FannieMae

To: Single Family Business Credit Committee

From: Charles Rumfola, Patti Parsons, Kevin Kim
Single Family Business Product Management & Development

Re: PMD Proposal for Increasing Housing Goal Loans (Amended 5/12/06)

Date: May 5, 2006

Proposal Overview

As an on-going effort to meet our annual HUD housing goals, a corporate wide effort was initiated to evaluate past performances and to estimate potential shortfalls for 2006. Based on this effort, it was determined that the low- and moderate- income subgoal (LMS) loans have the biggest potential shortfall of all the HUD goals, with an estimated deficit of 64,000 loans if no action is taken to mitigate this risk.

LMS is defined as owner occupied, PMM loans where the household income is equal to or less than the estimated area median incomes (AMI), which are provided to us by HUD each year. The low- to mod- goal and subgoal have the highest targets for their respective categories (see Table 1), making it the most difficult to attain. Although there are potential shortfalls in the other HUD goals, these deficits are expected to be smaller and more readily attainable and are not the focus of the initiatives being evaluated.

Table 1 – 2006 HUD Goals (* no change from 2005)

Categories	Base Goal	PMM Subgoal
Low-Mod	53%	46%
Special Affordable	23%	17%*
Underserved	38%	33%

To address the LMS deficit, various Fannie Mae business channels have been engaged to develop strategies that will proactively target and solicit LMS eligible loans. The following are some of the products and business channels that are being developed or enhanced to achieve this objective:

- MCM product and process enhancements (PMD)
- DU level bump on all EA loans (AU Business & Tech)
- HFA/CRA bulk deals (Investor Channel)
- MH chattel (Alternate Delivery Solutions)
- HFA flow business (ACG)
- Dedicated channel express (Investor Channel)
- MCM broker enhancements (CMCL & Multicultural Outreach team)

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In assessing the potential of each strategy to increase LMS loans, the following issues had to be considered:

1. The potential for the new strategy to cannibalize existing products, business lines or counteracting other strategies being proposed;
2. Time and effort to implement (we need quick solutions that will impact the 2006 goal targets);
3. Cost of new strategy on per loan and aggregate basis (e.g., cost of pricing subsidies, model fee hit for charter MI and etc.);
4. Estimate of new incremental loans that are LMS eligible (total new LMS eligible loans that is over the 46% HUD target)

Proposal Description

This memo submits for approval key MCM product and guideline enhancements that PMD has determined will result in additional incremental LMS eligible loans.

PMD evaluated enhancements to existing mortgage products that could increase the number of incremental LMS loans. Based on the 2005 goals performance of Flex, EA and MCM products (see Table 2) it was obvious that these products are ideally suited for enhancements that could increase new LMS loans. For instance, 92.3% of all MCM loans in 2005 met the LMS criteria, which resulted in 16,593 total LMS loans and 7,674 incremental loans above 46%.

Table 2 – HGW preliminary Dec 2005 results run on 1/31/06

	Total UPB	Low/Mod Base Goal		PMM Low/Mod Subgoal		Incremental above 46%
		Scored Subset	% Meets	Scored Subset	% Meets	
Flex	$21,319,410,928	148,699	53.6%	123,746	54.1%	10,023
EA	$14,987,905,583	108,784	68.4%	40,756	71.2%	10,287
MCM	$2,258,097,841	20,096	92.1%	16,593	92.3%	7,674
Lender Custom*	$3,295,200,291	26,254	72.2%	22,498	74.2%	6,351
Total	$41,860,614,643	303,833	63.1%	203,593	62.9%	34,336

*One-offs of MCM including CHL Optimum, etc.

After evaluating all product related strategies, it was determined that key enhancements to MCM would provide the best potential because of its lower Gfee (37.5 bps), LLPA waiver for EA loans and charter minimum MI. Although the lower fees for MCM can lower the borrower's up-front costs, the charter minimum MI can lower the monthly mortgage debt through the lower MI coverage requirement (see Table 3).

Table 3 – MI coverage comparison between charter minimum and standard

Max. LTV	100%	97%	95%	90%	85%
Charter Minimum MI	20	18	16	12	6
Standard MI	35	35	30	25	12

In addition to the built-in price and product guideline advantages of MCM, loans are limited to owner-occupied properties where the maximum borrower income is generally

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100% or less of the AMI.[1] With these two requirements, most MCM loans are automatically eligible for the low/mod income base goals and if the loan is also a purchase transaction in an MSA, it qualifies for LMS.

Since the addition of charter minimum MI in July 2005, MCM has been steadily increasing in terms of monthly volume. Although there is always a risk that MCM will cannibalize EA loans (Flex is less impacted since there is minimal price advantage) and in some instances this will happen, it is our opinion that the enhancements will result in more new loans that Fannie Mae would not have gotten without more flexible guidelines and lower costs of MCM.

In evaluating which MCM enhancements would add the most to the incremental LMS loans, PMD participated with a team led by Karen Pallotta and worked with the Lender/Investor/Broker channels, Housing Goals Oversight, Community & Multicultural Lending, customer account teams and other business groups to get their input. These teams helped identify and evaluate the various product enhancements, which were further scrutinized by other Fannie Mae business groups, external business partners such as the MI companies and a few of our customers.

By expanding our reach, not only did we get universal confirmation of the need for the MCM enhancements listed in this memo, we identified other corporate initiatives that would also benefit from these efforts. Initiatives such as those supporting the hurricane Katrina regions and those of HCD's to provide better product solutions to Housing Finance Agencies (HFA) were identified. Most of the enhancements described in this proposal will provide the type of product features that have been identified as critical needs of these initiatives.

