




Date : February 6, 2003
To : Timothy Howard
Dan Mudd
From : Adolfo Marzol 
Subject : Quarterly Credit Risk Assessment – YE 2002

Introduction

This memo is the first of what I plan to be quarterly written updates to you of credit risk results and risk management issues. I plan to report to you prior to each QBR, informed by written assessments from each business unit credit officer, and by observations from my team and me. This memo replaces a quarterly “Credit Trends” report I had been preparing, which was focused on single-family credit performance and was broadly distributed. I hope through this format to accomplish several objectives:

- Provide both of you with constructive, candid updates of my assessment regarding the management of credit risk at Fannie Mae. You are the only ones to whom this document will be addressed, enabling a more candid exposition.
- As compared to the Credit Trends, provide a broader, corporate-wide perspective rather than a single-family focus. In addition, I will include more qualitative and judgment-based perspectives, rather than what had been a very quantitative risk summary. The Credit MIS group led by Laura Kenney will continue to produce the Credit Trends report and, if you find that material helpful, we will keep you on the distribution.
- Address people, leadership, and organizational issues in recognition of the highly decentralized structure of credit decision-making. I believe the quality of our credit leaders, the effectiveness of the credit organizational design and the structure of our credit decision process will drive our ultimate success.

This initial memo will cover some highlights for 2002 but will primarily focus on key credit risk management challenges and priorities for 2003. I have met with the business unit credit officers and reviewed their initial set of issues and priorities for 2003 and have drawn from those efforts in providing you my summary. With subsequent quarterly reports, I will update you on priority risk issues and highlight new issues that may be emerging.

I look forward to your feedback, comments and suggestion so that future versions can be improved.

2002 Overview - Successes

2002 was a very good year for business results at Fannie Mae, and credit results were no exception. A number of credit accomplishments stand out in my mind that the company should be very pleased with.

- Credit-related losses totaled \$87.0 million, resulting in credit loss ratio of only 0.5 bps. This compares to \$137.2 million and a credit loss ratio of 0.8 bps in the 2002 plan and \$81.3 million and 0.6 bps for 2001.
- Total Single Family P&L Credit Costs (credit-related expenses, stopped interest and cost of REO carry) rose in 2002 to \$249.3 million, which represents a total credit cost rate of 1.3 bps. That is an increase from \$174.3 million in total Single Family P&L Credit Costs recorded in 2001. (See Table I for a breakdown of 2002 and 2001 results).
- Business growth was strong, with the SFMB portfolio growing 18.4% over the 4-quarter period ending 3Q02, versus SF MDO growth of 11.5% over the same time period. The Multifamily business grew 15.4% over the 4-quarter period ending 3Q02, versus MF MDO growth of 9.6% over the same time period. We continue to have success with new product and market development, enabling already large businesses to expand their reach into underserved corners of the market or segments served by higher cost players.
- Single-family made great strides in closing the guaranty fee gap, which could not have come at a better time considering \$800B of business was put on the books in 2002.
- MF did a terrific job in restructuring the two large properties that were impacted by the collapse of the WTC.
- The LIP had a wonderful year, especially given the very poor state of the overall corporate credit environment. Once again there were no credit losses in the LIP and that team avoided the high profile corporate credit meltdowns.
- There were no material counterparty losses in 2002 from any of the business units, although we did take a sizeable write down (relative to that portfolio's modest size) on the CDFI portfolio.

There were very noteworthy risk management accomplishments in 2002, including:

- The re-invigoration of the SFMB guaranty fee gap metric through the development of the Credit Works model and the support of P&C and the OOC. A high quality measure of risk adjusted margin is an essential tool for management oversight of the business overall and a compliment to gross revenue in making pricing and transaction structuring decisions within the business unit. As such, we need to develop a similar quality metric and discipline in MF.
- The comprehensive review and the announcement of changes in definitions, underwriting and pricing of cash-out refinance transactions. Debbie Tretler drove the analytical effort with exceptional support from Hsiu-Wen Wu in our research team. Tom Lund was instrumental in implementing the changes.
- The Closer Look management team led by Mercy Jimenez (with invaluable support by Bob Sanborn and Hope Evans) made a critical contribution to the risk management of the EA/TPR product line.
- The appointment of Marianne Sullivan to lead the NUC, Loss Mitigation and NPDC is already producing improvements in these critical areas.
- The development of a corporate wide framework to measure and track counterparty exposure, and the establishment of counterparty exposure limits. Kathy Rock's thoughtful and relentless leadership

over this issue has truly made a tremendous difference.

