

OFFERING CIRCULAR

3,000,000 Shares



5.25% Non-Cumulative Preferred Stock, Series D
(stated value \$50 per share)

Dividends on the 5.25% Non-Cumulative Preferred Stock, Series D (stated value \$50 per share) (the "Preferred Stock") of the Federal National Mortgage Association (the "Corporation" or "Fannie Mae") will accrue from and including September 30, 1998 and will be payable quarterly on March 31, June 30, September 30 and December 31 of each year, commencing December 31, 1998, at the annual rate of \$2.625 per share. Such dividends will be payable when, as and if declared by the Board of Directors of the Corporation in its sole discretion out of funds legally available for such payment.

Dividends on the Preferred Stock will not be cumulative. Because dividends on the Preferred Stock are non-cumulative, if for any reason a dividend on the Preferred Stock is not declared for a dividend period, the Corporation will have no obligation to pay a dividend for such period, whether or not dividends on the Preferred Stock are declared for any future dividend period. If, however, dividends have not been paid or set aside for payment on the Preferred Stock in respect of a dividend period, the Corporation may not pay dividends on its common stock in respect of such period.

On or after September 30, 1999, the Preferred Stock will be redeemable, in whole or in part, at any time or from time to time, at the option of the Corporation at the redemption price of \$50.00 per share plus an amount equal to the dividend for the then-current quarterly dividend period accrued to but excluding the date of such redemption (whether or not declared, but without accumulation of any dividends for prior dividend periods).

The Preferred Stock will not have any voting rights, except as set forth under "Description of Preferred Stock—Voting Rights; Amendments."

The Preferred Stock has not been listed on a stock exchange.

THE OBLIGATIONS OF THE CORPORATION UNDER THE TERMS OF THE PREFERRED STOCK ARE OBLIGATIONS OF THE CORPORATION ONLY AND ARE NOT THOSE OF THE UNITED STATES OR OF ANY INSTRUMENTALITY THEREOF OTHER THAN THE CORPORATION.

	Price to Public (1)	Underwriting Discount (2)	Proceeds to Corporation (1) (3)
Per Share	\$50.00	\$0.50	\$49.50
Total	\$150,000,000	\$1,500,000	\$148,500,000

(1) Plus accrued dividends, if any, from September 30, 1998.

(2) The Corporation has agreed to indemnify the Underwriter against certain liabilities. See "Underwriting."

(3) Before deducting expenses payable by the Corporation estimated at \$100,000.

The Preferred Stock is offered by the Underwriter, subject to prior sale, when, as and if issued to and accepted by it and subject to certain other conditions. The Underwriter reserves the right to withdraw, cancel or modify such offer and to reject orders in whole or in part. It is expected that delivery of the Preferred Stock will be made in New York, New York, on or about September 30, 1998 against payment therefor in immediately available funds.

Bear, Stearns & Co. Inc.

August 20, 1998

THE UNDERWRITER PARTICIPATING IN THIS OFFERING MAY ENGAGE IN TRANSACTIONS THAT STABILIZE, MAINTAIN OR OTHERWISE AFFECT THE PRICE OF THE PREFERRED STOCK. SUCH TRANSACTIONS MAY INCLUDE STABILIZING AND THE PURCHASE OF PREFERRED STOCK TO COVER SHORT POSITIONS OF THE UNDERWRITER. FOR A DESCRIPTION OF THESE ACTIVITIES, SEE "UNDERWRITING."

The shares of Preferred Stock are exempt from the registration requirements of the Securities Act of 1933 and are "exempted securities" within the meaning of the Securities Exchange Act of 1934. Accordingly, no registration statement has been filed with the Securities and Exchange Commission. The Preferred Stock has not been approved or disapproved by the Securities and Exchange Commission or any state securities commission nor has the Securities and Exchange Commission or any state securities commission passed upon the accuracy or adequacy of this Offering Circular. Any representation to the contrary is a criminal offense.

The distribution of this Offering Circular and the offer, sale and delivery of the Preferred Stock in certain jurisdictions may be restricted by law. Persons into whose possession this Offering Circular comes are required by the Corporation and the Underwriter to inform themselves about and to observe any such restrictions.

DOCUMENTS INCORPORATED BY REFERENCE

This Offering Circular should be read only in conjunction with the Corporation's Information Statement dated March 31, 1998 and the Supplements thereto dated May 15, 1998 and August 13, 1998 (collectively, the "Information Statement"), which are attached hereto and incorporated herein by this reference. This Offering Circular, together with the Information Statement and any documents incorporated herein by reference, are referred to herein as the "Offering Circular." Any Information Statement, supplement thereto, or proxy statement published by the Corporation subsequent to the date of this Offering Circular and prior to the termination of the offering of the Preferred Stock shall be deemed to be incorporated herein by this reference. Any statement contained herein or in a document incorporated or deemed to be incorporated by reference herein shall be deemed to be modified or superseded for purposes of this Offering Circular to the extent that a statement contained herein or in any other subsequent document that also is or is deemed to be incorporated by reference herein modifies or supersedes such statement. Any such statement so modified or superseded shall not be deemed, except as so modified or superseded, to constitute a part of this Offering Circular.

AVAILABLE INFORMATION

Copies of any or all documents incorporated herein by reference may be obtained without charge from the Office of Investor Relations, Fannie Mae, 3900 Wisconsin Avenue N.W., Washington, D.C. 20016 (telephone: (202) 752-7115). The Information Statement, proxy statements and other information concerning the Corporation also may be inspected at the offices of the New York Stock Exchange, the Chicago Stock Exchange and the Pacific Stock Exchange.

The Corporation is not subject to the periodic reporting requirements of the Securities Exchange Act of 1934 and does not file reports or other information with the Securities and Exchange Commission.

SUMMARY OF THE OFFERING

The following summary is qualified in its entirety by, and should be read in conjunction with, the more detailed information and financial data appearing elsewhere in this Offering Circular, the Information Statement and the Certificate of Designation (as defined under "Description of Preferred Stock").

The Corporation

Fannie Mae is a federally chartered and stockholder-owned corporation organized and existing under the Federal National Mortgage Association Charter Act (the "Charter Act"). It is the largest investor in home mortgage loans in the United States. The Corporation provides funds to the mortgage market by purchasing mortgage loans from lenders, thereby replenishing their funds for additional lending. The Corporation acquires funds to purchase loans from many capital market investors that ordinarily may not invest in mortgage loans, thereby expanding the total amount of funds available for housing. The Corporation also issues mortgage-backed securities ("MBS"). The Corporation receives guaranty fees for its guarantee of timely payment of principal and interest on MBS certificates.

The Offering

Issuer	Fannie Mae.
Securities Offered	3,000,000 shares of 5.25% Non-Cumulative Preferred Stock, Series D, no par value, stated value and liquidation preference \$50.00 per share (the "Preferred Stock").
Dividends	Holder of Preferred Stock will be entitled to receive non-cumulative, quarterly cash dividends which will accrue from and including September 30, 1998 and will be payable on March 31, June 30, September 30 and December 31 of each year, commencing December 31, 1998, at the annual rate of \$2.625 per share, when, as and if declared by the Board of Directors.
Preferences	The Preferred Stock will be entitled to a preference, both as to dividends and upon liquidation, over the common stock (and any other junior stock) of the Corporation.
Optional Redemption	On or after September 30, 1999, the Preferred Stock will be redeemable, in whole or in part, at any time or from time to time, at the option of the Corporation at the redemption price of \$50.00 per share plus an amount equal to the dividend for the then-current quarterly dividend period accrued to but excluding the date of such redemption (whether or not declared, but without accumulation of any dividends for prior dividend periods). Holder of Preferred Stock will have no right to require redemption of Preferred Stock.
Liquidation Rights	Upon any dissolution, liquidation or winding up of the Corporation, record holders of the outstanding shares of Preferred Stock will be entitled to receive, out of the assets of the Corporation available for distribution to stockholders, before any payment or distribution is made on the common stock (or any other junior stock) of the Corporation, \$50.00 per share plus an amount equal to the dividend for the then-current quarterly dividend period accrued to but excluding the date of such liquidation payment (whether or not declared, but without accumulation of any dividends for prior dividend periods).

Voting Rights	None, except as to certain amendments relating to the terms of the Preferred Stock.
Preemptive and Conversion Rights	None.
Use of Proceeds	To be added to the working capital of the Corporation and used for general corporate purposes and may be used to repurchase common stock of the Corporation.
Listing	The Preferred Stock has not been listed on a stock exchange.

Summary Selected Financial Data
(Unaudited)
(Dollars in millions)

	June 30,		December 31,				
	1998	1997	1997	1996	1995	1994	1993
Balance Sheet Data:							
Mortgage portfolio, net	\$349,282	\$296,799	\$316,316	\$286,259	\$252,588	\$220,525	\$189,892
Total assets	429,448	365,997	391,673	351,041	316,550	272,508	216,979
Total liabilities	415,263	352,733	377,880	338,268	305,591	262,967	208,927
Stockholders' equity	14,185	13,264	13,793	12,773	10,959	9,541	8,052
Capital(1)	14,973	14,019	14,575	13,520	11,703	10,367	8,893
	Six Months Ended June 30,		Year Ended December 31,				
	1998	1997	1997	1996	1995	1994	1993
Income Statement Data:							
Net interest income	\$ 2,067	\$ 1,920	\$ 3,949	\$ 3,592	\$ 3,047	\$ 2,823	\$ 2,533
Guaranty fees	644	630	1,274	1,196	1,086	1,083	961
Fee and other income, net	135	62	125	86	93	143	259
Special contribution	—	—	—	—	(350)	—	—
Net income	1,672	1,487	3,056	2,725	2,144	2,132	1,873
	Six Months Ended June 30,		Year Ended December 31,				
	1998	1997	1997	1996	1995	1994	1993
Other Data:							
Average net interest margin	1.10%	1.17%	1.17%	1.18%	1.16%	1.24%	1.38%
Ratio of earnings to combined fixed charges and preferred stock dividends(2)	1.19:1	1.19:1	1.19:1	1.19:1	1.17:1	1.22:1	1.22:1
Mortgage purchases	\$ 72,379	\$ 27,421	\$ 70,465	\$ 68,618	\$ 56,598	\$ 62,389	\$ 92,037
MBS issued	142,139	61,327	149,429	149,869	110,456	130,622	221,444
MBS outstanding at period end(3) ...	761,359	673,931	709,582	650,780	582,959	530,343	495,525

(1) Stockholders' equity plus general allowance for losses at period end.

(2) "Earnings" consists of (i) income before federal income taxes and extraordinary item and (ii) fixed charges. "Fixed charges" consists of interest expense. There was no preferred stock outstanding for the years 1993 through 1995.

(3) Includes MBS in portfolio of \$156 billion and \$116 billion at June 30, 1998 and 1997, respectively, and \$130 billion, \$103 billion, \$70 billion, \$44 billion, and \$24 billion at December 31, 1997, 1996, 1995, 1994, and 1993, respectively.

THE CORPORATION

Fannie Mae is a federally chartered and stockholder-owned corporation organized and existing under the Federal National Mortgage Association Charter Act, 12 U.S.C. § 1716 *et seq.* (the “Charter Act”). See “Government Regulation and Charter Act” in the Information Statement. It is the largest investor in home mortgage loans in the United States. The Corporation originally was established in 1938 as a United States government agency to provide supplemental liquidity to the mortgage market and was transformed into a stockholder-owned and privately managed corporation by legislation enacted in 1968.

The Corporation provides funds to the mortgage market by purchasing mortgage loans from lenders, thereby replenishing their funds for additional lending. The Corporation acquires funds to purchase loans from many capital market investors that ordinarily may not invest in mortgage loans, thereby expanding the total amount of funds available for housing. Operating nationwide, the Corporation helps to redistribute mortgage funds from capital-surplus to capital-short areas.

The Corporation also issues mortgage-backed securities (“MBS”), receiving guaranty fees for its guarantee of timely payment of principal and interest on MBS certificates. The Corporation issues MBS primarily in exchange for pools of mortgage loans from lenders. The issuance of MBS enables the Corporation to further its statutory purpose of increasing the liquidity of residential mortgage loans.

In addition, the Corporation offers various services to lenders and others for a fee. These include issuing certain types of MBS and providing technology services in support of originating and underwriting mortgage loans. See “Business” in the Information Statement.

The Corporation’s principal office is located at 3900 Wisconsin Avenue, N.W., Washington, D.C. 20016 (telephone: (202) 752-7000).

USE OF PROCEEDS

The net proceeds from the sale of the Preferred Stock (as defined under “Description of Preferred Stock”) will be added to the working capital of the Corporation and used for general corporate purposes and may be used to repurchase common stock of the Corporation.

The Corporation anticipates that additional financing, including financing through various types of equity and debt securities, will be required from time to time. The amount and nature of the Corporation’s financing activities are dependent upon a number of factors, including the volume of the Corporation’s maturing debt obligations, the volume of mortgage loan prepayments, the volume and type of mortgage loans purchased by the Corporation, and general market conditions.

CAPITALIZATION

The following table sets forth the capitalization of the Corporation as of June 30, 1998, and as adjusted to give effect to the issuance of the Preferred Stock offered hereby (before giving effect to the payment of estimated offering expenses and underwriting discount):

	Average Maturity	Average Cost (1)	Actual Outstanding at June 30, 1998	As Adjusted
(Dollars in millions)				
Debtures, notes, and bonds, net:				
Due within one year:				
Short-term notes	2 mos.	5.57%	\$100,691	\$100,691
Debentures	5 mos.	5.82	13,575	13,575
Medium-term notes (2)	8 mos.	5.60	59,745	59,745
Other (3)	—	5.83	931	931
Total due within one year			174,942	174,942
Due after one year:				
Debentures	5 yrs. 5 mos.	6.62	74,784	74,784
Medium-term notes (2)	6 yrs. 1 mos.	6.42	153,649	153,649
Other	18 yrs. 6 mos.	8.14	2,787	2,787
Total due after one year			231,220	231,220
Total debtures, notes, and bonds			\$406,162	\$406,162
Stockholders' equity:				
Preferred stock, \$50.00 stated value, 100,000,000 shares authorized— 23,000,000 shares issued				
Series A, 7,500,000 shares issued			\$ 375	\$ 375
Series B, 7,500,000 shares issued			375	375
Series C, 5,000,000 shares issued			250	250
Series D, 3,000,000 shares issued			—	150
Common stock, \$.525 stated value, no maximum authorization—1,129 million shares issued				
Additional paid-in capital			593	593
Retained earnings			1,537	1,537
Accumulated other comprehensive income			14,469	14,469
			1	1
			17,600	17,750
Less treasury stock, at cost—103 million shares (4)				
			3,415	3,415
Total stockholders' equity			\$ 14,185	\$ 14,335

- (1) Represents weighted-average cost, which includes the amortization of discounts, premiums, issuance costs, hedging results, and the effects of currency and debt swaps.
- (2) Medium-term notes may have maturities of one day or longer.
- (3) Average maturity is indeterminate because the outstanding amount includes investment agreements that have varying maturities.
- (4) Does not reflect any repurchases of the Corporation's common stock that may be made using proceeds from the sale of the Preferred Stock, Series D. See "Use of Proceeds."

The Corporation issues debentures, notes and other debt obligations frequently. The amount of debentures, notes, and other debt obligations outstanding on any date subsequent to June 30, 1998 may differ from that shown in the table above.

GOVERNMENT REGULATION AND CHARTER ACT

The Corporation is a federally chartered and stockholder-owned corporation organized and existing under the Charter Act (12 U.S.C. § 1716 *et seq.*) whose purpose is to (1) provide stability in the secondary market for residential mortgages, (2) respond appropriately to the private capital market, (3) provide ongoing assistance to the secondary market for residential mortgages (including activities relating to mortgages on housing for low- and moderate-income families involving a reasonable economic return that may be less than the return earned on other activities) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing, and (4) promote access to mortgage credit throughout the nation (including central cities, rural areas and underserved areas) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing.

Fannie Mae originally was incorporated in 1938 pursuant to Title III of the National Housing Act as a wholly owned government corporation and in 1954, under a revised Title III called the Federal National Mortgage Association Charter Act, became a mixed-ownership corporate instrumentality of the United States. From 1950 to 1968, it operated in the Housing and Home Finance Agency, which was succeeded by the Department of Housing and Urban Development (“HUD”). Pursuant to amendments to the Charter Act enacted in the Housing and Urban Development Act of 1968 (the “1968 Act”), the then Federal National Mortgage Association was divided into two separate institutions, the present Corporation and the Government National Mortgage Association, a wholly owned corporate instrumentality of the United States within HUD, which carried on certain special financing assistance and management and liquidation functions. Under the 1968 Act, the Corporation was constituted as a federally chartered corporation and the entire equity interest in the Corporation became stockholder-owned.

Although the 1968 Act eliminated all federal ownership interest in the Corporation, it did not terminate government regulation of the Corporation. Under the Charter Act, approval of the Secretary of the Treasury is required for the Corporation’s issuance of its debt obligations and MBS. In addition, the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (the “1992 Act”) established an independent Office of Federal Housing Enterprise Oversight (“OFHEO”) within HUD under the management of a Director (the “Director”) who is responsible for ensuring that the Corporation is adequately capitalized and operating safely in accordance with the 1992 Act. The 1992 Act established risk-based capital, minimum capital and critical capital levels for the Corporation and required the Director to establish, by regulation, a risk-based capital test to be used to determine the amount of total capital the Corporation must have to exceed the risk-based capital level from time to time. OFHEO issued a final rule (the “Rule”) in 1996 related to the minimum capital levels for Fannie Mae and Federal Home Loan Mortgage Corporation (“Freddie Mac”) that sets forth how minimum capital requirements for both entities are to be calculated, reported and classified on a quarterly basis. The Rule, which finalized an original proposal dated June 1995, formalized the interim capital standards applied by OFHEO, with which the Corporation has been in compliance since their inception. See also “Management’s Discussion and Analysis of Financial Condition and Results of Operations—Balance Sheet Analysis—Regulatory Capital Requirements” in the Information Statement.

In 1996, OFHEO released for comment part one (“Part I”) of the proposed regulations to establish the risk-based capital test. Part I specifies the “benchmark loss experience” that will be combined with other yet to be determined assumptions and applied each quarter to the Corporation’s book of business to establish credit losses under the risk-based capital standard for the Corporation. Part I also specifies the house price index that OFHEO will use in connection with the risk-based capital standard. The Corporation submitted comments to OFHEO in October 1996 stating that several aspects of the initial proposal require adjustments or amendment, because it does not accurately capture the Corporation’s credit history and derives credit loss rates that are significantly worse than any reasonable representation of Fannie Mae’s and Freddie Mac’s loss experience.

OFHEO has indicated that it plans to release a proposed second part of the risk-based capital regulation, which will specify, among other matters, remaining aspects of the stress test and how the stress test will be used to determine the Corporation's risk-based capital requirements. Management understands that OFHEO expects to publish this second part in January 1999. Management is optimistic that the final regulations will permit the Corporation to manage its business in a reasonably efficient manner.

If the Corporation fails to meet one or more of these capital standards under the 1992 Act, the Director is required to take certain remedial measures and may take others, depending on the standards the Corporation fails to meet. The Director is given enforcement powers that include the power to impose temporary and final cease-and-desist orders and civil penalties on the Corporation and on a director or executive officer of the Corporation. If the Director determines that the Corporation is engaging in conduct not approved by the Director that could result in a rapid depletion of core capital or that the value of the property subject to mortgages held or securitized by the Corporation has decreased significantly, the Director is authorized to treat the Corporation as not meeting one of the capital standards that the Corporation otherwise meets. In addition, the Corporation is required to submit a capital restoration plan if it fails to meet any of the capital standards. If the Director does not approve the plan or determines that the Corporation has failed to make reasonable efforts to comply with the plan, then the Director may treat the Corporation as not meeting one of the capital standards that it otherwise meets. Also, if the Corporation fails to meet or is treated by the Director as not meeting one of the capital standards and the Director has reasonable cause to believe that the Corporation or any executive officer or director of the Corporation is engaging in or about to engage in any conduct that threatens to result in a significant depletion of the Corporation's core capital, then the Director is authorized to commence proceedings pursuant to which, after a hearing, the Director could issue a cease-and-desist order prohibiting such conduct. The Director could issue such an order without a hearing, which would be effective until completion of the cease-and-desist proceedings, if the Director determined that the conduct in question was likely to cause a significant depletion of core capital. Prior approval of the Director is required for the Corporation to pay a dividend if the dividend would decrease the Corporation's capital below risk-based capital or minimum capital levels established under the 1992 Act. The Director is authorized to levy, pursuant to annual Congressional appropriations, annual assessments on the Corporation and Freddie Mac to cover reasonable expenses of OFHEO.

The 1992 Act also gives the Director the authority to conduct annually an on-site examination of the Corporation for purposes of ensuring the Corporation's financial safety and soundness. The Director also has the discretion to conduct more frequent examinations if deemed necessary for safety and soundness. In addition, the Corporation is required to submit annual and quarterly reports of the financial condition and operations of the Corporation to the Director. Moreover, the Charter Act, as amended by the 1992 Act, authorizes the General Accounting Office ("GAO") to audit the programs, activities, receipts, expenditures and financial transactions of the Corporation. The Corporation also is required to submit an annual report to the House and Senate Banking Committees and the Secretary of HUD regarding the Corporation's performance in meeting housing goals relating to the purchase of mortgages on housing for low- and moderate-income families, mortgages on rental and owner-occupied housing for low-income families in low-income areas or for very-low-income families, and mortgages on housing located in rural or other underserved areas.

Under the 1992 Act, the Secretary of HUD retains general regulatory authority to promulgate rules and regulations to carry out the purposes of the Charter Act, excluding authority over matters granted exclusively to the Director in the 1992 Act. The Secretary of HUD also must approve any new conventional mortgage program that is significantly different from those approved or engaged in prior to the 1992 Act. The Secretary of HUD is required to approve any new program unless it is not authorized by the Charter Act or the Secretary of HUD finds that the new program is not in the public interest. Until one year after the final regulations establishing the risk-based capital test are in effect, however, the Secretary of HUD must disapprove a new program if the Director determines that the

program would risk significant deterioration of the financial condition of the Corporation. The Secretary of HUD has adopted regulations related to the program approval requirement.

Thirteen members of the Corporation's eighteen-member Board of Directors (the "Board of Directors") are elected by the holders of the Corporation's common stock, and the remaining five members are appointed by the President of the United States. The appointed directors must include one person from the home building industry, one person from the mortgage lending industry, and one person from the real estate industry. Under the 1992 Act, one appointed director also must be from an organization that has represented consumer or community interests for not less than two years or a person who has demonstrated a career commitment to the provision of housing for low-income households. Any member of the Board of Directors who is appointed by the President of the United States may be removed by the President for good cause.

In addition to placing the Corporation under federal regulation, the Charter Act also grants to the Corporation certain privileges. For instance, securities issued by the Corporation are deemed to be "exempt securities" under laws administered by the Securities and Exchange Commission ("SEC") to the same extent as securities that are obligations of, or guaranteed as to principal and interest by, the United States. Registration statements with respect to the Corporation's securities are not filed with the SEC. The Corporation also is not required to file periodic reports with the SEC.

The Secretary of the Treasury of the United States has discretionary authority to purchase obligations of the Corporation up to a maximum of \$2.25 billion outstanding at any one time. This facility has not been used since the Corporation's transition from government ownership in 1968. Neither the United States nor any agency thereof is obligated to finance the Corporation's operations or to assist the Corporation in any other manner.

The Corporation is exempt from all taxation by any state or by any county, municipality, or local taxing authority except for real property taxes. The Corporation is not exempt from payment of federal income taxes. Also, the Corporation may conduct its business without regard to any qualifications or similar statute in any state of the United States or the District of Columbia.

The Federal Reserve Banks are authorized to act as depositaries, custodians, and fiscal agents for the Corporation, for its own account, or as fiduciary.

DESCRIPTION OF PREFERRED STOCK

The Corporation is authorized by the Charter Act to have preferred stock on such terms and conditions as the Board of Directors of the Corporation may prescribe. On December 27, 1995, the Board of Directors of the Corporation amended the bylaws of the Corporation to authorize the Corporation to issue up to 100,000,000 shares of preferred stock. On March 1, 1996, the Corporation issued 7,500,000 shares of its 6.41% Non-Cumulative Preferred Stock, Series A (stated value \$50 per share) (the "Preferred Stock, Series A"), on April 12, 1996, the Corporation issued 7,500,000 shares of its 6.50% Non-Cumulative, Preferred Stock, Series B (stated value \$50 per share) (the "Preferred Stock, Series B") and on September 20, 1996, the Corporation issued 5,000,000 shares of its 6.45% Non-Cumulative Preferred Stock, Series C (stated value \$50 per share) (the "Preferred Stock, Series C").

The terms of the Preferred Stock, Series D (the "Preferred Stock") will be established by a Certificate of Designation of Terms of 5.25% Non-Cumulative Preferred Stock, Series D (the "Certificate of Designation"), adopted by a duly authorized committee of the Board of Directors of the Corporation, which will be substantially in the form attached as Appendix A to this Offering Circular. The following is a brief description of the terms of the Preferred Stock which does not purport to be complete and is subject to and qualified by reference to the Certificate of Designation.

General

The Corporation will have the right to create and issue additional shares of the Preferred Stock and to create and issue additional classes or series of stock ranking, as to dividends, liquidation or otherwise, prior to, on a parity with or junior to the Preferred Stock without the consent of holders of the Preferred Stock. As of the date hereof, the shares of Preferred Stock, Series A, Preferred Stock, Series B and Preferred Stock, Series C were the only shares of preferred stock of the Corporation outstanding. The Preferred Stock will rank on a parity, as to the payment of dividends and the distribution of assets upon dissolution, liquidation or winding up of the Corporation, with the Preferred Stock, Series A, the Preferred Stock, Series B and the Preferred Stock, Series C.

The Preferred Stock has no par value, has a stated value and liquidation preference of \$50 per share and, upon issuance against full payment of the purchase price therefor, will be fully paid and nonassessable.

The Preferred Stock will not be convertible into any other stock or obligations of the Corporation and will have no preemptive rights.

First Chicago Trust Company of New York will be the transfer agent, dividend disbursing agent and registrar for shares of Preferred Stock.

The obligations of the Corporation under the terms of the Preferred Stock are obligations of the Corporation only and are not those of the United States or of any instrumentality thereof other than the Corporation.

Dividends

Dividends on shares of the Preferred Stock will not be mandatory. Holders of record of Preferred Stock as they appear on the books and records of the Corporation (the "Holders") will be entitled to receive, when, as and if declared by the Board of Directors of the Corporation, or a duly authorized committee thereof, in its sole discretion out of funds legally available therefor, non-cumulative, quarterly cash dividends which will accrue from and including September 30, 1998 and will be payable on March 31, June 30, September 30 and December 31 of each year (each, a "Dividend Payment Date"), commencing December 31, 1998, at the annual rate of \$2.625 per share. Dividends on the Preferred Stock will be payable to the Holders on the relevant record date fixed by the Board of Directors, or a duly authorized committee thereof, which may not be earlier than 45 days or later than 10 days prior to the applicable Dividend Payment Date. If declared, the initial dividend, which will be for the period from and including September 30, 1998 to but excluding December 31, 1998, will be \$0.65625 per share. Thereafter, the dividend period relating to a Dividend Payment Date will be the period from and including the preceding Dividend Payment Date to but excluding such Dividend Payment Date. If a Dividend Payment Date is not a Business Day, dividends (if declared) on the Preferred Stock will be paid on the succeeding business day, without interest. A "Business Day" shall mean any day other than a Saturday, Sunday or other day on which banking institutions in New York, New York are authorized or required by law to close. Dividends payable on the Preferred Stock for any period greater or less than a full dividend period will be computed on the basis of a 360-day year consisting of twelve 30-day months and the actual number of days elapsed in any period of less than one month. Dividends payable on the Preferred Stock for each full dividend period will be computed by dividing the per annum dividend rate by four.

The Preferred Stock will rank prior to the common stock of the Corporation with respect to the payment of dividends to the extent provided in the Certificate of Designation. No dividend (other than dividends or distributions paid in shares of, or options, warrants or rights to subscribe for or purchase shares of, the common stock of the Corporation or any other stock of the Corporation ranking junior to the Preferred Stock as to the payment of dividends and the distribution of assets upon dissolution, liquidation or winding up of the Corporation) may be declared or paid or set apart for payment on the Corporation's common stock (or on any other stock of the Corporation ranking, as

to the payment of dividends, junior to the Preferred Stock) unless dividends have been declared and paid or set apart (or ordered to be set apart) on the Preferred Stock for the then-current quarterly dividend period. When dividends are not paid in full upon the Preferred Stock and all other classes or series of stock of the Corporation, if any, ranking on a parity as to the payment of dividends with the Preferred Stock, all dividends declared upon shares of Preferred Stock and all such other stock of the Corporation will be declared pro rata so that the amount of dividends declared per share on the Preferred Stock and all such other stock will in all cases bear to each other the same ratio that accrued dividends per share on the shares of Preferred Stock (but without accumulation of unpaid dividends for prior dividend periods) and such other stock bear to each other.

Dividends on the Preferred Stock will not be cumulative. If a dividend is not declared and paid on the Preferred Stock, the Holders of Preferred Stock will have no claim in respect of such non-payment so long as no dividend (other than those referred to in the preceding paragraph) is declared or paid on the Corporation's common stock (or any other stock of the Corporation ranking, as to the payment of dividends, junior to the Preferred Stock) for the then-current quarterly dividend period.

The Board of Directors, or a duly authorized committee thereof, may, in its discretion, choose to pay dividends on the Preferred Stock without the payment of any dividends on the Corporation's common stock (or any other stock of the Corporation ranking, as to the payment of dividends, junior to the Preferred Stock).

No dividends may be declared or paid or set apart for payment on any shares of the Preferred Stock if at the same time any arrears exist or default exists in the payment of dividends on any outstanding class or series of stock of the Corporation ranking prior to the Preferred Stock with respect to the payment of dividends. At the time of issuance of the Preferred Stock, no class or series of stock of the Corporation ranking prior to the Preferred Stock with respect to the payment of dividends will exist.

Holders of Preferred Stock will not be entitled to any dividends, whether payable in cash or property, other than as described above and will not be entitled to interest, or any sum in lieu of interest, in respect of any dividend payment.

See "Regulatory Matters" for a description of certain regulatory restrictions on the Corporation's payment of dividends.

Optional Redemption

The Preferred Stock is not subject to any mandatory redemption, sinking fund or other similar provisions. On or after September 30, 1999, the Corporation, at its option, may redeem the Preferred Stock, in whole or in part, at any time or from time to time, out of funds legally available therefor, at the redemption price of \$50.00 per share plus an amount equal to the dividend (whether or not declared) for the then-current quarterly dividend period accrued to but excluding the date of such redemption, but without accumulation of unpaid dividends on the Preferred Stock for prior dividend periods. If less than all of the outstanding shares of the Preferred Stock are to be redeemed, the Corporation will select shares to be redeemed from the outstanding shares not previously called for redemption by lot or pro rata (as nearly as possible) or by any other method that the Board of Directors, or a duly authorized committee thereof, in its sole discretion deems equitable.

The Corporation will give notice of any such redemption by mail to Holders of Preferred Stock not less than 30 days prior to the date fixed by the Board of Directors, or duly authorized committee thereof, for such redemption. Each such notice will state the number of shares of Preferred Stock to be redeemed and, if fewer than all of the shares of Preferred Stock held by the applicable Holder are to be redeemed, the number of shares to be redeemed from such Holder, the redemption price, the redemption date and the place at which such Holder's certificate(s) representing shares of the Preferred Stock must be presented upon such redemption.

Under certain circumstances, the Corporation may need the approval of the Director prior to exercising its right to redeem shares of Preferred Stock. See “Regulatory Matters.”

Holders of Preferred Stock will have no right to require redemption of Preferred Stock.

Notice having been given as aforesaid, from and after the redemption date, dividends on the Preferred Stock called for redemption will cease to accrue and such Preferred Stock called for redemption will no longer be deemed outstanding, and all rights of the Holders thereof as registered holders of the Preferred Stock will cease.