While reviewing the various MCM enhancements with key business groups (e.g., SF Credit, Lender Strategy), it was determined that not all elements required SF Credit approval. To ensure that the SF Credit Committee has a comprehensive view of all the MCM enhancements being proposed and approved for both credit and non-credit related changes, two tables have been included in this memo that details each of these features.

Table 4 compares the current MCM guidelines with the new enhancements that are credit-related and require SFCC approval. The table provides a brief description of the new enhancements along with key benefits and potential risks.

As described earlier, there are several MCM enhancements that were either deemed non-credit related and/or were previously approved for implementation and are listed in Table 5. Since these enhancements have already been approved, only a brief summary of the changes have been provided.

[1] MCM eligibility allows household income up to 100% of AMI, with the following exceptions: 115% of AMI in non-metro areas, no income limits for FannieNeighbors (i.e. HUD Underserved areas), and higher income limits for certain high-cost areas: 165% in NYC MSA; 120% in Portland MSA; 120% in Seattle MSA; 125% in Newark MSA; 135% in Boston MSA; 140% in state of California; and 170% in state of Hawaii.

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Unfortunately, not all enhancements that were evaluated could be included in this initiative due to significant business and system issues that would have delayed the implementation of other MCM enhancements. Several of these enhancements are listed in Exhibit A along with the rationale for not including them in this proposal.

Table 4

<table>
<tr><th colspan="5">MCM Enhancements Requiring SF Credit Committee Approval
(Refer to Exhibit B for detailed DU and Manual Underwriting Guidelines)</th></tr>
<tr><th>Features</th><th>Current MCM</th><th>MCM Enhancements</th><th>Benefits</th><th>Issues/Risks</th></tr>
<tr><td rowspan="2">Interest First Products</td><td rowspan="2">No</td><td rowspan="2"><u>Allowed</u>
- 30 YR FRM
- 35 YR FRM
- 40 YR FRM
- 5/1 ARM
- 100% LTV
- PMM
- LCOR

<u>Not Allowed</u>
- 7/1 ARM
- 10/1 ARM
- Community Renovation</td><td colspan="2">Description:
• Add four IF products with two different interest only periods:
<u>w/10YR IO Period</u>
o 40YR FRM (fully amortizing for remaining 30 years)
o 30YR FRM (fully amortizing for remaining 20 years)
o 5/1 ARM with 2/2/5 caps (fully amortizing for remaining 20 years)
<u>w/5YR IO Period</u>
o 35YR FRM (fully amortizing for remaining 30 years)
• Current LTV limits that are based on number of units still applies (e.g., 2-units limited to 97% LTV and 3-4 units limited to 95% LTV)
• Other terms were evaluated but were rejected due to marginal price differences and increased level of effort (see exhibit A for details)
• For all IF products, the borrowers will be qualified using the initial IO payment; see Temporary Buydown section for additional qualifying rules
• System development effort – high impact to DU and ESO</td></tr>
<tr><td>• Provides lower initial payment versus a fully amortizing mortgage
• Easier qualification for low/mod income borrowers if qualifying at the initial IO payment
• Matches Alt A and subprime</td><td>• If underwritten at fully amortizing payment, it will offset the value of using an IO option to qualify
• For 5/1 ARM, a 10-year IO period still produces payment shock at the end of year 5 when IO payments will go up as interest rates increase</td></tr>
<tr><td rowspan="2">Maximum Interested Party Contribution</td><td rowspan="2">3%</td><td rowspan="2"><u>Allowed</u>
- 6%
- 100% LTV
- PMM
- 1-unit

<u>Not Allowed</u>
- LCOR
- 2-4 units (3% maximum)
- Community Renovation</td><td colspan="2">Description:
• Lenders have requested this option to cover closing costs, prepaids, temporary buydowns or single finance MI premium
• System development effort – no impact to DU or ESO</td></tr>
<tr><td>• Reduces borrower's out of pocket expenses for customary closing costs
• Per Legal, TBA MBS execution will be allowed provided there is a full appraisal
• Exceeds Freddie HomePossible product that permits up to 6% for 90/10 financing
• Already available to several lenders as a variance ranging from 4-6%
• Matches FHA for 97% LTV
• Matches Alt A and subprime</td><td>• MI companies have voiced substantial opposition to increasing contribution limits
• May result in appraisal bias and the property being over valued</td></tr>
<tr><td>Temporary Buydown</td><td>No</td><td><u>Allowed</u>
- 2-1 only
- 100% LTV
- PMM
- 1-2 units</td><td colspan="2">Description:
• In DU, qualifying rate is the bought-down rate + 1.0% for LTV ≤ 95% and at the note rate if LTV > 95%
• In manual underwriting, the qualifying rate is the bought-down rate for LTV ≤ 95% and same as DU for LTV > 95% (DTI is limited to 43% in manual)
• System development – DU system change to allow B/D, no ESO impact</td></tr>
</table>

