FEDERAL NATIONAL MORTGAGE ASSOCIATION FANNIE MAE
Form 10-Q
August 04, 2016

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-Q

þ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended June 30, 2016
OR
o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to
Commission File No.: 0-50231
Federal National Mortgage Association
(Exact name of registrant as specified in its charter)
Fannie Mae

Federally chartered corporation	52-0883107
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

3900 Wisconsin Avenue, NW	20016
Washington, DC	(Zip Code)

(Address of principal executive offices)
Registrant's telephone number, including area code:
(800) 2FANNIE (800-232-6643)
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 þ No o
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes þ No o
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer þ	Accelerated filer o
Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No þ
As of June 30, 2016, there were 1,158,082,750 shares of common stock of the registrant outstanding.

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PART I—FINANCIAL INFORMATION

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

We have been under conservatorship, with the Federal Housing Finance Agency ("FHFA") acting as conservator, since September 6, 2008. As conservator, FHFA succeeded to all rights, titles, powers and privileges of the company, and of any shareholder, officer or director of the company with respect to the company and its assets. The conservator has since delegated specified authorities to our Board of Directors and has delegated to management the authority to conduct our day-to-day operations. Our directors do not have any fiduciary duties to any person or entity except to the conservator and, accordingly, are not obligated to consider the interests of the company, the holders of our equity or debt securities or the holders of Fannie Mae MBS unless specifically directed to do so by the conservator. We describe the rights and powers of the conservator, key provisions of our agreements with the U.S. Department of the Treasury ("Treasury"), and their impact on shareholders in our Annual Report on Form 10-K for the year ended December 31, 2015 ("2015 Form 10-K") in "Business—Conservatorship and Treasury Agreements."

You should read this Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") in conjunction with our unaudited condensed consolidated financial statements and related notes and the more detailed information in our 2015 Form 10-K.

This report contains forward-looking statements that are based on management's current expectations and are subject to significant uncertainties and changes in circumstances. Please review "Forward-Looking Statements" for more information on the forward-looking statements in this report. Our actual results may differ materially from those reflected in our forward-looking statements due to a variety of factors including, but not limited to, those discussed in "Risk Factors" and elsewhere in this report and in our 2015 Form 10-K.

You can find a "Glossary of Terms Used in This Report" in the "MD&A" of our 2015 Form 10-K.

INTRODUCTION

Fannie Mae is a government-sponsored enterprise ("GSE") that was chartered by Congress in 1938. We serve an essential role in the functioning of the U.S. housing market and are investing in improvements to the U.S. housing finance system. Our public mission is to support liquidity and stability in the secondary mortgage market, where existing mortgage-related assets are purchased and sold, and to increase the supply of affordable housing. Our charter does not permit us to originate loans or lend money directly to consumers in the primary mortgage market.

Fannie Mae provides reliable, large-scale access to affordable mortgage credit and indirectly enables families to buy, refinance or rent homes. We securitize mortgage loans originated by lenders into Fannie Mae mortgage-backed securities that we guarantee, which we refer to as Fannie Mae MBS. One of our key functions is to evaluate, price and manage the credit risk on the loans and securities that we guarantee. We also purchase mortgage loans and mortgage-related securities, primarily for securitization and sale at a later date. We use the term "acquire" in this report to refer to both our securitizations and our purchases of mortgage-related assets. We obtain funds to support our business activities by issuing a variety of debt securities in the domestic and international capital markets, which attracts global capital to the United States housing market.

We remain in conservatorship and our conservatorship has no specified termination date. We do not know when or how the conservatorship will terminate, what further changes to our business will be made during or following conservatorship, what form we will have and what ownership interest, if any, our current common and preferred stockholders will hold in us after the conservatorship is terminated or whether we will continue to exist following conservatorship. In addition, as a result of our agreements with Treasury and dividend directives from our conservator, we are not permitted to retain our net worth (other than a limited amount that will decrease to zero by 2018), rebuild our capital position or pay dividends or other distributions to stockholders other than Treasury. Our senior preferred stock purchase agreement with Treasury also includes covenants that significantly restrict our business activities. Congress and the Obama Administration continue to consider options for reform of the housing finance system, including the GSEs. We cannot predict the prospects for the enactment, timing or final content of housing finance reform legislation or actions the Administration or FHFA may take with respect to housing finance reform. The conservatorship, the uncertainty of our future, limitations on executive and employee compensation, and negative publicity concerning the GSEs have had and are likely to continue to have an adverse effect on our ability to retain and recruit well-qualified executives and other employees. We provide additional information on the conservatorship, the provisions of our agreements with Treasury, and their impact on our business in our 2015 Form 10-K in