Liquidation Rights

Upon any voluntary or involuntary dissolution, liquidation or winding up of the Corporation, after payment or provision for the liabilities of the Corporation and the expenses of such dissolution, liquidation or winding up, the Holders of the outstanding shares of the Preferred Stock will be entitled to receive out of the assets of the Corporation or proceeds thereof available for distribution to stockholders, before any payment or distribution of assets is made to holders of the Corporation’s common stock (or any other stock of the Corporation ranking, as to the distribution of assets upon dissolution, liquidation or winding up of the Corporation, junior to the Preferred Stock), the amount of \$50.00 per share plus an amount equal to the dividend (whether or not declared) for the then-current quarterly dividend period accrued to but excluding the date of such liquidation payment, but without accumulation of unpaid dividends on the Preferred Stock for prior dividend periods. If the assets of the Corporation available for distribution in such event are insufficient to pay in full the aggregate amount payable to Holders of the Preferred Stock and holders of all other classes or series of stock of the Corporation, if any, ranking, as to the distribution of assets upon dissolution, liquidation or winding up of the Corporation, on a parity with the Preferred Stock, the assets will be distributed to the Holders of Preferred Stock and holders of such other stock pro rata, based on the full respective preferential amounts to which they are entitled, but without accumulation of unpaid dividends on the Preferred Stock for prior dividend periods. After payment of the full amount of the distribution of assets upon dissolution, liquidation or winding up of the Corporation to which they are entitled, the Holders of Preferred Stock will not be entitled to any further participation in any distribution of assets by the Corporation.

Notwithstanding the foregoing, Holders of Preferred Stock will not be entitled to be paid any amount in respect of a dissolution, liquidation or winding up of the Corporation until holders of any classes or series of stock of the Corporation ranking, as to the distribution of assets upon dissolution, liquidation or winding up of the Corporation, prior to the Preferred Stock have been paid all amounts to which such classes or series are entitled. At the time of issuance of the Preferred Stock, no class or series of stock of the Corporation ranking prior to the Preferred Stock with respect to the distribution of assets upon dissolution, liquidation or winding up of the Corporation will exist.

Neither the sale, lease or exchange (for cash, shares of stock, securities or other consideration) of all or substantially all of the property and assets of the Corporation, nor the merger, consolidation or combination of the Corporation into or with any other corporation or the merger, consolidation or combination of any other corporation into or with the Corporation, shall be deemed to be a dissolution, liquidation or winding up, voluntary or involuntary, for the purposes of these provisions on liquidation rights.

Regulatory Matters

Holders of Preferred Stock are entitled to receive dividends if, as and when declared by the Board of Directors, or a duly authorized committee thereof. However, certain provisions of the 1992 Act may operate to restrict the ability of the Board of Directors to declare dividends in certain circumstances. The 1992 Act established risk-based capital, minimum capital, and critical capital levels for the Corporation, and required the Director of OFHEO to establish, by regulation, a risk-based capital test to be used to determine the amount of total capital the Corporation must have to exceed the risk-

based capital level from time to time. (See “Government Regulation and Charter Act” herein and the Information Statement for the current status of the required regulations.) Until one year after the final regulations establishing the risk-based capital test are in effect, a dividend may be paid without the prior approval of the Director if the Corporation meets the minimum capital level established under the 1992 Act and the dividend payment would not decrease the Corporation’s base capital below such level.

One year after final regulations establishing the risk-based capital test take effect, a dividend may be paid without the prior approval of the Director if the Corporation meets both the risk-based capital and minimum capital levels and the dividend payment would not decrease the Corporation’s total capital below the risk-based capital level or its core capital below the minimum capital level. If the Corporation meets either the risk-based capital standard or the minimum capital standard, it may make a dividend payment without obtaining the approval of the Director only if the dividend payment would not cause the Corporation to fail to meet another capital standard. At any time when the Corporation does not meet the risk-based capital standard but meets the minimum capital standard, the Corporation is prohibited from making a dividend payment that would cause the Corporation to fail to meet the minimum capital standard. If the Corporation meets neither the risk-based capital standard nor the minimum capital standard but does meet the critical capital standard established under the 1992 Act, it may make a dividend payment only if the Corporation would not fail to meet the critical capital standard as a result of such payment and the Director approves the payment after finding that it satisfies certain statutory conditions. The Director has the authority to require the Corporation to submit a report to the Director regarding any capital distribution (including any dividend) declared by the Corporation before the Corporation makes the distribution. See also “Government Regulation and Charter Act” herein and “Management’s Discussion and Analysis of Financial Condition and Results of Operations—Balance Sheet Analysis—Regulatory Capital Requirements” in the Information Statement regarding the capital standards applicable to the Corporation.

Voting Rights; Amendments

Except as provided below, the Holders of Preferred Stock will not be entitled to any voting rights.

Without the consent of the Holders of Preferred Stock, the Corporation will have the right to amend, alter, supplement or repeal any terms of the Preferred Stock (i) to cure any ambiguity, or to cure, correct or supplement any defective provision contained in the Certificate of Designation or (ii) to make any other provision with respect to matters or questions arising with respect to the Preferred Stock that is not inconsistent with the provisions of the Certificate of Designation so long as such action does not materially and adversely affect the interests of the Holders of Preferred Stock; *provided, however*, that any increase in the amount of authorized or issued Preferred Stock or the creation and issuance, or an increase in the authorized or issued amount, of any other class or series of stock of the Corporation, whether ranking prior to, on a parity with or junior to the Preferred Stock as to dividends or liquidation or otherwise will not be deemed to materially and adversely affect the interests of the Holders of Preferred Stock. Otherwise, the terms of the Preferred Stock may be amended, altered, supplemented or repealed only with the consent of the Holders of at least two-thirds of the outstanding shares of Preferred Stock. On matters requiring their consent, Holders of Preferred Stock will be entitled to one vote per share.

Absence of Trading Market

The Corporation has not applied for listing of the Preferred Stock on any stock exchange and the Corporation does not expect an active trading market to develop with respect to the Preferred Stock. Accordingly, the ability of a Holder to dispose of the Preferred Stock may be limited.

LEGALITY OF INVESTMENT

National banks may purchase, hold and invest in for their own accounts the shares of Preferred Stock without regard to limitations generally applicable to investment securities. The Preferred Stock would be subject to a 100% risk weighting for capital adequacy purposes.

Federal savings associations and federal savings banks may invest in the shares of Preferred Stock without regard to limitations generally applicable to investments. Preferred Stock held by a federal savings association or federal savings bank would be subject to a 100% risk weighting for capital adequacy purposes.

Federally insured state-chartered banks, state-chartered savings banks and state-chartered savings and loan associations may invest in the shares of Preferred Stock to the extent permitted by the Secondary Mortgage Market Enhancement Act of 1984 (“SMMEA”) and by applicable state law, after complying with any procedures imposed by the state. Preferred Stock held by such an institution would be subject to a 100% risk weighting for federal capital adequacy purposes.

Federal credit unions may purchase the shares of Preferred Stock without regard to limitations generally applicable to investments.

The shares of Preferred Stock are “stock . . . of a corporation which is an instrumentality of the United States” within the meaning of § 7701(a)(19)(C)(ii) of the Internal Revenue Code of 1986, as amended to the date hereof (“Code”), for purposes of the 60 percent of assets limitation applicable to domestic building and loan associations.

In addition to the specific authorizations discussed above, § 106(a)(1) of SMMEA provides that any person, trust, corporation, partnership, association, business trust or business entity created pursuant to or existing under the laws of the United States or any state (including the District of Columbia and Puerto Rico) (an “investor”) is authorized to purchase, hold and invest in securities issued or guaranteed by the Corporation (including the shares of Preferred Stock) to the same extent that such investor is authorized to purchase, hold or invest in obligations issued or guaranteed as to principal and interest by the United States or any agency or instrumentality thereof. Prior to October 4, 1991, states were authorized by SMMEA to enact legislation that either prohibited or limited an investor’s authority to purchase, hold or invest in securities issued or guaranteed by the Corporation. To the best of the Corporation’s knowledge, 18 states currently have legislation limiting to varying extents the ability of certain entities (in most cases, insurance companies) to invest in securities issued or guaranteed by the Corporation, including the shares of Preferred Stock.

Notwithstanding the above, investors should consult their legal advisors to determine whether and to what extent the shares of Preferred Stock constitute legal investments for such investors or are eligible to be used as security for borrowings. The foregoing does not take into consideration the application of statutes, regulations, orders, guidelines or agreements generally governing investments made by a particular investor, including but not limited to “prudent investor” provisions, safety and soundness conditions and percentage-of-assets limits. The regulatory authorities that administer the legal provisions referred to above generally reserve discretion as to whether securities, such as the Preferred Stock, that are otherwise acceptable for investment may be purchased or pledged by the institutions subject to their jurisdiction. An institution under the jurisdiction of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, the National Credit Union Administration, or any other federal or state agency with similar authority should review any applicable regulations, policy statements and guidelines before purchasing the Preferred Stock.

UNITED STATES TAXATION

The Preferred Stock and payments thereon are not generally exempt from taxation by the United States or other U.S. or non-U.S. taxing jurisdictions.

In the opinion of Arnold & Porter, special tax counsel to the Corporation, the following discussion correctly describes the principal U.S. federal income tax treatment of U.S. Persons (as defined below) that are beneficial owners (“Owners”) of the Preferred Stock. This discussion does not address the U.S. federal income tax treatment of Owners that are not U.S. Persons. This discussion is based on the Code, existing and proposed Treasury regulations, revenue rulings and judicial decisions, changes to any of which subsequent to the date of this Offering Circular may affect the tax consequences described herein.

This summary discusses only preferred stock held as a capital asset (within the meaning of section 1221 of the Code). This discussion does not purport to address all of the U.S. federal income tax consequences that may be applicable to particular investors in light of their individual circumstances or to Owners subject to special rules, such as dealers in securities, certain financial institutions and certain securities traders. In all cases, investors are advised to consult their own tax advisors regarding the U.S. federal tax consequences to them of holding, owning and disposing of Preferred Stock, as well as any tax consequences arising under the laws of any state or other taxing jurisdiction.

For purposes of this discussion, “U.S. Person” generally means (i) a citizen or individual resident of the United States, (ii) a corporation or partnership created or organized in or under the laws of the United States or any political subdivision thereof, (iii) an estate the income of which is includible in its gross income for U.S. federal income tax purposes without regard to its source, or (iv) a trust if a court within the United States is able to exercise primary supervision over its administration and at least one United States person has the authority to control all substantial decisions of the trust.

Dividends

Dividends declared and paid on the Preferred Stock will be dividends for U.S. federal income tax purposes to the extent paid out of the Corporation’s current or accumulated earnings and profits, as determined for federal income tax purposes, and will be taxable as ordinary income. Although the Corporation expects that its current and accumulated earnings and profits will be such that all dividends paid with respect to the Preferred Stock will qualify as dividends for federal income tax purposes, it cannot guarantee that result. The Corporation’s accumulated earnings and profits or its current earnings and profits in future years will depend in significant part on its future profits or losses, which the Corporation cannot accurately predict. To the extent that the amount of any dividend paid on a share of Preferred Stock exceeds the Corporation’s current or accumulated earnings and profits for federal income tax purposes attributable to that share, such dividend will be treated first as a return of capital (rather than as ordinary income) and will be applied against and reduce the Owner’s adjusted tax basis in that share of Preferred Stock. The amount of any such dividend in excess of the Owner’s adjusted tax basis will then be taxed as capital gain. For purposes of the remainder of this discussion, it is assumed that dividends paid with respect to the Preferred Stock will constitute dividends for U.S. federal income tax purposes.

Dividends received by Owners that are corporations generally will be eligible for the 70-percent dividends-received deduction under section 243 of the Code. The 70-percent dividends-received deduction will not be available with respect to a dividend received on Preferred Stock that an Owner has held for 45 days or less (including the day of disposition, but excluding the day of acquisition) during the 90-day period beginning on the day which is 45 days before the date on which the Preferred Stock becomes ex-dividend with respect to that dividend. If the dividend is attributable to a period or periods aggregating more than 366 days, the dividend received deduction will be available only if the Owner has held the Preferred Stock for more than 90 days (including the day of disposition, but excluding the day of acquisition) during the 180-day period beginning 90 days before the date on which the Preferred Stock becomes ex-dividend. The length of time that a corporate shareholder is

deemed to have held stock for these purposes is reduced for periods during which the shareholder's risk of loss with respect to the stock is diminished by reason of the existence of certain options, contracts to sell, short sales or other similar transactions. The aggregate dividends-received deduction allowed a corporate shareholder cannot exceed 70 percent of its taxable income (with certain adjustments). Moreover, the dividends-received deduction is reduced if a corporate shareholder incurs indebtedness "directly attributable" to a "portfolio stock" investment in another company, which would include an investment in the Preferred Stock.

Dispositions, Including Redemptions

Any sale, exchange, redemption (except as discussed below) or other disposition of the Preferred Stock generally will result in taxable gain or loss equal to the difference between the amount of cash received and the shareholder's adjusted tax basis in the Preferred Stock. Such gain or loss will be capital gain or loss and will be long-term capital gain or loss if the holding period for the Preferred Stock exceeds one year. Tax rates on capital gain for individual Owners vary depending on each Owner's income and holding period for the Preferred Stock. Owners that are individuals should contact their own tax advisors for more information or for the capital gains tax rate applicable to specific shares of Preferred Stock. The deduction of capital losses is subject to certain limitations.

A redemption of Preferred Stock may be treated as a dividend, rather than as payment in exchange for the Preferred Stock, unless the redemption is "not essentially equivalent to a dividend" with respect to the Owner within the meaning of section 302(b)(1) of the Code, "is in complete redemption of all of the stock" of the Corporation held by the Owner as described in section 302(b)(3) of the Code or otherwise meets the requirements of one of the other exceptions from dividend treatment provided in section 302(b) of the Code. In applying these rules, the Owner must take into account not only the Preferred Stock and other stock of the Corporation that it owns directly, but also the Preferred Stock and other stock in the Corporation that it constructively owns within the meaning of section 318 of the Code. Because of the complex nature of these rules, each Owner should consult its tax advisor to determine whether a redemption of Preferred Stock will be treated as a dividend or as payment in exchange for the Preferred Stock. If the redemption payment is treated as a dividend, the rules discussed above under "Dividends" apply.

Information Reporting and Backup Withholding

Payments of dividends on shares of Preferred Stock held of record by U.S. persons other than corporations and other exempt holders are required to be reported to the IRS.

Backup withholding of U.S. federal income tax at a rate of 31 percent may apply to payments made with respect to shares of Preferred Stock, as well as payments of proceeds from the sale of shares of Preferred Stock, to holders or Owners that are not "exempt recipients" and that fail to provide certain identifying information (such as the taxpayer identification number of the holder or Owner) in the manner required. Individuals generally are not exempt recipients, whereas corporations and certain other entities generally are exempt recipients.

THE U.S. FEDERAL TAX DISCUSSION SET FORTH ABOVE IS INCLUDED FOR GENERAL INFORMATION ONLY AND MAY NOT BE APPLICABLE DEPENDING UPON AN OWNER'S PARTICULAR SITUATION. EACH OWNER SHOULD CONSULT ITS OWN TAX ADVISOR WITH RESPECT TO THE TAX CONSEQUENCES TO IT OF THE OWNERSHIP AND DISPOSITION OF THE PREFERRED STOCK, INCLUDING THE TAX CONSEQUENCES UNDER THE TAX LAWS OF THE UNITED STATES, STATES, LOCALITIES, COUNTRIES OTHER THAN THE UNITED STATES AND ANY OTHER TAXING JURISDICTION AND THE POSSIBLE EFFECTS OF CHANGES IN SUCH TAX LAWS.

UNDERWRITING

Subject to the terms and conditions set forth in the underwriting agreement (the “Underwriting Agreement”), the Corporation has agreed to sell to Bear, Stearns & Co. Inc. (the “Underwriter”), and the Underwriter has agreed to purchase, 1,500,000 shares of Preferred Stock.

In the Underwriting Agreement, the Underwriter has agreed, subject to the terms and conditions set forth therein, to purchase all the Preferred Stock offered hereby if any is purchased.

The Underwriter has advised the Corporation that the Underwriter proposes initially to offer the Preferred Stock to the public at the price set forth on the cover page of this Offering Circular.

Prior to this offering, there has been no public market for the Preferred Stock. The Preferred Stock has not been listed on any stock exchange.

In the Underwriting Agreement, the Corporation and the Underwriter have agreed to indemnify each other against and contribute toward certain liabilities.

The Underwriter and certain affiliates thereof engage in transactions with and perform services for the Corporation in the ordinary course of business.

The Underwriter may engage in certain transactions that stabilize the price of such Preferred Stock. Such transactions may include entering stabilizing bids, which means the placing of a bid or the effecting of a purchase for the purpose of pegging, fixing or maintaining the price of the Preferred Stock. Neither the Corporation nor the Underwriter makes any representation or prediction as to the direction or magnitude of any effect that the transactions described above may have on the price of the Preferred Stock. The Underwriter is not required to engage in any of these transactions. When so doing, the Underwriter acts on its own behalf and not as a representative of the Corporation. Any such transactions, if commenced, may be discontinued at any time.

VALIDITY OF THE PREFERRED STOCK

The validity of the Preferred Stock will be passed upon for the Corporation by Wilmer, Cutler & Pickering, Washington, D.C., and for the Underwriter by Sullivan & Cromwell, Washington, D.C. Certain U.S. federal income tax matters will be passed upon for the Corporation by Arnold & Porter, Washington, D.C.

**CERTIFICATE OF DESIGNATION OF TERMS OF
5.25% NON-CUMULATIVE PREFERRED STOCK, SERIES D**

1. Designation, Par Value and Number of Shares.

The designation of the series of preferred stock of the Federal National Mortgage Association (the "Corporation") created by this resolution shall be "5.25% Non-Cumulative Preferred Stock, Series D" (the "Series D Preferred Stock"), and the number of shares constituting the Series D Preferred Stock is Three Million (3,000,000). Shares of Series D Preferred Stock will have no par value and a stated value and liquidation preference of \$50 per share. The Board of Directors of the Corporation, or a duly authorized committee thereof, in its sole discretion, may increase the number of shares of Series D Preferred Stock and may reduce the number of shares of Series D Preferred Stock, provided such reduction is not below the number of shares of Series D Preferred Stock then outstanding.

2. Dividends.

(a) Holders of record of Series D Preferred Stock (each individually a "Holder", or collectively the "Holders") will be entitled to receive, when, as and if declared by the Board of Directors of the Corporation, or a duly authorized committee thereof, in its sole discretion out of funds legally available therefor, non-cumulative, quarterly cash dividends which will accrue from and including September 30, 1998, and will be payable on March 31, June 30, September 30 and December 31 of each year (each, a "Dividend Payment Date"), commencing December 31, 1998, at the annual rate of \$2.625 per share or 5.25% of the stated value and liquidation preference of \$50 per share (without taking into account any adjustments referred to in clause (b) below). Dividends on the Series D Preferred Stock will be payable to the Holders as they appear on the books and records of the Corporation on the relevant record date fixed by the Board of Directors, or a duly authorized committee thereof, which may not be earlier than 45 days or later than 10 days prior to the applicable Dividend Payment Date. If declared, the initial dividend, which will be for the period from and including September 30, 1998 to but excluding December 31, 1998, will be \$0.65625 per share. Thereafter, the dividend period relating to a Dividend Payment Date will be the period from and including the preceding Dividend Payment Date to but excluding such Dividend Payment Date. If a Dividend Payment Date is not a Business Day, dividends (if declared) on the Series D Preferred Stock will be paid on the succeeding Business Day, without interest. A "Business Day" shall mean any day other than a Saturday, Sunday or other day on which banking institutions in New York, New York are authorized or required by law to close. Dividends payable on the Series D Preferred Stock for any period greater or less than a full dividend period will be computed on the basis of a 360-day year consisting of twelve 30-day months and the actual number of days elapsed in any period of less than one month. Dividends payable on the Series D Preferred Stock for each full dividend period will be computed by dividing the per annum dividend rate by four.

(b) No dividend (other than dividends or distributions paid in shares of, or options, warrants or rights to subscribe for or purchase shares of, the common stock of the Corporation or any other stock of the Corporation ranking, as to the payment of dividends and the distribution of assets upon dissolution, liquidation or winding up of the Corporation, junior to the Series D Preferred Stock) may be declared or paid or set apart for payment on the Corporation's common stock (or on any other stock of the Corporation ranking, as to the payment of dividends, junior to the Series D Preferred Stock) unless dividends have been declared and paid or set apart (or ordered to be set apart) on the Series D Preferred Stock for the then-current quarterly dividend period; provided, however, that the foregoing dividend preference shall not be cumulative and shall not in any way create any claim or right in favor of the Holders of Series D Preferred Stock in the event that dividends have not been declared or paid or set apart (or ordered to be set apart) on the Series D Preferred Stock in respect of

any prior dividend period. If the full dividend on the Series D Preferred Stock is not paid for any quarterly dividend period, the Holders of Series D Preferred Stock will have no claim in respect of the unpaid amount so long as no dividend (other than those referred to above) is paid on the Corporation's common stock (or any other stock of the Corporation ranking, as to the payment of dividends, junior to the Series D Preferred Stock) for such dividend period.

(c) The Board of Directors of the Corporation, or a duly authorized committee thereof, may, in its discretion, choose to pay dividends on the Series D Preferred Stock without the payment of any dividends on the Corporation's common stock (or any other stock of the Corporation ranking, as to the payment of dividends, junior to the Series D Preferred Stock).

(d) No full dividends shall be declared or paid or set apart for payment on any stock of the Corporation ranking, as to the payment of dividends, on a parity with the Series D Preferred Stock for any period unless full dividends have been declared and paid or set apart for payment on the Series D Preferred Stock for the then-current quarterly dividend period. When dividends are not paid in full upon the Series D Preferred Stock and all other classes or series of stock of the Corporation, if any, ranking, as to the payment of dividends, on a parity with the Series D Preferred Stock, all dividends declared upon shares of Series D Preferred Stock and all such other stock of the Corporation will be declared pro rata so that the amount of dividends declared per share of Series D Preferred Stock and all such other stock will in all cases bear to each other the same ratio that accrued dividends per share of Series D Preferred Stock (but without accumulation of unpaid dividends on the Series D Preferred Stock for prior dividend periods) and such other stock bear to each other.

(e) No dividends may be declared or paid or set apart for payment on any shares of Series D Preferred Stock if at the same time any arrears exist or default exists in the payment of dividends on any outstanding class or series of stock of the Corporation ranking, as to the payment of dividends, prior to the Series D Preferred Stock.

(f) Holders of Series D Preferred Stock will not be entitled to any dividends, whether payable in cash or property, other than as herein provided and will not be entitled to interest, or any sum in lieu of interest, in respect of any dividend payment.

3. Optional Redemption.

(a) On or after September 30, 1999, the Corporation, at its option, may redeem the Series D Preferred Stock, in whole or in part, at any time or from time to time, out of funds legally available therefor, at the redemption price of \$50.00 per share plus an amount equal to the dividend (whether or not declared) for the then-current quarterly dividend period accrued to but excluding the date of such redemption, but without accumulation of unpaid dividends on the Series D Preferred Stock for prior dividend periods. If less than all of the outstanding shares of Series D Preferred Stock are to be redeemed, the Corporation will select the shares to be redeemed from the outstanding shares not previously called for redemption by lot or pro rata (as nearly as possible) or by any other method that the Board of Directors of the Corporation, or a duly authorized committee thereof, in its sole discretion deems equitable.

(b) In the event the Corporation shall redeem any or all of the Series D Preferred Stock as aforesaid, the Corporation will give notice of any such redemption to Holders of Series D Preferred Stock not less than 30 days prior to the date fixed by the Board of Directors of the Corporation, or duly authorized committee thereof, for such redemption. Each such notice will state: (1) the number of shares of Series D Preferred Stock to be redeemed and, if fewer than all of the shares of Series D Preferred Stock held by a Holder are to be redeemed, the number of shares to be redeemed from such Holder; (2) the redemption price; (3) the redemption date; and (4) the place at which a Holder's certificate(s) representing shares of Series D Preferred Stock must be presented upon such redemption. Failure to give notice, or any defect in the notice, to any Holder of Series D Preferred Stock shall not affect the validity of the proceedings for the redemption of shares of any other Holder of Series D Preferred Stock being redeemed.

(c) Notice having been given as herein provided, from and after the redemption date, dividends on the Series D Preferred Stock called for redemption shall cease to accrue and such Series D Preferred Stock called for redemption will no longer be deemed outstanding, and all rights of the Holders thereof as registered holders of such shares of Series D Preferred Stock will cease. Upon surrender in accordance with said notice of the certificate(s) representing shares of Series D Preferred Stock so redeemed (properly endorsed or assigned for transfer, if the Board of Directors of the Corporation, or a duly authorized committee thereof, shall so require and the notice shall so state), such shares shall be redeemed by the Corporation at the redemption price aforesaid. Any shares of Series D Preferred Stock that shall at any time have been redeemed shall, after such redemption, be cancelled and not reissued. In case fewer than all the shares represented by any such certificate are redeemed, a new certificate shall be issued representing the unredeemed shares without cost to the Holder thereof.

(d) The Series D Preferred Stock will not be subject to any mandatory redemption, sinking fund or other similar provisions. In addition, Holders of Series D Preferred Stock will have no right to require redemption of any shares of Series D Preferred Stock.

4. Liquidation Rights.

(a) Upon any voluntary or involuntary dissolution, liquidation or winding up of the Corporation, after payment or provision for the liabilities of the Corporation and the expenses of such dissolution, liquidation or winding up, the Holders of outstanding shares of the Series D Preferred Stock will be entitled to receive out of the assets of the Corporation or proceeds thereof available for distribution to stockholders, before any payment or distribution of assets is made to holders of the Corporation's common stock (or any other stock of the Corporation ranking, as to the distribution of assets upon dissolution, liquidation or winding up of the Corporation, junior to the Series D Preferred Stock), the amount of \$50.00 per share plus an amount equal to the dividend (whether or not declared) for the then-current quarterly dividend period accrued to but excluding the date of such liquidation payment, but without accumulation of unpaid dividends on the Series D Preferred Stock for prior dividend periods.

(b) If the assets of the Corporation available for distribution in such event are insufficient to pay in full the aggregate amount payable to Holders of Series D Preferred Stock and holders of all other classes or series of stock of the Corporation, if any, ranking, as to the distribution of assets upon dissolution, liquidation or winding up of the Corporation, on a parity with the Series D Preferred Stock, the assets will be distributed to the Holders of Series D Preferred Stock and holders of all such other stock pro rata, based on the full respective preferential amounts to which they are entitled, but without accumulation of unpaid dividends on the Series D Preferred Stock for prior dividend periods.

(c) Notwithstanding the foregoing, Holders of Series D Preferred Stock will not be entitled to be paid any amount in respect of a dissolution, liquidation or winding up of the Corporation until holders of any classes or series of stock of the Corporation ranking, as to the distribution of assets upon dissolution, liquidation or winding up of the Corporation, prior to the Series D Preferred Stock have been paid all amounts to which such classes or series are entitled.

(d) Neither the sale, lease or exchange (for cash, shares of stock, securities or other consideration) of all or substantially all of the property and assets of the Corporation, nor the merger, consolidation or combination of the Corporation into or with any other corporation or the merger, consolidation or combination of any other corporation into or with the Corporation, shall be deemed to be a dissolution, liquidation or winding up, voluntary or involuntary, for the purposes of this Section 4.

(e) After payment of the full amount of the distribution of assets upon dissolution, liquidation or winding up of the Corporation to which they are entitled pursuant to paragraphs (a), (b) and (c) of this Section 4, the Holders of Series D Preferred Stock will not be entitled to any further participation in any distribution of assets by the Corporation.

5. No Conversion or Exchange Rights.

The Holders of shares of Series D Preferred Stock will not have any rights to convert such shares into or exchange such shares for shares of any other class or classes, or of any other series of any class or classes, of stock or obligations of the Corporation.

6. No Pre-emptive Rights.

No Holder of Series D Preferred Stock shall be entitled as a matter of right to subscribe for or purchase, or have any pre-emptive right with respect to, any part of any new or additional issue of stock of any class whatsoever, or of securities convertible into any stock of any class whatsoever, whether now or hereafter authorized and whether issued for cash or other consideration or by way of dividend.

7. Voting Rights; Amendments.

(a) Except as provided below, the Holders of Series D Preferred Stock will not be entitled to any voting rights, either general or special.

(b) Without the consent of the Holders of Series D Preferred Stock, the Corporation will have the right to amend, alter, supplement or repeal any terms of the Series D Preferred Stock (i) to cure any ambiguity, or to cure, correct or supplement any defective provision contained in this Certificate of Designation or (ii) to make any other provision with respect to matters or questions arising with respect to the Series D Preferred Stock that is not inconsistent with the provisions of this Certificate of Designation so long as such action does not materially and adversely affect the interests of the Holders of Series D Preferred Stock; *provided, however*, that any increase in the amount of authorized or issued Series D Preferred Stock or the creation and issuance, or an increase in the authorized or issued amount, of any other class or series of stock of the Corporation, whether ranking prior to, on a parity with or junior to the Series D Preferred Stock, as to the payment of dividends or the distribution of assets upon dissolution, liquidation or winding up of the Corporation, or otherwise, will not be deemed to materially and adversely affect the interests of the Holders of Series D Preferred Stock.

(c) Except as set forth in paragraph (b) of this Section 7, the terms of the Series D Preferred Stock may be amended, altered, supplemented or repealed only with the consent of the Holders of at least two-thirds of the shares of Series D Preferred Stock then outstanding, given in person or by proxy, either in writing or at a meeting of stockholders at which the Holders of Series D Preferred Stock shall vote separately as a class. On matters requiring their consent, Holders of Series D Preferred Stock will be entitled to one vote per share.

(d) The rules and procedures for calling and conducting any meeting of Holders (including, without limitation, the fixing of a record date in connection therewith), the solicitation and use of proxies at such a meeting, the obtaining of written consents, and any other aspect or matter with regard to such a meeting or such consents shall be governed by any rules that the Board of Directors of the Corporation, or a duly authorized committee thereof, in its discretion, may adopt from time to time, which rules and procedures shall conform to the requirements of any national securities exchange on which the shares of the Series D Preferred Stock are listed at the time.

8. Additional Classes or Series of Stock.

The Board of Directors of the Corporation, or a duly authorized committee thereof, shall have the right at any time in the future to authorize, create and issue, by resolution or resolutions, one or more additional classes or series of stock of the Corporation, and to determine and fix the distinguishing characteristics and the relative rights, preferences, privileges and other terms of the shares thereof. Any such class or series of stock may rank prior to, on a parity with or junior to the Series D Preferred

Stock as to the payment of dividends or the distribution of assets upon dissolution, liquidation or winding up of the Corporation, or otherwise.

9. Priority.

For purposes of this Certificate of Designation, any stock of any class or series of the Corporation shall be deemed to rank:

(a) Prior to the shares of Series D Preferred Stock, either as to the payment of dividends or the distribution of assets upon dissolution, liquidation or winding up of the Corporation, if the holders of such class or series shall be entitled to the receipt of dividends or of amounts distributable upon dissolution, liquidation or winding up of the Corporation, as the case may be, in preference or priority to the Holders of shares of Series D Preferred Stock.

(b) On a parity with shares of Series D Preferred Stock, either as to the payment of dividends or the distribution of assets upon dissolution, liquidation or winding up of the Corporation, whether or not the dividend rates or amounts, dividend payment dates or redemption or liquidation prices per share, if any, be different from those of the Series D Preferred Stock, if the holders of such class or series shall be entitled to the receipt of dividends or of amounts distributable upon dissolution, liquidation or winding up of the Corporation, as the case may be, in proportion to their respective dividend rates or amounts or liquidation prices, without preference or priority, one over the other, as between the holders of such class or series and the Holders of shares of Series D Preferred Stock.

(c) Junior to shares of Series D Preferred Stock, either as to the payment of dividends or the distribution of assets upon dissolution, liquidation or winding up of the Corporation, if such class shall be common stock of the Corporation or if the Holders of shares of Series D Preferred Stock shall be entitled to the receipt of dividends or of amounts distributable upon dissolution, liquidation or winding up of the Corporation, as the case may be, in preference or priority over the holders of such class or series.