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		Not Allowed - *5/1 ARM* - *LCOR* - *3-4 units* - *Community Renovation*	• Lowers initial payment • In DU, matches current guideline • Temporary buydowns already available for manual underwriting under Community Solutions • Matches Alt A and subprime	• Annual payment shock, even when qualifying at note rate • Additional risk when combined with Interest First and 100% LTV
Minimum Borrower Contribution	$500	**Allowed** - **$0 borr. cont.** - **PMM** - **1-unit** *Not Allowed* - *LCOR* - *2-4 units* - *Community Renovation*	**Description:** • Eliminating the $500 minimum contribution is more about documentation rather than what the borrower is contributing from their own funds • System development effort – DU messaging change, no ESO impact • Eliminates need to document $500 • We currently allow zero borrower contribution under the hurricane Katrina relief issued with LL02-05 • Matches Alt A and subprime	• Borrower has zero equity in the property
Borrower Education	Required for all first time homebuyer	**Allowed** - **Not required on 1-unit** - **PMM** *Not Allowed* - *LCOR* - *2-4 units* - *Community Renovation*	**Description:** • Does not change requirement for landlord counseling on 2-4 units • System development effort – DU message change, no ESO impact • Eliminates perceived barrier and matches sub-prime products	• First time home buyers may not be informed about the "basics of homeownership" and complexity of various mortgage products • Consumer advocates and counselors may not be in favor of this change
Cooperative Projects	Maximum LTV Limited to 90%	**Allowed** - **100%** - **1 unit** - **PMM** - **LCOR** *Not Allowed* - *2-4 units* - *Community Renovation*	**Description:** • Treat cooperatives the same as standard condominiums by allowing subordinate financing, charter minimum MI coverage, zero borrower contribution and increase the maximum LTV to 100% on one-unit properties • System development effort – DU message change, no ESO impact • We currently allow 100% LTV on condominiums • There's no evidence that the cooperatives perform worse than condos	• Coops are concentrated in major cities and metropolitan areas (e.g., Chicago, New York and etc.)

Table 5

MCM Enhancements Already Approved and in Process			
	Current MCM	**Approved MCM Enhancements**	**Summary**
Minimum LTV/CLTV	$\geq$ 95%	No minimum	• Extends MCM benefits to goals-rich loans with lower LTV/CLTV in DU (currently permitted for manual underwriting) and matches Freddie's Home Possible
Lender Approval	Lenders must be pre-approved; over 400 lenders have already been approved	No lender approval required	• This change results in process efficiency for account teams and eliminates SOX lender allocation monitoring issue • Improves perception issue with customers that we want this business without constraints and matches Freddie's Home Possible
Volume Caps	2% of total volume	No volume cap	

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MCM Enhancements Already Approved and in Process			
MCM in Selling Guide	Negotiated product	Add MCM to Selling Guide	• Scheduled for release in June Guide Announcement
Fannie Neighbors List	Limited to HUD Underserved areas	Add impacted regions to FannieNeighbors	• For a limited time period (e.g., two years), allow specific impacted regions to be added to the Fannie Neighbors list so that the income limits can be ignored
Streamline MCM Pricing	Has multiple Gfees by product option	Consolidate to single Gfee	• Will be implemented in July with the 40 year FRM

Competitive Landscape

As mentioned earlier in this memo, PMD worked extensively with various internal and external business groups to develop a comprehensive list of product features that could add to the incremental LMS loans. These groups provided feedback on what type of products were already offered in the marketplace and specific product features or variances that our customers have requested. From this working list, PMD was able to whittle down the features based on expected effectiveness, costs and our ability to implement quickly to ensure that it will have a positive impact to the 2006 goals.

The advent of product enhancements from Freddie Mac, FHA, Alt-A and subprime lenders have all contributed to increased competition for goals rich loans. For instance, Freddie's HomePossible product is a near identical match to MCM but without MCM's current limitations such as lender approval requirement and volume caps. In addition to these limitations, HomePossible also allows greater flexibility on several key product features such as allowing higher seller contributions based on LTV's rather than CLTV's.

On the issue of higher seller contributions, even FHA has expanded their guidelines by allowing 6% contributions for LTV's up to 97% that can be used towards closing, prepaid expenses, discount points and other financing concessions. This change was announced on January 27, 2006 through Mortgagee Letter 2006-04. In its explanation for this change, FHA states in the Mortgage Letter that, "The unintended consequence (of their previous guidelines on seller contribution) was that the homebuyer was then forced into a less suitable and often more expensive mortgage product".

Other MCM enhancements listed in Table 4 are also based on current market availability and customer demand. Bank of America already has CRA products that match the MCM enhancements with features such as a 40 year fixed rate that is available as either fully amortizing or interest only, with seller contributions up to 4% and other MCM-like features. Lenders such as Wells and National City with their respective CRA products, Home Opportunities and National Dream, can also match several key MCM enhancements such as zero down and higher seller contribution limits.

The availability and use of the interest only products are also expanding thanks to the ever increasing home values (albeit at a slower pace in certain regions) and the higher interest rate environment. Although a 40 year IO product is priced slightly worse than a

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30 year IO, the added security of a 30 year amortization after the IO period is appealing to more and more borrowers.

The 35 year IO product with a five year IO period is a specific need that was identified for several Housing Finance Agencies that already offer this term and find it more appealing than the standard 40 year fixed rate. Even though the 35 year term is not expected to have a broad market appeal, it is worth including in this proposal due to the goals richness of the program and the potential volume from the California HFA alone (they expect to originate $600M of this product from June 2005 to June 2006 – their first year offering the product).

Although the MCM enhancements requested in this memo and those already approved by Lender Strategy and Credit (Table 5) constitutes a more aggressive and risky MCM product, there already exists a market for these features. This proposal attempts to match or only slightly exceed market trends and is not an attempt to create new market demand for these features. In order to compete for the same business everyone is going after, we need to keep pace with the market and provide the necessary solutions to remain competitive.

