities in 2005. We recorded unrealized gains on trading securities of $8 million in 2006, compared with unrealized losses of $415 million in 2005. The unrealized gain in 2006 reflects favorable changes in fair value due to implied volatility, virtually offset by increasing interest rates during the year. In 2005, we recorded an unrealized loss mainly due to fair value losses resulting from the increase in interest rates and the widening of option adjusted spreads.

Derivatives fair value losses decreased 64% to $1.5 billion in 2006 primarily due to the overall rise in interest rates in 2006 from 2005, which resulted in an increase in the fair value of our derivatives. In particular, the aggregate fair value of our interest rate swaps increased and we experienced a significant reduction in the net contractual interest expense recognized on our interest rate swaps. This increase in fair value was partially offset by decreases in the fair value of our option-based derivatives during each year due to the combined effect of time decay of these options and decreases in implied volatility in each of these years.

Expenses increased 30% in 2006 from 2005 primarily due to an increase in the segment allocation of indirect corporate expenses during the period, mostly driven by an increase in costs associated with our restatement and related matters. The provision for income taxes decreased by $607 million as a result of lower segment net income in 2006.

Net income for the Capital Markets group increased by $1.1 billion, or 50%, in 2005 from 2004. The reduction in net interest income and an increase in investment losses were 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 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. 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. 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 Capital Markets group continues to seek ways 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. In an effort to gain better returns, we have acquired new products for which we have been attractively compensated for the risk assumed. We will continue to seek out these beneficial opportunities in the future.

Changes to Business Segment Reporting in 2007

During 2007, we began to develop new metrics based on fair value changes, inclusive of fee income and costs incurred, and may use these measures in the future as an indicator of segment profitability. Refer to Glossary of Terms Used in This Report for additional information on option-adjusted spreads.

Additionally, we changed our methodology for the allocation of indirect administrative expenses, primarily our corporate overhead functions, to better align these expenses to the segment these functions serve. As a result,

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our Single-Family segment will absorb a higher amount of indirect costs resulting in an increase in their administrative expenses.

CONSOLIDATED BALANCE SHEET ANALYSIS

We seek to structure the composition of our balance sheet and manage its size to ensure compliance with our regulatory and internal capital requirements, to provide adequate liquidity to meet our needs, to mitigate our interest rate and credit risk exposure, and to maximize long-term stockholder value. Total assets grew to $843.9 billion as of December 31, 2006, an increase of $9.8 billion, or 1%, from December 31, 2005. Total liabilities were $802.3 billion, an increase of $7.5 billion, or less than 1%, from December 31, 2005. Stockholders equity of $41.5 billion reflected an increase of $2.2 billion, or 6%, from December 31, 2005. The major asset components of our balance sheet include our mortgage-related assets and non-mortgage investments. We fund and manage the interest rate risk on these investments through the issuance of debt securities and the use of derivatives. Our debt securities and derivatives represent the major liability components of our balance sheet. Following is a discussion of the major components of our assets and liabilities.

Mortgage Investments

Table 12 shows the composition of our mortgage portfolio by product type and the carrying value, which reflects the net impact of our purchases, sales and liquidations, as of the end of each year of the five-year period ended December 31, 2006.

Table 12: Mortgage Portfolio Composition[1]

	As of December 31,				
	2006	2005	2004	2003	2002
	(Dollars in millions)				
Mortgage loans:[2]					
Single-family:					
Government insured or guaranteed	$ 20,106	$ 15,036	$ 10,112	$ 7,284	$ 6,404
Conventional:					
Long-term, fixed-rate	202,339	199,917	230,585	250,915	223,794
Intermediate-term, fixed-rate[3]	53,438	61,517	76,640	85,130	59,521
Adjustable-rate	46,820	38,331	38,350	19,155	12,142
Total conventional single-family	302,597	299,765	345,575	355,200	295,457
Total single-family	322,703	314,801	355,687	362,484	301,861
Multifamily:					
Government insured or guaranteed	968	1,148	1,074	1,204	1,898
Conventional:					
Long-term, fixed-rate	5,098	3,619	3,133	3,010	3,165
Intermediate-term, fixed-rate[3]	50,847	45,961	39,009	29,717	15,213
Adjustable-rate	3,429	1,151	1,254	1,218	1,107