(d) The shares of Preferred Stock of the Corporation designated “6.41% Non-Cumulative Preferred Stock, Series A” (the “Series A Preferred Stock”), “6.50% Non-Cumulative Preferred Stock, Series B” (the “Series B Preferred Stock”) and “6.45% Non-Cumulative Preferred Stock, Series C” (“the Series C Preferred Stock”) shall be deemed to rank on a parity with shares of Series D Preferred Stock as to the payment of dividends and the distribution of assets upon dissolution, liquidation or winding up of the Corporation. Accordingly, the holders of record of Series A Preferred Stock, the holders of record of Series B Preferred Stock, the holders of record of Series C Preferred Stock and the Holders of Series D Preferred Stock shall be entitled to the receipt of dividends and of amounts distributable upon dissolution, liquidation or winding up of the Corporation, as the case may be, in proportion to their respective dividend rates or amounts or liquidation prices, without preference or priority, one over the other.

10. Transfer Agent, Dividend Disbursing Agent and Registrar.

The Corporation hereby appoints First Chicago Trust Company of New York as its initial transfer agent, dividend disbursing agent and registrar for the Series D Preferred Stock. The Corporation may at any time designate an additional or substitute transfer agent, dividend disbursing agent and registrar for the Series D Preferred Stock.

11. Notices.

Any notice provided or permitted by this Certificate of Designation to be made upon, or given or furnished to, the Holders of Series D Preferred Stock by the Corporation shall be made by first-class mail, postage prepaid, to the addresses of such Holders as they appear on the books and records of the Corporation. Such notice shall be deemed to have been sufficiently made upon deposit thereof in the United States mail. Notwithstanding anything to the contrary contained herein, in the case of the

suspension of regular mail service or by reason of any other cause it shall be impracticable, in the Corporation's judgment, to give notice by mail, then such notification may be made, in the Corporation's discretion, by publication in a newspaper of general circulation in The City of New York or by hand delivery to the addresses of Holders as they appear on the books and records of the Corporation.

RECEIPT AND ACCEPTANCE OF A SHARE OR SHARES OF THE SERIES D PREFERRED STOCK BY OR ON BEHALF OF A HOLDER SHALL CONSTITUTE THE UNCONDITIONAL ACCEPTANCE BY SUCH HOLDER (AND ALL OTHERS HAVING BENEFICIAL OWNERSHIP OF SUCH SHARE OR SHARES) OF ALL OF THE TERMS AND PROVISIONS OF THIS CERTIFICATE OF DESIGNATION. NO SIGNATURE OR OTHER FURTHER MANIFESTATION OF ASSENT TO THE TERMS AND PROVISIONS OF THIS CERTIFICATE OF DESIGNATION SHALL BE NECESSARY FOR ITS OPERATION OR EFFECT AS BETWEEN THE CORPORATION AND THE HOLDER (AND ALL SUCH OTHERS).

No dealer, salesperson, or other person has been authorized to give any information or to make any representation not contained in this Offering Circular and, if given or made, such information or representation must not be relied upon as having been authorized by the Corporation or the Underwriter. Neither delivery of this Offering Circular nor any sale of Preferred Stock shall under any circumstances create an implication that there has been no change in the affairs of the Corporation since the date of this Offering Circular or that the information contained herein is correct as of any time subsequent to the date of such information. This Offering Circular does not constitute an offer to sell or a solicitation of an offer to buy any securities other than the Preferred Stock offered hereby or an offer to sell or a solicitation of an offer to buy such Preferred Stock by or to any person in any jurisdiction or in any circumstance in which such offer or solicitation would be unlawful or not authorized.

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3,000,000 Shares



**5.25% Non-Cumulative
Preferred Stock, Series D**
(stated value \$50 per share)

OFFERING CIRCULAR

Bear, Stearns & Co. Inc.

August 20, 1998

Information Statement



This Information Statement describes the business and operations of the Federal National Mortgage Association ("Fannie Mae" or the "Corporation") as of March 31, 1998 and its financial condition as of December 31, 1997.

In connection with offerings of securities, the Corporation distributes Offering Circulars or Prospectuses that describe securities offered, their selling arrangements and other information. Although typically incorporated by reference into such selling documents, the Information Statement does not offer any securities for sale. Any incorporation of this Information Statement by reference includes all supplements hereto. You may obtain copies of the Corporation's current Information Statement, any supplements thereto and other available information from the office listed on page 2.

This Information Statement contains Fannie Mae's audited financial statements for the year ended December 31, 1997. Fannie Mae updates its Information Statement quarterly.

Fannie Mae is a federally chartered corporation. Its principal office is located at 3900 Wisconsin Avenue, NW, Washington, DC 20016 (202/752-7000). Its Internal Revenue Service employer identification number is 52-0883107.

The Corporation's securities are not required to be registered under the Securities Act of 1933. At the close of business on February 28, 1998, approximately 1,037 million shares of the Corporation's common stock (without par value) were outstanding.

The delivery of this Information Statement at any time shall not under any circumstances create an implication that there has been no change in the affairs of the Corporation since the date hereof or that the information contained herein is correct as of any time subsequent to its date.

March 31, 1998

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DOCUMENTS INCORPORATED BY REFERENCE

Fannie Mae’s Proxy Statement for the 1997 Annual Meeting of Shareholders is incorporated by reference herein under “Management—Additional Information.” Any later proxy statement published by Fannie Mae prior to the publication of a new Information Statement is incorporated herein by this reference. Fannie Mae will supplement this Information Statement to reflect its quarterly financial results and other events and information as Fannie Mae determines. References to the “Information Statement” include any documents incorporated herein by reference and any applicable amendments or supplements hereto. If Fannie Mae modifies or updates information in the Information Statement in a later supplement or in a document incorporated by reference in this Information Statement, the information as modified or updated replaces the information initially reported by the Corporation in this Information Statement.

AVAILABLE INFORMATION

The Corporation periodically makes available statistical information on its mortgage purchase and mortgage-backed securities volumes as well as other relevant information about the Corporation. You may obtain copies of this Information Statement, any supplements relating hereto, as well as the Corporation’s annual and quarterly reports to stockholders, the Federal National Mortgage Association Charter Act, the Corporation’s bylaws and other information regarding the Corporation without charge from the Office of Investor Relations, Fannie Mae, 3900 Wisconsin Avenue, NW, Washington, DC 20016 (telephone: (202/752-7115)). You may inspect reports and other information concerning the Corporation at the offices of the New York Stock Exchange, the Chicago Stock Exchange and the Pacific Stock Exchange. Fannie Mae does not file reports or other information with the Securities and Exchange Commission.

BUSINESS

General

Fannie Mae is a federally chartered and stockholder-owned corporation and is the largest investor in home mortgage loans in the United States. The Corporation was established in 1938 as a United States government agency to provide supplemental liquidity to the mortgage market and was transformed into a stockholder-owned and privately managed corporation by legislation enacted in 1968.

The Corporation provides funds to the mortgage market by purchasing mortgage loans from lenders, thereby replenishing their funds for additional lending. The Corporation acquires funds to purchase these loans by issuing debt securities to capital market investors, many of whom ordinarily would not invest in mortgages. In this manner, the Corporation is able to expand the total amount of funds available for housing.

The Corporation also issues Mortgage-Backed Securities (“MBS”), receiving guaranty fees for its guarantee of timely payment of principal and interest on MBS certificates. The Corporation issues MBS primarily in exchange for pools of mortgage loans from lenders. The issuance of MBS enables the Corporation to further its statutory purpose of increasing the liquidity of residential mortgage loans.

In addition, the Corporation offers various services to lenders and others for a fee. These services include issuing certain types of MBS and providing technology services for originating and underwriting loans.

For information regarding the Corporation’s mortgage loan, MBS and other activities in 1997, see “Management’s Discussion and Analysis of Financial Condition and Results of Operations.”

In this document, both whole loans and participation interests in loans are referred to as “loans,” “mortgage loans” and “mortgages.” (The Corporation purchases participation interests that range from 50 to 99 percent.) The term “mortgage” also is used to refer to the security instrument securing a loan rather than the loan itself, and when so used also refers to a deed of trust. Mortgage loans secured by four or fewer dwelling units are referred to as “single-family” mortgage loans, and mortgage loans secured by more than four dwelling units are referred to as “multifamily” mortgage loans.

Mortgage Loan Portfolio

Mortgage Loans Purchased

The Corporation purchases primarily single-family, conventional (i.e., not federally insured or guaranteed), fixed- or adjustable-rate, first mortgage loans, but it also purchases other types of residential mortgage loans for its loan portfolio, including mortgage loans insured by the Federal Housing Administration (“FHA”), mortgage loans guaranteed by the Department of Veterans Affairs (“VA”), mortgage loans guaranteed by the Rural Housing Service, multifamily mortgage loans and second mortgage loans (i.e., loans secured by second liens). The Corporation’s purchases have a variety of maturities. The Corporation’s purchases of adjustable-rate mortgage loans (“ARMs”), fixed-rate loans with intermediate terms of 20 years or less and second mortgage loans are designed to provide a secondary market for a variety of loans that may be attractive to potential homeowners.

The composition of the Corporation’s loan portfolio at the end of each of the last five years is shown in the table in “Portfolio Composition.” The composition of its purchases during the last three years is shown in “Management’s Discussion and Analysis of Financial Condition and Results of Operations—Balance Sheet Analysis—Mortgage Portfolio.” Of the single-family and multifamily mortgage loans that the Corporation purchased in 1997, including mortgage-backed securities, approximately 69 percent (measured by unpaid principal balance (“UPB”)) were from investment banking companies, 10 percent were from mortgage banking companies, 7 percent were from commercial and mutual savings banks, 6 percent were from savings and loan associations and 8 percent were from other institutions. All of the Corporation’s mortgage loan purchases from investment banking companies were through purchases of mortgage-backed securities.

Principal Balance Limits. Maximum principal balance limits apply to the Corporation's mortgage loan purchases. For 1997, the Corporation could not purchase conventional mortgage loans on one-family dwellings if the loan's original principal balance exceeded \$214,600, except for loans secured by properties in Alaska, Hawaii and the Virgin Islands. Higher principal balance limits apply to loans secured by properties in those areas or secured by two- to four-family dwelling units. The maximum principal balance limits applicable to such conventional mortgage loans secured by one- to four-family dwellings can be adjusted by the Corporation annually based on the national average price of a one-family dwelling as surveyed by the Federal Housing Finance Board. In January 1998, the Corporation increased its maximum principal balance limit to \$227,150.

Under the Charter Act, maximum principal balance limits also apply to the Corporation's purchases of conventional multifamily mortgage loans. Such limits are affected by the location of the property and other factors.

Mortgage loans insured by the FHA or guaranteed by the Rural Housing Service are subject to statutory maximum amount limitations. The Corporation will not purchase VA-guaranteed mortgage loans that have principal amounts in excess of amounts that the Corporation specifies from time to time.

Fixed-Rate/Adjustable-Rate. Substantially all fixed-rate mortgage loans purchased by the Corporation provide for level monthly installments of principal and interest. Some of these loans (1 percent of the single-family portfolio at December 31, 1997) have balloon payments due 5, 7 or 10 years after origination, but with monthly payments based on longer (in many cases 30-year) amortization schedules. Many of the 7-year balloon single-family mortgage loans permit the borrower to refinance the balloon payment at maturity with a 23-year fixed-rate mortgage loan if certain requirements are satisfied. Many of the multifamily mortgage loans have balloon payments due 5, 7, 10 or 15 years after origination, but with payments based on 25- or 30-year amortization schedules.

The interest rates on ARMs are determined by formulas providing for automatic adjustment, up or down, at specified intervals in accordance with changes in specified indices. Substantially all ARMs also provide for monthly installments of principal and/or interest with the total amount of monthly installments adjusted (up or down) after the interest rate on the loan is adjusted because of changes in the applicable index. The Corporation currently purchases ARMs only if the ARMs have a cap on the amount the interest rate may change over the life of the loan. A substantial number of the ARMs purchased by the Corporation provide the mortgagor with the option, at specified times or during specified periods of time, to convert the ARM to a fixed-rate mortgage loan with payment of a small fee.

The Corporation also purchases certain ARMs, called reverse mortgages, that provide for monthly installments of principal to be paid to the borrower. Over the life of the loan, interest and certain other fees accrue on the balance of the payments made to the borrower. As described above, the Corporation currently purchases reverse mortgages only if the reverse mortgages are subject to a cap on the amount the interest rate may change over the life of the loan. Generally, the loan is due when the borrower no longer occupies the property.

Maturity. The Corporation currently purchases conventional, single-family fixed- and adjustable-rate mortgage loans with original maturities of up to 30 years and 40 years, respectively. Only a small portion of such ARMs purchased have maturities of more than 30 years. The multifamily mortgage loans that the Corporation currently purchases for its portfolio generally are conventional fixed-rate loans that have maturities of up to 30 years.

Repayments

The majority of the single-family mortgage loans in the Corporation's portfolio are prepayable by the borrower. Therefore, the Corporation bears the risk that prepayments may increase when interest rates decline significantly or as a result of other factors. The Corporation manages this risk as

described in “Management’s Discussion and Analysis of Financial Condition and Results of Operations—Risk Management—Interest Rate Risk Management.” Most multifamily loans in the Corporation’s portfolio provide for a prepayment premium that is calculated under a formula that is intended to protect the Corporation from loss of yield on its investment in the mortgage loan being prepaid.

Portfolio Composition

The following table shows the composition of the Corporation’s mortgage loan portfolio and the weighted-average yield (net of servicing) on the mortgage loan portfolio. The table includes mortgage loans that back MBS held in the Corporation’s mortgage loan portfolio.

Mortgage Loan Portfolio Composition (Dollars in millions)

	December 31,				
	<u>1997</u>	<u>1996</u>	<u>1995</u>	<u>1994</u>	<u>1993</u>
Single-family:					
Government insured or guaranteed.....	\$ 19,478	\$ 15,912	\$ 13,102	\$ 11,659	\$ 8,525
Conventional:					
Long-term, fixed-rate	211,541	177,070	140,466	109,079	82,170
Intermediate-term, fixed-rate	61,571	66,284	68,752	68,166	64,623
Adjustable-rate.....	11,373	12,783	15,108	16,718	19,439
Second	268	323	423	536	772
Multifamily	<u>12,447</u>	<u>14,680</u>	<u>15,660</u>	<u>15,899</u>	<u>15,332</u>
Total UPB	<u>\$316,678</u>	<u>\$287,052</u>	<u>\$253,511</u>	<u>\$222,057</u>	<u>\$190,861</u>
Yield.....	<u>7.60%</u>	<u>7.69%</u>	<u>7.80%</u>	<u>7.80%</u>	<u>7.79%</u>

Commitments

The Corporation issues commitments to purchase, during the term of the commitment, a specified dollar amount of mortgage loans. The Corporation purchases mortgage loans through standard product commitments with posted yields and through negotiated commitments.

The Corporation purchases most of its mortgage loans pursuant to mandatory delivery commitments. Under such commitments, lenders are obligated to sell loans to the Corporation at the commitment yield. Mandatory delivery commitments are available for standard product and negotiated transactions. If a lender is not able to deliver the mortgage loans required under a mandatory delivery commitment during its term, the lender may buy back the commitment at any time during the commitment term for a fee.

The Corporation issues master commitments to lenders to facilitate the delivery of mortgages into MBS pools or portfolio. In order to deliver under a master commitment, a lender must either deliver mortgages in exchange for MBS or enter into a mandatory delivery portfolio commitment with the yield established upon execution of the portfolio commitment.

The Corporation also issues to lenders negotiated standby commitments that commit the Corporation to purchase a designated dollar amount of single-family mortgage loans from the lenders if they convert their standby commitments to mandatory delivery commitments. Standby commitments do not obligate the lenders to sell the loans to the Corporation; they are obligated to do so only after such commitments are converted to mandatory delivery commitments. The yield on the mortgage loans is established at the time of the conversion in the case of standby commitments. See “Management’s Discussion and Analysis of Financial Condition and Results of Operations—Balance Sheet Analysis—Liquidity and Capital Resources.”

Underwriting Guidelines

The Corporation has established certain underwriting guidelines for purchases of conventional mortgage loans in an effort to reduce the risk of loss from mortgagor defaults. These guidelines are designed to assess the creditworthiness of the mortgagor as well as the value of the mortgaged property relative to the amount of the mortgage loan. The Corporation, in its discretion, accepts deviations from the guidelines. The Corporation also reviews and changes its guidelines from time to time. As part of its affordable housing initiatives, the Corporation continues to introduce new underwriting criteria that could make the mortgage finance system more accessible to minorities, low-and moderate-income families, underserved and rural residents and people with special housing needs. In addition, the Corporation is continuing its community-based experiments involving alternative methods of assessing the creditworthiness of potential borrowers, among other factors. See “Affordable Housing Initiatives and Goals.”

The Corporation generally relies on lender representations to ensure that the mortgage loans it purchases conform to its underwriting guidelines. The Corporation also performs quality control reviews of selected loans to monitor compliance with the guidelines. In the event that a lender is found to have breached its representations with respect to a loan’s compliance with the guidelines, the Corporation can demand that the lender repurchase the loan.

In 1996 and 1997, the Corporation enhanced Desktop Underwriter[®], its automated underwriting system, to assist lenders in meeting its underwriting standards. Desktop Underwriter is designed to help lenders process mortgage applications in a more efficient and accurate manner and to apply Fannie Mae’s underwriting criteria consistently and objectively to all prospective borrowers. If Desktop Underwriter provides an “approved” recommendation to a loan application, the Corporation waives certain representations as long as the loan is originated in accordance with the information that was submitted to Desktop Underwriter.

The Corporation generally requires that the UPB of each conventional single-family first mortgage loan it purchases not be greater than 80 percent of the value of the mortgaged property unless the excess over a specified level is insured by a mortgage insurance company acceptable to the Corporation. If mortgage insurance is required initially, it must be maintained as long as the UPB is greater than 80 percent of the original value (or of the appraised value as determined by a subsequent appraisal). The Corporation does not require mortgage insurance on conventional single-family loans with LTV ratios greater than 80 percent if the mortgage loan seller provides other acceptable credit enhancement. The Corporation bears the risk that in some cases parties assuming credit enhancement obligations may be unable to meet their contractual obligations to the Corporation. Fannie Mae regularly monitors this risk and follows specific criteria in evaluating and accepting credit enhancement arrangements in order to minimize its exposure to credit loss.

The Corporation has required credit enhancement for a majority of the mortgage loans in its multifamily loan portfolio. See “Management’s Discussion and Analysis of Financial Condition and Results of Operations—Risk Management—Credit Risk Management—Multifamily.”

Servicing

The Corporation does not service mortgage loans held in the portfolio or backing MBS, except for government-insured multifamily loans, for which the primary servicing functions are performed by a major servicing entity under a subservicing arrangement. However, the Corporation generally manages and markets properties acquired through foreclosure. Fannie Mae mortgage loans can be serviced only by a servicer approved by the Corporation, and must be serviced subject to the Corporation’s guidelines. Lenders who sell single-family mortgage loans and conventional multifamily loans to the Corporation often are such servicers. Servicing includes the collection and remittance of principal and interest payments, administration of escrow accounts, evaluation of transfers of ownership interests, responding to requests for partial releases of security, granting of easements, handling proceeds from casualty losses, problem loan workouts and, if necessary, processing of

foreclosures. In the case of multifamily loans, servicing also includes performing property inspections, evaluating the financial condition of owners and administration of various types of agreements (including agreements regarding replacement reserves, completion/repair and operations and maintenance). The Corporation compensates servicers by permitting them to retain a specified portion of each interest payment on a serviced mortgage loan. The Corporation reserves the right to remove servicing responsibility from a lender.

Mortgage-Backed Securities

MBS are mortgage pass-through trust certificates issued and guaranteed by the Corporation that represent beneficial interests in pools of mortgage loans or other MBS. The Corporation serves as trustee for each trust.

MBS are backed by loans from one of three sources: a single lender, multiple lenders or the Corporation's portfolio. Single-lender MBS generally are issued through lender swap transactions in which a lender exchanges pools of mortgage loans for MBS. Multiple-lender MBS allow several lenders to pool mortgage loans together and, in return, receive MBS representing a proportionate share of a larger pool (called Fannie Majors®). MBS may back other securities, including Fannie Megas® ("Megas"), Stripped MBS ("SMBS"), real estate mortgage investment conduit securities ("REMICs") and other mortgage securities utilizing a "grantor trust" structure.

MBS are not assets of the Corporation, except when acquired for investment purposes, nor are MBS recorded as liabilities. The Corporation, however, is liable under its guarantee to make timely payments to investors of principal and interest on the mortgage loans in the pools, even if the Corporation has not received payments of principal or interest on the mortgage loans in the underlying pools. MBS enable the Corporation to further its statutory purpose of increasing the liquidity of residential mortgage loans and create a source of guaranty fee income to the Corporation without assuming any debt refinancing risk on the underlying pooled mortgages. Because of the Corporation's guarantees, it assumes the ultimate credit risk of borrowers' defaults on all mortgage loans underlying MBS, as it does for portfolio mortgage loans. See "Management's Discussion and Analysis of Financial Condition and Results of Operations—Risk Management—Credit Risk Management."

The Corporation issues MBS backed by single-family or multifamily first or second mortgage loans, with fixed or adjustable rates. Generally, the mortgage loans are either conventional, FHA, VA or Rural Housing Service-guaranteed mortgage loans. The conventional mortgage loans are subject to the maximum principal balance limits applicable to the Corporation's purchases as described under "Mortgage Loan Portfolio—Mortgage Loans Purchased—Principal Balance Limits." The mortgage loans also are subject to the same underwriting guidelines as those for mortgage loans purchased for portfolio as described under "Mortgage Loan Portfolio—Underwriting Guidelines." The substantial majority of the Corporation's MBS outstanding represents beneficial interests in conventional fixed-rate mortgage loans on single-family dwellings.

The Corporation issues and guarantees several forms of MBS, including Fannie Majors, that involve only a single class of certificates with each investor receiving a portion of the payments of principal and interest on the underlying mortgage loans equal to its undivided interest in the pool. With a standard MBS, an investor has an undivided interest in a pool of underlying mortgage loans that generally are provided either by one lender or by the Corporation out of the Corporation's mortgage loan portfolio. Megas represent undivided interests in a pool of MBS, REMIC tranches or pass-through certificates guaranteed by the Government National Mortgage Association ("Ginnie Mae certificates") of the same type. In addition, the Corporation issues and guarantees MBS in the form of single-class "grantor trust" securities representing an undivided interest in a pool of MBS, Ginnie Mae certificates, other mortgage-backed securities or mortgage loans.

The Corporation also issues and guarantees MBS that involve more than one class of certificates and, therefore, require special allocations of cash flows. SMBS are issued in series, with one or more

classes that are each entitled to different cash flows and may represent (a) an undivided interest solely in the principal payments, (b) an undivided interest solely in the interest payments or (c) different percentage interests in principal and interest payments, to be made on a pool of mortgage loans, MBS, REMICs, other SMBS and/or Ginnie Mae certificates. REMICs represent beneficial interests in a trust having multiple classes of certificates entitled to different cash flows from the underlying mortgage loans, MBS, SMBS, Ginnie Mae certificates and/or certificates from other REMICs. Pursuant to its guarantee of REMICs and SMBS, the Corporation is obligated to make timely distribution of required installments of principal and/or interest and, in the case of REMICs, to distribute the principal balance in full by a specified date, whether or not sufficient funds are available in the related REMIC trust (the Corporation has issued a limited amount of subordinated REMIC classes that are not guaranteed by the Corporation).

The Corporation receives guaranty fees for a significant portion of its MBS (principally its standard MBS and Fannie Majors). Such fees are paid monthly until the underlying mortgage loans have been repaid or otherwise liquidated from the pool (generally as a result of delinquency). The aggregate amount of guaranty fees received by the Corporation depends upon the amount of MBS outstanding and on the guaranty fee rate. The amount of MBS outstanding is influenced by the repayment rates on the underlying mortgage loans and by the rate at which the Corporation issues new MBS. In general, when the level of interest rates declines significantly below the interest rates on loans underlying MBS, the rate of prepayments is likely to increase; conversely, when interest rates rise above the interest rates on loans underlying MBS, the rate of prepayments is likely to slow. In addition to interest rate changes, the rate of principal payments is influenced by a variety of economic, demographic and other factors. The Corporation also generally receives one-time fees for swapping SMBS, REMICs, Megas and grantor trust securities for MBS, mortgage loans, Ginnie Mae certificates, SMBS, REMIC certificates or other mortgage-backed securities.

In many instances, the lender or lenders that originated the loans in an MBS pool created from the Corporation's portfolio or the lender or lenders that exchanged the loans for the MBS (in the case of a "swap" transaction) initially service the loans. The Corporation, however, reserves the right to remove the servicing responsibility from a lender at any time if it considers such removal to be in the best interest of MBS certificate holders. In such event, the Corporation finds a replacement lender that will service the loans. Generally, the Corporation ultimately is responsible to MBS holders for the administration and servicing of mortgage loans underlying MBS, including the collection and receipt of payments from lenders, and the remittance of distributions and certain reports to holders of MBS certificates.

Affordable Housing Initiatives and Goals

In 1994, the Chairman of the Corporation announced that for the seven years from 1994 through the year 2000 the Corporation would commit \$1 trillion to help finance over 10 million homes for families and communities most in need (the "Trillion Dollar Commitment"). As part of the Trillion Dollar Commitment announcement, the Chairman laid out 11 initiatives targeting specific areas of the mortgage finance system for improvement. (In early 1996, the Fannie Mae Foundation undertook three of the initiatives.) By the end of 1997, the Corporation was able to report the following progress with respect to each of the eleven initiatives (including progress on the three Foundation initiatives that were supported by the Corporation): (i) established 28 Partnership Offices around the country and announced plans to open five additional offices in 1998 (initiative: Fannie Mae Partnership Offices); (ii) integrated research on credit scoring and loan performance with the Corporation's automated underwriting, offering lenders a tool that allows them to use the most flexible loan criteria to extend full consideration for each borrower's unique credit profile (initiative: Underwriting Flexibilities); (iii) issued \$7.3 billion of total commitments to specific underwriting experiments intended to lower barriers to homeownership (initiative: Underwriting Experiments); (iv) addressed emerging markets with products designed to meet home improvement renovation financing needs and targeted those most in need with products designed for seniors, disabled people and their families, and Native Americans (initiative: Innovations for Change); (v) originated \$25.7 billion in multifamily

financing (initiative: Multifamily Housing Finance); (vi) identified potential savings of approximately \$800 per mortgage related to the origination costs of mortgages through the use of Fannie Mae technology (initiative: Technology to Reduce Costs); (vii) approved more than \$38.2 million of investments in community development financial institutions and increased the percentage of lending to minority borrowers to over 17 percent of the Corporation's total loan volume (initiative: Fighting Discrimination); (viii) together with 29 for-profit, nonprofit and governmental organizations, created the American Homeowner Education and Counseling Institute, an independent nonprofit organization committed to increased professionalism in homeowner counseling and to identifying more effective ways to finance home buyer education (initiative: HomePath Initiative); (ix) exceeded its original commitment to increase giving to the Fannie Mae Foundation (initiative: Increased Foundation Giving); (x) handled nearly 1.5 million consumers' requests for homeownership information (initiative: Opening Doors for Every American campaign); and (xi) provided 1.3 million immigrants with home-buying information, using multilingual media and community organizations supportive of immigrants (initiative: New Americans Campaign).

Under the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (the "1992 Act"), the Corporation has certain goals to promote affordable housing for moderate-, low- and very low-income families and to serve the housing needs of those in underserved areas. In 1997, the Corporation exceeded the applicable goals. See "Management's Discussion and Analysis of Financial Condition and Results of Operations—Housing Goals."

Delinquencies and REO

When a mortgage loan for which Fannie Mae bears the default risk is liquidated by foreclosure, the Corporation generally acquires the underlying property (such real estate owned is called "REO") and holds it for sale. The level of delinquencies and number of REO are affected by economic conditions, loss mitigation efforts (which include contacting delinquent borrowers to offer the options of a preforeclosure sale or modification) and a variety of other factors. The Corporation manages the risk of delinquencies and REO as described in "Management's Discussion and Analysis of Financial Condition and Results of Operations—Risk Management—Credit Risk Management."

Fee-Based Services

The Corporation offers certain services to lenders and other customers in return for a fee. These include issuing REMICs, SMBS, Fannie Megas®, and grantor trust securities, technology services for originating and underwriting loans, and the facilitation of securities transactions.

The Corporation receives fee income from dealers in exchange for creating and issuing REMICs, SMBS, grantor trust securities and Megas. In addition to issuing these securities, the Corporation is responsible for all tax reporting and administration costs associated with these securities.

The Corporation also receives fee income in return for providing technology related services such as Desktop Underwriter®, Desktop Originator®, Desktop Trader®, and other on-line services. These services provide lenders the ability to underwrite mortgage loans electronically, communicate with third-party originators, access Fannie Mae loan pricing schedules, and enter into sale commitments with the Corporation on a real-time basis.

The Corporation also simultaneously purchases and sells MBS and certain other mortgage-related securities, such as Ginnie Mae certificates, with the intention of earning a spread on such trades or as a service to customers. In addition, the Corporation receives fee income through other activities, such as repurchase transactions, and by providing other investment alternatives for customers.

Competition

The Corporation competes, within the limits prescribed by its Charter Act, for the purchase of mortgage loans for portfolio and the issuance of mortgage-backed securities in the secondary mortgage market. For single-family products, the Corporation competes primarily with the Federal Home Loan

Mortgage Corporation (“Freddie Mac”), another government-sponsored enterprise regulated by the Department of Housing and Urban Development (“HUD”) and the Office of Federal Housing Enterprise Oversight with a mission and authority that is virtually identical to that of Fannie Mae. Fannie Mae competes to a lesser extent with savings and loan associations, savings banks, commercial banks, other government-sponsored entities, and companies that purchase for their own portfolio or pool single-family mortgage loans for sale to investors as whole loans or mortgage-backed securities. Fannie Mae competes with the Federal Housing Administration (“FHA”) insurance program, a HUD program, for the business of guaranteeing the credit performance of mortgage loans and, due to the eligibility of such FHA-insured loans for securitization by the Government National Mortgage Association (“Ginnie Mae”), with Ginnie Mae as well. The proposed fiscal year 1999 federal budget calls for an increase in the maximum principal balance for loans eligible for the FHA insurance program to equal Fannie Mae’s loan limits. Currently, Fannie Mae is limited to purchasing and guaranteeing the credit performance of mortgage loans with a maximum principal balance of \$227,150 (or more depending upon geographical area and number of dwelling units) while the FHA is limited to insuring mortgage loans with a range of maximum principal balances from \$86,317 to \$170,362. Such an increase for the FHA would require legislation and, if enacted into law, likely result in expanded competition for the Corporation’s guaranty business. (For additional information on the maximum principal balances for loans purchased by the Corporation, see “Mortgage Loan Portfolio—Mortgage Loans Purchased—Principal Balance Limits.”)

In the case of multifamily products, the Corporation generally competes with government housing programs and with the same kinds of entities as in the case of single-family products, but Freddie Mac is just one among many competitors that vigorously compete in this market. Competition for multifamily mortgage loans is intense from certain entities typically sponsored by investment banks who purchase such loans and pool them for sale to investors in the commercial mortgage-backed securities market. Such entities are referred to as “conduits,” and their role in the multifamily mortgage market increased significantly in 1997.

The Corporation’s market share of loans purchased for cash or swapped for MBS is affected by the volume of mortgage loans offered for sale in the secondary market by loan originators and other market participants and the amount purchased by other market participants that compete with the Corporation.

The Corporation competes primarily on the basis of price, products, and services offered. Competition based on advances in technology-related and other fee-based services continues to increase, as do the types and nature of the products offered by the Corporation and Freddie Mac and other market participants.

Competition is particularly intense for multifamily mortgage loans eligible for government subsidies, which have low-income rent and occupancy restrictions. As a prerequisite to expansion or merger plans, commercial banks must fund such loans to meet certain housing goals under the Community Reinvestment Act, and they often are willing to do so at or below their own cost of funds. Fannie Mae competes for these same investment opportunities to meet its housing goals.