Pricing (Comments and analysis from SF Credit Policy and Risk Mgmt. memo dated 5/1/06)

Background

Single Family has proposed several enhancements to the MCM product to increase goals volume. Single Family Credit Pricing was requested to provide pricing impact for the following features and the combinations of two or more of them:

- Allow interest only for both FRM 30, 35 and 40 as well as 5/1 ARM
- Allow 4-6% seller contributions (we typically limit the amount of money a seller can contribute to closing costs at 3%)
- Allow 80/20 execution
- Allow 2-1 Buydown
- Zero Down instead of $500 down
- Allow Manufactured Housing (MH)

Pricing Analysis

To quantify the impact of these adjustments, we borrowed the profile used by Credit Finance in their Mar. 2006 analysis for this project. We adjusted the profile to set all loans at 100% LTV and 20% charter minimum MI. We then ran each scenario through the Pricing Engine of CreditWorks, where MCM loans are normally priced at delivery.

Observations and Assumptions

- Take a FRM30 loan as an example, the base fee is priced at 106 bps. The impact of different features increases the model fee between 9 bps (seller contribution) to

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121 bps (MH), except for the 80/20 execution which reduces the model fee by 7 bps.

- FRM35 and FRM40 are currently priced the same in CreditWorks.
- IO FRM10/30 and IO FRM5/30 are currently priced the same as regular IO FRM30.
- Excessive seller contribution only has pricing impact on loans with over 90% first lien LTV under the current pricing model. Hence adding seller contribution on top of the 80/20 structure does not get extra pricing adjustment. The excessive seller contribution impact may not have been fully captured for the 80/20 structure.
- Zero Down has no pricing impact in the current model due to lack of data to determine how these loans will perform relative to other 100% LTV loans.

<u>Issues/Caveats</u>

- CreditWorks is not built with sufficient data of high risk loans. As a result, pricing with multiple risk layers at the high end of the risk spectrum is a weak area of the model. So this analysis is not finalized but is meant to provide guidance around the potential impact of different features.
- Due to a Pricing Engine problem, we obtained the model fee for seller contribution from the graphical user interface of CreditWorks, which is another application of the model. The values would be a little different but good for the purpose of this analysis.

Individual Enhancements (cost analysis for "base" MCM enhancements - not layered)	**30 YR FRM**			**5/1 ARM**			**35- and 40- YR FRM**		
	Model Fee	**Average Default %**	**Gap [1]**	**Model Fee**	**Average Default % [2]**	**Gap [1]**	**Model Fee**	**Average Default %**	**Gap [1]**
Base: 100% LTV, 20% MI	**106**	**34**	**-68.50**	**133**	N/A	**-95.50**	**121**	**38**	**-83.50**
Interest First (IF)	129	40	-91.50	155	N/A	-117.50	129	40	-91.50
Seller Contribution (SC)	115	23	-77.50	144	N/A	-106.50	134	27	-96.50
Temporary B/D (BD)	118	37	-80.50	143	N/A	-105.50	133	41	-95.50
Zero Down (ZD)	106	34	-68.50	133	N/A	-95.50	121	38	-83.50
Manufactured Housing (MH) [3]	*227*	*42*	*-189.50*	*261*	*N/A*	*-223.50*	*251*	*46*	*-213.50*
Combined Enhancements (cost analysis for "layering" several MCM enhancements)	**30 YR FRM**			**5/1 ARM**			**35- and 40- YR FRM**		
	Model Fee	**Average Default %**	**Gap [1]**	**Model Fee**	**Average Default % [2]**	**Gap [1]**	**Model Fee**	**Average Default %**	**Gap [1]**
IF + SC	129	40	-91.50	155	N/A	-117.50	129	40	-91.5
IF + ZD	129	40	-91.50	155	N/A	-117.50	129	40	-91.5
IF + BD	140	43	-102.50	164	N/A	-126.50	140	43	-102.50
IF + MH [3]	263	48	-225.50	291	N/A	-253.50	263	48	-225.50
All Enhancements (cost analysis for combining all MCM enhancements)	**30 YR FRM**			**5/1 ARM**			**35- and 40- YR FRM**		
	Model Fee	**Average Default %**	**Gap [1]**	**Model Fee**	**Average Default % [2]**	**Gap [1]**	**Model Fee**	**Average Default %**	**Gap [1]**
IF + SC + ZD + BD	140	43	-102.50	N/A [4]	N/A [4]	N/A [4]	140	43	-102.50
IF + SC + ZD	N/A	N/A	N/A	155	N/A	-117.50	N/A	N/A	N/A
Current EA Model Fees for Comparison	**30 YR FRM**			**5/1 ARM**			**35- and 40- YR FRM**		
	Model Fee	**Average Default %**	**Gap [1]**	**Model Fee**	**Average Default % [2]**	**Gap [1]**	**Model Fee**	**Average Default %**	**Gap [1]**
EA Level 2	101 [5]	N/A	-63.50	N/A	N/A	N/A	N/A	N/A	N/A
EA Level 3	129 [5]	N/A	-91.50	N/A	N/A	N/A	N/A	N/A	N/A

[1] Gap is based on the current MCM 37.5bps Charged Fee

[2] As of 4th quarter 2005, the pricing engine no longer provides the average default percentage for ARMs and instead uses ACI for FRM in calculating the Gfee

[3] Manufactured housing is not included in this proposal and is only for illustrative purposes

[4] Temporary B/D will not be permitted for 5/1 ARMs

[5] Model fees for EA 2 and EA 3 were derived from LPP

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MI Company Feedback

A high level MCM enhancement table that outlines the proposal contained in this memo was sent to MGIC, UGIC and PMI to determine if they had any concerns regarding the changes. The intent was to get their "gut" reaction to the proposal to make sure there were no insurability issues with the MCM enhancements.