- Kieran Gifford and his team developed a Version 1.0 Bond Watch modeling and reporting capability, which is being used to measure loss exposure in the MH Bond portfolio and positioning us to analyze other complex structured transactions in the future.
- The implementation by Randy Berdine of a rigorous post-closing loan underwriting review function in MF, with real consequences to DUS lenders for poor underwriting in the form of penalties imposed.
- The cleanup of the ACF portfolio was basically completed (pending closure on Civano) and Dana Moore established the basic set of credit disciplines in the ACF that should serve us well in the future.
- The credit enhancement “back-office”, led by Carlos Perez, was restructured. All “red” items on the audit list were addressed by YE 2002.
- Our credit disclosures took a major step forward in 2002, especially the implementation effort led by Janet Pennewell to change our reporting of SFMB SDQ rates. Laura Kenney did invaluable work behind the scenes to design the new approach and support the implementation process.
- The development of a written framework between SFMB and Credit Policy on respective roles and responsibilities and the establishment of a single-family credit officer. I am indebted to Bob and Brian for their support in both the design and execution of the organizational model.
- The business unit credit officers met regularly at the Credit Committee, informal briefing meetings and lunches. An *esprit de corps* among the business unit credit officers and the leadership of Credit Policy has begun to develop, helping foster a stronger credit culture.

Externally, I believe we communicated the credit story of Fannie Mae well in 2002. The factory tours were very well received and allowed investors to see “hands on” the quality of our people, process and critical systems such as DU. Also, some great work was done to substantively assess the issue of a “housing bubble” and to develop countervailing arguments to the “housing bubble” theories and communicate our analysis to investors.

2002 Overview – Lessons Learned

There were some disappointments in 2002, several of which are issues we will be dealing with into 2003 and beyond. It is important to identify these issues, not to dwell on mistakes, but to learn from them and strengthen our business.

- Consecro – we were wise to have limited our participation to basically AAA paper. But, we might have benefited significantly from a credit officer focused on that business, perhaps enabling us to identify earlier the changing nature of the market and weaknesses in rating agency analysis.
- CSFB – this Alt A lender has proven to be very problematic. We adopted a strategy of working through the issues rather than cutting the business off. If I had that decision to make over again, I would vote for cutting them off. The problems have been larger than I expected and the risks are high that at some point CSFB will simply determine the mortgage business is non-strategic and exit, dropping the cleanup on Fannie Mae. The parent entity financial condition also remains a concern.

- Flow MH – we should have known sooner that we had a much larger flow MH portfolio than the \$1B our systems reflected based on special feature codes. This has reinforced concerns regarding other potential weaknesses in the database that put Fannie Mae at risk. We should consider a strategic database audit to ascertain the accuracy level of key elements of the database.
- MF Research and Modeling – fell into complete disrepair. During 2002 a number of issues were brought to the Credit Committee where the members noted the lack of detailed supporting analysis that should have accompanied requests for approval. At times, the ability to produce basic revenue, loss and return projections for transactions was lacking. The business unit recognized this gap. The hiring of Luiz de Toledo confirmed with resources allocated by Brian from the research team has allowed MF to begin making some progress in this area.
- MF Forwards – disappointing that one property, Huntington Meadows, would produce such a large loss. I have yet to see a comprehensive assessment of the reasons for the problem and systematic steps that may be needed to correct the product line.
- Speed - Perhaps my biggest concern from 2002 is that we do not seem to be able to get to execution faster on important risk issues. FDR noted this as an issue of concern to him at Turnberry. A few examples that struck me in reflecting on this concern included:
 - (1) Cashouts were recognized as a risk issue and revenue opportunity in late 2001. Credit Policy completed a comprehensive analysis in February 2002 yet we did not get to market with changes until February 2003.
 - (2) Servicing rules for high-risk product (EA/TPR), which were expected to be implemented by Q3 2002 after an analysis of best practices, have yet to be announced.
 - (3) Flow MH was recognized as a problem in mid 2002 because of MH cashouts in EA/TPR.
 - (4) Getting consensus on scorecard/cutoff changes for DU 5.2 took many more months than should have been needed to agree on how to change the scorecard and cutoffs to achieve our business objectives.

I hope the new organizational model and strong leadership from our business unit credit officers, as well as the support of our business leaders, enables us to reduce the cycle times between when we recognize an important credit risk issue and when we get to market with needed changes.

The following sections describe credit risk management priorities in 2003. I have organized the priorities into the following categories: process and roles, people and organization, credit culture and risk management issues.