Since 1993, Freddie Mac has been adding to its mortgage portfolio significantly, which has increased the competition between the Corporation and Freddie Mac for mortgage loans. In addition, beginning in 1993, Freddie Mac, other traditional lenders, and new lenders began to acquire, or recommenced acquiring, multifamily mortgage loans. In 1994, Ginnie Mae became a competitor in the market for REMICs backed by Ginnie Mae certificates. In addition, both Fannie Mae and Ginnie Mae issued pooled mortgage-backed securities (Megas and Platinums, respectively) backed by Ginnie Mae certificates. However, because the Ginnie Mae guaranty is directly backed by the full faith and credit of the United States, dealers are more likely to exchange their Ginnie Mae certificates for Ginnie Mae Platinums than for Fannie Mae Megas, except in limited situations. Fannie Mae continues to issue REMICs backed by Ginnie Mae certificates.

Competition also is a consideration in connection with the issuance of the Corporation's debt securities. The Corporation competes with Freddie Mac, the Student Loan Marketing Association, the Federal Home Loan Bank ("FHLB") system and other government-sponsored entities for funds raised through the issuance of unsecured debt in the "agency" debt market. Increases in the issuance of unsecured debt by other government-sponsored entities generally, and in the issuance of callable debt in particular, may have an adverse effect on the issuance of the Corporation's unsecured debt, or result in the issuance of such debt at higher interest rates than would otherwise be the case. In addition, the availability and cost of funds raised through the issuance of certain types of unsecured debt may be affected adversely by regulatory initiatives that tend to reduce investments by certain depository institutions in unsecured debt with greater than normal volatility or interest-rate sensitivity.

Under the 1992 Act, the Secretary of HUD must approve any new Fannie Mae or Freddie Mac program that is significantly different from those approved or engaged in prior to that Act's enactment. The ability of Fannie Mae and Freddie Mac to compete with other competitors possibly could be affected by this requirement. See "Government Regulation and Charter Act."

Facilities

The Corporation owns its principal office, which is located at 3900 Wisconsin Avenue, NW, Washington, DC, an office at 3939 Wisconsin Avenue, NW, Washington, DC, and two facilities in Herndon, Virginia. In addition, the Corporation leases approximately 379,000 square feet of office space at 4000 Wisconsin Avenue, NW, which is adjacent to the Corporation's principal office, and approximately 64,000 square feet of office space at 2115 Wisconsin Avenue, NW. The present lease for 4000 Wisconsin Avenue expires in 2003, but the Corporation has options to extend the lease for up to 15 additional years, in 5-year increments. The lease for 2115 Wisconsin expires in 2002. The Corporation also maintains regional offices in leased premises in Pasadena, California; Atlanta, Georgia; Chicago, Illinois; Philadelphia, Pennsylvania; and Dallas, Texas. The regional offices negotiate mortgage loan and MBS business with lenders, assist in supervising the servicing of the Corporation's mortgage loan portfolio by lenders, assist in supervising or managing the handling and disposition of REO and provide training to the staffs of lenders. In addition to the regional offices, the Corporation has opened 30 "Fannie Mae Partnership Offices" to date in leased premises around the country which will work with cities, rural areas and other underserved communities. The Corporation also plans to establish three additional Partnership Offices in 1998. There currently are Fannie Mae Partnership Offices in Phoenix, Arizona; Los Angeles, California; Denver, Colorado; Hartford, Connecticut; Washington, D.C.; Miami, Florida; Orlando, Florida; Atlanta, Georgia; Chicago, Illinois; Des Moines, Iowa; Kansas City, Kansas; New Orleans, Louisiana; Baltimore, Maryland; Boston, Massachusetts; Detroit, Michigan; St. Paul, Minnesota; Jackson, Mississippi; St. Louis, Missouri; Lincoln, Nebraska; Albuquerque, New Mexico; Las Vegas, Nevada; New York, New York; Charlotte, North Carolina; Cleveland, Ohio; Columbus, Ohio; Portland, Oregon; Houston, Texas; San Antonio, Texas (two offices, one of which is responsible for border region issues); and Seattle, Washington.

Employees

At December 31, 1997, the Corporation employed approximately 3,500 full-time personnel.

GOVERNMENT REGULATION AND CHARTER ACT

The Corporation is a federally chartered and stockholder-owned Corporation organized and existing under the Charter Act (12 U.S.C. § 1716 *et seq.*) whose purpose is to (1) provide stability in the secondary market for residential mortgages, (2) respond appropriately to the private capital market, (3) provide ongoing assistance to the secondary market for residential mortgages (including activities relating to mortgages on housing for low- and moderate-income families involving a reasonable economic return that may be less than the return earned on other activities) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing and (4) promote access to mortgage credit throughout the nation (including central cities, rural areas and underserved areas) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing.

Fannie Mae originally was incorporated in 1938 pursuant to Title III of the National Housing Act as a wholly owned government corporation and in 1954, under a revised Title III called the Federal National Mortgage Association Charter Act, became a mixed-ownership corporate instrumentality of the United States. From 1950 to 1968, it operated in the Housing and Home Finance Agency, which was succeeded by the Department of Housing and Urban Development (“HUD”). Pursuant to amendments to the Charter Act enacted in the Housing and Urban Development Act of 1968 (the “1968 Act”), the then Federal National Mortgage Association was divided into two separate institutions, the present Corporation and the Government National Mortgage Association, a wholly owned corporate instrumentality of the United States within HUD, which carried on certain special financing assistance and management and liquidation functions. Under the 1968 Act, the Corporation was constituted as a federally chartered corporation and the entire equity interest in the Corporation became stockholder-owned.

Although the 1968 Act eliminated all federal ownership interest in the Corporation, it did not terminate government regulation of the Corporation. Under the Charter Act, approval of the Secretary of the Treasury is required for the Corporation’s issuance of its debt obligations and MBS. In addition, the 1992 Act established an independent Office of Federal Housing Enterprise Oversight (“OFHEO”) within HUD under the management of a Director (the “Director”) who is responsible for ensuring that the Corporation is adequately capitalized and operating safely in accordance with the 1992 Act. The 1992 Act established minimum capital, risk-based capital and critical capital levels for the Corporation and required the Director to establish, by regulation, a risk-based capital test to be used to determine the amount of total capital the Corporation must have to exceed the risk-based capital level from time to time. OFHEO issued a final rule (the “Rule”) in 1996 related to the minimum capital levels for Fannie Mae and Freddie Mac that sets forth how minimum capital requirements for both entities are to be calculated, reported and classified on a quarterly basis. The Rule, which finalized an original proposal dated June 1995, formalized the interim capital standards applied by OFHEO, with which the Corporation has been in compliance since their inception. See also “Management’s Discussion and Analysis of Financial Condition and Results of Operations—Balance Sheet Analysis—Regulatory Capital Requirements.”

In 1996, OFHEO also released for comment part one (“Part I”) of the proposed regulations to establish the risk-based capital test. Part I specifies that “benchmark loss experience” will be combined with other yet to be determined assumptions and applied each quarter to the Corporation’s book of business to establish credit losses under the risk-based capital standard for the Corporation. Part I also specifies the house price index that OFHEO will use in connection with the risk-based capital standard. The Corporation submitted comments to OFHEO in October 1996 stating that several aspects of the initial proposal require adjustments or amendment, because it does not accurately capture the Corporation’s credit history and derives credit loss rates that are significantly worse than any reasonable representation of Fannie Mae’s and Freddie Mac’s loss experience. OFHEO has indicated that it plans to release a proposed second part of the risk-based capital regulation, which will specify, among other matters, remaining aspects of the stress test and how the

stress test will be used to determine Fannie Mae's and Freddie Mac's risk-based capital requirements. Management understands that OFHEO expects to publish this second part in January 1999. Management is optimistic that the final regulations will permit the Corporation to manage its business in a reasonably efficient manner.

If the Corporation fails to meet one or more of the capital standards under the 1992 Act, the Director is required to take certain remedial measures and may take others, depending on the standards the Corporation fails to meet. The Director's enforcement powers include the power to impose temporary and final cease-and-desist orders and civil penalties on the Corporation and on directors or executive officers of the Corporation. If the Director determines that the Corporation is engaging in conduct not approved by the Director that could result in a rapid depletion of core capital or that the value of the property subject to mortgages held or securitized by the Corporation has decreased significantly, the Director is authorized to treat the Corporation as not meeting one of the capital standards that it otherwise meets. In addition, the Corporation is required to submit a capital restoration plan if it fails to meet any of the capital standards. If the Director does not approve the plan or determines that the Corporation has failed to make reasonable efforts to comply with the plan, then the Director may treat the Corporation as not meeting one of the capital standards that it otherwise meets. Also, if the Corporation fails to meet or is treated by the Director as not meeting one of the capital standards and the Director has reasonable cause to believe that the Corporation or any executive officer or director of the Corporation is engaging in or about to engage in any conduct that threatens to result in a significant depletion of the Corporation's core capital, then the Director is authorized to commence proceedings pursuant to which, after a hearing, the Director could issue a cease and desist order prohibiting such conduct. The Director could issue such an order without a hearing, which would be effective until completion of the cease-and-desist proceedings, if the Director determined that the conduct in question was likely to cause a significant depletion of core capital. Prior approval of the Director is required for the Corporation to pay a dividend if the dividend would decrease the Corporation's capital below risk-based capital or minimum capital levels established under the 1992 Act. See "Common Stock." The Director is authorized to levy, pursuant to annual Congressional appropriations, annual assessments on Fannie Mae and Freddie Mac to cover reasonable expenses of OFHEO.

The 1992 Act also gives the Director the authority to conduct on-site examinations of the Corporation for purposes of ensuring the Corporation's financial safety and soundness. In addition, the Corporation is required to submit annual and quarterly reports of the financial condition and operations of the Corporation to the Director. Moreover, the Charter Act, as amended by the 1992 Act, authorizes the General Accounting Office to audit the programs, activities, receipts, expenditures and financial transactions of the Corporation. The Corporation also is required to submit an annual report to the House and Senate Banking Committees and the Secretary of HUD regarding the Corporation's performance in meeting housing goals relating to the purchase of mortgages on housing for low- and moderate-income families, mortgages on rental and owner-occupied housing for low-income families in low-income areas or for very-low-income families, and mortgages on housing located in rural or other underserved areas.

Under the 1992 Act, the Secretary of HUD retains general regulatory authority to promulgate rules and regulations to carry out the purposes of the Charter Act, excluding authority over matters granted exclusively to the Director in the 1992 Act. The Secretary of HUD also must approve any new conventional mortgage program that is significantly different from those approved or engaged in prior to the 1992 Act. The Secretary is required to approve any new program unless it is not authorized by the Charter Act of the Corporation or the Secretary finds that it is not in the public interest. However, until one year after the final regulations establishing the risk-based capital test are in effect, the Secretary must disapprove a new program if the Director determines that the program would risk significant deterioration of the financial condition of the Corporation. The Secretary has adopted regulations related to the program approval requirement.

Thirteen members of the Corporation's eighteen-member Board of Directors are elected by the holders of the Corporation's common stock, and the remaining five members are appointed by the President of the United States. The appointed directors must include one person from the home building industry, one person from the mortgage lending industry, and one person from the real estate industry. Under the 1992 Act, one appointed director also must be from an organization that has represented consumer or community interests for not less than two years or a person who has demonstrated a career commitment to the provision of housing for low-income households. Any member of the Board of Directors that is appointed by the President of the United States may be removed by the President for good cause.

In addition to placing the Corporation under federal regulation, the Charter Act also grants to the Corporation certain privileges. For instance, securities issued by the Corporation are deemed to be "exempt securities" under laws administered by the Securities and Exchange Commission ("SEC") to the same extent as securities that are obligations of, or guaranteed as to principal and interest by, the United States. Registration statements with respect to the Corporation's securities are not filed with the SEC. The Corporation also is not required to file periodic reports with the SEC.

The Secretary of the Treasury of the United States has discretionary authority to purchase obligations of the Corporation up to a maximum of \$2.25 billion outstanding at any one time. This facility has not been used since the Corporation's transition from government ownership in 1968. Neither the United States nor any agency thereof is obligated to finance the Corporation's operations or to assist the Corporation in any other manner.

The Corporation is exempt from all taxation by any state or by any county, municipality, or local taxing authority except for real property taxes. The Corporation is not exempt from payment of federal corporate income taxes. Also, the Corporation may conduct its business without regard to any qualifications or similar statute in any state of the United States or the District of Columbia.

The Federal Reserve Banks are authorized to act as depositaries, custodians, and fiscal agents for the Corporation, for its own account, or as fiduciary.

LEGAL PROCEEDINGS

In the ordinary course of business, the Corporation is involved in legal proceedings that arise in connection with properties acquired by the Corporation, either through foreclosure on properties securing delinquent mortgage loans owned by the Corporation or by receiving deeds to such properties in lieu of foreclosure. For example, claims related to possible tort liability and compliance with applicable environmental requirements arise from time to time, primarily in the case of single-family REO.

The Corporation is a party to legal proceedings from time to time arising from its relationships with its seller/servicers. Disputes with lenders concerning their loan origination or servicing obligations to the Corporation, or disputes concerning termination by the Corporation (for any of a variety of reasons) of a lender's authority to do business with the Corporation as a seller and/or servicer, can result in litigation. Also, loan servicing issues have resulted from time to time in claims against the Corporation brought as putative class actions for borrowers.

The Corporation also is a party to legal proceedings from time to time arising from other aspects of its business and administrative policies.

Claims and proceedings of all types are subject to many uncertain factors that generally cannot be predicted with assurance. However, in the case of the legal proceedings and claims that are currently pending against the Corporation, management believes that their outcome will not have a material adverse effect on the Corporation's financial condition or results of operations.

COMMON STOCK

Section 303(a) of the Charter Act provides that the Corporation shall have common stock, without par value. The common stock is vested with all voting rights. Each share of common stock is entitled to one vote at all elections of directors and on all other matters presented for common stockholder vote. The holders of the common stock elect thirteen directors, and the President of the United States appoints the remaining five directors. Any member of the Board of Directors that is appointed by the President of the United States may be removed by the President for good cause. The Charter Act, the Corporation's governing instrument, cannot be amended by the stockholders, but only by an Act of Congress.

The Corporation also is authorized by the Charter Act to have preferred stock on such terms and conditions as the Board of Directors of the Corporation may prescribe. No common stockholder approval is required to issue preferred stock. The Corporation issued \$1 billion of non-cumulative preferred stock in 1996 that is redeemable at the Corporation's option beginning in 2001. See "Notes to Financial Statements — Note 12" for additional information on preferred stock.

The Charter Act contains no limitation on the amount of stock that may be issued, except that if the Corporation fails to meet certain minimum capital standards, the Director could require that the Director approve the Corporation's issuance of stock or securities convertible into stock. At February 28, 1998, there were outstanding approximately 1,037 million shares of common stock, which were held by approximately 21,000 stockholders of record. Based on the number of requests for proxies and quarterly reports, the Corporation estimates that on February 28, 1998 there were approximately 280,000 additional stockholders who held shares through banks, brokers and nominees.

Holders of the common stock are entitled to receive cash dividends if, as and when declared by the Board of Directors. However, certain provisions of the 1992 Act may operate to restrict the ability of the Board of Directors to declare dividends in certain circumstances. The 1992 Act established risk-based capital, minimum capital and critical capital levels for the Corporation, and required the Director of OFHEO to establish, by regulation, a risk-based capital test to be used to determine the amount of total capital the Corporation must have to exceed the risk-based capital level from time to time. The Corporation submitted comments on Part I of OFHEO's proposed regulation for the risk-based capital test (released in 1996) and management understands that OFHEO expects to publish for comment in January 1999 the second part of the proposed regulations. See "Government Regulation and Charter Act." Until one year after the final regulations establishing the risk-based capital test are in effect, a dividend may be paid without the prior approval of the Director if the Corporation meets the minimum capital level established under the 1992 Act and the dividend payment would not decrease the Corporation's base capital below such level. See "Government Regulation and Charter Act" regarding the final rule applicable to the minimum capital level.

One year after final regulations establishing the risk-based capital test take effect, a dividend may be paid without the prior approval of the Director if the Corporation meets both the risk-based capital and minimum capital levels and the dividend payment would not decrease the Corporation's total capital below the risk-based capital level or its core capital below the minimum capital level. If the Corporation meets either the risk-based capital standard or the minimum capital standard, it may make a dividend payment without obtaining the approval of the Director only if the dividend payment would not cause the Corporation to fail to meet another capital standard. At any time when the Corporation does not meet the risk-based capital standard but meets the minimum capital standard, the Corporation is prohibited from making a dividend payment that would cause the Corporation to fail to meet the minimum capital standard. If the Corporation meets neither the risk-based capital standard nor the minimum capital standard but does meet the critical capital standard established under the 1992 Act, it may make a dividend payment only if the Corporation would not fail to meet the critical capital standard as a result of such payment and the Director approves the payment after finding that it satisfies certain statutory conditions. The Director has the authority to require the Corporation to submit a report to the Director regarding any capital distribution (including any

dividend) declared by the Corporation before the Corporation makes the distribution. See “Government Regulation and Charter Act” and “Management’s Discussion and Analysis of Financial Condition and Results of Operations—Balance Sheet Analysis—Regulatory Capital Requirements” regarding the capital standards applicable to the Corporation.

The payment of dividends on common stock also is subject to the payment of dividends on any preferred stock outstanding. Accordingly, no cash dividend may be declared or paid or set apart for payment on common stock unless cash dividends have been declared and paid or set apart (or ordered to be set apart) on preferred stock outstanding for the then-current dividend period.

Dividends on common stock have been declared and paid for each quarter during the Corporation’s two most recent fiscal years. See “Quarterly Results of Operations” on pages 69-70 for quarterly dividends paid on common stock during 1997 and 1996.

In the event of liquidation of the Corporation, holders of common stock are entitled to share ratably, in accordance with their holdings, in the remaining assets of the Corporation after payment of all liabilities of the Corporation and amounts payable to the holders of preferred stock.

The common stock has no conversion or pre-emptive rights or redemption or sinking fund provisions. The outstanding shares of common stock are fully paid and nonassessable. There is no prohibition against the purchase by the Corporation of its own common stock, holding such common stock in its treasury, and reselling such stock.

This description is summarized from the Charter Act, the 1992 Act, the bylaws and certain resolutions of the Board of Directors and stockholders of the Corporation. This description does not purport to be complete and is qualified in its entirety by reference to the Charter Act, the 1992 Act, the bylaws of the Corporation and such resolutions. Copies of the Charter Act, the bylaws of the Corporation and any applicable resolutions may be obtained from the Corporation.

The Corporation’s common stock is publicly traded on the New York, Pacific and Chicago stock exchanges and is identified by the ticker symbol “FNM.” The transfer agent and registrar for the common stock is First Chicago Trust Company of New York, 525 Washington Boulevard, Jersey City, New Jersey 07310.

The following table shows, for the periods indicated, the high and low prices per share of the Corporation’s common stock on the New York Stock Exchange Composite Transactions as reported in the Bloomberg Financial Markets service.

Quarterly Common Stock Data

<u>Quarter</u>	1997		1996	
	High	Low	High	Low
1st	\$43.75	\$36.13	\$35.75	\$28.75
2nd	47.63	36.13	34.50	27.50
3rd.....	49.44	41.13	35.38	29.13
4th.....	57.31	44.69	41.63	34.50

The closing price of the Corporation’s common stock on March 27, 1998, as so reported, was \$63.63.

FORWARD-LOOKING INFORMATION

From time to time, the Corporation may make forward-looking statements relating to matters such as the Corporation’s anticipated financial performance, business prospects, future business plans, financial condition or other matters. For example, “Management’s Discussion and Analysis of Financial Condition and Results of Operations” includes forward-looking statements, which are

statements therein that are not historical facts or explanations of historical data. The words “believes,” “anticipates,” “expects” and similar expressions generally identify forward-looking statements.

Forward-looking statements reflect management’s expectations based on various assumptions and management’s estimates of trends and economic factors in the markets in which the Corporation is active, as well as the Corporation’s business plans. As such forward-looking statements are subject to risks and uncertainties, the Corporation’s actual results may differ (possibly significantly) from those indicated in such statements. Among the factors that may affect the performance, development or results of the Corporation’s business, and thereby cause actual results to differ from management’s expressed expectations, are the following:

- significant changes in borrower preferences for fixed- or adjustable-rate mortgages, originator preferences for selling mortgages in the secondary market, investor preferences for the Corporation’s securities versus other investments, the availability of funding at attractive spreads in the financial markets (in particular from callable debt), and other factors affecting the overall mix of mortgage loans available for purchase, the Corporation’s funding opportunities or the Corporation’s net interest margins;
- significant changes in employment rates, housing price appreciation or other factors affecting delinquency or foreclosure levels and credit losses;
- significant changes in the Corporation’s policies or strategies, such as its underwriting requirements or its interest rate risk management, credit loss mitigation or investment strategies;
- regulatory or legislative changes affecting the Corporation, its competitors or the markets in which the Corporation is active, including changes in taxes or capital requirements applicable to the Corporation or its activities (see “Government Regulation and Charter Act,” “Competition” and “Management’s Discussion and Analysis of Financial Condition and Results of Operations—Balance Sheet Analysis—Regulatory Capital Requirements” regarding certain matters currently being considered by regulators, legislators or the Administration);
- competitive developments in the markets for mortgage loan purchases and for the sale of mortgage-backed and debt securities, or significant changes in the rate of growth in conforming residential mortgage debt;
- significant changes in the amount and rate of growth of the Corporation’s expenses, and the costs (and effects) of legal or administrative proceedings (see “Legal Proceedings”) or changes in accounting policies or practices;
- significant changes in general economic conditions or the monetary or fiscal policy of the United States; and
- unanticipated, substantial changes in interest rates. While the Corporation has achieved 40 consecutive quarters of record operating earnings despite major fluctuations in interest rates during this period and employs a variety of interest rate risk management techniques, it is possible that sudden, severe swings in interest rates could have at least a short-term significant effect on the Corporation’s results.

The Corporation does not undertake to update any forward-looking statement herein or that may be made from time to time on behalf of the Corporation.

SELECTED FINANCIAL INFORMATION: 1993-1997

The following selected financial data for the years 1993 through 1997 (which data are not covered by the independent auditors' report) have been summarized or derived from the audited financial statements and other financial information. These data should be read in conjunction with the audited financial statements and notes to the financial statements.

(Dollars in millions, except per common share amounts)					
Income Statement Data for the year ended December 31:	1997	1996	1995	1994	1993
Interest income	\$ 26,378	\$ 23,772	\$ 21,071	\$ 17,347	\$ 14,833
Interest expense	22,429	20,180	18,024	14,524	12,300
Net interest income	3,949	3,592	3,047	2,823	2,533
Guaranty fees	1,274	1,196	1,086	1,083	961
Miscellaneous income, net	125	86	93	143	259
Credit-related expenses	(375)	(409)	(335)	(378)	(305)
Administrative expenses	(636)	(560)	(546)	(525)	(443)
Special contribution	—	—	(350)	—	—
Income before federal income taxes and extraordinary item	4,337	3,905	2,995	3,146	3,005
Provision for federal income taxes	(1,269)	(1,151)	(840)	(1,005)	(963)
Income before extraordinary item	3,068	2,754	2,155	2,141	2,042
Extraordinary loss—early extinguishment of debt, net of tax effect	(12)	(29)	(11)	(9)	(169)
Net income	<u>\$ 3,056</u>	<u>\$ 2,725</u>	<u>\$ 2,144</u>	<u>\$ 2,132</u>	<u>\$ 1,873</u>
Preferred stock dividends	(65)	(42)	—	—	—
Net income available to common stockholders	<u>\$ 2,991</u>	<u>\$ 2,683</u>	<u>\$ 2,144</u>	<u>\$ 2,132</u>	<u>\$ 1,873</u>
Basic earnings per common share(1):					
Earnings before extraordinary item	\$ 2.87	\$ 2.53	\$ 1.98	\$ 1.96	\$ 1.87
Extraordinary item	(.02)	(.03)	(.01)	(.01)	(.16)
Net earnings	<u>\$ 2.85</u>	<u>\$ 2.50</u>	<u>\$ 1.97</u>	<u>\$ 1.95</u>	<u>\$ 1.71</u>
Diluted earnings per common share(1):					
Earnings before extraordinary item	\$ 2.84	\$ 2.51	\$ 1.96	\$ 1.95	\$ 1.86
Extraordinary item	(.01)	(.03)	(.01)	(.01)	(.15)
Net earnings	<u>\$ 2.83</u>	<u>\$ 2.48</u>	<u>\$ 1.95</u>	<u>\$ 1.94</u>	<u>\$ 1.71</u>
Cash dividends per common share	\$.84	\$.76	\$.68	\$.60	\$.46
Balance Sheet Data at December 31:					
Mortgage portfolio, net	\$316,316	\$286,259	\$252,588	\$220,525	\$189,892
Investments	64,596	56,606	57,273	46,335	21,396
Total assets	391,673	351,041	316,550	272,508	216,979
Borrowings:					
Due within one year	175,400	159,900	146,153	112,602	71,950
Due after one year	194,374	171,370	153,021	144,628	129,162
Total liabilities	377,880	338,268	305,591	262,967	208,927
Stockholders' equity	13,793	12,773	10,959	9,541	8,052
Capital(2)	14,575	13,520	11,703	10,367	8,893
Other Data for the year ended December 31:					
Average net interest margin	1.17%	1.18%	1.16%	1.24%	1.38%
Return on average common equity	24.6	24.1	20.9	24.3	25.3
Dividend payout ratio	29.4	30.4	34.6	30.8	26.9
Average effective guaranty fee rate .....	.227	.224	.220	.225	.213
Credit loss ratio .....	.041	.053	.050	.057	.040
Ratio of earnings to combined fixed charges and preferred stock dividends(3)	1.19:1	1.19:1	1.17:1	1.22:1	1.22:1
Mortgage purchases	\$ 70,465	\$ 68,618	\$ 56,598	\$ 62,389	\$ 92,037
MBS issued	149,429	149,869	110,456	130,622	221,444
MBS outstanding at year-end(4)	709,582	650,780	582,959	530,343	495,525
Weighted-average diluted common shares outstanding, in millions	1,056	1,080	1,098	1,098	1,098

(1) Earnings per common share amounts prior to 1997 have been restated to comply with Statement of Financial Accounting Standards No. 128, *Earnings per Share*.

(2) Stockholders' equity plus general allowance for losses.

(3) "Earnings" consists of (i) income before federal income taxes and extraordinary item and (ii) fixed charges. "Fixed charges" represents interest expense. There was no preferred stock outstanding in 1995, 1994 and 1993.

(4) Includes \$130 billion, \$103 billion, \$70 billion, \$44 billion, and \$24 billion of MBS in portfolio at December 31, 1997, 1996, 1995, 1994, and 1993, respectively.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This discussion highlights significant factors influencing Fannie Mae's financial condition and results of operations. It should be read in conjunction with the financial statements and related notes. This discussion (and other sections of this Information Statement) includes certain forward-looking statements based on management's estimates of trends and economic factors in markets in which the Corporation is active, as well as the Corporation's business plans. In light of recent securities law developments, including the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995, the Corporation notes that such forward-looking statements are subject to risks and uncertainties. Accordingly, the Corporation's actual results may differ from those set forth in such statements. Significant changes in economic conditions; regulatory or legislative changes affecting Fannie Mae, its competitors, or the markets in which it is active; or changes in other factors may cause future results to vary from those expected by the Corporation. The "Forward-Looking Information" section in this Information Statement discusses certain factors that may cause such differences to occur.

Overview

Fannie Mae once again achieved record earnings in 1997, increasing its earnings per common share ("EPS") by 14 percent. The Corporation posted its eleventh consecutive year of double-digit growth in operating earnings by growing the mortgage portfolio, effectively managing interest rate risk, and improving credit performance. Net income increased to \$3.056 billion, up 12 percent from last year's total of \$2.725 billion, while earnings per common share reached \$2.83, compared with \$2.48 in 1996.

During the year, the Corporation's net mortgage portfolio grew by 10 percent. In addition, the Corporation took advantage of lower interest rates to reduce its exposure to the effects of the scheduled maturity of low-cost debt in 1998. The average net interest margin remained relatively stable, declining .01 percentage point to 1.17 percent in 1997, compared with 1.18 percent in 1996.

The Corporation's credit risk management continued to improve during 1997. The decline in credit-related expenses was a result of an improved housing market (particularly in California and the Northeast), increased benefits of mortgage insurance, and continued loss mitigation activities. The credit loss ratio—credit losses as a percentage of the average UPB of total mortgages in portfolio and Fannie Mae MBS outstanding—declined to .041 percent in 1997 from .053 percent in 1996.

The Corporation's core capital (stockholders' equity) grew 8 percent, to \$13.8 billion at December 31, 1997, in spite of the repurchase of \$1.3 billion of common stock during the year. Core capital exceeded regulatory capital standards by \$1.1 billion at December 31, 1997. Management expects that continued growth in retained earnings will ensure compliance with all applicable capital standards in the future.

The remainder of Management's Discussion and Analysis includes detailed information on the Corporation's results of operations, risk management, balance sheet analysis, MBS activity and housing goals.

Results of Operations

Net Interest Income

Net interest income increased \$357 million to \$3.949 billion in 1997 as a result of a \$30 billion, or 11 percent, increase in the average mortgage portfolio balance, which was partially offset by a .01 percentage point decrease in the average net interest margin. For 1998, management expects that net interest income will continue to increase because of continued growth in the average mortgage portfolio, while the average net interest margin is expected to decline somewhat as a result of several factors. These factors include the scheduled maturity of low-cost debt in 1998, as well as the continued

repurchase of common stock. The repurchase of common stock reduces net interest margin but has a positive effect on earnings per common share.

Net interest income excludes interest receivable on nonperforming loans. Conventional single-family and multifamily loans are classified as nonperforming and previously accrued interest is removed from income when a payment is 90 days or more past due.

Guaranty Fee Income

Guaranty fees compensate the Corporation for its guarantee of the timely payment of principal and interest to investors in MBS and for the assumption of credit risk on loans underlying MBS. Guaranty fees on Fannie Mae MBS held in portfolio are included in interest income. Guaranty fee income increased \$78 million to \$1.274 billion in 1997, compared with \$1.196 billion in 1996. The increase in guaranty fee income resulted from a \$27 billion increase in average net Fannie Mae MBS outstanding and an increase of .003 percentage points in the average effective guaranty fee rate.

The following table presents guaranty fee income as a percentage of the average balance of MBS outstanding, net of MBS held in portfolio, in 1997, 1996, and 1995.

Guaranty Fee Data

	1997	1996	1995
	(Dollars in millions)		
Guaranty fee income	\$ 1,274	\$ 1,196	\$ 1,086
Average balance of net MBS outstanding	561,079	534,553	494,689
Effective guaranty fee rate . . . . .	.227%	.224%	.220%

Additional information on the Corporation's MBS and guaranty fees is presented under "Mortgage-Backed Securities."

Miscellaneous Income

Miscellaneous income is composed of REMIC and other MBS-related fees, as well as other miscellaneous items, and is net of operating losses from equity investments in affordable housing projects. Miscellaneous income increased \$39 million to \$125 million in 1997, compared with \$86 million in 1996. The 45 percent increase was primarily due to an increased demand for REMICs and an increase in other miscellaneous items. Additional information on REMIC activity is presented under "Mortgage-Backed Securities."

Credit-Related Expenses

Credit-related expenses decreased \$34 million to \$375 million in 1997, compared with \$409 million in 1996. The Corporation experienced lower expenses in 1997 despite an increase in the number of acquired properties. The decrease in credit-related expenses was driven by a reduction in the provision for losses, reflecting a lower average loss per foreclosed property in 1997. A stronger national housing market, the increased benefits of mortgage insurance, and continued loss mitigation efforts contributed to the lower average loss per foreclosed property.

Management anticipates that credit-related expenses will continue to decline in 1998, despite growth in the mortgage portfolio and MBS outstanding. In 1998, Fannie Mae expects to continue to benefit from a healthy housing market and the Corporation's loss mitigation programs.

Administrative Expenses

Administrative expenses grew 14 percent to \$636 million in 1997, compared with \$560 million in 1996. The increase in administrative expenses resulted primarily from additional investments in

systems development, which included efforts to make the Corporation's computer systems Year 2000 compliant, expenses associated with restructuring the Corporation's regional offices, and the effect of a higher common share price on the Corporation's stock-based compensation plans. Compensation expense was \$394 million in 1997, compared with \$344 million in 1996.