UGIC had concerns about the suitability of the IF 5/1 ARM due to the adjustable nature of the product and the full amortization after the 10th year. They felt that this financing structure may be too complicated for the typical first time homebuyers that are also low/mod income borrowers. In addition, UGIC reminded us that they charged a higher premium for loans with temporary buydowns because of the adjustable feature, even for fixed rate mortgages.

PMI and MGIC's primary concern was on allowing temporary buydowns on IF products, especially where we qualify the borrower at anything less than the full note rate. MGIC believes that allowing the borrower to qualify at a lower rate just because of a lower LTV doesn't reduce the risk because, "while the severity risk is less for both Fannie Mae and the insurer with a lower LTV, the incidence risk due to the inability to afford the monthly payment as the buydown is exhausted remains with a lower LTV."

All the MI companies had some degree of concern in offering IF products to low/mod borrowers due to payment shock risks. Combining the IF products with LTV's up to 100% was of particular concern due to the zero equity should something go wrong. PMI was more favorable towards the 40 year IF product because of the 30 year fully amortizing period. PMI indicated that they may charge a higher premium for these type of products due to the added risk.

On the issue of removing the homebuyer education requirement, MGIC responded, "comprehensive home buyer education for first-time home buyers can meaningfully impact the ultimate success of homeownership, especially for those who do not come from a family in which homeownership is common. We also believe that education conducted prior to home shopping is more valuable than education conducted as part of the loan process regardless of how such education is delivered (face-to-face, telephone or on-line)." However, MGIC has no plans to charge a higher premium or limit its insurance activities for loans without the homebuyer education.

In the original request to the MI companies, the higher seller contribution was not included in the list of enhancements because we were contemplating only allowing this enhancement as a lender variance. However, when the MI companies (the same ones previously mentioned) were contacted about allowing higher seller contributions in the past, they expressed the following concerns and were "adamantly" against it:

- closing costs in general don't exceed 3%;

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- it will further exacerbate negative equity for borrowers already borrowing 100% of the purchase price (particularly in a flat to down home price environment);
- they believe that borrowers can already purchase homes with less cash down than it takes to lease/rent for 12 months;
- they're concerned about where some contributions will come from (e.g., Nehemiah);
- if we did increase to 6% they would probably increase their premium rates for those loans

Legal

Legal had no issue except that loans with seller contributions above 3% require a full appraisal. This requirement already exists in DU and will not require any changes.

Franchise

This enhancement is not expected to pose a Franchise risk.

Operations and Automated Underwriting

Table 6 is a summary of the various MCM enhancements that are submitted in this memo for SFCC approval and those that have already been approved for implementation. The focus of this summary is to determine system and operational impacts for each enhancement and document the short term manual workarounds and long term system solutions.

The manual workaround is important for us to identify so that we can ensure speed to market. Those enhancements that have a manual workaround will be rolled out to lenders as soon as approval is obtained and the appropriate internal and external communications are drafted.

Table 6 – Operational and System Impacts

	ESO		DU	
Enhancement	Need to Change Acquisitions?	Immediate Workaround?	Need to Change DU?	Immediate Workaround?
40-year fully amortizing	Yes – in process for July timeframe for completion	No workaround available	Slated for DU 5.6 release	No workaround available
Interest Only **w/10YR IO Period** - **40YR FRM** - **30YR FRM** - **5/1 ARM** **w/5YR IO Period** - **35YR FRM**	Yes, business req'ts in development	No workaround available	Yes, specifications and DU release to be determined	No workaround available
Allow up to 6% seller contributions	No	N/A	Slated for DU 5.6 release; change message on seller contribution limit	**Yes, include in June Guide Ann. for MCM; give immediate guidance to all DU lenders to ignore messaging about interested party contribution (require lenders to manually**

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Enhancement	ESO: Need to Change Acquisitions?	ESO: Immediate Workaround?	DU: Need to Change DU?	DU: Immediate Workaround?
				confirm contributions do not exceed 6%) - "Based on the data entered, the total amount of interested-party contributions exceeds the maximum allowable contributions of 3.0 percent for this CLTV. In order for the loan to be eligible for delivery, the amount paid by interested parties that exceeds the maximum allowable contributions must meet the requirements stated in the Selling Guide, Part X, Chapter 6, Section 602."
Eliminate $500 borrower contribution on 1-unit properties	No	N/A	Slated for DU 5.6 release; delete message to verify borrower contribution	**Yes, include in June Guide Ann. for MCM; give immediate guidance to all DU lenders to ignore messaging to verify the $500 –** "Verify the borrower is contributing $500 of their own funds to the down payment, closing costs or prepaid fees."
Waive Pre-purchase Homebuyer Education (HBE)	No	N/A	Slated for DU 5.6 release; eliminate message for HBE requirement	**Yes, include in June Guide Ann. for MCM; give immediate guidance to all DU lenders to ignore HBE messaging – "**Each borrower signing the Note must complete an acceptable home buyer education program either in the form of a face-to-face tutorial, or a classroom or workshop session. Documentation of completion must be provided. Telephone sessions are allowed if the lender uses the services of a mortgage insurer that have an established program that bases its homebuyer education on telephone communications with the borrower."
Allow buydowns	No	N/A	Slated for DU 5.6 release; eliminate Ineligible message	**Yes, include in June Guide Ann. for MCM; give immediate guidance to all DU lenders to ignore Ineligible message** - "This case is ineligible because the interest rate on a Community Lending product cannot be temporarily bought down."
Expansion of Fannie Neighbors in hurricane areas	No	N/A	No changes needed, FannieNeighbors field is user-entered	**Not required, provide lender variance listing geography now eligible as FannieNeighbors**
Eliminating lender approval and volume allocations	No	N/A	Slated for DU 5.6 release; remove scope rule that makes loans "Out of Scope" if lender is not approved	**Yes, lenders will be manually activated; since this a manually intensive process, only those lenders who requests MCM will be activated until the DU scope rule is removed in release 5.6**
Eliminate minimum CLTV/LTV in DU	No	N/A	Slated for DU 5.6 release; eliminate Ineligible message	**Yes, include in June Guide Ann. for MCM; give immediate guidance to all DU lenders to ignore Ineligible finding for MCM**

Rollout/Implementation Strategy

The rollout strategy for each of the enhancements will be based on the type and level of system/operational changes required and possible manual workarounds (see Table 6). Based on input from the AU team and ESO, each enhancement has been grouped under three different release phases (see below). Since we need to make immediate impact to the 2006 targets, speed to market and its effectiveness in attaining the LMS loans have been the highest priority.