2003 Priorities – Process and Roles

As we establish the principles and more detailed process steps of credit decision making in the company, I hope we will clarify the roles and responsibilities of Credit Policy and the CCO. I also believe an improved process and greater clarity in roles and responsibilities will improve the time lags between analysis and execution. The single most important thing we need to do in 2003 is decide on what credit decision-making process we want to have corporately. For example, do we still we want a Credit Committee? If so, who should the membership be, and how does the Credit Committee's role relate to P&C, OTI, and the SLT? I would put this set of issues in a broader context by making two points:

- The work Susan Holik did in gathering views about the Credit Committee revealed that our senior management has fundamentally differing views about the roles and responsibilities of the Credit Committee, the P&C Committee, the OTI Committee and the newly formed SLT.
- Many people express to me that there remains a lack of clarity about the distinction between “policy” and “transactions” and about the role the company wants Credit Policy to play versus the role of the company wants the business units to play.

Bob Engelstad will lead this effort, but the ultimate credit decision makers for almost all the big decisions will be the both of you. Your active engagement and honest feedback about how you want things done will be essential to establishing a set of guiding principles and process that work.

2003 Priorities – People and Organization

My highest priority in the area of people and organization is to work with Rob Levin to address the organizational structure and skill level of the credit organization in H&CD. While not a comprehensive list, key items of concern that Rob and I have discussed include:

- (1) The loss of Dana Moore and the lack of experience/seasoning of the acting ACF credit officer. Dana was an exceptional commercial credit risk officer with very strong leadership skills.
- (2) The lack of a senior credit leader over all commercial credit risks that integrates a front-to-back view of how we should manage commercial risk. Today, critical risk management accountabilities are distributed throughout H&CD into the ACF and into various teams within MF led by several officers (Parks, Arpin, Berdine, Lawch etc). We should have a senior level credit officer in H&CD to be the thought leader and integrator of the risk management process for commercial credit risk.
- (3) Pricing analysis and modeling reports to the head of MF production (Lawch). I believe there should be separation in these roles.
- (4) Equity transactions are managed in multiple locations with different levels of credit oversight (CDFI, ACF, LIHTC, MF Equity rehab deals).
- (5) Asset management is weak and has gaps. Dan asked for an end-to-end asset management review in the last QBR and I think that was a terrific suggestion. Jef Arpin is leading this review.

- (6) Some segments of the business have lacked dedicated credit oversight – including MRB investments and LIHTC.
- (7) It makes little sense to have a credit team in H&CD managing single-family credit risks. Those efforts should be integrated with Pam and her team.

Rob has been exceptionally open to my concerns and we have discussed these and other issues at length. I believe we are in broad agreement about the direction of change needed. I understand that Rob has briefed Dan regarding the organizational changes Rob has in mind. I ask that you both support these changes.

A secondary priority is to work with Mike Williams to assess credit organizational changes for Dedicated Channel. When the channel was small, it was acceptable to have David Voth serve as Chief Marketing Officer, head of new product development and Credit Officer. But now that the channel is a success and volumes have become material, the credit responsibilities in the channel need a more independent voice. Mike has been considering alternative organizational models and I expect recommendations from him shortly.

Finally, the people and process changes that needed to be made to establish Pam Johnson as the SFMB Credit Officer are materially complete. The one exception is finalizing Pam's role within the Investor Channel Delegation of Authority. I am very confident that, if we deal with the issues identified in "Process and Roles" (e.g., policy versus transactions), we will have a productive framework.

2003 Priorities – Credit Culture

One of my highest priorities is to nurture and deepen the credit culture. I have instituted some initiatives that I hope will serve to enhance our credit culture in 2003. Primary among these is to hold monthly meetings that will include all the credit officers, my senior staff and frequently key guests with senior credit roles (e.g. Marianne Sullivan, Dana Moore, Bob Sanborn) to discuss priorities and identify emerging issues. The first of these meetings was held in late 2002 and went very well, and we have met once already in 2003. Dan, I liked your suggestion of broadening the perspectives of the group through ideas like an occasional outside speaker.

One of the things I believe has been corrosive to the credit culture is the lack of a clear framework to balance the tradeoffs necessary to the attainment of housing goals. I understand that the company wants to achieve the housing goals and is willing to make "investments" (e.g. very low return transactions, approving risks we don't normally accept) when needed. But currently we seem to lack basic controls, oversight and accountability. I look forward to making a very significant positive contribution towards these issues in 2003 and will need your help in developing a framework.