The Corporation has been actively addressing its Year 2000 problem, which is caused by computer programs that currently use two digits instead of four digits to identify the year in a date field. To correct this problem, the Corporation has undertaken a major effort to identify and modify internal systems. In addition, the Corporation is coordinating with companies with which it electronically interacts to ensure that their systems are or will be Year 2000 compliant. If this problem is not resolved, the Corporation's computer systems or those of its business counterparts may make incorrect calculations or fail. The Corporation plans to complete its efforts related to the Year 2000 problem for its computer systems in early 1999.

The ratio of the Corporation's administrative expenses to the average net mortgage portfolio plus average net MBS outstanding increased to .074 percent in 1997, compared with .070 percent in 1996. The ratio of administrative expenses to revenues (net interest income, guaranty fees, and miscellaneous income) was 11.9 percent in 1997 and 11.5 percent in 1996.

Income Taxes

The provision for federal income taxes, net of the tax benefit from extraordinary losses, was \$1.262 billion in 1997, compared with \$1.135 billion in 1996. The effective federal income tax rate was 29 percent in both 1997 and 1996.

Extraordinary Loss

The repurchase and call of debt and the call of certain interest rate swaps are part of the Corporation's interest rate risk management strategy.

As a result of repurchase and call activity, the Corporation recognized net extraordinary losses of \$19 million (\$12 million after tax) in 1997, compared with \$45 million (\$29 million after tax) in 1996. The repurchase or call of high-coupon debt favorably affects the Corporation's future cost of funds.

During 1997, the amount of long-term debt called or repurchased and the notional principal amount of interest rate swaps called was \$31 billion, with a weighted-average cost of 7.22 percent. The comparable amount in 1996 was \$26 billion, with a weighted-average cost of 7.09 percent.

Risk Management

The Corporation is subject to two major risks: interest rate risk and credit risk. Active management of these risks is an essential part of Fannie Mae's operations and a key determinant of its ability to maintain steady earnings growth. The following discussion highlights the Corporation's various strategies to diversify and mitigate these two risks.

Interest Rate Risk Management

Fannie Mae's management of interest rate risk involves analyses and actions that position the Corporation to meet its objective of consistent earnings growth in a wide range of interest rate environments. The Corporation's interest rate risk is concentrated primarily in the mortgage portfolio, where exposure to changes in interest rates is managed to achieve stable earnings growth and an acceptable return on equity over time. Central elements of Fannie Mae's approach to managing interest rate risk include (1) investing in assets and issuing liabilities that perform similarly in different interest rate environments, (2) assessing the sensitivity of portfolio profitability and risk to changes in interest rates, and (3) taking actions in the context of a well-defined risk management process.

The first element of interest rate risk management is the funding of mortgage assets with liabilities that have similar durations, or average cash flow patterns through time. To achieve the desired liability durations, Fannie Mae issues debt across a broad spectrum of final maturities. Because the durations of mortgage assets change as interest rates change, callable debt with similar duration characteristics is frequently issued. The duration of callable debt, like that of a mortgage asset, shortens when interest rates decrease and lengthens when interest rates increase. In addition to callable debt, the Corporation utilizes off-balance-sheet financial instruments, primarily interest rate swaps, to achieve its desired liability structure and to better match the prepayment risk of the mortgage portfolio. A high degree of diversification of the interest rate option characteristics embedded in the assets and liabilities of the portfolio also serves to reduce interest rate risk.

Because the assets and the liabilities in Fannie Mae's portfolio are not perfectly matched, the portfolio's projected performance changes to some degree with movements in interest rates. Accordingly, the second element of interest rate risk management involves regularly assessing the portfolio's risk through a diverse set of analyses and measures. Portfolio net interest income is projected both with specific rising and falling interest rate paths and with interest rate simulations incorporating a wide range of possible interest rate scenarios based on historical interest rate volatility. These analyses generally include assumptions about new business activity in order to provide the most realistic assessment of possible portfolio performance. The portfolio duration gap—the difference between the durations of portfolio assets and liabilities—summarizes for management the extent to which asset and liability estimated cash flows are matched, on average, through time. Unlike the net interest income projections, the duration gap measures the risk of the existing portfolio only. Additional information about interest rate risk is obtained by means of financial performance simulations in which highly stressful interest rate scenarios are assumed. In analyzing performance measures, management evaluates the sensitivity of results to changes in assumptions. The methods used by the Corporation to assess projected portfolio performance are regularly reevaluated, and modeling tools are changed as appropriate.

The third element of Fannie Mae's interest rate risk management is a framework that facilitates the communication and attainment of corporate objectives. The Board of Directors oversees interest rate risk management through the adoption of corporate goals and objectives, and the review of regular reports on performance against these goals. Senior management attempts to ensure that the appropriate long-term strategies are in place to achieve the corporate goals and objectives, and that short-term strategies, tactics and the execution of transactions are consistent with the long-term strategies. Management establishes reference points for key performance measures that are used to signal material changes in risk and to assist in determining whether adjustments in portfolio strategy are required to achieve long-term objectives. These measures and reference points are reported regularly to the Board of Directors. By comparing the performance measures with the reference points, management makes decisions about the necessity or desirability of portfolio rebalancing. Examples of techniques that might be used to adjust the portfolio's performance profile include restructuring portfolio assets or liabilities or using off-balance-sheet financial instruments.

During 1997, portfolio interest rate risk, as measured by the duration gap, remained largely within established reference points and required little increased focus on portfolio rebalancing. At December 31, 1997, the duration gap of Fannie Mae's mortgage portfolio was a negative four months, compared with a positive duration gap of four months at the end of 1996. A negative duration gap results when the duration of mortgage assets is shorter than the duration of the related liabilities; it generally indicates that the Corporation has greater interest rate exposure to declining rates than to rising rates over the long term. A goal of the Corporation is to maintain the duration gap close to zero by managing the durations of its assets and liabilities. During 1997, the duration gap peaked in March and declined gradually through the remainder of the year because of a combination of lower interest rates and moderate portfolio rebalancing.

In contrast with the long-term interest rate exposure to declining interest rates indicated by the portfolio duration gap at the end of 1997, the projected net interest income of the mortgage portfolio

over the next one to two years was evenly exposed to rising and declining interest rates. That is, portfolio net interest income was projected to grow at a somewhat slower rate in both rising and declining interest rate environments, relative to an environment in which interest rates remain constant. Actual portfolio net interest income performance may differ from projections because of interest rate movements, changing business conditions and management actions.

Another indicator of the interest rate exposure of the Corporation's existing business is the sensitivity of the fair value of net assets ("net asset value") to changes in interest rates. The table below presents the Corporation's estimated net asset value as of December 31, 1997, and two projections of the value 12 months later assuming hypothetical changes in interest rates over the 12-month period. The changes from the net asset value of the Corporation as of December 31, 1997 to the 12-month projected net asset values, if negative, represent the potential loss in the net asset value of the Corporation's existing business for the given changes in interest rates. These interest rate movements represent the most extreme changes in rates that would be expected over this period within a 95 percent confidence interval, based on a simulation of many hypothetical future interest rate scenarios reflecting historical interest rate volatility. The interest rate changes include an increase in long-term U.S. Treasury yields of approximately 200 basis points and a decrease of approximately 150 basis points from December 31, 1997 levels.

Interest Rate Sensitivity of Net Asset Value

	Net Asset Value	Percentage of December 31, 1997 Net Asset Value
	(Dollars in millions)	
December 31, 1997	\$15,982	—
Assuming a 200 basis point increase	17,692	111%
Assuming a 150 basis point decrease	14,806	93

The net asset value of the Corporation on December 31, 1997, as presented in the above table is the same as that disclosed in the Notes to Financial Statements, "Disclosures of Fair Value of Financial Instruments." The 12-month projected net asset values were derived in a manner consistent with the estimation procedures described in the Notes to Financial Statements, "Disclosures of Fair Value of Financial Instruments." The interest rate sensitivities apply to the Corporation's year-end 1997 book of business only. The net asset value sensitivities do not necessarily represent the changes in the Corporation's net asset value that would actually occur for the given interest rate scenarios, because the sensitivities neither reflect changes in the value of the Corporation as a going concern nor consider prospective asset/liability rebalancing or other hedging actions the Corporation might take over the 12-month period.

Changes in the net asset value take into account several factors, including changes in the values of all mortgage assets and the debt funding these assets, changes in the value of net guaranty fee income from off-balance-sheet obligations, and changes in the value of swap obligations. As shown in the table above, the Corporation's hypothetical net asset value increases if interest rates rise significantly over the next 12 months and declines if rates fall. These sensitivities largely reflect changes in the value of the mortgage portfolio and net guaranty fee stream. In the rising interest rate scenario, the values of both the mortgage portfolio and the net guaranty fee stream increased moderately, while in the falling interest rate scenario, the value of each of these components declined to a small extent.

Additional information on interest rate risk management is presented under "Balance Sheet Analysis—Financing Activities."

Credit Risk Management

The Corporation's primary exposure to credit risk results from the possibility that it will not recover amounts due from borrowers. Management's overall objective in managing credit risk is to minimize losses by applying prudent underwriting guidelines and loan servicing requirements. Furthermore, the Corporation and its servicers use analytical models to apply credit risk analysis throughout the life of a loan.

The Corporation also is subject to the credit risk that counterparties to its transactions may be unable to meet their contractual obligations to Fannie Mae. Additional information on this credit risk exposure is presented under "Balance Sheet Analysis—Financing Activities" and in the Notes to Financial Statements, "Financial Instruments with Off-Balance-Sheet Risk" and "Concentrations of Credit Risk." The discussion that follows addresses the major elements of credit risk management as they pertain to conventional single-family and multifamily mortgage loans.

Single-Family

The Corporation manages its single-family mortgage credit risk by focusing on two phases: loan underwriting and loan servicing. If these are not managed effectively, the likelihood of credit loss increases.

In the first phase, loan underwriting, the Corporation manages credit risk through its efforts to develop sound underwriting policies that ensure loans sold to Fannie Mae meet the Corporation's credit quality criteria.

Desktop Underwriter®, Fannie Mae's automated underwriting model, was designed to help lenders process mortgage applications in a more efficient, accurate, and consistent manner. It provides benefits to lenders, borrowers and Fannie Mae by consistently and objectively applying the Corporation's underwriting standards to all prospective borrowers, as well as customizing Fannie Mae's underwriting standards to a loan's unique combination of credit risk factors. Use of Desktop Underwriter increased significantly in 1997. During December 1997, Desktop Underwriter evaluated up to 6,000 loan submissions per day. Management expects the usage of Desktop Underwriter to increase significantly in 1998.

Fannie Mae enhanced Desktop Underwriter in 1997 by providing more lenders with point-of-sale credit and appraisal decisions on a full range of mortgage options. Desktop Underwriter is part of the Corporation's strategy to increase homeownership opportunities by providing a broad array of desktop products that enable lenders to process all of their business more efficiently. Management expects to continue investing in research and technology such as Desktop Underwriter to provide lenders and the Corporation with additional quantitative information for evaluating and managing credit risk while expanding homeownership opportunities.

In the second phase of credit risk management, loan servicing, the Corporation manages the risk of credit loss by requiring its servicers to follow guidelines for servicing a loan owned or securitized by Fannie Mae. The guidelines help ensure that loans are serviced consistently and efficiently.

An important element in loan servicing is the servicer's responsibility to carry out loss mitigation activities. A major component of loss mitigation is early intervention in a delinquency. To help keep borrowers in their homes or reduce the costs incurred when a loan goes through the foreclosure process, borrowers often are contacted early in a delinquency to determine whether their loan might be worked out through a repayment plan, temporary forbearance, or modification of terms. If repayment plans, forbearance, or modification are not appropriate, the loan servicer may attempt to arrange a preforeclosure sale. The benefits of a preforeclosure sale include avoidance of the costs of foreclosure and a tendency for the property to sell at a better price because the home generally is occupied. If a preforeclosure sale is not possible, the Corporation's goal is to handle the foreclosure process expeditiously to minimize the amount of time the Corporation retains a nonearning asset.

In 1997, Fannie Mae introduced two new initiatives that it believes will reduce future credit losses. The first initiative, Risk Profiler™, is a default prediction model that assists servicers in loss mitigation activities. Risk Profiler predicts the likelihood that a loan will go into foreclosure by using updated borrower credit data, current property values, and loan characteristics, all of which are strong predictors of mortgage risk. Servicers can integrate the results from Risk Profiler into their automated collection systems, enabling them to focus their efforts more directly on borrowers whose loans are most likely to go into foreclosure.

The second initiative involves placing Fannie Mae employees on site with certain servicers to facilitate loss mitigation efforts. The Corporation believes this arrangement will improve loss mitigation efforts and increase the flow of information between the Corporation and its servicers.

As shown in the table below, single-family credit-related losses declined by 15 percent, or \$62 million, in 1997, compared with 1996. The decrease in credit losses stemmed from a decline in the average loss per foreclosed property, which was partially offset by an increase in the number of single-family foreclosed property acquisitions. The reduction in the average loss per foreclosed property (from \$16.8 thousand in 1996 to \$12.8 thousand in 1997) was primarily due to a strong housing market (especially in California and the Northeast), the increased benefits of mortgage insurance, the Corporation's continuing efforts in loss mitigation, and the success of certain business initiatives, such as centralizing the property disposition process. Single-family foreclosed property acquisitions increased to 22,222 in 1997, compared with 20,726 in 1996, primarily as a result of an increasing portion of the Corporation's book of business reaching its peak default years and continued acquisitions in California.

Single-Family Credit-Related Losses

	Year Ended December 31,		
	1997	1996	1995
	(Dollars in millions)		
Charge-offs	\$ 66	\$191	\$146
Foreclosed property expenses	<u>279</u>	<u>216</u>	<u>199</u>
Credit-related losses	<u>\$345</u>	<u>\$407</u>	<u>\$345</u>
Credit loss ratio . . . . .	.042%	.053%	.049%

The Corporation continued to experience a significant portion of credit-related losses from its California book of business in 1997. At December 31, 1997, 20 percent of Fannie Mae's total book of business was located in California, while 45 percent of the Corporation's acquired properties during the year were from California. The comparable amounts in 1996 were 21 percent and 53 percent, respectively. Moreover, 61 percent of total credit-related losses came from California loans in 1997, compared with 67 percent in 1996. Although California represents a significant portion of the Corporation's credit-related losses, management expects the improving real estate market in California and continued loss mitigation activities to reduce California's effect on total credit-related losses.

Fannie Mae's single-family credit loss ratio—credit-related losses as a percentage of the average UPB of total mortgages in portfolio and underlying MBS outstanding—declined to .042 percent in 1997, compared with .053 percent in 1996. Management expects the 1998 credit loss ratio to continue to decline from the 1997 level.

The total number of single-family properties owned by Fannie Mae at December 31, 1997, was 9,481, compared with 9,631 at December 31, 1996. These properties had net carrying amounts of \$735 million and \$820 million at December 31, 1997 and 1996, respectively.

In evaluating expected future credit performance, management analyzes the risk profile of the conventional single-family loans in the Corporation's portfolio and underlying MBS. The loan-to-value ("LTV") ratio is an important factor in credit performance because the amount of equity a borrower has in a home has proven to be a key determinant of both the incidence and severity of default. The Corporation reduces its potential risk of loss by requiring mortgage insurance or other credit protection on loans with LTV ratios over 80 percent.

Experience has shown that loan age is also a major factor affecting delinquency rates and that the incidence of default for a group of mortgage loans peaks in the third through fifth years after origination. Unless real estate values decline significantly, loans outstanding after five years tend to have lower default rates because borrowers have a history of being able to make their payments and most likely have built up additional equity in their properties. Between 1992 and 1994, the Corporation acquired a significant portion of the loans in its portfolio and underlying MBS outstanding (48 percent of total outstanding UPB at December 31, 1997), and in 1997, these loans were at the stage when they were most likely to be delinquent or in foreclosure.

Product mix also influences potential future credit losses because the credit risks associated with each product type vary. Adjustable-rate mortgages generally have a higher incidence of default than long-term, fixed-rate mortgages, while intermediate-term, fixed-rate mortgages tend to have a lower incidence of default.

The following table presents data, by percentage of UPB, on conventional mortgage loans outstanding for the Corporation's own portfolio or underlying its MBS issued at December 31, 1997 and 1996 by product distribution, original LTV ratio and current LTV ratio. In addition, the table presents data by product distribution and original LTV ratio for conventional loans purchased in the Corporation's portfolio or underlying its MBS in the years 1997, 1996 and 1995. Current LTV ratios are derived by adjusting the value of a property by the estimated change in the price of the home since the mortgage was originated and by comparing this adjusted value with the current UPB of the mortgage at December 31, 1997 and 1996, respectively.

**Distribution of Single-Family Loans
by Product Type and Loan-to-Value Ratio**

	Outstanding at December 31,		Percentage of Business Volumes		
	1997	1996	1997	1996	1995
Product:					
Long-term, fixed-rate	64%	62%	72%	70%	70%
Intermediate-term, fixed-rate(1)	26	28	17	22	19
Adjustable-rate	10	10	11	8	11
Total	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>
Original loan-to-value ratio:					
Greater than 90%	14%	12%	16%	16%	19%
81% to 90%	17	17	17	18	18
71% to 80%	38	38	40	38	36
61% to 70%	14	14	13	13	12
Less than 61%	17	19	14	15	15
Total	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>
Average original loan-to-value ratio	74%	74%	76%	76%	77%
Current loan-to-value ratio:					
Greater than 90%	2%	5%			
81% to 90%	13	14			
71% to 80%	22	24			
61% to 70%	22	20			
Less than 61%	41	37			
Total	<u>100%</u>	<u>100%</u>			
Average current loan-to-value ratio	62%	64%			
Average loan amount	\$80,800	\$83,200	\$99,900	\$99,900	\$97,400
(Maximum \$214,600 in 1997)					

(1) Contractual maturities of 20 years or less at purchase for portfolio loans and 15 years or less at issue date for MBS issuances.

The following table summarizes conventional single-family serious delinquencies by region as of December 31, 1997, 1996, and 1995. Single-family serious delinquency rates are based on the number of conventional loans in portfolio and underlying MBS for which the Corporation has primary risk of loss and that are delinquent 90 days or more or in the process of foreclosure.

Single-Family Serious Delinquency Rates

	December 31,		
	1997	1996	1995
Northeast .....	.89%	.87%	.83%
Southeast .....	.59	.51	.45
Midwest .....	.40	.33	.28
Southwest .....	.45	.40	.36
West .....	.71	.74	.82
Total	<u>.62%</u>	<u>.58%</u>	<u>.56%</u>

Multifamily

There are two primary risks involved in the underwriting and management of income-producing multifamily properties: (1) that underlying property cash flows will be insufficient to service the debt over the life of the loan and (2) that proceeds from the sale or refinancing of a property will be insufficient to repay the loan at maturity.

Fannie Mae manages the credit risk on its multifamily loan portfolio in several ways. First, the Corporation maintains rigorous loan-underwriting guidelines coupled with extensive real estate due diligence examinations for loan acquisitions. Because multifamily loans are primarily cash flow dependent and much larger than single-family loans, management monitors the ongoing performance of individual loans by requiring servicers to submit annual operating information and property condition reviews. This information, combined with other loan risk characteristics, is used to evaluate the credit quality of the portfolio, identify potential problem loans, and initiate appropriate loss mitigation activities.

In 1997, Fannie Mae further enhanced the credit risk management of its multifamily portfolio by centralizing asset management, creating a dedicated portfolio monitoring team, and expanding the quality control group. Quality control now includes a centralized group to review all large transactions as well as a dedicated staff to review lenders.

The Corporation also manages its credit risk exposure through various forms of credit enhancement. For the majority of multifamily loans, the Corporation has shared risk arrangements with lenders, full or partial recourse to lenders or third parties for loan losses (which may be secured by letters of credit or pledged collateral), or government mortgage insurance. The following table presents the risk profile, by UPB, of multifamily loans in portfolio and underlying MBS at December 31, 1997, 1996, and 1995.

Multifamily Risk Profile

	December 31,		
	1997	1996	1995
Fannie Mae risk	14%	15%	17%
Shared risk(1)	48	44	39
Recourse(2)	38	41	44
Total	<u>100%</u>	<u>100%</u>	<u>100%</u>

(1) Includes loans where the lender initially bears losses of up to 5 percent of UPB and shares any remaining losses with Fannie Mae.

(2) Includes loans not included in “shared risk” that have government mortgage insurance, or full or partial recourse to lenders or third parties.

Multifamily serious delinquencies at December 31, 1997, 1996, and 1995 were .37 percent, .68 percent, and .81 percent, respectively. Multifamily serious delinquencies are those loans for which the Corporation has primary risk of loss (including those with shared risk) that are two months or more delinquent. Multifamily delinquency percentages are based on the UPB of such loans in portfolio and underlying MBS.

As a result of strong underwriting standards and quality control processes, continued improvements in the multifamily rental market, declining interest rates, and continued emphasis on early loss mitigation efforts, the level of serious delinquencies for multifamily loans has declined significantly over the past several years.

Multifamily foreclosed property acquisitions, where Fannie Mae has the primary risk of loss, totaled 28 properties and 54 properties during 1997 and 1996, respectively. At December 31, 1997 and

1996, the Corporation held 14 primary risk foreclosed properties with an aggregate carrying value of \$17 million, and 27 foreclosed properties with an aggregate carrying value of \$34 million, respectively.

Credit-related losses and the ratio of credit losses to average UPB outstanding for multifamily loans in portfolio and underlying MBS are summarized in the table below.

Multifamily Credit-Related Losses

	Year Ended December 31,		
	1997	1996	1995
	(Dollars in millions)		
Charge-offs	\$ 11	\$ 19	\$ 26
Foreclosed property income, net	<u>(4)</u>	<u>(3)</u>	<u>(4)</u>
Credit-related losses	<u>\$ 7</u>	<u>\$ 16</u>	<u>\$ 22</u>
Credit loss ratio .....	.020%	.054%	.085%

In 1997, multifamily credit-related losses decreased as a result of lower charge-offs and an increase in foreclosed property income. Despite increased business, credit-related losses have declined over the past two years primarily because of aggressive management of delinquent multifamily assets and a healthy multifamily rental market. Management views the current level of credit-related losses as exceptionally low and anticipates that these losses will increase in 1998.

Allowance for Losses

In evaluating the risk of loss on portfolio loans and MBS outstanding, management considers current delinquency levels, historical loss experience, current economic conditions, geographic concentrations, estimates of future losses, and other pertinent factors. The allowance for losses is established by recording an expense for the provision for losses and is reduced through charge-offs. Changes in the allowance for losses for the years 1993 through 1997 are presented in the following table.

Allowance for Losses

	Total
	(Dollars in millions)
Balance, January 1, 1993	\$ 780
Provision	175
Net foreclosure losses charged off	<u>(114)</u>
Balance, December 31, 1993	841
Provision	155
Net foreclosure losses charged off	<u>(169)</u>
Balance, December 31, 1994	827
Provision	140
Net foreclosure losses charged off	<u>(172)</u>
Balance, December 31, 1995	795
Provision	195
Net foreclosure losses charged off	<u>(210)</u>
Balance, December 31, 1996	780
Provision	100
Net foreclosure losses charged off	<u>(77)</u>
Balance, December 31, 1997	<u>\$ 803</u>

Balance Sheet Analysis

This section discusses the Corporation's mortgage portfolio and other investments, as well as related financing activities. Information regarding liquidity and capital resources, and regulatory capital requirements also are included.

Mortgage Portfolio

As of December 31, 1997, the net mortgage portfolio totaled \$316 billion, compared with \$286 billion at December 31, 1996. The yield on the net mortgage portfolio was 7.60 percent at December 31, 1997, compared with 7.69 percent at December 31, 1996. The yield on the net mortgage portfolio averaged 7.67 percent in 1997, compared with 7.71 percent in 1996. The decline in both the ending yield and average yield for the year was largely due to lower purchase yields relative to the yields on liquidations in 1997.

The following table summarizes mortgage purchases, sales, and repayments for the years 1995 through 1997.

Mortgage Portfolio Activity

	Purchases			Sales			Repayments (1)		
	1997	1996	1995	1997	1996	1995	1997	1996	1995
	(Dollars in millions)								
Single-family:									
Government insured or guaranteed	\$ 5,539	\$ 4,461	\$ 2,669	\$ —	\$ —	\$ —	\$ 1,973	\$ 1,650	\$ 1,226
Conventional:									
Long-term, fixed-rate	55,925	54,021	42,659	563	105	281	20,995	17,554	10,972
Intermediate-term, fixed-rate ..	6,001	8,139	9,235	26	44	126	10,688	10,564	8,545
Adjustable-rate	1,977	706	1,017	476	—	—	2,807	2,789	2,624
Second	29	17	11	—	—	—	84	117	125
Total single-family	69,471	67,344	55,591	1,065	149	407	36,547	32,674	23,492
Multifamily	994	1,274	1,007	23	—	11	3,204	2,254	1,235
Total	<u>\$70,465</u>	<u>\$68,618</u>	<u>\$56,598</u>	<u>\$1,088</u>	<u>\$149</u>	<u>\$418</u>	<u>\$39,751</u>	<u>\$34,928</u>	<u>\$24,727</u>
Average net yield	7.40%	7.57%	7.75%				7.70%	7.81%	7.90%
Repayments as a percentage of average mortgage portfolio							13.2%	12.9%	10.6%

(1) Includes mortgage loan prepayments, scheduled amortization, and foreclosures.

Investments

The Corporation maintains an investment portfolio consisting of high-quality, short-term nonmortgage investments, such as federal funds, commercial paper, repurchase agreements, asset-backed securities, and other investments. The objectives of the investment portfolio are to serve as a source of liquidity and to provide a return on the excess capital of the Corporation. As of December 31, 1997, the balance in the Corporation's investment portfolio was \$65 billion, compared with \$57 billion at December 31, 1996. The weighted-average rate earned on investment securities in 1997 was 5.82 percent, compared with 5.68 percent in 1996.

Additional information on these investments is presented in Note 4 to the Financial Statements, "Investments."

Financing Activities

The following table sets forth the amount and average cost of debt issued and repaid in 1997, 1996, and 1995, and the debt outstanding at the end of each year. The average cost of debt outstanding

at December 31, 1997 was 6.46 percent, compared with 6.49 percent at December 31, 1996. The average cost of debt outstanding at December 31, 1997 declined primarily because of lower interest rates in late 1997, the call and refunding of higher cost debt, and an increase in short-term debt issued to support short-term investments. The weighted-average maturity of effective long-term, fixed-rate debt outstanding at December 31, 1997 and 1996 was 66 months and 64 months, respectively.

Short-Term and Long-Term Debt Activity

	<u>1997</u>	<u>1996</u>	<u>1995</u>
	(Dollars in millions)		
Issued during the year:			
Short-term(1):			
Amount	\$755,281	\$635,595	\$699,311
Average cost	5.53%	5.36%	5.87%
Long-term(1):			
Amount	\$ 86,325	\$ 80,302	\$ 49,922
Average cost	6.37%	6.17%	6.55%
Repaid during the year:			
Short-term(1):			
Amount	\$738,552	\$636,768	\$678,989
Average cost	5.49%	5.41%	5.86%
Long-term(1):			
Amount	\$ 63,690	\$ 46,937	\$ 28,391
Average cost	6.65%	6.93%	7.50%
Outstanding at year end:			
Due within one year:			
Net amount	\$175,400	\$159,900	\$146,153
Average cost(2)	5.76%	5.66%	5.90%
Due after one year:			
Net amount	\$194,374	\$171,370	\$153,021
Average cost(2)	6.67%	6.66%	6.83%
Total debt:			
Net amount	\$369,774	\$331,270	\$299,174
Average cost(3)	6.46%	6.49%	6.55%

(1) "Short-term" refers to the face amount of debt issued with an original term of one year or less. "Long-term" is the face amount of debt issued with an original term greater than one year.

(2) Average cost includes the amortization of premiums, discounts, issuance costs, hedging results, and the effects of currency and debt swaps.

(3) Average cost includes the amortization of premiums, discounts, issuance costs, hedging results, and the effects of currency, debt, and interest rate swaps.

The Corporation also utilizes a Global Debt Facility through which it can issue debt securities in global markets. During 1997, the Corporation issued debt securities totaling \$9 billion under its Global Debt Facility, compared with \$7 billion in 1996. The Corporation continued to expand its investor base by issuing securities denominated in foreign currencies. In 1997, Fannie Mae issued its first global

debt in pounds sterling, Hong Kong dollars, Australian dollars and New Zealand dollars. Concurrently with issuing foreign denominated debt securities, the Corporation enters into currency swaps that convert the proceeds of certain borrowings into dollars or provide for scheduled exchanges of currencies to eliminate the Corporation's foreign currency exposure.

As described under "Risk Management—Interest Rate Risk Management," matching the duration of mortgage assets with the duration of liabilities funding those assets is accomplished through the use of different debt maturities and embedded option characteristics, as well as the use of off-balance-sheet financial instruments, primarily interest rate swaps.

The following table presents the amount of callable debt combined with the notional amount of callable interest rate swaps issued and outstanding for each of the past two years. The percentage of callable debt supporting the mortgage portfolio is a function of the characteristics of the specific callable debt structures employed, the prepayment sensitivity of the mortgages in the portfolio, and economic and financial market conditions.

Callable Debt

	<u>1997</u>	<u>1996</u>
	(Dollars in billions)	
Issued during the year	\$ 36	\$ 44
Percentage of total long-term debt issued	46%	52%
Outstanding at year-end	\$136	\$127
<u>Percentage of total long-term debt outstanding(1)</u>	<u>46%</u>	<u>48%</u>

(1) Includes the notional amount of callable swaps and excludes long-term debt with a repricing frequency of one year or less.

Interest rate swaps increase the flexibility of the Corporation's funding alternatives by providing the specific cash flows or characteristics that the portfolio requires but that might not be as readily available or cost-effective if obtained in the standard debt market. Fannie Mae does not speculate using derivatives and does not engage in derivatives trading. The Corporation primarily uses two types of interest rate swaps: (1) generic swaps, which involve the exchange of fixed and variable interest payments based on contractual notional principal amounts and may include callable swaps (which give the counterparties the right to terminate the interest rate swap agreement before its stated final maturity), and (2) basis swaps, whereby the Corporation exchanges variable payments that have maturities similar to the underlying debt but rates based on different indices.

The following table summarizes the Corporation's interest rate swap activity, the notional amount of, and weighted-average interest rates to be received and paid on, interest rate swaps outstanding for the years ended December 31, 1996 and 1997, together with the expected maturities for the interest rate swaps outstanding at December 31, 1997.

Interest Rate Swap Activity and Maturity Data

	Generic-pay fixed / receive variable (1)			Generic-pay variable / receive fixed			Basis Swaps	Total
	Notional (2)	Pay Rate (3)	Receive Rate (3)	Notional (2)	Pay Rate (3)	Receive Rate (3)		
	(Dollars in millions)							
Balance at January 1, 1996	\$ 75,536	6.68%	5.87%	\$13,538	5.76%	6.97%	\$34,106	\$123,180
Additions	31,516	6.82	5.56	12,420	5.38	6.33	26,649	70,585
Maturities	<u>6,941</u>	<u>6.59</u>	<u>5.50</u>	<u>10,334</u>	<u>5.67</u>	<u>6.90</u>	<u>20,677</u>	<u>37,952</u>
Balance at December 31, 1996	100,111	6.73	5.59	15,624	5.43	6.50	40,078	155,813
Additions	12,557	6.56	5.71	24,685	5.56	6.27	15,234	52,476
Maturities	<u>15,955</u>	<u>6.36</u>	<u>5.69</u>	<u>10,656</u>	<u>5.56</u>	<u>6.54</u>	<u>32,929</u>	<u>59,540</u>
Balance at December 31, 1997	<u>\$ 96,713</u>	<u>6.77%</u>	<u>5.82%</u>	<u>\$29,653</u>	<u>5.63%</u>	<u>6.30%</u>	<u>\$22,383</u>	<u>\$148,749</u>
Future Maturities(4)								
1998	\$ 8,740	5.32%	5.79%	\$11,784	5.60%	5.87%	\$15,207	\$ 35,731
1999	6,125	6.70	5.49	4,935	5.70	6.09	4,666	15,726
2000	4,367	6.09	5.80	5,875	5.67	6.34	1,020	11,262
2001	7,850	6.67	5.82	650	5.66	6.28	—	8,500
2002	4,675	6.30	5.82	1,275	5.66	6.83	79	6,029
Thereafter	<u>64,956</u>	<u>7.06</u>	<u>5.86</u>	<u>5,134</u>	<u>5.58</u>	<u>7.44</u>	<u>1,411</u>	<u>71,501</u>
	<u>\$ 96,713</u>	<u>6.77%</u>	<u>5.82%</u>	<u>\$29,653</u>	<u>5.63%</u>	<u>6.30%</u>	<u>\$22,383</u>	<u>\$148,749</u>

- (1) Included in the notional amounts are callable swaps of \$23 billion and \$28 billion with weighted-average pay rates of 6.58 percent and 6.68 percent and weighted-average receive rates of 5.89 percent and 5.62 percent, as of December 31, 1997 and 1996, respectively.
- (2) The notional value indicates only the amount on which swap payments are being calculated and does not represent the amount at risk of loss.
- (3) The weighted-average interest rate receivable and payable is as of the date indicated. Where the pay rate or receive rate is variable, the rate may change as prevailing interest rates change.
- (4) Based on the swap's stated maturity. Assumes that variable interest rates remain constant at December 31, 1997 levels.