Most of the MCM enhancements will require "minor" to "medium" level of system/ operational changes in order for lenders to deliver eligible loans. However, depending on

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the type of system impact, there may be a manual workaround that can be instituted to override or ignore system messages and restrictions. These enhancements will be in Phase I since they can be released to lenders as soon as they are approved and require little or no additional effort beyond communicating the workarounds internally and externally.

For enhancements where no manual workaround is feasible, the releases have been broken out to two release phases based on the level of system/operational development required and the expected implementation date. Phase II will be limited to changes that can be implemented in a couple of months and for those that are already in process, while Phase III will be reserved for new product implementations that can take several months such as the addition of the Interest First products.

Phase I – Little or no system/operational impact and a manual workaround exists for lenders to deliver, can be released to lenders once the enhancements are approved (May implementation)**:**

- Eliminate lender approval and volume caps (DU/ESO system changes to be made in Phase II)
- Eliminate minimum LTV & CLTV (DU/ESO system changes to be made in Phase II)
- Eliminate minimum borrower contribution (DU/ESO system changes to be made in Phase II)
- Add impacted Katrina regions to Fannie Neighbors list
- Allow seller contribution to 6% (DU/ESO system changes to be made in Phase II)
- Add 2-1 buydown (DU/ESO system changes to be made in Phase II)

Phase II – Requires system/operational development:

- Enhancements previously approved and in process but have not been released to lenders:
    1. Add MCM to Selling guide (June implementation)
    2. Add 40 year FRM (July implementation)
    3. Streamlining of MCM pricing (July implementation)
- Integrating into DU 5.6 release (late July) the changes that were provided in workarounds during Phase I:
    1. Eliminate lender approval and volume caps
    2. Eliminate minimum LTV & CLTV
    3. Eliminate minimum borrower contribution
    4. Allow seller contribution to 6% for LTV's up to 100%
    5. Add 2-1 buydown

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Phase III – Major system/operational impacts that require new product development lifecycle; release to lenders once enhancements are approved and necessary changes are completed (2-3 months development effort):

- Add 30-, 40- year FRM & 5/1 ARM Interest First w/10 year IO periods
- Add 35 year FRM w/5 year IO period

Post Implementation

1. Quality Control Strategy

   - Standard Fannie Mae QC procedures will be applied to loans delivered under these eligibility requirements.
   - PMD will work with the NUC to determine if an automated reporting tool can be implemented to allow PMD to receive and monitor QC review findings on a monthly basis.
   - PMD will work with ESO, FMIS and the AU team to implement tracking and reporting capabilities to monitor key loan delivery characteristics, such as temporary buydowns, seller contribution, and Interest First products.
   - Lenders will be required to comply with the random and discretionary mortgage review process as outlined in Fannie Mae's Selling Guide for loans originated under these eligibility requirements.

2. Early Warning Monitoring

   Credit Finance will track the early warning performance of each segment to determine if performance is in line with expectations based on certain features (e.g., Interest First products, amount of seller contribution and use of temporary buydown). As with any product, if the performance is significantly *Worse than AtComp* on a consistent basis, Credit Finance will review the segment and determine if any pricing adjustments are warranted.

3. Product Management

   - PMD will monitor deliveries on a monthly basis for a period of 1-year. Loan deliveries will be compared to projected volume estimates in order to determine if the initiative is generating sufficient volume or more than expected volume.

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- At the end of the 1-year period, PMD will work with NUC, Credit Policy & Risk Management and Credit Finance to determine if additional monitoring is necessary.

4. Revenue / Mission Management

- ***Gap Analysis*** – PMD will work with SFB Lender Strategies to establish tracking procedures and thresholds to accurately track how the initiative contributes to the overall profitability of the Single-Family Mortgage Business and when and how to act if the overall contribution is less than expected.

- ***Goal Analysis*** – PMD will work with SFB Regulatory & Corporate Housing Goals Oversight to establish tracking procedures and thresholds to accurately track the impacts the initiative has on Fannie Mae's housing goal requirements and when and how to act if the overall contribution is less than expected.

5. Market Watch

PMD will work with lender partners to assess how the initiative is being received in the market, resolve potential problems, and highlight best practices for marketing, originations, and servicing. This information is intended to aid in generating increased volume and acceptability, eliminating potential issues, determining price points, and obtaining valuable information that will help in the development of future enhancements.

6. Exit Strategy

Although the immediate focus is to meet the 2006 HUD housing goals, these challenges are expected to be on-going, especially since one or more of the goal and subgoal targets will continue to increase each year until 2008. In addition to the annual increases, we are in constant competition with FHA, Freddie Mac and other private labels for the same goals-eligible loans.