2003 Priorities - Risk Management Issues

Each of the business unit credit officers has developed and will maintain a priority list of risk management issues for their business unit. I will be monitoring progress against those priorities. In addition, Credit Policy will be taking a leadership role on a variety of credit risk management issues as identified in the Credit Policy written priorities. Given the size and complexity of our business, these lists are long and you do not need to be familiar with all of the items. Here are the ones, as I see them currently, that merit your focus (not in order of priority):

- (1) MH Bonds and MH Flow – managing our overall risk exposure in this market is without exception our single biggest risk management issue.
- (2) Subprime – expansion into subprime through EA/TPR and subprime deals has been rapid and substantial. These two initiatives totaled \$16.2B of YTD 3Q02 volume and, although small as a percentage of our overall SF portfolio, the dollars are large on an absolute basis and will continue growing rapidly. Fannie Mae must continue to refine and evolve our strategy towards subprime lenders. A major risk is that subprime lenders (or subprime correspondents) begin to use our DU scorecard - a scorecard that has not been estimated on data reflective of the risks and performance of hardcore subprime loans. The “data gaps” segment reviews should address these critical concerns.
- (3) “Emerging Markets” risks and new channels – there are critical issues of risk and policy that Fannie Mae will need to consider and resolve as our business units seek to expand deeper into the minority market and compete more directly with FHA and aggressive CRA lenders on risk features and economic subsidies. For example, the Always Home initiative is likely to raise many questions, as does the ongoing activity of Channel 3. In addition, many of these efforts (e.g. Channel 3, SAI, EASE) include new business partners and new processes that are higher risk than our core business. What I want you both to be aware of is that, as we consider initiatives and transactions individually, the sum total of a series of seemingly smaller and targeted efforts may fundamentally change our policies and risk posture in the marketplace.
- (4) Investment Banks as Sellers of Higher Risk Products – We have learned some tough lessons from doing high risk products with CSFB. Other investment banks are jumping into these higher risk product segments (Alt A, FHA/VA reperformers, subprime) and we have been expanding our business with them. Freddie seems to be pulling back. We need to assess through the data gaps product segment reviews if this class of sellers broadly and each company individually really has the competencies and staying power (financial, technological, etc) that will bring us and them long run success and profitability in these segments.
- (5) Early Funding – the rapidly growing demand by lenders, large and small, to rent our balance sheet through early funding programs is creating risk management challenges. We will need to ensure that we are making the investments in people and systems that are required in 2003 to manage the credit risk and maintain very sound operational controls.

- (6) Cover the All the White Space – I think we had some white space in terms of credit oversight over MH Bonds. I want 2003 to be the year we make any remaining “white spaces” are identified and covered. Areas we may have some white space vulnerability that I am looking into include:
- Oversight of Mortgage Revenue Bonds (totaling \$14.1 billion on the balance sheet as of YE 2002).
 - Oversight of LIHTC credit risk
- (7) Counterparty risk – I debated putting this on the list, but counterparty risk has been thought of and described in our financial statements as Fannie Mae’s “secondary” risk, with loan risk being our primary risk. And there are many obvious signs of that second tier status around Fannie Mae, such as not having a counterparty risk limits framework in place until 2002. But with financial services consolidation, and rapid growth in our business, this “secondary” risk is going to be very large. Consider, for example, a LIP twice the size of today’s to meet Fannie Mae’s future liquidity needs. Do we have the people, technology, research and other skills and capabilities that will be required to play versus Citigroup, JP Morgan Chase, Merrill and others. These questions about capabilities will exist for every business unit because counterparty risk is inherent in mortgage insurance, recourse, DUS, derivatives, LIP, COLI and many other activities. So, while I do not see counterparty as a burning issue for 2003 in terms of immediate business results, it is an issue we need to keep an eye on and push ourselves to keep taking the steps needed to compete with the big players and to do it fast enough so we get to where the Fannie Mae of 2006 will need to be.
- (8) Skills Gaps In Credit Policy – While we have an exceptionally strong credit team, there are areas where I believe our skills may fall short of those needed to meet the growing risks of the company. These include:
- Counterparty default risk
 - Capital markets views of credit risk (credit spreads etc)
 - Basic business expertise gaps in both SF and MF risk. The transfer of the staff that went to SFMB to support Pam included many of our best people with regards to understanding the single family primary market and our lending standards and policies.

I am developing some organizational changes within Credit Policy that should mitigate partially some of these skill gaps and will review these with Tim shortly. I hope through our closer association with the Finance team that we can address some of the more technical gaps in our skills.

Table 1

	<u>2002</u>	<u>2001</u>
REO Properties	19,500	14,486
Deeds in Lieu	192	163
Presales	1,410	1,182
Total Default Terminations	21,102	15,831
(\$ millions)		
Credit Related Loss	\$68.7	\$76.4
Cost of REO Carry*	\$35.5	\$26.1
Stopped Interest	\$145.1	\$71.8
Total Single Family P&L Credit Costs	\$249.3	\$174.3
Less Title I Losses	\$14.7	\$15.1
Core P&L Credit Costs**	\$234.6	\$159.2
Core P&L Credit Costs per Default Termination	\$11,117	\$10,056
Total Single Family P&L Credit Costs/Average Book of Business (bps)	1.29	1.59

* Based on 2% of default UPB assumption.

** Excludes Title I.