The Corporation's interest rate swaps had a weighted-average term of 72 months at year-end 1997 and 71 months at year-end 1996. Long-term debt outstanding, including the effect of swaps but excluding effective variable-rate debt (i.e., long-term debt that reprices within one year), totaled \$294 billion at December 31, 1997, and \$267 billion at December 31, 1996. Interest rate swaps effectively lengthened the final maturity of the Corporation's liabilities by 18 months at December 31, 1997, and 20 months at December 31, 1996.

The primary risk posed by the Corporation's interest rate swaps is credit risk or the risk that a counterparty will fail to meet its contractual obligations on a swap transaction, causing the Corporation to have to replace the swap at market prices. The Corporation manages this risk by dealing with experienced swap counterparties with high credit quality, diversifying its swaps across many counterparties, and entering into swaps under master agreements that require counterparties to post collateral if the Corporation is exposed to credit loss on the related swaps exceeding an agreed-upon threshold. In addition, master agreements provide for netting of certain amounts payable by each party. Fannie Mae regularly monitors the exposures on its interest rate swaps by determining the

market value of positions via dealer quotes and internal pricing models. The Corporation held \$4 million of collateral for interest rate swaps at December 31, 1997.

The Corporation's off-balance-sheet exposure on interest rate swaps (taking into account master agreements that allow for netting of payments) was \$26 million at December 31, 1997, compared with \$8 million at December 31, 1996.

The Corporation also hedges against fluctuations in interest rates on planned debt issuances using derivative instruments that simulate the short sale of Treasury securities and deferred rate setting agreements. Gains and losses on these instruments are deferred and reflected as basis adjustments to the cost of the debt when issued. The hedging of anticipated debt issuances enables the Corporation to maintain an orderly and cost-effective debt issuance schedule so that it can make daily loan purchase commitments without significantly increasing its interest rate exposure.

Additional information on interest rate swaps and other off-balance-sheet financial instruments are presented in the Notes to Financial Statements, "Financial Instruments with Off-Balance-Sheet Risk" and "Disclosures of Fair Value of Financial Instruments."

Liquidity and Capital Resources

Fannie Mae's statutory mission requires that it provide ongoing assistance to the secondary market for mortgage loans. The Corporation therefore must raise funds continually to support its mortgage purchase activity. The capital markets traditionally have treated the Corporation's obligations as "federal agency" debt. As a result, even though the U.S. government does not guarantee Fannie Mae's debt, the Corporation has had ready access to funding at relatively favorable spreads.

Fannie Mae's primary sources of cash are issuances of debt obligations, mortgage loan repayments, interest income, and MBS guaranty fees. In addition, at December 31, 1997, Fannie Mae had cash and cash equivalents and short-term investments totaling \$67 billion, compared with \$57 billion at December 31, 1996. Primary uses of cash include the purchase of mortgages and other securities, repayment of debt, interest payments, administrative expenses, and taxes.

At December 31, 1997, the Corporation had mandatory delivery commitments and lender-option commitments outstanding to purchase \$3.6 billion and \$1.6 billion of mortgage loans, respectively, compared with \$1.9 billion and \$1.2 billion, respectively, outstanding at December 31, 1996.

The Corporation's capital base (stockholders' equity plus general allowance for losses) grew to \$14.6 billion at December 31, 1997, compared with \$13.5 billion at the end of 1996. At year-end 1997, there were 1.037 billion shares of common stock outstanding. In January 1998, the Board of Directors approved a quarterly dividend rate for 1998 of 24 cents per common share, and dividends of 80.125 cents per Series A preferred share, 81.250 cents per Series B preferred share, and 80.625 cents per Series C preferred share for the period from and including December 31, 1997 to but excluding March 31, 1998. In 1997, the quarterly dividend rate was 21 cents per common share.

During 1997, the Corporation continued implementing its capital restructuring program, approved by the Board of Directors in December 1995, by repurchasing 31 million shares of common stock. The shares were repurchased pursuant to the Board's approval for the repurchase up to an additional 6 percent of outstanding common shares as of December 27, 1995 (adjusted for the stock split), and to offset the dilutive effect of common shares issued or expected to be issued in conjunction with various stock compensation plans. In 1996, the Corporation repurchased 48 million shares of common stock in order to fund the contribution to the Fannie Mae Foundation, fully utilize the proceeds of the issuance of \$1 billion in preferred stock, and offset the effect of shares issued in conjunction with various stock compensation plans.

Regulatory Capital Requirements

The Corporation is subject to capital adequacy and risk-based standards established by the 1992 Act. The capital adequacy standards require that the Corporation’s core capital equal or exceed a minimum capital standard and a critical capital standard. The following table shows the Corporation’s core capital compared with the requirement.

Capital Requirements

	<u>December 31,</u>	
	<u>1997</u>	<u>1996</u>
	<u>(Dollars in millions)</u>	
Core capital(1)	\$13,793	\$12,773
Required minimum capital(2)	12,703	11,466
Required critical capital(3)	6,528	5,890
Excess of core capital over minimum capital	<u>\$ 1,090</u>	<u>\$ 1,307</u>

- (1) The sum of (a) the par value of outstanding common stock; (b) the par value of outstanding noncumulative perpetual preferred stock; (c) paid-in capital; and (d) retained earnings.
- (2) The sum of (a) 2.50 percent of on-balance-sheet assets; (b) .45 percent of outstanding MBS; and (c) .45 percent of other off-balance-sheet obligations, except as adjusted by the Director of OFHEO.
- (3) The sum of (a) 1.25 percent of on-balance-sheet assets; (b) .25 percent of outstanding MBS; and (c) .25 percent of other off-balance-sheet obligations, except as adjusted by the Director of OFHEO.

The Director of OFHEO also is developing a risk-based standard consistent with the parameters specified in the 1992 Act. The risk-based standard includes credit and interest rate risk components along with an additional amount of capital for management and operations risk. To meet that standard, the Corporation must hold total capital equal to the amount necessary to meet the combined occurrence of highly stressful credit and interest rate conditions over a ten-year period, plus an additional 30 percent of this amount for management and operations risk.

The Director of OFHEO released Part I of the proposed regulations for the risk-based standard in 1996. Part I creates benchmarks for credit stress testing and specifies the housing price index that will be used in connection with this standard. See “Government Regulation and Charter Act” for additional information regarding Part I. The second part of the proposed risk-based capital regulation, which OFHEO has indicated it will issue for public comment in 1999, is expected to propose the remaining credit risk criteria and the interest rate risk criteria. The 1992 Act provides that the final regulations will be enforceable one year after issuance.

Mortgage-Backed Securities

MBS outstanding grew to \$710 billion at December 31, 1997, compared with \$651 billion at December 31, 1996. MBS are backed by loans from a single lender, from multiple lenders, or from the Corporation’s mortgage loan portfolio. Single-lender MBS are issued through lender swap transactions in which a lender exchanges pools of mortgage loans for MBS. Multiple-lender MBS allow several lenders to pool mortgage loans and receive, in return, MBS (called Fannie Majors®) representing a proportionate share of a larger pool. In some instances, the Corporation buys loans, and at the same time, enters into a forward sale commitment. These loans are designated as held for sale and sold from the portfolio as MBS.

MBS are not assets of the Corporation, except when acquired for investment purposes, nor are they recorded as liabilities. However, the Corporation is liable under its guarantee to make timely payment of principal and interest to investors. The issuance of MBS creates guaranty fee income for Fannie Mae. Sellers of pools of mortgage loans may retain or transfer to one or more third parties the primary default risk on loans constituting the MBS pools or they may elect to transfer this credit risk to Fannie Mae. The guaranty fee paid by the lender varies, depending on the risk profile of the loans securitized as well as the level of credit risk assumed by Fannie Mae. The Corporation, however, assumes the ultimate risk of loss on all MBS.

The following table summarizes MBS issued and outstanding for the years ended December 31, 1997, 1996, and 1995. The increase in the percentage of total MBS issued in the lender risk category in 1997, compared with 1996 was primarily due to an increase in lenders' acquisition of pool insurance policies, which reduces the lender's and Fannie Mae's risk of loss.

MBS Risk Distribution

	Issued				Outstanding (1)		
	Lender Originated (1)				Lender Risk (2)	Fannie Mae Risk	
	Lender Risk	Fannie Mae Risk	Fannie Mae Originated	Total		Total (3)	
	(Dollars in millions)						
1997	\$35,740	\$111,413	\$2,276	\$149,429	\$94,262	\$615,320	\$709,582
1996	13,389	135,677	803	149,869	70,642	580,138	650,780
1995	16,681	93,359	416	110,456	67,080	515,879	582,959

- (1) Based on primary default risk category. MBS outstanding includes MBS that have been pooled to back Megas, SMBS, or REMICs.
- (2) Included in lender risk are \$57 billion, \$31 billion, and \$30 billion at December 31, 1997, 1996, and 1995, respectively, on which the lender or a third party had agreed to bear default risk limited to a certain portion or percentage of the loans delivered and, in some cases, the lender had pledged collateral to secure that obligation.
- (3) Included are \$130 billion, \$103 billion, and \$70 billion at December 31, 1997, 1996, and 1995, respectively, of MBS in Fannie Mae's portfolio.

Fannie Mae issues REMICs backed by MBS, SMBS, Ginnie Mae mortgage-backed securities, other REMIC securities, or whole loans. REMICs provide an additional source of fee income that does not subject the Corporation to added credit risk, except for REMICs backed by whole loans. In 1997, REMIC issuances increased to \$75 billion, compared with \$27 billion in 1996. The increase was primarily due to increased investor demand. The outstanding balance of REMICs at December 31, 1997, was \$329 billion, compared with \$283 billion at December 31, 1996.

Housing Goals

The 1992 Act gives the Secretary of HUD authority to establish low- and moderate-income, underserved areas, and special affordable housing goals for Fannie Mae. In December 1995, the Secretary of HUD issued final regulations regarding the Corporation's housing goals for 1996 to 1999. Under the new regulations, the Corporation's 1997 goal in low- and moderate-income housing increased to 42 percent of the Corporation's conventional mortgage business from 40 percent in 1996. The 1997 geographic goal, based on underserved census tracts in metropolitan statistical areas and counties in rural areas, was 24 percent of the Corporation's conventional mortgage business, compared with 21 percent in 1996. The special affordable housing goal, which serves very low-income families and low-income families in low-income areas, was 14 percent of the Corporation's 1997 single-family conventional mortgage business and multifamily business, compared with 12 percent in 1996. Under this goal, the Corporation also must include mortgage purchases of multifamily units totaling no less

than \$1.3 billion (.8 percent of the Corporation's 1994 total dollar volume of mortgage purchases). All of these goals are measured as a percentage of dwelling units financed.

In 1997 and 1996, the Corporation exceeded its low- and moderate-income housing goal, with 45 percent of its conventional mortgage business counting toward this goal in both years. In 1997, the Corporation exceeded its geographic goal, with 29 percent of its conventional mortgage business counting toward this goal. The Corporation exceeded the 1996 geographic goal, with 28 percent of the conventional mortgage business serving families in underserved areas. In addition, in 1997 the Corporation exceeded its special affordable housing goal, with 19 percent of the conventional single-family and multifamily business counting toward this goal and with \$3.2 billion of multifamily business meeting the \$1.3 billion multifamily requirement. In 1996, the Corporation exceeded the special affordable housing goal, with 17 percent of single-family and multifamily business counting toward this goal and with special affordable multifamily purchases of \$2.4 billion.

Fannie Mae has built a solid foundation in affordable housing through significant community outreach efforts, products directed at certain disadvantaged groups, and the introduction of products with targeted underwriting flexibilities, including an initiative to purchase loans with lower down payments to help low-income households afford homes. In 1994, the Corporation introduced an initiative to provide \$1 trillion from 1994 through 2000 to finance homes for families and communities most in need. This targeted housing finance will serve families with incomes below the median for their areas, minorities and new immigrants, families who live in central cities and distressed communities, and people with special housing needs. By the end of the decade, the initiative is intended to show an additional ten million families a way to achieve the American dream of homeownership.

New Accounting Standard

During 1997, the Financial Accounting Standards Board issued Financial Accounting Standard No. 130, *Reporting Comprehensive Income* ("FAS 130").

FAS 130 requires reporting of comprehensive income by its components and in total in the financial statements. Comprehensive income is defined as the change in equity of a business enterprise during a period from transactions and other events and circumstances from nonowner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners. This standard is effective beginning in 1998. In management's opinion, this standard will not have a material impact on the Corporation's financial results.

Comparison of 1996 versus 1995

The following discussion and analysis provides a comparison of the Corporation's results of operations for the years ended December 31, 1996 and 1995.

Results of Operations

Net income increased to \$2.725 billion in 1996 from \$2.144 billion in 1995, and earnings per common share were \$2.48, up from \$1.95 in 1995. Results for 1995 included the effect of a commitment to contribute \$350 million in Fannie Mae common stock to the Fannie Mae Foundation. Without this special contribution, 1995 earnings would have been \$2.372 billion, or \$2.15 per common share.

Net interest income increased \$545 million to \$3.592 billion in 1996, as a result of a \$36 billion, or 16 percent, increase in the average mortgage portfolio balance and a .02 percentage point increase in the average net interest margin. The increase in the average net interest margin to 1.18 percent in 1996 was caused, in part, by the Corporation's calling and refunding a substantial amount of higher cost debt when interest rates declined in early 1996.

Guaranty fee income increased \$110 million to \$1.196 billion in 1996, compared with \$1.086 billion in 1995. The increase in guaranty fee income resulted from a \$40 billion increase in average net MBS outstanding and an increase of .004 percentage points in the average effective guaranty fee rate. The increase in the effective guaranty fee rate was largely a result of higher fee rates on new business in 1996.

Miscellaneous income declined during 1996 as a result of lower REMIC fee income, which was partially offset by an increase in other miscellaneous fees.

Credit-related expenses were \$409 million in 1996, compared with \$335 million in 1995. The increase in credit-related expenses reflected continued high levels of property acquisitions in California as well as the Corporation's efforts to shorten the period between delinquency and foreclosure, which had the effect of accelerating future losses into 1996.

Administrative expenses were \$560 million in 1996, compared with \$546 million in 1995. Compensation expense was \$344 million in 1996, compared with \$312 million in 1995. The ratio of administrative expenses to the average net mortgage portfolio plus average net MBS outstanding declined to .070 percent in 1996 from .075 percent in 1995. The ratio of administrative expenses to revenues (net interest income, guaranty fees, and miscellaneous income) was 11.5 percent in 1996 and 12.9 percent in 1995.

The provision for federal income taxes, net of the tax benefit from extraordinary losses, was \$1.135 billion in 1996, compared with \$834 million in 1995. The effective federal income tax rate increased to 29 percent in 1996 from 28 percent in 1995. The increase from the previous year was due to a favorable settlement with the Internal Revenue Service in 1995 of several items related to the 1986 and 1987 tax years.

During 1996, the amount of long-term debt called or repurchased and the notional principal amount of interest rate swaps called was \$26 billion, with a weighted-average cost of 7.09 percent. The comparable amount in 1995 was \$20 billion, with a weighted-average cost of 7.24 percent. As a result of repurchase and call activity, the Corporation recognized net extraordinary losses of \$45 million (\$29 million after tax) in 1996, compared with \$17 million (\$11 million after tax) in 1995. The repurchase or call of high-coupon debt favorably affects the Corporation's future cost of funds.

FANNIE MAE

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INDEPENDENT AUDITORS' REPORT

To the Board of Directors and Stockholders of Fannie Mae:

We have audited the accompanying balance sheets of Fannie Mae as of December 31, 1997 and 1996, and the related statements of income, changes in stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 1997. These financial statements are the responsibility of Fannie Mae's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Fannie Mae as of December 31, 1997 and 1996, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 1997, in conformity with generally accepted accounting principles.

We also have audited in accordance with generally accepted auditing standards the supplemental fair value balance sheets of Fannie Mae as of December 31, 1997 and 1996, included in Note 15 to the financial statements. As described in Note 15, the supplemental fair value balance sheets have been prepared by management to present relevant financial information that is not provided by the financial statements and is not intended to be a presentation in conformity with generally accepted accounting principles. In addition, the supplemental fair value balance sheets do not purport to present the net realizable, liquidation, or market value of Fannie Mae as a whole. Furthermore, amounts ultimately realized by Fannie Mae from the disposal of assets may vary significantly from the fair values presented. In our opinion, the supplemental fair value balance sheets included in Note 15 present fairly, in all material respects, the information set forth therein.

KPMG Peat Marwick LLP

Washington, DC
January 14, 1998

FANNIE MAE
STATEMENTS OF INCOME

	Year Ended December 31,		
	1997	1996	1995
	(Dollars in millions, except per common share amounts)		
Interest income:			
Mortgage portfolio	\$22,716	\$20,560	\$18,154
Investments and cash equivalents	3,662	3,212	2,917
Total interest income	26,378	23,772	21,071
Interest expense:			
Short-term debt	3,659	3,395	3,994
Long-term debt	18,770	16,785	14,030
Total interest expense	22,429	20,180	18,024
Net interest income	3,949	3,592	3,047
Other income:			
Guaranty fees	1,274	1,196	1,086
Miscellaneous, net	125	86	93
Total other income	1,399	1,282	1,179
Other expenses:			
Provision for losses	100	195	140
Foreclosed property	275	214	195
Administrative	636	560	546
Special contribution	—	—	350
Total other expenses	1,011	969	1,231
Income before federal income taxes and extraordinary item	4,337	3,905	2,995
Provision for federal income taxes	1,269	1,151	840
Income before extraordinary item	3,068	2,754	2,155
Extraordinary loss—early extinguishment of debt (net of tax effect of \$7 million in 1997, \$16 million in 1996, and \$6 million in 1995)	12	29	11
Net income	\$ 3,056	\$ 2,725	\$ 2,144
Preferred stock dividends	65	42	—
Net income available to common stockholders	\$ 2,991	\$ 2,683	\$ 2,144
Basic earnings per common share (1):			
Earnings before extraordinary item	\$ 2.87	\$ 2.53	\$ 1.98
Extraordinary item .....	.02	.03	.01
Net earnings	\$ 2.85	\$ 2.50	\$ 1.97
Diluted earnings per common share (1):			
Earnings before extraordinary item	\$ 2.84	\$ 2.51	\$ 1.96
Extraordinary item .....	.01	.03	.01
Net earnings	\$ 2.83	\$ 2.48	\$ 1.95
Cash dividends per common share	\$.84	\$.76	\$.68
Weighted-average common shares outstanding (in millions):			
Basic	1,049	1,071	1,091
Diluted	1,056	1,080	1,098

(1) Earnings per common share amounts prior to 1997 have been restated to comply with Statement of Financial Accounting Standards No. 128, *Earnings per Share*.

See Notes to Financial Statements

FANNIE MAE
BALANCE SHEETS

Assets

	December 31,	
	1997	1996
	(Dollars in millions)	
Mortgage portfolio, net	\$316,316	\$286,259
Investments:		
Held-to-maturity	58,690	53,106
Available-for-sale	5,906	3,500
Cash and cash equivalents	2,205	850
Accrued interest receivable	2,864	2,419
Acquired property and foreclosure claims, net	919	954
Other	4,773	3,953
Total assets	\$391,673	\$351,041

Liabilities and Stockholders' Equity

Liabilities:

 Debentures, notes and bonds, net:

Due within one year	\$175,400	\$159,900
Due after one year	194,374	171,370
Total	369,774	331,270
Accrued interest payable	4,611	4,236
Other	3,495	2,762
Total liabilities	377,880	338,268

Stockholders' Equity:

Preferred stock, \$50 stated value, 100 million shares authorized— 20 million shares issued	1,000	1,000
Common stock, \$.525 stated value, no maximum authorization— 1,129 million shares issued	593	593
Additional paid-in capital	1,495	1,451
Retained earnings	13,325	11,214
	16,413	14,258
Less: Treasury stock, at cost, 92 million shares in 1997 and 68 million shares in 1996	2,620	1,485
Total stockholders' equity	13,793	12,773
Total liabilities and stockholders' equity	\$391,673	\$351,041

See Notes to Financial Statements

FANNIE MAE

STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

	Number of Shares Outstanding (1)	Preferred Stock	Common Stock	Additional Paid-in Capital	Retained Earnings	Treasury Stock	Total Stockholders' Equity
(Dollars and shares in millions)							
Balance, January 1,							
1995	273	\$ —	\$593	\$1,365	\$ 7,933	\$ (350)	\$ 9,541
Four-for-one stock split ..	818	—	—	—	—	—	—
Net income	—	—	—	—	2,144	—	2,144
Dividends	—	—	—	—	(741)	—	(741)
Shares repurchased	(2)	—	—	—	—	(46)	(46)
Treasury stock issued for stock options and benefit plans	3	—	—	24	—	25	49
Securities-available-for- sale, market value adjustment, net of tax effect	—	—	—	—	12	—	12
Balance, December 31,							
1995	1,092	—	593	1,389	9,348	(371)	10,959
Net income	—	—	—	—	2,725	—	2,725
Dividends	—	—	—	—	(857)	—	(857)
Shares repurchased	(48)	—	—	—	—	(1,536)	(1,536)
Preferred stock issued ...	—	1,000	—	(20)	—	—	980
Contribution to Foundation	11	—	—	12	—	338	350
Treasury stock issued for stock options and benefit plans	6	—	—	70	—	84	154
Securities-available-for- sale, market value adjustment, net of tax effect	—	—	—	—	(2)	—	(2)
Balance, December 31,							
1996	1,061	1,000	593	1,451	11,214	(1,485)	12,773
Net income	—	—	—	—	3,056	—	3,056
Dividends	—	—	—	—	(945)	—	(945)
Shares repurchased	(31)	—	—	—	—	(1,291)	(1,291)
Treasury stock issued for stock options and benefit plans	7	—	—	44	—	156	200
Balance, December 31,							
1997	<u>1,037</u>	<u>\$1,000</u>	<u>\$593</u>	<u>\$1,495</u>	<u>\$13,325</u>	<u>\$(2,620)</u>	<u>\$13,793</u>

(1) Number of shares at January 1, 1995 reflect a pre-split basis.

See Notes to Financial Statements

FANNIE MAE
STATEMENTS OF CASH FLOWS

	Year Ended December 31,		
	1997	1996	1995
	(Dollars in millions)		
Cash flows from operating activities:			
Net income	\$ 3,056	\$ 2,725	\$ 2,144
Adjustments to reconcile net income to net cash provided by operating activities:			
Discount amortization on short-term debt	5,012	4,338	5,070
Provision for losses	100	195	140
Loss on early extinguishment of debt	19	45	17
Other decreases, net.....	<u>(1,691)</u>	<u>(830)</u>	<u>(922)</u>
Net cash provided by operating activities.....	<u>6,496</u>	<u>6,473</u>	<u>6,449</u>
Cash flows from investing activities:			
Purchases of mortgages.....	(70,768)	(68,471)	(56,738)
Proceeds from sales of mortgages.....	1,082	102	408
Mortgage principal repayments.....	37,714	32,853	23,062
Net proceeds from disposition of foreclosed properties.....	3,085	2,448	1,968
Net (increase) decrease in investments	<u>(7,990)</u>	<u>667</u>	<u>(10,937)</u>
Net cash used in investing activities	<u>(36,877)</u>	<u>(32,401)</u>	<u>(42,237)</u>
Cash flows from financing activities:			
Proceeds from issuance of long-term debt	86,079	79,189	50,039
Payments to redeem long-term debt	(63,716)	(46,966)	(28,620)
Proceeds from issuance of short-term debt	737,054	606,427	694,962
Payments to redeem short-term debt	(725,584)	(610,876)	(679,754)
Net payments for stock activities.....	<u>(2,097)</u>	<u>(1,314)</u>	<u>(752)</u>
Net cash provided by financing activities	<u>31,736</u>	<u>26,460</u>	<u>35,875</u>
Net increase in cash and cash equivalents	1,355	532	87
Cash and cash equivalents at beginning of year	<u>850</u>	<u>318</u>	<u>231</u>
Cash and cash equivalents at end of year.....	<u>\$ 2,205</u>	<u>\$ 850</u>	<u>\$ 318</u>
Supplemental disclosures of cash flow information:			
Cash paid during the year for:			
Interest	\$ 21,622	\$ 19,526	\$ 16,076
Income taxes	1,240	1,053	666

See Notes to Financial Statements

FANNIE MAE

NOTES TO FINANCIAL STATEMENTS

1. Summary of Significant Accounting Policies

Fannie Mae is a federally chartered and stockholder-owned corporation operating in the residential mortgage finance industry.

The accounting and reporting policies of the Corporation conform with generally accepted accounting principles. Certain amounts in prior years' financial statements have been reclassified to conform with the current presentation.

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Mortgage Portfolio

Mortgages and mortgage-backed securities that the Corporation has the ability and positive intent to hold to maturity are classified as held-to-maturity and are carried at their unpaid principal balances ("UPB") adjusted for unamortized purchase discount or premium and deferred loan fees. Mortgage loans held for sale are carried at the lower of cost or fair value with any unrealized losses included in current period earnings. Mortgage-backed securities that the Corporation intends to hold for an undetermined period, but not necessarily to maturity, are classified as available-for-sale and are carried at fair value, with any valuation adjustments reported as an adjustment to equity, net of deferred taxes.

The Corporation uses actual principal prepayment experience and estimates of future principal prepayments in calculating the constant effective yield necessary to apply the interest method in the amortization of loan fees and purchase discount or premium. In evaluating prepayments, loans are aggregated by similar characteristics (e.g., loan type, acquisition date, and maturity). Factors used in determining estimates of future prepayments include historical prepayment data and expected prepayment performance under varying interest rate scenarios.

The accrual of interest on conventional mortgages (i.e., mortgages that are not federally insured or guaranteed) is discontinued when the mortgages become 90 days or more delinquent. Any accrued but uncollected interest on mortgages that are 90 days delinquent is reversed against current-period interest income. Interest income on such mortgages is recognized only to the extent that cash payments are received.

Investments

Nonmortgage investments are classified as either available-for-sale or held-to-maturity. Investments that are classified as available-for-sale are carried at fair value as of the balance sheet date, with any valuation adjustments reported as an adjustment to equity, net of deferred taxes. Investments that are classified as held-to-maturity are carried at historical cost, adjusted for unamortized discount or premium. Interest income is recognized on an accrual basis unless the collection of interest income is considered doubtful, in which case interest income is recognized on a cash basis.

Guaranteed Mortgage-Backed Securities

The Corporation guarantees the timely payment of principal and interest on Fannie Mae Mortgage-Backed Securities ("MBS"). These securities represent beneficial interests in pools of

FANNIE MAE

NOTES TO FINANCIAL STATEMENTS— (Continued)

mortgages or other mortgage-backed securities held in trust by the Corporation. The pools of mortgages or mortgage-backed securities are not assets of the Corporation, except when acquired for investment purposes, nor are the related outstanding securities liabilities; accordingly, neither is reflected on the accompanying balance sheets. The Corporation receives monthly guaranty fees for each MBS pool based on a percentage of the pool's outstanding balance. Adjustments to the guaranty fee rate effected through an upfront payment at securitization are deferred and amortized into guaranty fee income over the estimated life of the underlying loans using the interest method. For MBS pools held in the Corporation's portfolio, the guaranty fee is reflected as interest income.

Allowance for Losses

The allowance for losses is based on an analysis of the mortgage portfolio and MBS outstanding, and provides for future foreclosure losses. The analysis considers credit profile factors such as mortgage characteristics, geographic concentrations, economic conditions, and actual and expected loss experience. The allowance is increased by provisions charged as an expense in the income statement and reduced by charge-offs, net of recoveries. In management's judgment, the allowance for losses is adequate to provide for expected losses.

Acquired Property

Foreclosed assets are carried at the lower of cost or fair value less estimated costs to sell. Cost is defined as fair value at foreclosure and represents the amount that a willing seller could reasonably expect from a willing buyer in an arm's-length transaction. The difference between estimated fair value of the collateral at foreclosure and the principal owed on the underlying loan is recorded as a charge-off against the allowance for losses. Foreclosure, holding, and disposition costs are charged directly to earnings.

Hedging Instruments

The Corporation utilizes certain financial instruments, such as interest rate swaps, derivative instruments that simulate the short sale of Treasury securities, deferred rate setting agreements and foreign currency swaps to achieve a specific financing or investment objective at a desired cost or yield. The Corporation does not engage in trading or other speculative use of these financial instruments. Specific criteria must be met for financial instruments to qualify as a hedge on either an accrual or deferred basis. Financial instruments not qualifying as hedges are marked to market through earnings. Financial instruments used to hedge the anticipated issuance of debt must maintain a high correlation between the hedging instrument and the item being hedged, both at inception and throughout the hedge period.

Interest rate swaps are contractual agreements between two parties for the exchange of periodic payments, generally based on a notional principal amount and agreed-upon fixed and variable rates. The Corporation has long-term interest rate swap agreements with various parties to extend the effective maturity of certain short-term debt obligations and to adjust the effective maturity of certain long-term debt obligations. The Corporation also has interest rate swap agreements that are linked to specific debt issues (debt swaps) or specific investments (asset swaps). These swaps achieve a specific financing or investment objective at a desired cost or yield. The costs and terms of the specific debt issues and yield of these specific investments, as presented in the financial statements, include the effects of these swaps. Interest rate swaps are accounted for on an accrual basis with the net payable or receivable recognized as an adjustment to interest income or expense on the related assets or liabilities. Gains or losses on terminated interest rate swaps are deferred and amortized over the shorter of the remaining life of the hedged items or the term of the original swap. The fair value of the

FANNIE MAE

NOTES TO FINANCIAL STATEMENTS— (Continued)

interest rate swap agreements and changes in these fair values as a result of changes in market interest rates are not recognized in the financial statements.

Derivative instruments that simulate the short sale of Treasury securities are used to hedge interest rate risk on planned debt issuances. Gains and losses that result from the hedge positions are deferred and recognized as adjustments to debt cost over the life of the hedged debt issuance.

The Corporation enters into deferred rate setting agreements at the same time it issues certain fixed-rate debt. Under these agreements, the Corporation is able to set the effective interest rate on the debt based on prevailing market conditions at one or more future dates. At settlement of all or a portion of a deferred rate setting agreement, the Corporation pays or receives cash in an amount representing the present value of the interest rate differential between the fixed-rate debt and the prevailing rate. Gains and losses that result from the hedge position are deferred and recognized as adjustments to debt cost over the life of the debt issuance.

The Corporation issues debt securities in which principal, interest, or both are payable in a foreign currency or are determined by reference to an index that includes one or more foreign currencies. Concurrently, the Corporation enters into currency swaps that convert the proceeds of certain borrowings into dollars or provide for scheduled exchanges of the currencies to insulate the Corporation against foreign currency exchange risk. Foreign currency swaps are accounted for on an accrual basis with the net differential received or paid under such swaps recognized as an adjustment to interest income or expense on the related asset or liability. Foreign currency borrowings and the related net receivables and payables from currency swaps are translated at the market rates of exchange as of the balance sheet date.

Cash and Cash Equivalents

The Corporation considers highly liquid investment instruments, generally with an original maturity of three months or less, to be cash equivalents. Cash equivalents are carried at cost, which approximates market value.