“Business—Conservatorship and Treasury Agreements” and “Risk Factors.” We discuss the uncertainty of our future in

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"Executive Summary—Outlook" and "Risk Factors" in this report. We discuss proposals for housing finance reform that could materially affect our business in our 2015 Form 10-K in "Business—Housing Finance Reform."

Although Treasury owns our senior preferred stock and a warrant to purchase 79.9% of our common stock, and has made a commitment under a senior preferred stock purchase agreement to provide us with funds to maintain a positive net worth under specified conditions, the U.S. government does not guarantee our securities or other obligations.

Our common stock is traded in the over-the-counter market and quoted on the OTC Bulletin Board under the symbol "FNMA." Our debt securities are actively traded in the over-the-counter market.

EXECUTIVE SUMMARY

Overview

We reported net income of $2.9 billion for the second quarter of 2016, compared with net income of $4.6 billion for the second quarter of 2015. See "Summary of Our Financial Performance" below for an overview of our financial performance for the second quarter and first half of 2016, compared with the second quarter and first half of 2015. We expect to remain profitable on an annual basis for the foreseeable future; however, certain factors, such as changes in interest rates or home prices, could result in significant volatility in our financial results from quarter to quarter or year to year. For more information regarding our expectations for our future financial performance, see "Outlook" below.

With our expected September 2016 dividend payment to Treasury, we will have paid a total of $151.4 billion in dividends to Treasury on our senior preferred stock. The aggregate amount of draws we have received from Treasury to date under the senior preferred stock purchase agreement is $116.1 billion. Under the terms of the senior preferred stock purchase agreement, dividend payments do not offset prior Treasury draws. For more information regarding our dividend payments to Treasury, see "Treasury Senior Preferred Stock Purchase Agreement" below.

Our Strategy and Business Objectives

Our vision is to be America's most valued housing partner and to provide liquidity, access to credit and affordability in all U.S. housing markets at all times, while effectively managing and reducing risk to our business, taxpayers and the housing finance system. In support of this vision, we are focused on:

- advancing a sustainable and reliable business model that reduces risk to the housing finance system and taxpayers;
- providing reliable, large-scale access to affordable mortgage credit for qualified borrowers and helping struggling homeowners; and
- serving customer needs and improving our business efficiency.

Advancing a sustainable and reliable business model that reduces risk to the housing finance system and taxpayers

We have significantly changed our business model since we entered conservatorship in 2008 and our business continues to evolve. We have strengthened our underwriting and eligibility standards, we are moving from a portfolio-focused business to a guaranty-focused business and we are transferring an increasing portion of the credit risk on our guaranty book of business. These changes are transforming our business model and reducing certain risks of our business as compared with our business prior to entering conservatorship.

Stronger Underwriting and Eligibility Standards. Beginning in 2008, we made changes to strengthen our underwriting and eligibility standards that have improved the credit quality of our single-family guaranty book of business and contributed to improvement in our credit performance. See "Single-Family Guaranty Book of Business" below for information on the credit performance of the mortgage loans in our single-family guaranty book of business and on our recent single-family acquisitions.

Moving from a portfolio-focused business to a guaranty-focused business. In recent years, an increasing portion of our net interest income has been derived from the guaranty fees we receive for managing the credit risk on loans underlying our Fannie Mae MBS, rather than from interest income on our retained mortgage portfolio assets. This shift has been driven by both the impact of guaranty fee increases implemented in 2012 and the reduction of our retained mortgage portfolio in accordance with the requirements of our senior preferred stock purchase agreement with Treasury and direction from FHFA. Our "retained mortgage portfolio" refers to the mortgage-related assets we own (which excludes the portion of assets held by consolidated MBS trusts that back mortgage-related securities owned by third parties). In the first half of 2016, approximately two-thirds of our net interest income was derived from our guaranty business. As described in more detail in

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"Outlook—Revenues" below, we expect that guaranty fees will continue to account for an increasing portion of our net interest income.