As long as these external pressures exist, our efforts will continue to be focused on offering competitive products to acquire more goals eligible loans. However, we also recognize the need to balance our efforts with the financial, political and reputation risks associated with these strategies. In addition to closely monitoring MCM performance in terms of meeting our housing goals, the credit performance will be more closely monitored and scrutinized than in the past. Of particular interest will be any trends that can be traced back to a specific product enhancement approved under this memo.

It is expected that the goals attainment will not reach full impact until all enhancements are implemented, especially the new IF products. With an

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expected ramp-up time of two months after a product is implemented to see a material impact in volume and our 90-day delinquency tracking procedure, it could be mid-2007 before any significant information is available.

As MCM's performance data becomes available, its performance will be measured against the default model to determine where it stands. If the MCM performance is below expectations, the findings from these analyses will be shared with senior management to determine what, if any actions will be taken.

If a decision is made by senior management to limit or terminate one or more of the approved MCM features, the following strategy will be implemented:

- Provide 90-days notice to all participating lenders that a feature or set of features are either limited or have been discontinued
- Issue Lender Letter or Guide Announcement communicating the termination of the feature(s)
- Issue an update to the Fannie Mae Selling / Servicing Guide and DU Guide to Underwriting
- Implement changes in DU and ESO

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Exhibit A

This exhibit details how the amortization terms were selected and the analysis used in rejecting manufactured housing as an MCM enhancement. This section was added to address the persistent questions around why manufactured housing and Interest First 7/1 and 10/1 ARMs were not included in this proposal.

Product/Amortization Terms

In order to help minimize borrowers' monthly debt from mortgage payments, several popular amortization types were analyzed. In determining the feasibility of each product, risk factors such payment shock and level of effort to implement were weighed against expected payment reductions to select the best options for the borrower and Fannie Mae.

Since adding each new product/amortization type would add to the level of effort and delay other product implementations, PMD decided to focus on those that had the best "benefit to risk" ratio. For instance, there was no point in implementing Interest First 5/1, 7/1 and 10/1 ARM products since the 5/1 ARM had the biggest savings when compared to a fully amortizing 30 year FRM and the savings diminished as the ARM term lengthened.

Conversely, the Interest First 3/1 ARM had the biggest savings but also had the greatest risk from payment shock, which PMD determined would not benefit the borrower or Fannie Mae in the long run. The fully amortizing 3/1 ARM on the other hand had a slightly lower payment shock risk than the Interest First 3/1 ARM but the payment reduction when compared to a 30 year fixed rate was insignificant.

MCM average loan amount for past 12 months = $114K	Base on Par Rate on March 28	Monthly Mortgage Payment	Mortgage Payment Reduction from 30YR Fixed Full Amort.
3/1 - fully amortizing	5.625%	$656	$ (27)
3/1 - IO	5.766%	$548	$ (135)
5/1 - IO	5.969%	$567	$ (116)
7/1 - IO	6.118%	$581	$ (102)
10/1 - IO	6.367%	$605	$ (78)
30/40YR FRM - IO	6.500%	$618	$ (65)
30YR FRM - fully amortizing	6.000%	$683	N/A

* The yield used in the calculation came from portfolio and is based market estimates for par price on March 28th.

Based on the "benefit to risk" analysis, it was concluded that adding the Interest First products for the 5/1 ARM and 30 year FRM would provide the biggest benefit to the borrower and Fannie Mae. Although the Interest First 35- and 40- year FRM are priced about the same as the 30 year and do not change the monthly payment, these products were specific requests from HCD and CAMs. The decision to implement the IF 35- and

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40- year FRM will be based on its impact for implementing the Interest First 30 year FRM and 5/1 ARM products.

Manufactured Homes (MH)

MH has always been a good source of goals eligible loans but also poses one of the biggest risks for Fannie Mae. This risk is reflected in the very negative DU treatment of MH loans (manual underwriting is not permitted for MH) and the significant model fees assessed by Credit Finance (see "Pricing" section of memo).

Due to the goals rich nature of MH loans and the needs of the Hurricane Katrina impacted regions, PMD evaluated the request to add MH to the MCM enhancements. Two major factors were identified that would make MH too difficult and time consuming to incorporate in this initiative:

1. Due to the significant risk of MH and DU's treatment of these loans, we would need to at a minimum add EA3 to MCM, which would result in significant efforts and costs if the fees were waived. Without also adding EA3, the likelihood that an Interest First loan with 100% LTV would be approved as an MCM was extremely unlikely. Without doing further research but based on current approval rates, there were doubts that even adding EA3 would not have yielded a noticeable approval rate if all the enhancements were layered on top of MH. Without changing the DU scorecard for MH, adding MH in MCM would most likely have been pointless.

2. Based on the analysis from Credit Finance, the model fee almost doubled when MH was added to any of the MCM enhancements (see "Pricing" section of memo). With the intent of waiving the increased model fees to make these options affordable for LMS eligible borrowers, the resulting negative gap for MH loans would have been 131bps higher than the current MCM gap of 96bps.

The issues listed above could not be resolved in time to make an impact for the 2006 goals and would have delayed the development and implementation of other enhancements that could have a material impact for the current year. For this reason, PMD has notified the other business partners that the MH enhancement will not be included in this initiative. The more global issue of how DU scores MH loans will be addressed in a separate initiative by the appropriate business group.

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Exhibit B

This chart summarizes the key eligibility and underwriting criteria for My Community Mortgage. Changes to the current guidelines are highlighted in green and bolded.