Income Taxes

Deferred federal income tax assets and liabilities are established for temporary differences between financial and taxable income and are measured using the current marginal statutory tax rate. Investment and other tax credits are deferred and amortized over the lives of the related assets.

Earnings per Common Share

In 1997, the Financial Accounting Standards Board issued Statement No. 128 (“FAS 128”), *Earnings per Share*. FAS 128 replaced the calculation of primary and fully diluted earnings per share with basic and diluted earnings per share.

Basic earnings per share is computed by dividing income available to common stockholders by the weighted-average number of common shares outstanding during the period. Diluted earnings per share adjusts for the assumed conversion of all potentially dilutive securities. Potentially dilutive securities are those that do not have a current right to participate fully in earnings but could do so in the future by virtue of their option or conversion rights. The exercise of options or conversion of convertible securities is not assumed if the result would be antidilutive for the period being calculated. All earnings per common share amounts have been presented and, where appropriate, restated to conform to FAS 128 requirements.

FANNIE MAE

NOTES TO FINANCIAL STATEMENTS— (Continued)

2. Mortgage Portfolio, Net

The mortgage portfolio consisted of the following at December 31, 1997 and 1996.

	<u>1997</u>	<u>1996</u>
	<u>(Dollars in millions)</u>	
Single-family mortgages:		
Government insured or guaranteed	\$ 19,478	\$ 15,912
Conventional:		
Long-term, fixed-rate	211,541	177,070
Intermediate-term, fixed-rate(1)	61,571	66,284
Adjustable-rate	11,373	12,783
Second	<u>268</u>	<u>323</u>
	<u>304,231</u>	<u>272,372</u>
Multifamily mortgages:		
Government insured	3,360	3,673
Conventional	<u>9,087</u>	<u>11,007</u>
	<u>12,447</u>	<u>14,680</u>
Total unpaid principal balance	316,678	287,052
Less:		
Unamortized discount and deferred loan fees, net	86	524
Allowance for losses	<u>276</u>	<u>269</u>
Net mortgage portfolio	<u>\$316,316</u>	<u>\$286,259</u>

(1) Intermediate-term consists of portfolio loans with contractual maturities at purchase equal to or less than 20 years and MBS held in portfolio with maturities of 15 years or less at issue date.

Included in the mortgage portfolio are \$157 billion and \$119 billion of MBS and other mortgage-related securities at December 31, 1997 and 1996, respectively, with fair values of \$163 billion and \$120 billion, respectively. MBS held in portfolio at December 31, 1997 and 1996, included \$35 billion and \$22 billion, respectively, of Real Estate Mortgage Investment Conduits (“REMICs”) and Stripped MBS (“SMBS”). REMICs and SMBS backed by MBS do not subject the Corporation to added credit risk but generally have different interest rate risks than MBS. At December 31, 1997, these securities had aggregate gross unrealized losses of \$175 million and gross unrealized gains of \$796 million. At December 31, 1996, the aggregate gross unrealized losses and gains were \$218 million and \$669 million, respectively.

Mortgage assets held for sale were \$.6 billion and \$.1 billion at December 31, 1997 and 1996, respectively.

The UPB of impaired loans at December 31, 1997 was \$351 million, of which \$161 million had a specific loss allowance, compared with \$445 million and \$221 million, respectively, at December 31, 1996. The average balance of impaired loans during 1997 and 1996 was \$438 million and \$421 million, respectively.

FANNIE MAE

NOTES TO FINANCIAL STATEMENTS— (Continued)

Nonperforming loans outstanding totaled \$2.6 billion at the end of 1997, compared with \$2.1 billion at the end of 1996. If these nonperforming loans had been fully performing, they would have contributed an additional \$138 million to net interest income in 1997 and \$147 million in 1996.

3. Allowance for Losses

Changes in the allowance for the years 1995 through 1997 are summarized below.

	Total
	(Dollars in millions)
Balance, January 1, 1995	\$ 827
Provision	140
Net foreclosure losses charged off.....	(172)
Balance, December 31, 1995	795
Provision	195
Net foreclosure losses charged off.....	(210)
Balance, December 31, 1996	780
Provision	100
Net foreclosure losses charged off.....	(77)
Balance, December 31, 1997	\$ 803

At December 31, 1997, \$276 million of the allowance for losses is included in the Balance Sheet under “Mortgage portfolio, net,” which represents the allocation for portfolio loan losses; \$523 million is included in liabilities under “Other” for estimated losses on MBS; and the remainder, or \$4 million, which relates to unrecoverable losses on Federal Housing Administration loans, is included in “Acquired property and foreclosure claims, net.” The corresponding amounts at December 31, 1996 were \$269 million, \$507 million, and \$4 million, respectively. Included in the allowance for losses at December 31, 1997, is \$21 million of specific allowances for impaired loans, compared with \$33 million in 1996. During 1997, the Corporation established \$29 million of specific allowances for these loans, compared with \$20 million in 1996.

FANNIE MAE

NOTES TO FINANCIAL STATEMENTS— (Continued)

4. Investments

Presented below are the amortized cost and fair value of nonmortgage investments classified as held-to-maturity at December 31, 1997 and 1996.

	1997				1996			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(Dollars in millions)							
Held-to-maturity investments:								
Asset-backed securities . . .	\$13,034	\$ 1	\$—	\$13,035	\$12,777	\$15	\$—	\$12,792
Eurodollar time deposits	12,828	1	—	12,829	13,956	—	—	13,956
Commercial paper	11,745	4	—	11,749	6,191	1	—	6,192
Repurchase agreements . .	6,715	—	—	6,715	4,667	—	—	4,667
Federal funds	6,384	—	—	6,384	7,778	—	—	7,778
Auction rate preferred stock	1,641	—	—	1,641	2,064	—	—	2,064
Other held-to-maturity securities	6,343	6	—	6,349	5,673	4	4	5,673
Total	<u>\$58,690</u>	<u>\$12</u>	<u>\$—</u>	<u>\$58,702</u>	<u>\$53,106</u>	<u>\$20</u>	<u>\$ 4</u>	<u>\$53,122</u>

Presented below are the amortized cost and fair value of nonmortgage investments classified as available-for-sale at December 31, 1997 and 1996.

	1997				1996			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(Dollars in millions)							
Available-for-sale securities:								
Asset-backed securities . . .	\$3,607	\$—	\$2	\$3,605	\$1,860	\$—	\$2	\$1,858
Other available-for-sale securities . . .	2,301	—	—	2,301	1,642	—	—	1,642
Total	<u>\$5,908</u>	<u>\$—</u>	<u>\$2</u>	<u>\$5,906</u>	<u>\$3,502</u>	<u>\$—</u>	<u>\$2</u>	<u>\$3,500</u>

The following table shows the amortized cost, fair value, and yield of nonmortgage investments at December 31, 1997 and 1996, by remaining maturity.

	1997			1996		
	Amortized Cost	Fair Value	Yield	Amortized Cost	Fair Value	Yield
	(Dollars in millions)					
Due within one year	\$44,562	\$44,567	5.93%	\$38,624	\$38,623	5.84%
Due after one year through five years	3,395	3,401	6.13	3,347	3,349	5.85
	47,957	47,968	5.95	41,971	41,972	5.84
Asset-backed securities (1)	16,641	16,640	6.16	14,637	14,650	5.90
Total	<u>\$64,598</u>	<u>\$64,608</u>	<u>6.00%</u>	<u>\$56,608</u>	<u>\$56,622</u>	<u>5.86%</u>

(1) Contractual maturity of asset-backed securities is not a reliable indicator of their expected life because borrowers have the right to repay their obligations at any time.

FANNIE MAE

NOTES TO FINANCIAL STATEMENTS— (Continued)

5. Debentures, Notes, and Bonds, Net

Borrowings Due Within One Year

Borrowings due within one year at December 31, 1997 and 1996 are summarized below. Amounts are net of unamortized discount and premium.

	1997					1996				
	Outstanding at December 31		Average Outstanding During Year		Maximum Outstanding at Any Month End	Outstanding at December 31		Average Outstanding During Year		Maximum Outstanding at Any Month End
	Amount	Cost (1)	Amount	Cost (1)		Amount	Cost (1)	Amount	Cost (1)	
	(Dollars in millions)									
Short-term notes	\$104,964	5.69%	\$91,535	5.57%	\$104,964	\$ 90,166	5.48%	\$80,013	5.42%	\$90,166
Other short-term debt	32,226	5.74	36,874	5.59	41,044	30,494	5.47	32,305	5.48	34,681
Current portion of borrowings due after one year(2):										
Debtentures	14,300	6.40				8,553	7.89			
Medium-term notes	23,629	5.68				30,352	5.73			
Other	281	6.50				335	6.40			
Total due within one year	<u>\$175,400</u>	<u>5.76%</u>				<u>\$159,900</u>	<u>5.65%</u>			

- (1) Represents weighted-average cost, which includes the amortization of discounts, premiums, issuance costs, hedging results, and the effects of currency and debt swaps.
- (2) Information on average amount and cost of debt outstanding during the year and maximum amount outstanding at any month end is not meaningful. See "Borrowings Due After One Year" for additional information.

FANNIE MAE

NOTES TO FINANCIAL STATEMENTS— (Continued)

Borrowings Due After One Year

Borrowings due after one year consisted of the following at December 31, 1997 and 1996.

	Maturity Date	1997		1996	
		Amount Outstanding	Average Cost (1)	Amount Outstanding	Average Cost (1)
(Dollars in millions)					
Debentures, net of \$99 million of discount for 1997 (\$127 million for 1996)	1998-2022	\$ 35,170	7.36%	\$ 51,016	7.20%
Global debt, net of \$28 million of discount for 1997 (\$34 million for 1996)	1998-2007	21,752	6.47	14,170	6.43
Medium-term notes, net of \$299 million of discount for 1997 (\$142 million for 1996)	1998-2027	135,453	6.48	104,618	6.37
Zero-coupon securities and subordinated capital debentures, net of \$12,612 million of discount for 1997 (\$11,208 million for 1996)	1998-2019	2,671	8.96	1,557	10.65
Long-term other, net of \$47 million of discount for 1997 (\$50 million for 1996)	1998-2018	<u>193</u>	<u>9.99</u>	<u>198</u>	<u>9.99</u>
		195,239	6.67%	171,559	6.66%
Adjustment for foreign currency translation		<u>(865)</u>		<u>(189)</u>	
Total due after one year		<u>\$194,374</u>		<u>\$171,370</u>	

(1) Represents weighted-average cost, which includes the amortization of discounts, premiums, issuance costs, hedging results, and the effects of currency and debt swaps.

Debentures, notes, and bonds at December 31, 1997 included \$128 billion of callable debt, which generally is redeemable in whole or in part (and, in certain cases, at a specified premium), at the option of the Corporation any time on or after a specified date, and \$.5 billion of other debt instruments that are subject to mandatory redemptions tied to certain indices or rates after an initial nonredemption period.

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NOTES TO FINANCIAL STATEMENTS— (Continued)

The following table summarizes the amounts and call periods of callable debt, the notional amount of callable swaps, and other redeemable debt and swaps, including \$14 billion of callable debt which was swapped to variable rate debt. Medium-term notes and subordinated capital debentures that are redeemable at the Corporation's option also are included in the table.

<u>Call Date</u>	<u>Year of Maturity</u>	<u>Amount Outstanding</u>	<u>Average Cost</u>
	(Dollars in millions)		
Callable debt and callable swaps (notional amount):			
Currently callable	1998-2001	\$ 40,624	5.70%
1998	1999-2022	47,740	6.58
1999	2000-2024	29,814	7.08
2000	2001-2026	15,386	7.10
2001	2002-2026	9,265	7.31
2002	2007-2027	5,600	6.91
2003 and later	2006-2014	<u>1,624</u>	<u>6.28</u>
		150,053	6.55
Other redeemable debt and swaps	1998-2002	<u>527</u>	<u>6.77</u>
Total		<u>\$150,580</u>	<u>6.55%</u>

Principal amounts at December 31, 1997 of total debt payable in the years 1999-2003, assuming callable debt is paid at maturity and assuming callable debt is redeemed at the initial call date, are as follows:

	<u>Total Debt by Year of Maturity (1)</u>	<u>Assuming Callable Debt Redeemed at Initial Call Date (1)</u>
	(Dollars in millions)	
1999	\$32,485	\$52,642
2000	28,675	30,661
2001	21,230	11,552
2002	28,764	18,294
2003	11,837	2,920

(1) Includes \$14 billion of callable debt which was swapped to variable-rate debt.

In 1997 and 1996, the Corporation repurchased or called \$31 billion of debt and swaps with an average cost of 7.22 percent and \$26 billion with an average cost of 7.09 percent, respectively. The Corporation recorded extraordinary losses of \$19 million (\$12 million after tax) in 1997 and \$45 million (\$29 million after tax) in 1996 on the early extinguishment of debt.

Pursuant to the Corporation's Charter Act, approval of the Secretary of the Treasury is required for the Corporation's issuance of its debt obligations.

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NOTES TO FINANCIAL STATEMENTS— (Continued)

6. Income Taxes

Components of the provision for federal income taxes for the years ended December 31, 1997, 1996, and 1995, were as follows:

	1997	1996	1995
	(Dollars in millions)		
Current	\$1,247	\$1,109	\$819
Deferred	22	42	21
	1,269	1,151	840
Tax benefit of extraordinary loss	(7)	(16)	(6)
Net federal income tax provision	\$1,262	\$1,135	\$834

The tax effects of temporary differences that gave rise to significant portions of the deferred tax assets and deferred tax liabilities at December 31, 1997 and 1996 consisted of the following:

	1997	1996
	(Dollars in millions)	
Deferred tax assets:		
MBS guaranty and REMIC fees	\$404	\$373
Provision for losses	339	311
Purchase discount and deferred fees	1	—
Other items, net	54	49
Deferred tax assets	798	733
Deferred tax liabilities:		
Benefits from tax-advantaged investments	171	142
Purchase discount and deferred fees	—	20
Other items, net	23	26
Deferred tax liabilities	194	188
Net deferred tax assets	\$604	\$545

Management anticipates that it is more likely than not that the results of future operations will generate sufficient taxable income to realize the entire balance of deferred tax assets.

The Corporation's effective tax rates differed from statutory federal rates for the years ended December 31, 1997, 1996, and 1995, as follows:

	1997	1996	1995
Statutory corporate rate	35%	35%	35%
Tax-exempt interest and dividends received deductions	(4)	(4)	(4)
Equity investments in affordable housing projects	(2)	(2)	(2)
Settlement of IRS issues	—	—	(1)
Effective rate	29%	29%	28%

The Corporation is exempt from state and local taxes, except for real estate taxes.

FANNIE MAE

NOTES TO FINANCIAL STATEMENTS— (Continued)

7. Earnings per Common Share

The following table sets forth the computation of basic and diluted earnings per common share:

	<u>1997</u>	<u>1996</u>	<u>1995</u>
	(Dollars and shares in millions, except per common share amounts)		
Numerator:			
Net income before extraordinary loss	\$3,068	\$2,754	\$2,155
Extraordinary loss	(12)	(29)	(11)
Preferred stock dividends	<u>(65)</u>	<u>(42)</u>	<u>—</u>
Numerator for basic and diluted earnings per common share— income available to common stockholders	<u>\$2,991</u>	<u>\$2,683</u>	<u>\$2,144</u>
Denominator:			
Denominator for basic earnings per common share—weighted- average common shares	1,049	1,071	1,091
Dilutive potential common shares(1)	<u>7</u>	<u>9</u>	<u>7</u>
Denominator for diluted earnings per common share—adjusted weighted-average common shares	<u>1,056</u>	<u>1,080</u>	<u>1,098</u>
Basic earnings per common share:			
Earnings before extraordinary item	\$ 2.87	\$ 2.53	\$ 1.98
Net earnings	2.85	2.50	1.97
Diluted earnings per common share:			
Earnings before extraordinary item	\$ 2.84	\$ 2.51	\$ 1.96
Net earnings	<u>2.83</u>	<u>2.48</u>	<u>1.95</u>

(1) Dilutive potential common shares consist primarily of the dilutive effect from employee stock options and other stock compensation plans.

For additional disclosures regarding the Corporation's stock compensation plans and the outstanding preferred stock, see Notes 8 and 12, respectively.

8. Stock Compensation Plans

At December 31, 1997, the Corporation had five stock-based compensation plans. Financial Accounting Standards No. 123 ("FAS 123"), *Accounting for Stock-Based Compensation*, gives companies the option of either recording an expense for all stock compensation awards based on fair value at grant date or continuing to follow Accounting Principles Board Opinion No. 25 ("APB Opinion 25") with the additional requirement that they disclose, in a footnote, pro forma net income and earnings per share as if they had adopted the expense recognition provisions of FAS 123. Fannie Mae elected to apply APB Opinion 25 and related interpretations in accounting for its plans. As a result, no compensation expense has been recognized for the nonqualified stock options and employee stock purchase plan. Had compensation expense been recognized for benefits under all five plans, based on their fair value at grant date and consistent with FAS 123, the Corporation's net income and diluted earnings per common share would have been \$3.025 billion and \$2.80, \$2.701 billion and \$2.46, and \$2.120 billion and \$1.94 for the years ended December 31, 1997, 1996, and 1995, respectively.

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NOTES TO FINANCIAL STATEMENTS— (Continued)

The fair value of benefits under the Corporation’s stock-based plans was determined using a Black-Scholes pricing model. The following table summarizes the major assumptions used in the model.

	<u>1997</u>	<u>1996</u>	<u>1995</u>
Risk free rate(1)	5.53 - 6.80%	6.45 - 7.74%	5.26 - 6.73%
Volatility	23 - 25	21 - 22	21 - 22
Forfeiture	15	15	15
Dividend(2)	\$.84	\$.76	\$.68
<u>Expected life</u>	1 - 5 yrs.	1 - 5 yrs.	1 - 5 yrs.

(1) The closing yield on the comparable weighted-average life U.S. Treasury on the day prior to grant.

(2) Dividend rate on common stock at date of grant. Dividend rate assumed to remain constant over the option life.

Employee Stock Purchase Plan

The Corporation has an Employee Stock Purchase Plan that allows issuance of up to 36 million shares of common stock to qualified employees at a price equal to 85 percent of the fair market value on the date of issuance. In 1997, the Corporation granted each qualified employee, excluding certain officers, the right to purchase in January 1998 up to 629 shares of common stock. Under the 1997 offering, 1,883,197 common shares were purchased at \$33.73 per common share, compared with 2,348,048 common shares at \$27.47 under the 1996 offering. The Board of Directors has approved a 1998 offering under the plan, granting each qualified employee the right to purchase 393 common shares at \$54.03 per common share.

Employee Stock Ownership Plan

The Corporation has an Employee Stock Ownership Plan (“ESOP”) for qualified employees. The Corporation may contribute to the ESOP an amount based on defined earnings goals, not to exceed 4 percent of the aggregate base salary for all participants. The contribution is made in the subsequent year either in shares of Fannie Mae common stock or in cash that is used to purchase such stock.

Performance Shares

Fannie Mae’s Stock Compensation Plans authorize eligible employees to receive performance awards, generally issued with an award period that can range from three to five years. The performance awards become actual awards only if the Corporation attains the goals set for the award period. At the end of such time, the awards generally are payable in common stock, in three installments over a two-year period. The outstanding contingent grants made for the 1998-2000, 1997-1999, and 1996-1998 periods were 311,580 common shares, 252,964 common shares, and 347,842 common shares, respectively.

Nonqualified Stock Options

Stock options may be granted to eligible employees and nonmanagement members of the Board of Directors. The options generally do not become exercisable until at least one year after the grant date, and generally expire ten years from the grant date. The purchase price of the common stock covered by each option is equal to the fair value of the stock on the date the option is granted.

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NOTES TO FINANCIAL STATEMENTS— (Continued)

The following table summarizes stock option activity for the years 1995-1997:

	1997		1996		1995	
	Options	Weighted-average Exercise Price	Options	Weighted-average Exercise Price	Options	Weighted-average Exercise Price
			(options in thousands)			
Balance, January 1	23,910	\$22.24	24,249	\$18.90	22,095	\$16.52
Granted	3,373	50.16	3,418	38.67	5,021	26.95
Exercised	(4,065)	17.46	(3,014)	14.31	(2,288)	13.71
Forfeited	(441)	26.16	(743)	21.01	(579)	18.25
Balance, December 31	<u>22,777</u>	<u>\$27.15</u>	<u>23,910</u>	<u>\$22.24</u>	<u>24,249</u>	<u>\$18.90</u>
Options vested, December 31	<u>13,275</u>	<u>\$20.30</u>	<u>11,767</u>	<u>\$17.65</u>	<u>9,271</u>	<u>\$15.05</u>

The following table summarizes information about stock options outstanding at December 31, 1997:

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Number of Options	Weighted-average Remaining Contractual Life	Weighted-average Exercise Price	Number of Options Exercisable	Weighted-average Exercise Price
			(options in thousands)		
\$ 3.94 - \$16.06	1,833	3.2 yrs.	\$11.37	1,833	\$11.37
17.22 - 28.95	14,329	6.7	21.15	10,542	20.28
30.13 - 41.00	3,593	8.9	38.86	842	38.42
42.13 - 54.09	<u>3,022</u>	<u>9.9</u>	<u>51.28</u>	<u>58</u>	<u>42.79</u>
Total	<u>22,777</u>	<u>7.2 yrs.</u>	<u>\$27.15</u>	<u>13,275</u>	<u>\$20.30</u>

Restricted Stock

In 1997, 66,240 shares of restricted stock were awarded, issued, and placed in escrow under the Stock Compensation Plans and Restricted Stock Plan for Directors (95,000 in 1996); 138,968 shares were released as vesting of participants occurred (173,411 shares in 1996).

9. Employee Retirement Benefits

Retirement Savings Plan

All regular employees of the Corporation scheduled to work 1,000 hours or more in a calendar year are eligible to participate in the Corporation's Retirement Savings Plan, which includes a 401(k) option. In 1997, employees could contribute up to the lesser of 12 percent of their base salary or the current annual dollar cap established and revised annually by the IRS, with the Corporation matching such contributions up to 3 percent of base salary.

Postretirement Benefit Plans

All regular employees of the Corporation scheduled to work 1,000 hours or more in a calendar year are covered by a noncontributory corporate retirement plan or by the contributory Civil Service Retirement Law. Benefits payable under the corporate plan are based on years of service and compensation using the average pay during the 36 consecutive highest paid months of the last 120 months of employment. The Corporation's policy is to contribute an amount no less than the

FANNIE MAE

NOTES TO FINANCIAL STATEMENTS— (Continued)

minimum required employer contribution under the Employee Retirement Income Security Act of 1974. Contributions to the corporate plan reflect benefits attributed to employees' service to date as well as compensation expected to be paid in the future. A \$10 million contribution was made to the corporate plan in 1997. Corporate plan assets consist primarily of listed stocks, fixed-income securities, and other liquid assets. At December 31, 1997 and 1996, the projected benefit obligations for services rendered, were \$185 million and \$149 million, respectively, while the plan assets were \$190 million and \$141 million, respectively. The pension liability (included in liabilities under "Other") at December 31, 1997 and 1996 was \$36 million and \$38 million, respectively, while net periodic pension costs were \$8 million and \$11 million, respectively.

At December 31, 1997 and 1996, the weighted-average discount rates used in determining the actuarial present value of the projected benefit obligation were 7.25 percent and 7.75 percent, respectively; the average rates of increase in future compensation levels used in the calculation were 5.75 percent for both 1997 and 1996; and the expected long-term rates of return on assets were 9.25 percent and 9.50 percent, respectively. The Corporation uses the straight-line method of amortization for prior service costs.

The Corporation also has an Executive Pension Plan and a Supplemental Pension Plan, which supplement for key senior officers the benefits payable under the retirement plan. Estimated benefits under the supplemental plans are accrued as an expense over the period of employment. Accrued benefits under the Executive Pension Plan generally are funded through a Rabbi trust.

Fannie Mae sponsors a postretirement health care plan that covers substantially all full-time employees. The plan pays stated percentages of most necessary medical expenses incurred by retirees, after subtracting payments by Medicare or other providers and after a stated deductible has been met. Participants become eligible for the benefits if they retire from the Corporation after reaching age 55 with 5 or more years of service. The plan is contributory, with retiree contributions adjusted annually. The expected cost of these postretirement benefits is charged to expense during the years that employees render service. Cost-sharing percentages are based on length of service with the Corporation. Fannie Mae does not fund this plan.

The Corporation's accrued postretirement health care cost liability for the years ending December 31, 1997 and 1996 was \$27 million and \$22 million, respectively. The net periodic postretirement health care costs were \$6 million in 1997 and \$7 million in both 1996 and 1995. In determining the net postretirement health care cost for 1997, a 6.25 percent annual rate of increase in the per capita cost of covered health care claims was assumed for 1997; the rate was assumed to decrease gradually to 4.5 percent over five years and remain at that level thereafter. The health care cost trend rate assumption has a significant effect on the amounts reported. In determining the net postretirement health care cost for 1996, a 6.5 percent annual rate of increase in the per capita cost of covered health care claims was assumed for 1996; the rate was assumed to decrease gradually to 4.5 percent over six years and remain at that level thereafter. To illustrate, increasing the assumed health care cost trend rates by one percentage point in each year would increase the accumulated postretirement benefit obligation as of December 31, 1997 by \$7 million and the aggregate of the service and interest cost components of net postretirement health care cost for the year then ended by \$1 million.

The weighted-average discount rates used in determining the health care cost and the year-end accumulated postretirement benefit obligation were 7.25 percent at December 31, 1997 and 7.75 percent at December 31, 1996.

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NOTES TO FINANCIAL STATEMENTS— (Continued)

10. Line of Business Reporting

Management analyzes corporate performance on the basis of two lines of business: Portfolio Investment and Credit Guaranty.

The Portfolio Investment business includes the management of asset purchases and funding activities for the Corporation's mortgage and nonmortgage investment portfolios. Income is derived primarily from the difference, or spread, between the yield on mortgage loans and nonmortgage investments, and the borrowing costs related to those loans and investments.

The Credit Guaranty business involves guaranteeing the credit performance of both single-family and multifamily mortgage loans for a fee. Guaranty fees for MBS are based on a market rate of return for the credit risk assumed. For mortgages held in portfolio, the Credit Guaranty business charges the Portfolio Investment business a guaranty fee similar to what it would charge on an MBS. These "notional" guaranty fees are classified as net interest income for the Credit Guaranty business. Net interest income for the Credit Guaranty business also includes interest on capital invested in guaranty activities and income from temporary investment of principal and interest payments on guaranteed mortgages prior to remittance to investors, and is net of interest charges paid to the Portfolio Investment business for delinquent loans.

The Corporation assigns actual direct revenues and expenses among its lines of business and uses estimates to apportion overhead and other corporate items. For instance, administrative expenses are allocated on the basis of direct expenses for the line of business or, where not assignable to a particular associated business, are based on revenues, profits, or volumes, as applicable. Capital is allocated to the separate businesses through an assessment of the interest rate and credit risk associated with each business.

The following table sets forth the Corporation's financial performance by line of business for the years ended December 31, 1997, 1996, and 1995.

	1997			1996			1995			
	Portfolio Investment	Credit Guaranty	Total	Portfolio Investment	Credit Guaranty	Total	Portfolio Investment	Credit Guaranty	Special Contribution (1)	Total
	(Dollars in millions)									
Net interest income	\$3,482	\$ 467	\$ 3,949	\$3,180	\$ 412	\$ 3,592	\$2,640	\$ 407	\$ —	\$3,047
Guaranty fees	(771)	2,045	1,274	(730)	1,926	1,196	(630)	1,716	—	1,086
Miscellaneous, net	18	107	125	32	54	86	22	71	—	93
Credit-related expenses	—	(375)	(375)	—	(409)	(409)	—	(335)	—	(335)
Administrative expenses	(151)	(485)	(636)	(130)	(430)	(560)	(132)	(414)	—	(546)
Special contribution	—	—	—	—	—	—	—	—	(350)	(350)
Federal income taxes	(719)	(550)	(1,269)	(661)	(490)	(1,151)	(520)	(442)	122	(840)
Extraordinary item—early extinguishment of debt	(12)	—	(12)	(29)	—	(29)	(11)	—	—	(11)
Net income	<u>\$1,847</u>	<u>\$1,209</u>	<u>\$ 3,056</u>	<u>\$1,662</u>	<u>\$1,063</u>	<u>\$ 2,725</u>	<u>\$1,369</u>	<u>\$1,003</u>	<u>\$ (228)</u>	<u>\$2,144</u>

(1) In 1996 the Corporation completed the first phase of the capital restructuring program announced at the end of 1995 which included a \$350 million contribution in Fannie Mae common stock to the Fannie Mae Foundation.

11. Dividend Restrictions

The Corporation's payment of dividends is subject to certain statutory restrictions, including approval by the Director of the Office of Federal Housing Enterprise Oversight of any dividend payment that would cause the Corporation's capital to fall below specified capital levels.

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NOTES TO FINANCIAL STATEMENTS— (Continued)

The Corporation has exceeded the applicable capital standard since the adoption of these restrictions in 1992, and, consequently, has been making dividend payments without the need for Director approval.

Payment of dividends on common stock also is subject to payment of dividends on preferred stock outstanding.

12. Preferred Stock

The following table presents the non-voting preferred stock outstanding as of December 31, 1997 and 1996.

	<u>Issue Date</u>	<u>Shares Issued and Outstanding</u>	<u>Stated Value Per Share</u>	<u>Annual Dividend Rate</u>	<u>Redeemable On or After</u>
Series A	March 1, 1996	7,500,000	\$50	6.41%	March 1, 2001
Series B	April 12, 1996	7,500,000	50	6.50	April 12, 2001
Series C(1)	September 20, 1996	<u>5,000,000</u>	50	6.45	September 20, 2001
Total		<u><u>20,000,000</u></u>			

- (1) The amount of dividends payable is subject to adjustment in the event of a reduction in the dividends received deduction prior to 18 months after the original issuance. The adjustment to the preferred stock dividends will offset the effect of such reduction to the extent such reduction is not to a deduction level below 50%; no adjustment will be made to the extent any such reductions are to a level below 50%.

Holders of preferred stock are entitled to receive noncumulative, quarterly dividends when, and if, declared by the Corporation’s Board of Directors. Payment of dividends on preferred stock is not mandatory but has priority over payment of dividends on common stock. After the specified period, preferred stock is redeemable at its stated value at the option of the Corporation.

13. Financial Instruments with Off-Balance-Sheet Risk

The Corporation is a party to transactions involving financial instruments with off-balance-sheet risk. The Corporation uses these instruments to fulfill its statutory purpose of meeting the financing needs of the secondary mortgage market and to reduce its own exposure to fluctuations in interest rates. These financial instruments include MBS, commitments to purchase mortgages or to issue and guarantee MBS, credit enhancements, and certain hedge instruments. These instruments involve, to varying degrees, elements of credit and market risk in excess of amounts recognized on the balance sheet.

Guaranteed Mortgage-Backed Securities

As issuer and guarantor of MBS, the Corporation is obligated to disburse scheduled monthly installments of principal and interest (at the certificate rate) and the full unpaid principal balance of any foreclosed mortgage to MBS investors, whether or not any such amounts have been received. The Corporation also is obligated to disburse unscheduled principal payments received from borrowers.

The Corporation’s credit risk is mitigated to the extent that sellers of pools of mortgages elect to remain at risk for the loans sold to the Corporation or other credit enhancement was provided to protect against the risk of loss from borrower default. Lenders have the option to retain the primary

FANNIE MAE

NOTES TO FINANCIAL STATEMENTS— (Continued)

default risk, in whole or in part, in exchange for a lower guaranty fee. Fannie Mae, however, bears the ultimate risk of default.

Commitments

The Corporation enters into master delivery commitments with lenders on either a mandatory or optional basis. Under a mandatory master commitment, a lender must either deliver loans under an MBS contract at a specified guaranty fee rate or enter into a mandatory portfolio commitment with the yield established upon executing the portfolio commitment.

The Corporation also will accept mandatory or lender-option delivery commitments not issued pursuant to a master commitment. These commitments may be for portfolio or MBS. The guaranty fee rate on MBS lender-option commitments is specified in the contract while the yield for portfolio lender-option commitments is set at the date of conversion to a mandatory commitment.

The cost of funding future portfolio purchases generally is hedged upon issuance of, or conversion to, a mandatory commitment. Therefore, the interest rate risk relating to loans purchased pursuant to those commitments is largely mitigated.