Transferring a portion of the mortgage credit risk on our single-family book of business. In late 2013, we began entering into credit risk transfer transactions with the goal of transferring, to the extent economically sensible, a portion of the mortgage credit risk on some of the recently-acquired loans in our single-family book of business in order to reduce the economic risk to us and to taxpayers of future borrower defaults. In the aggregate, our credit risk transfer transactions completed through June 30, 2016 transferred a significant portion of the mortgage credit risk on single-family mortgages with an unpaid principal balance of over $660 billion. We intend to continue to engage in credit risk transfer transactions on an ongoing basis, subject to market conditions. Approximately 19% of the loans in our single-family conventional guaranty book of business as of June 30, 2016, measured by unpaid principal balance, were included in a reference pool for a Connecticut Avenue Securities™ ("CAS") or a Credit Insurance Risk Transfer™ ("CIRT™") transaction. Over time, we expect that a larger portion of our single-family conventional guaranty book of business will be covered by credit risk transfer transactions. For further discussion of our credit risk transfer transactions, see "Risk Management—Credit Risk Management—Single-Family Mortgage Credit Risk Management—Transfer of Mortgage Credit Risk—Credit Risk-Sharing Transactions."

Our business also continues to evolve as a result of our many other efforts to build a safer and sustainable housing finance system and to pursue the strategic goals identified by our conservator, and we continue to invest significant resources towards these goals. See "Business—Executive Summary—Helping to Build a Sustainable Housing Finance System" in our 2015 Form 10-K for a discussion of these efforts and FHFA's strategic goals for our conservatorship, including a description of some of the actions we are taking pursuant to the mandates of FHFA's conservatorship scorecards in order to build the policies and infrastructure for a sustainable housing finance system. For more information on FHFA's 2016 conservatorship scorecard objectives, see our Current Report on Form 8-K filed with the Securities and Exchange Commission ("SEC") on December 17, 2015.

Providing reliable, large-scale access to affordable mortgage credit for qualified borrowers and helping struggling homeowners

We continued to provide reliable, large-scale access to affordable mortgage credit to the U.S. housing market in the second quarter of 2016 and remained a leading source of liquidity in the single-family and multifamily markets. We also continued to help struggling homeowners. In the second quarter of 2016, we provided approximately 27,000 loan workouts to help homeowners stay in their homes or otherwise avoid foreclosure. We discuss our activities to support the housing and mortgage markets in "Contributions to the Housing and Mortgage Markets" below.

Serving customer needs and improving our business efficiency

We are continuing our initiatives to better serve our customers' needs and improve our business efficiency in 2016. These initiatives include continuing to revise and clarify our representation and warranty framework, implementing innovative new and enhanced tools that deliver greater value and certainty to lenders, simplifying our business processes, and updating our infrastructure. We discuss these initiatives in "Serving Customer Needs and Improving Our Business Efficiency" below and in our 2015 Form 10-K in "Business—Executive Summary."

Summary of Our Financial Performance

Comprehensive Income

Quarterly Results

We recognized comprehensive income of $2.9 billion in the second quarter of 2016, consisting of net income of $2.9 billion and other comprehensive loss of $77 million. In comparison, we recognized comprehensive income of $4.4 billion in the second quarter of 2015, consisting of net income of $4.6 billion and other comprehensive loss of $281 million. The decline in our net income in the second quarter of 2016 compared with the second quarter of 2015 was primarily driven by a shift to fair value losses from fair value gains and a decline in net revenues, partially offset by a shift to credit-related income from credit-related expense.

We recognized fair value losses of $1.7 billion in the second quarter of 2016 compared with fair value gains of $2.6 billion in the second quarter of 2015. Fair value losses in the second quarter of 2016 were driven by declines in longer-term swap rates during the period. Fair value gains in the second quarter of 2015 were driven by increases in longer-term swap rates during the period.