		MCM in DU	Manual Underwriting
Loan Purpose, Type, and Term	**OLD**	Purchase or LCOR; 30 years or less fixed-rate, 5/1, 7/1, and 10/1 ARMs	
	NEW	**Purchase or LCOR** • **Fully Amortizing Products: 30 years or less fixed-rate, 5/1, 7/1, and 10/1 ARMs** • **Interest First Products: 5/1 ARM (2/2/5 caps), 30- and 40 year fixed-rate with 10 year IO period** • **35 year fixed rate with 5 year IO period**	
Occupancy and Property Type	**OLD**	Owner-occupied primary residence, 1–2 unit; condos; also tribal trust or restricted lands (cost-based appraisals allowed)	Same plus co-ops (90% LTV for co-ops)
	NEW	Owner-occupied primary residence, 1–2 unit; condos; also tribal trust or restricted lands (cost-based appraisals allowed)	Same plus co-ops **up to 100% LTV**
Funds to Close	**OLD**	Minimum contribution from borrower's own funds: $500 for 1-unit, 3% for 2-unit; cash on-hand accepted for down payment and closing costs	Same except 3% minimum borrower contribution for co-ops
	NEW	Minimum contribution from borrower's own funds: **$0 for 1-unit**, 3% for 2-4 units; cash on-hand accepted for down payment and closing costs	
LTV/CLTV Limits	**OLD**	Maximum LTVs: – 100% for 1-unit – 97% for 2-unit – 95% for 3-4-unit CLTV maximum of 105% with Community Seconds only; CLTV maximum of 100% for 1-2 units with subordinate financing (non-Community Seconds); Minimum CLTV 95%	Same except no minimum CLTV; up to 120% CLTV with forgivable Community Seconds and max. 97% LTV for 2-unit properties and for CHC option to fund renovation or access modifications
	NEW	Maximum LTVs: – 100% for 1-unit – 97% for 2-unit – 95% for 3-4-unit CLTV maximum of 105% with Community Seconds only; CLTV maximum of 100% for 1-2 units with subordinate financing (non-Community Seconds®) - ***delete reference to Minimum CLTV***	No Change
Subordinate Financing		Community Seconds allowed for all MCM options. Subordinate financing (non-Community Seconds) allowed for all MCM options except Community Renovation and cooperatives, following Fannie Mae's guidelines for Flexible 97 /Flexible 100 with Subordinate Financing.	
Borrower Credit/DU Recommendations		At least one borrower must have traditional credit history; eligibility determined by DU: Approve/Eligible, EA-I/Eligible, EA-II/Eligible are eligible for delivery as MCM loans	600 (97% LTV) / 620 (100% LTV or 2-unit) minimum credit score or enhanced credit evaluation for traditional or nontraditional credit; guidelines for co-borrower with no credit and for extenuating circumstances
Ratios	**OLD**	Determined by DU	43% single qualifying ratio; up to 50% with CS and CHC options (two months' reserves required), but max. 45% with 100% LTV
	NEW	No Change	43% single qualifying ratio; up to 50% with CS and CHC options (two months' reserves required), but max. 45% with 100% LTV **Loans with 2-1 temporary buydowns:**

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	MCM in DU	Manual Underwriting
		LTV > 95%, qualify at note rate LTV ≤ 95%, qualify at bought down rate
Borrower Income Limits	Income limits waived in FannieNeighbors areas (use Fannie Mae Property GeoCoder and follow DU Guide for override) and on tribal trust/restricted lands; otherwise, limited to borrowers at or below 100% of AMI, with higher limits in high-cost areas; but 115% in rural areas and for CHC	
Mortgage Insurance Coverage	20% for 97.01–100% LTV; 18% for 95.01%–97%; 16% for 90.01%–95%; 12% for 85.01–90.00%; 6% for 80.01–85.00%	
Financed Mortgage Insurance	Allowed up to 100% LTV *including* the financed MI	
Other Income	Smart Commute savings; rental income: 75% for 2-unit, 65% for 3- to 4-unit; Section 8 housing choice vouchers for homeownership; part-time and overtime income as determined by DU; for boarder income from relatives or non-relatives, see DU Guide	Smart Commute, rental income, Section 8, and boarder income (same); 30% of qualifying income from occupying co-borrower without credit history; for *CS only*, part-time/overtime income with 12-month history
Reserves	Determined by DU	1 month for EEM; for CS and CHC options, 1 month using 45% single qualifying ratio and 2 months at 50%
Non-Occupying Co-Borrowers	Allowed only for CHC option	Allowed only for CHC option with qualifying ratios of 33/38% for total qualifying income
Home-Buyer Education	**OLD** Required for first-time buyers; landlord counseling required for 2-, 3-, or 4-unit buyers	
	NEW Landlord counseling required for 2-, 3-, or 4-unit buyers	
Post-Purchase Early Delinquency Counseling	Required	
Community Solutions Option	For teachers/educational institution employees, police officers, firefighters, and health care workers; flexibilities include interest rate buydown (manual underwriting required), gifted reserves, higher ratios (use manual underwriting if ineligible through DU)	
Community HomeChoice Option	For borrowers with a disability or who have a family member with a disability; flexibilities include income limit to 115% of AMI, interest rate buydown (manual underwriting required), gifted reserves, higher ratios (use manual underwriting if ineligible through DU), non-occupying co-borrower	
Energy Efficient Mortgage (EEM) Option	Available for 1-unit properties; cannot be combined with CS or CHC options; see DU Guide for instructions	Available for 1-unit properties; cannot be combined with CS or CHC options; refer to lender terms and conditions
Smart Commute Option	Can increase borrower's qualifying income in approved Smart Commute markets; add to "Other Income"	
3- to 4-Family	Max. LTV 95%; fixed-rate only; refer to MCM Lender Terms and Conditions for details	
Community Renovation	1-4 unit, requires separate variance terms and conditions	

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