Net revenues, which consist of net interest income and fee and other income, were $5.5 billion in the second quarter of 2016, compared with $6.2 billion in the second quarter of 2015. We recognized net interest income of $5.3 billion in the second

quarter of 2016 compared with $5.7 billion in the second quarter of 2015. The decline in net interest income was due to a decline in the average balance of our retained mortgage portfolio, partially offset by higher guaranty fee income.
We recognized credit-related income of $1.5 billion in the second quarter of 2016 compared with credit-related expense of $1.2 billion in the second quarter of 2015. Credit-related income in the second quarter of 2016 was driven by a $1.6 billion benefit for credit losses during the quarter, which was primarily attributable to an increase in home prices. Higher home prices decrease the likelihood that loans will default and reduce the amount of credit loss on loans that do default, which impacts our estimate of losses and ultimately reduces our total loss reserves and provision for credit losses. A decline in actual and projected mortgage interest rates also contributed to the benefit for credit losses during the second quarter of 2016. As mortgage interest rates decline, we expect an increase in future prepayments on single-family individually impaired loans, including modified loans. Higher expected prepayments shorten the expected lives of modified loans, which decreases the impairment relating to concessions provided on these loans and results in a decrease in our provision for credit losses. Credit-related expense in the second quarter of 2015 was primarily attributable to an increase in mortgage interest rates during the period. As mortgage interest rates increase, we expect a decline in future prepayments on single-family individually impaired loans, including modified loans. Lower expected prepayments lengthen the expected lives of modified loans, which increases the impairment relating to concessions provided on these loans and results in an increase in our provision for credit losses. In addition, we redesignated certain nonperforming single-family loans from held for investment (“HFI”) to held for sale (“HFS”) in the second quarter of 2015. Those loans were adjusted to the lower of cost or fair value, which increased credit-related expense for the quarter. Credit-related expense was partially offset by a positive impact from an increase in home prices during the second quarter of 2015.

Year-to-Date Results

We recognized comprehensive income of $3.8 billion in the first half of 2016, consisting of net income of $4.1 billion and other comprehensive loss of $277 million. In comparison, we recognized comprehensive income of $6.2 billion in the first half of 2015, consisting of net income of $6.5 billion and other comprehensive loss of $373 million. The decline in our net income was driven by a shift to fair value losses from fair value gains and a decline in net revenues, partially offset by a shift to credit-related income from credit-related expense.
Fair value losses of $4.5 billion in the first half of 2016 and fair value gains of $687 million in the first half of 2015 were primarily a result of the same factors that affected our results for the second quarters of 2016 and 2015, as described above.
Net revenues were $10.4 billion in the first half of 2016 and $11.6 billion in the first half of 2015. The decrease in net revenues was primarily a result of the same factors that affected our results for the second quarters of 2016 and 2015, as described above.
We recognized credit-related income of $2.4 billion in the first half of 2016 and credit-related expense of $1.2 billion in the first half of 2015. Credit-related income in the first half of 2016 was primarily attributable to an increase in home prices. Additionally, a decline in actual and projected mortgage interest rates contributed to the credit-related income during the first half of 2016. Credit-related expense in the first half of 2015 was primarily attributable to an increase in mortgage interest rates during the period. In addition, we redesignated certain nonperforming single-family loans from HFI to HFS in the first half of 2015. Those loans were adjusted to the lower of cost or fair value, which increased credit-related expense for the period. Credit-related expense was partially offset by a positive impact from an increase in home prices during the first half of 2015.
We expect volatility from period to period in our financial results from a number of factors, particularly changes in market conditions that result in fluctuations in the estimated fair value of the financial instruments that we mark to market through our earnings. These instruments include derivatives and certain securities. The estimated fair value of our derivatives and securities may fluctuate substantially from period to period because of changes in interest rates, the yield curve, mortgage and credit spreads, and implied volatility, as well as activity related to these financial instruments. We use derivatives to manage the interest rate risk exposure of our net portfolio, which consists of our retained mortgage portfolio, cash and other investments portfolio, and outstanding debt of Fannie Mae. Some of these financial instruments in our net portfolio are not recorded at fair value in our condensed consolidated financial statements, and as a result we may experience accounting gains or losses due to changes in interest rates or other

market conditions that may not be indicative of the economic interest rate risk exposure of our net portfolio. See “Risk Management—Market Risk Management, Including Interest Rate Risk Management” for more information. In addition, our credit-related income or expense can vary substantially from period to period based on factors such as changes in actual and expected home prices, borrower paymen