Hedge Instruments

The Corporation typically uses derivative instruments that simulate the short sale of Treasury securities, interest rate swaps, and deferred rate setting agreements to hedge against interest rate movements. Changes in the value of these hedge instruments caused by fluctuations in interest rates are expected to offset changes in the value of the items hedged. Consequently, the primary risks associated with these hedging instruments are (1) that changes in the value of the item hedged will not substantially offset changes in the value of the hedge instrument, and (2) that the counterparty to the agreement will be unable or unwilling to meet the terms of the agreement.

Credit risk on derivative instruments that simulate the short sale of Treasury securities arises from the possible inability or unwillingness of the counterparty to pay any difference between the agreed-upon price and the current price for the referenced securities at settlement. This risk is reduced through the evaluation of the creditworthiness of counterparties and continuous monitoring of hedge positions. The amount of deferrable net unrealized losses on open hedge positions was \$3 million at December 31, 1997, compared with \$2 million of gains at December 31, 1996. Total deferred gains and losses on closed positions were \$188 million and \$231 million, respectively, at December 31, 1997, compared with \$203 million and \$239 million, respectively, at December 31, 1996.

The Corporation reduces counterparty risk on interest rate swaps by dealing only with experienced swap counterparties with high credit quality, diversifying its swaps across many counterparties and ensuring that swaps generally are executed under master agreements that provide for netting of certain amounts payable by each party. In addition, counterparties are obligated to post collateral if the Corporation is exposed to credit loss on the related swaps exceeding an agreed-upon threshold. The amount of required collateral is based on credit ratings and the level of credit exposure.

The Corporation generally requires overcollateralization from counterparties whose credit ratings have dropped below predetermined levels. Fannie Mae regularly monitors the exposures on its interest rate swaps by valuing the positions via dealer quotes and internal pricing models. At December 31, 1997, 91 percent of the notional principal amount of Fannie Mae's outstanding interest rate swaps were with counterparties rated A or better (67 percent with counterparties rated AA or better), and 100 percent of the notional principal of outstanding swaps were subject to collateral arrangements. At December 31, 1997, five swap counterparties represented approximately 63 percent of the total

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NOTES TO FINANCIAL STATEMENTS— (Continued)

notional principal amount of the outstanding interest rate swaps. These five counterparties are subject to master collateral agreements.

Counterparty risk on deferred rate setting arrangements is limited to the cash receivable, if any, due under the deferred rate setting agreement. This risk is reduced through evaluating the creditworthiness of counterparties.

Credit Enhancements

The Corporation provides credit enhancement for certain financings involving taxable or tax-exempt housing bonds issued by state and local governmental entities to finance multifamily housing for low- and moderate-income families. In these transactions, Fannie Mae issues an MBS, pledges an interest in certain mortgages it owns or otherwise provides contractual assurance of payment to a trustee for the bonds. Fannie Mae's credit enhancement in a multifamily housing bond transaction improves the rating on the bond, thus resulting in lower-cost financing for multifamily housing.

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NOTES TO FINANCIAL STATEMENTS— (Continued)

Credit Exposure for Off-Balance-Sheet Financial Instruments

The following table presents the contract or notional amount of off-balance-sheet financial instruments at December 31, 1997 and 1996.

	<u>1997</u>	<u>1996</u>
	<u>(Dollars in billions)</u>	
MBS outstanding (1)	\$ 709.1	\$ 650.3
MBS in portfolio	<u>(130.4)</u>	<u>(102.6)</u>
Net MBS outstanding (1)	578.7	547.7
Master commitments:		
Mandatory	38.2	24.3
Optional	45.9	37.2
Portfolio commitments:		
Mandatory	3.6	1.9
Optional	1.6	1.2
MBS commitments:		
Mandatory	—	1.1
Optional .....	.1	1.4
Short sales of Treasury securities	1.6	.4
Interest rate swaps (2)	96.1	97.9
Debt swaps (3)	52.7	57.9
Asset swaps (4)	1.0	2.6
Credit enhancements	7.3	4.4
Other guarantees	2.6	3.5

- (1) Net of \$523 million in allowance for losses in 1997 and \$507 million in 1996. Includes \$94.3 billion and \$70.6 billion of MBS with lender or third party recourse at December 31, 1997 and 1996, respectively.
- (2) The weighted-average interest rate being received under these swaps was 5.85 percent and the weighted-average interest rate being paid was 6.79 percent at December 31, 1997, compared with 5.61 percent and 6.76 percent, respectively, at December 31, 1996.
- (3) The weighted-average interest rate being received under these swaps was 5.94 percent and the weighted-average interest rate being paid was 5.65 percent at December 31, 1997, compared with 5.64 percent and 5.47 percent, respectively, at December 31, 1996.
- (4) The weighted-average interest rate being received under these swaps was 6.03 percent and the weighted-average interest rate being paid was 6.27 percent at December 31, 1997, compared with 5.96 percent and 6.11 percent, respectively, at December 31, 1996.

Contract or notional amounts do not necessarily represent the market or credit risk of the off-balance-sheet positions. The notional amounts of the instruments are used to calculate contractual cash flows to be exchanged. In addition, any measurement of risk is meaningful only to the extent that offsetting arrangements, such as master netting agreements and the value of related collateral, are included.

The Corporation's exposure to credit loss for off-balance-sheet financial instruments can be estimated by calculating the cost, on a present value basis, to replace at current market rates all those off-balance-sheet financial instruments outstanding for which the Corporation was in a gain position.

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NOTES TO FINANCIAL STATEMENTS— (Continued)

The Corporation's net exposure (taking into account master netting agreements) was \$26 million at December 31, 1997 and \$10 million at December 31, 1996. The Corporation expects the net credit exposure to fluctuate as interest rates change.

14. Concentrations of Credit Risk

Concentrations of credit risk exist when a significant number of counterparties (e.g., borrowers, lenders, and mortgage insurers) engage in similar activities or are susceptible to similar changes in economic conditions that could affect their ability to meet contractual obligations.

The following table presents UPB by primary default risk and the general geographic distribution of properties underlying mortgages in the portfolio and backing MBS outstanding as of December 31, 1997 and 1996.

<u>1997</u>	<u>Gross UPB</u> (Dollars in millions)	<u>Geographic Distribution</u>					<u>Total</u>
		<u>Northeast</u>	<u>Southeast</u>	<u>Midwest</u>	<u>Southwest</u>	<u>West</u>	
Fannie Mae risk	\$780,771	20%	21%	17%	15%	27%	100%
Lender risk	115,045	16	18	18	14	34	100
Total	<u>\$895,816</u>	<u>20%</u>	<u>20%</u>	<u>17%</u>	<u>15%</u>	<u>28%</u>	<u>100%</u>

<u>1996</u>	<u>Gross UPB</u> (Dollars in millions)	<u>Geographic Distribution</u>					<u>Total</u>
		<u>Northeast</u>	<u>Southeast</u>	<u>Midwest</u>	<u>Southwest</u>	<u>West</u>	
Fannie Mae risk	\$747,394	21%	20%	17%	15%	27%	100%
Lender risk	87,831	20	15	15	12	38	100
Total	<u>\$835,225</u>	<u>21%</u>	<u>20%</u>	<u>17%</u>	<u>14%</u>	<u>28%</u>	<u>100%</u>

No significant concentration exists at the state level except for California, where, at December 31, 1997, 20 percent of the gross UPB of mortgages in portfolio and backing MBS were located, compared with 21 percent at December 31, 1996.

To minimize credit risk, the Corporation requires primary mortgage insurance or other credit protection if the loan-to-value ("LTV") ratio of a single-family conventional mortgage loan (UPB of the loan divided by the value of the mortgaged property) when the loan is delivered to the Corporation is greater than 80 percent.

The Corporation accepts conventional loans delivered with mortgage insurance from 14 insurance organizations. At December 31, 1997, \$236 billion in current UPB of single-family conventional mortgage loans in portfolio and underlying MBS outstanding was covered by primary mortgage insurance at acquisition. Five companies, all rated AA- or higher, represented approximately 84 percent of that insurance coverage. The Corporation monitors, on a regular basis, the performance and financial strength of its mortgage insurers.

FANNIE MAE

NOTES TO FINANCIAL STATEMENTS— (Continued)

The following table presents the original LTV ratio distribution of single-family loans in portfolio and backing MBS outstanding at December 31, 1997 and 1996.

<u>1997</u>	<u>Gross UPB</u> (Dollars in millions)	<u>Loan-to-Value Ratio</u>						<u>Total</u>
		<u>60% and Less</u>	<u>61–70%</u>	<u>71–75%</u>	<u>76–80%</u>	<u>81–90%</u>	<u>Over 90%</u>	
Fannie Mae risk	\$752,654	19%	15%	15%	23%	16%	12%	100%
Lender risk	<u>86,195</u>	<u>9</u>	<u>10</u>	<u>12</u>	<u>26</u>	<u>24</u>	<u>19</u>	<u>100</u>
Total	<u>\$838,849</u>	<u>18%</u>	<u>14%</u>	<u>15%</u>	<u>23%</u>	<u>17%</u>	<u>13%</u>	<u>100%</u>

<u>1996</u>	<u>Gross UPB</u> (Dollars in millions)	<u>Loan-to-Value Ratio</u>						<u>Total</u>
		<u>60% and Less</u>	<u>61–70%</u>	<u>71–75%</u>	<u>76–80%</u>	<u>81–90%</u>	<u>Over 90%</u>	
Fannie Mae risk	\$720,503	19%	15%	15%	22%	17%	12%	100%
Lender risk	<u>62,514</u>	<u>14</u>	<u>13</u>	<u>15</u>	<u>27</u>	<u>20</u>	<u>11</u>	<u>100</u>
Total	<u>\$783,017</u>	<u>19%</u>	<u>14%</u>	<u>15%</u>	<u>23%</u>	<u>17%</u>	<u>12%</u>	<u>100%</u>

The rate at which mortgage loans prepay tends to be sensitive to the level and direction of prevailing market interest rates. In a declining interest rate environment, higher rate mortgage loans will pay off at a faster rate; conversely, in an increasing interest rate environment, lower interest rate mortgages will prepay at a slower rate. The following table presents the distribution by note rate of fixed-rate, single-family loans in the mortgage portfolio and underlying MBS at December 31, 1997 and 1996.

<u>Gross UPB at December 31,</u>	<u>Fixed-Rate Loans by Note Rate (1)</u>						<u>Total</u>
	<u>Under 7.00%</u>	<u>7.00% to 7.99%</u>	<u>8.00% to 8.99%</u>	<u>9.00% to 9.99%</u>	<u>10.00% to 10.99%</u>	<u>11.00% and over</u>	
	<u>(Dollars in billions)</u>						
1997	\$83	\$380	\$227	\$45	\$16	\$4	\$755
Percent of total	11%	50%	30%	6%	2%	1%	100%
1996	\$87	\$331	\$212	\$55	\$19	\$5	\$709
Percent of total	12%	46%	30%	8%	3%	1%	100%

(1) Excludes housing revenue bonds and non-Fannie Mae securities.

15. Disclosures of Fair Value of Financial Instruments

The basic assumptions used and the estimates disclosed in the Fair Value Balance Sheets represent management’s best judgment of appropriate valuation methods. These estimates are based on pertinent information available to management as of December 31, 1997 and 1996. In certain cases, fair values are not subject to precise quantification or verification and may change as economic and market factors, and management’s evaluation of those factors, change.

Although management uses its best judgment in estimating the fair value of these financial instruments, there are inherent limitations in any estimation technique. Therefore, these fair value estimates are not necessarily indicative of the amounts that the Corporation would realize in a market

FANNIE MAE

NOTES TO FINANCIAL STATEMENTS— (Continued)

transaction. The accompanying Fair Value Balance Sheets do not represent an estimate of the overall market value of the Corporation as a going concern, which would take into account future business opportunities.

Fair Value Balance Sheets

Assets

	<u>December 31, 1997</u>		<u>December 31, 1996</u>	
	<u>Cost</u>	<u>Fair Value</u>	<u>Cost</u>	<u>Fair Value</u>
	(Dollars in millions)			
Mortgage portfolio, net	\$316,316	\$325,500	\$286,259	\$290,254
Investments	64,596	64,608	56,606	56,624
Cash and cash equivalents	2,205	2,205	850	850
Other assets	<u>8,556</u>	<u>6,489</u>	<u>7,326</u>	<u>4,604</u>
	391,673	398,802	351,041	352,332
Off-balance-sheet items:				
Guaranty fee income, net	—	3,357	—	3,587
Swaps in gain position, net	—	4	—	6
Other	—	—	—	8
Total assets	<u>391,673</u>	<u>402,163</u>	<u>351,041</u>	<u>355,933</u>

Liabilities and Net Assets

Liabilities:

Noncallable debt:				
Due within one year	156,725	158,526	156,854	156,346
Due after one year	85,699	91,177	75,487	72,513
Callable debt:				
Due within one year	18,675	17,464	3,046	3,694
Due after one year	<u>108,675</u>	<u>108,706</u>	<u>95,883</u>	<u>101,822</u>
	369,774	375,873	331,270	334,375
Other liabilities	8,106	7,137	6,998	5,885
Off-balance-sheet items:				
Swaps in loss position, net	—	3,168	—	1,117
Other	—	3	—	—
Total liabilities	<u>377,880</u>	<u>386,181</u>	<u>338,268</u>	<u>341,377</u>
Net assets, net of tax effect	<u>\$ 13,793</u>	<u>\$ 15,982</u>	<u>\$ 12,773</u>	<u>\$ 14,556</u>

See accompanying Notes to Fair Value Balance Sheets.

Notes to Fair Value Balance Sheets

The following discussion summarizes the significant methodologies and assumptions used in estimating the fair values presented in the accompanying Fair Value Balance Sheets.

FANNIE MAE

NOTES TO FINANCIAL STATEMENTS— (Continued)

Mortgage Portfolio, Net

The fair value calculations of the Corporation's mortgage portfolio considered such variables as interest rates, credit quality, and loan collateral. Because an active market does not exist for a large portion of mortgage loans in the portfolio, the portfolio's unsecuritized mortgages were aggregated into pools by product type, coupon, and maturity and converted into notional MBS. A normal guaranty fee that Fannie Mae's credit guaranty business would charge for a pool of loans with similar characteristics was subtracted from the weighted-average interest rate less servicing fees. The method for estimating this guaranty fee and the credit risk associated with the mortgage portfolio is described under "Guaranty Fee Income, Net."

The Corporation then employed an option-adjusted spread ("OAS") approach to estimate fair values for both notional MBS (the mortgage loan portfolio) and MBS held in portfolio. The OAS represents the risk premium or incremental interest spread over Treasury rates that is included in a security's yield to compensate an investor for the uncertain effects of embedded prepayment options on mortgages. The OAS was calculated using quoted market values for selected benchmark securities and provided a generally applicable return measure that considers the effect of prepayment risk and interest rate volatility.

Investments

Fair values of the Corporation's investment portfolio were based on actual quoted prices or prices quoted for similar financial instruments.

Cash and Cash Equivalents

The carrying amount of cash and cash equivalents was used as a reasonable estimate of their fair value.

Other Assets

Other assets include accrued interest receivable, net currency swap receivables, and several other smaller asset categories. The fair value of other assets, excluding certain deferred items that have no fair value, approximates their carrying amount. Net currency swap receivables, which are included in other assets at cost, are reclassified as a component of the fair value of the related foreign-denominated debt.

Guaranty Fee Income, Net

MBS are not assets owned by the Corporation, except when acquired for investment purposes, nor are MBS recorded as liabilities of the Corporation. On MBS outstanding, the Corporation receives a guaranty fee calculated on the outstanding principal balance of the related mortgages. The guaranty fee represents a future income stream for the Corporation. Under generally accepted accounting principles, this guaranty fee is recognized as income over the life of the securities. The Fair Value Balance Sheets reflect the present value of guaranty fees, net of estimated future administrative costs and credit losses and taking into account estimated prepayments.

The Corporation estimates the credit loss exposure attached to the notional MBS, MBS held in portfolio, and off-balance-sheet MBS where Fannie Mae has the primary risk of default. The Corporation deducts estimated credit losses from the projected guaranty fee cash flows to arrive at the fair value. Estimated credit losses are calculated with an internal forecasting model based on actual

FANNIE MAE

NOTES TO FINANCIAL STATEMENTS— (Continued)

historical loss experience for the Corporation. The net guaranty fee cash flows are then valued through an OAS method similar to that described under “Mortgage Portfolio, Net.”

Swap Obligations, Net

The Corporation enters into interest rate swaps, including callable swaps that, in general, extend or adjust the effective maturity of certain debt obligations. Under these swaps, the Corporation generally pays a fixed rate and receives a floating rate based on a notional principal amount. The Corporation also enters into interest rate swaps that are linked to specific investments (asset swaps) or specific debt issues (debt swaps). The fair values of interest rate swaps are estimated based on either expected cash flows or quoted market values of these instruments. The effect of master netting agreements is included in determining swap obligations in a gain position or loss position.

Other Off-Balance-Sheet Items

The Corporation issues mandatory delivery commitments to purchase mortgages or issue MBS. Under mandatory delivery commitments, lenders are obligated to sell mortgages to the Corporation at the commitment yield. In certain instances, the Corporation enters into MBS sales commitments related to the commitments to purchase mortgages.

Mandatory commitments to purchase mortgages have been valued on the basis of the yield differential between required mortgage yields at the balance sheet date and actual commitment yields, discounted over the estimated life of the assets to be delivered, plus the estimated value of the expected guaranty fee, calculated as described under “Mortgage Portfolio, Net.” MBS sales commitments have been valued on the basis of the differential between MBS market prices at the balance sheet date and the prices on MBS sales commitments. Mandatory commitments to issue MBS have been valued on the basis of the expected guaranty fee stream, as described above.

Noncallable and Callable Debt

The fair value of the Corporation’s noncallable debt was estimated by using quotes for selected debt securities of the Corporation with similar terms. Similar to the valuation of the mortgage portfolio, the fair value of callable debt was estimated with an OAS model.

Other Liabilities

Other liabilities include accrued interest payable, amounts payable to MBS holders, estimated losses on MBS, net currency swap payables, and several other smaller liability categories. The fair value of other liabilities, excluding certain deferred items that have no fair value, approximates their carrying amount, except for net currency swap payables, which are included as a component of the fair value of the related foreign-denominated debt, and credit loss exposure for MBS, which is included as a component of the net MBS guaranty fee.

The fair value amount also includes the estimated effect on deferred income taxes of providing for federal income taxes, at the statutory corporate tax rate of 35 percent, for the difference between net assets at fair value and at cost.

FANNIE MAE

QUARTERLY RESULTS OF OPERATIONS (Unaudited)

The following unaudited results of operations include, in the opinion of management, all adjustments necessary for a fair presentation of the results of operations for such periods.

	1997 Quarter Ended			
	December	September	June	March
	(Dollars in millions, except per common share amounts)			
Interest income.....	\$6,884	\$6,651	\$6,514	\$6,329
Interest expense.....	<u>5,848</u>	<u>5,658</u>	<u>5,544</u>	<u>5,379</u>
Net interest income.....	1,036	993	970	950
Guaranty fees.....	324	320	317	313
Miscellaneous income, net.....	29	33	33	30
Provision for losses.....	—	(20)	(40)	(40)
Foreclosed property expenses.....	(77)	(71)	(61)	(66)
Administrative expenses.....	<u>(167)</u>	<u>(159)</u>	<u>(159)</u>	<u>(151)</u>
Income before federal income taxes and extraordinary item.....	1,145	1,096	1,060	1,036
Provision for federal income taxes.....	<u>(339)</u>	<u>(319)</u>	<u>(309)</u>	<u>(302)</u>
Income before extraordinary item.....	806	777	751	734
Extraordinary item—early extinguishment of debt (net of tax effect).....	<u>(12)</u>	<u>(2)</u>	<u>2</u>	<u>—</u>
Net income.....	<u>\$ 794</u>	<u>\$ 775</u>	<u>\$ 753</u>	<u>\$ 734</u>
Preferred stock dividends.....	<u>(16)</u>	<u>(16)</u>	<u>(17)</u>	<u>(16)</u>
Net income available to common stockholders..	<u>\$ 778</u>	<u>\$ 759</u>	<u>\$ 736</u>	<u>\$ 718</u>
Basic earnings per common share (1):				
Earnings before extraordinary item.....	\$.76	\$.73	\$.70	\$.68
Extraordinary item.....	<u>(.01)</u>	<u>—</u>	<u>—</u>	<u>—</u>
Net earnings.....	<u>\$.75</u>	<u>\$.73</u>	<u>\$.70</u>	<u>\$.68</u>
Diluted earnings per common share (1):				
Earnings before extraordinary item.....	\$.75	\$.72	\$.69	\$.67
Extraordinary item.....	<u>(.01)</u>	<u>—</u>	<u>—</u>	<u>—</u>
Net earnings.....	<u>\$.74</u>	<u>\$.72</u>	<u>\$.69</u>	<u>\$.67</u>
Cash dividends per common share.....	\$.21	\$.21	\$.21	\$.21

(1) The total of the four quarters does not equal the amount for the year because the amount for each period is calculated independently based on the weighted-average number of common shares outstanding during the period. The earnings per common share amounts have been restated to comply with Statement of Financial Accounting Standards No. 128, "Earnings per Share."

FANNIE MAE

QUARTERLY RESULTS OF OPERATIONS (Unaudited) — (Continued)

	1996 Quarter Ended			
	December	September	June	March
	(Dollars in millions, except per common share amounts)			
Interest income	\$6,190	\$5,993	\$5,832	\$5,757
Interest expense	5,267	5,093	4,948	4,872
Net interest income	923	900	884	885
Guaranty fees	308	304	296	288
Miscellaneous income, net	28	20	18	20
Provision for losses	(50)	(50)	(50)	(45)
Foreclosed property expenses	(56)	(52)	(53)	(53)
Administrative expenses	(145)	(142)	(138)	(135)
Income before federal income taxes and extraordinary item	1,008	980	957	960
Provision for federal income taxes	(295)	(289)	(282)	(285)
Income before extraordinary item	713	691	675	675
Extraordinary item—early extinguishment of debt (net of tax effect)	—	—	(8)	(21)
Net income	<u>\$ 713</u>	<u>\$ 691</u>	<u>\$ 667</u>	<u>\$ 654</u>
Preferred stock dividends	(17)	(12)	(11)	(2)
Net income available to common stockholders . .	<u>\$ 696</u>	<u>\$ 679</u>	<u>\$ 656</u>	<u>\$ 652</u>
Basic earnings per common share (1):				
Earnings before extraordinary item	\$.66	\$.64	\$.62	\$.62
Extraordinary item	—	—	(.01)	(.02)
Net earnings	<u>\$.66</u>	<u>\$.64</u>	<u>\$.61</u>	<u>\$.60</u>
Diluted earnings per common share (1):				
Earnings before extraordinary item	\$.65	\$.63	\$.61	\$.61
Extraordinary item	—	—	—	(.01)
Net earnings	<u>\$.65</u>	<u>\$.63</u>	<u>\$.61</u>	<u>\$.60</u>
Cash dividends per common share	\$.19	\$.19	\$.19	\$.19

(1) The total of the four quarters does not equal the amount for the year because the amount for each period is calculated independently based on the weighted-average number of common shares outstanding during the period. The earnings per common share amounts have been restated to comply with Statement of Financial Accounting Standards No. 128, "Earnings per Share."

FANNIE MAE

NET INTEREST INCOME AND AVERAGE BALANCES (Unaudited)

	1997	1996	1995
	(Dollars in millions)		
Interest income:			
Mortgage portfolio	\$ 22,716	\$ 20,560	\$ 18,154
Investments and cash equivalents	3,662	3,212	2,917
Total interest income	26,378	23,772	21,071
Interest expense(1):			
Short-term debt	3,659	3,395	3,994
Long-term debt	18,770	16,785	14,030
Total interest expense	22,429	20,180	18,024
Net interest income	3,949	3,592	3,047
Tax equivalent adjustment (2)	283	247	211
Net interest income tax equivalent basis	\$ 4,232	\$ 3,839	\$ 3,258
Average balances:			
Interest-earning assets(3):			
Mortgage portfolio, net	\$298,698	\$268,629	\$232,558
Investments and cash equivalents	63,441	57,161	48,143
Total interest-earning assets	\$362,139	\$325,790	\$280,701
Interest-bearing liabilities(1):			
Short-term debt	\$ 68,691	\$ 63,974	\$ 67,886
Long-term debt	277,129	246,733	199,497
Total interest-bearing liabilities	345,820	310,707	267,383
Interest-free funds	16,319	15,083	13,318
Total interest-bearing liabilities and interest-free funds	\$362,139	\$325,790	\$280,701
Average interest rates(2):			
Interest-earning assets:			
Mortgage portfolio, net	7.67%	7.71%	7.85%
Investments and cash equivalents	5.82	5.68	6.15
Total interest-earning assets	7.34	7.36	7.56
Interest-bearing liabilities(1):			
Short-term debt	5.29	5.22	5.85
Long-term debt	6.77	6.82	7.06
Total interest-bearing liabilities	6.48	6.49	6.75
Investment spread(4) .....	.86	.87	.81
Interest-free return(5) .....	.31	.31	.35
Net interest margin(6)	1.17%	1.18%	1.16%

- (1) Classification of interest expense and interest-bearing liabilities as short-term or long-term is based on effective maturity or repricing date, taking into consideration the effect of interest rate swaps.
- (2) Reflects pro forma adjustments to permit comparison of yields on tax-advantaged and taxable assets.
- (3) Includes average balance of nonperforming loans of \$2.2 billion in 1997 and 1996, and \$2.0 billion 1995.
- (4) Consists primarily of the difference between the yield on interest-earning assets, adjusted for tax benefits of nontaxable income, and the effective cost of funds on interest-bearing liabilities.
- (5) Consists primarily of the return on that portion of the investment portfolio funded by equity and non-interest-bearing liabilities.
- (6) Net interest income, on a tax equivalent basis, as a percentage of the average investment portfolio.

FANNIE MAE

RATE/VOLUME ANALYSIS (Unaudited)

	<u>Increase (Decrease)</u>	<u>Attributable to changes in (1)</u>	
		<u>Volume</u>	<u>Rate</u>
(Dollars in millions)			
<u>1997 vs. 1996</u>			
Interest income:			
Mortgage portfolio	\$2,156	\$2,287	\$(131)
Investments and cash equivalents	<u>450</u>	<u>361</u>	<u>89</u>
Total interest income	<u>2,606</u>	<u>2,648</u>	<u>(42)</u>
Interest expense(2):			
Short-term debt	264	251	13
Long-term debt	<u>1,985</u>	<u>2,059</u>	<u>(74)</u>
Total interest expense	<u>2,249</u>	<u>2,310</u>	<u>(61)</u>
Net interest income	<u>\$ 357</u>	<u>\$ 338</u>	<u>\$ 19</u>
<u>1996 vs. 1995</u>			
Interest income:			
Mortgage portfolio	\$2,406	\$2,767	\$(361)
Investments and cash equivalents	<u>295</u>	<u>518</u>	<u>(223)</u>
Total interest income	<u>2,701</u>	<u>3,285</u>	<u>(584)</u>
Interest expense(2):			
Short-term debt	(599)	(222)	(377)
Long-term debt	<u>2,755</u>	<u>3,227</u>	<u>(472)</u>
Total interest expense	<u>2,156</u>	<u>3,005</u>	<u>(849)</u>
Net interest income	<u>\$ 545</u>	<u>\$ 280</u>	<u>\$ 265</u>

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- (1) Combined rate/volume variances, a third element of the calculation, are allocated to the rate and volume variances based on their relative size.
 - (2) Classification of interest expense and interest-bearing liabilities as short-term or long-term is based on the effective maturity or repricing date, taking into consideration the effect of interest rate swaps.

MANAGEMENT

Directors

The age and background, as of March 31, 1998, of each of the members of the Board of Directors of the Corporation are as follows:

<u>Name and Age</u>	<u>Principal Occupation, Business Experience, and Residence</u>	<u>First Became Director</u>	<u>Other Directorships (1)</u>
Stephen B. Ashley, 58	Chairman and Chief Executive Officer, The Ashley Group, a group of commercial and multi-family real estate, brokerage and investment companies, January 1997 to present; Chairman and Chief Executive Officer, Sibley Mortgage Corporation, a mortgage banking company, 1985 to 1996; Chairman and Chief Executive Officer, Sibley Real Estate Services, Inc., a property management company, 1985 to 1996; Livonia, New York	1995	The Genesee Corporation; Hahn Automotive Warehouse, Inc.; Manning & Napiers Advisors, Inc.
Roger E. Birk, 67	Former President and Chief Operating Officer of the Corporation, November 1987 until his retirement in January 1992; Tequesta, Florida	1985	Golden Bear Golf; Mutual of America Capital Corp.; Penske Transportation; WellPoint Health Networks Inc.
Stephen Friedman, 60	Senior Chairman and Limited Partner, December 1994 to present, Co-Chairman or sole Chairman, December 1990 to November 1994, Goldman, Sachs & Co., an investment banking firm; New York, NY	1996	Wal-Mart Stores, Inc.
Thomas P. Gerrity, 56	Dean of The Wharton School of the University of Pennsylvania, an educational institution, July 1990 to present; President of CSC Consulting, a subsidiary of Computer Sciences Corporation, and Vice President of Computer Sciences Corporation, May 1989 to June 1990; Chairman and Chief Executive Officer, Index Group, a technology-oriented consulting company, 1969 to April 1989; Haverford, Pennsylvania	1991	CVS Corporation; Digital Equipment Corporation; Reliance Group Holdings, Inc.; Sun Company, Inc.; Union Carbide Corporation
Jamie S. Gorelick, 47	Vice Chair of the Corporation, May 1997 to present; Deputy Attorney General of the United States, March 1994 to April 1997; General Counsel to the U.S. Department of Defense, May 1993 to March 1994; Partner, Miller, Cassidy, Larroca & Lewin, a law firm, January 1981 to April 1993; Chevy Chase, Maryland	1997	
James A. Johnson, 54	Chairman of the Board of Directors and Chief Executive Officer of the Corporation, February 1991 to present; Vice Chairman of the Board of the Corporation, January 1990 to January 1991; Managing Director, Shearson Lehman Brothers, Inc., an investment banking firm, April 1985 to December 1989; Washington, D.C.	1990	Dayton Hudson Corporation; Kaufman and Broad Home Corporation; United HealthCare Corporation
Thomas A. Leonard(2), 51	Partner, Obermayer, Rebmann, Maxwell & Hippel, a law firm, January 1992 to present; Philadelphia, Pennsylvania	1993	
Vincent A. Mai, 57	President and Chief Executive Officer, AEA Investors Inc., a private investment company, April 1989 to present; Managing Director, Shearson Lehman Brothers, Inc., an investment banking firm, 1974 to April 1989; Port Washington, New York	1991	

<u>Name and Age</u>	<u>Principal Occupation, Business Experience, and Residence</u>	<u>First Became Director</u>	<u>Other Directorships (1)</u>
Ann McLaughlin, 56	Chairman, October 1996 to present, Vice Chairman, August 1993 to September 1996, The Aspen Institute, a nonprofit organization; President, Federal City Council, May 1990 to September 1995; President and Chief Executive Officer, New American Schools Development Corporation, June 1992 to April 1993; Visiting Fellow, Urban Institute, January 1989 to June 1992; Chairman, President's Commission on Aviation Security and Terrorism, September 1989 to May 1990; U.S. Secretary of Labor, December 1987 to December 1989; Washington, D.C.	1994	AMR Corporation (and its subsidiary, American Airlines); Donna Karan International Inc.; General Motors Corporation; Harman International Industries, Inc.; Host Marriott Corporation; Kellogg Company; Nordstrom Inc.; Potomac Electric Power Company; Sedgwick Group, plc; Union Camp Corporation; Vulcan Materials Company
Kevin M. O'Keefe(2), 50	Partner, O'Keefe, Ashendon, Lyons & Ward, a law firm; Deputy Assistant to the President of the United States in Intergovernmental Affairs, June 1994 to April 1997; Special Assistant to the President of the United States for Presidential Personnel, January 1993 to April 1994; Chicago, Illinois	1997	
Richard D. Parsons, 49	President, Time Warner Inc., a media and entertainment corporation, January 1995 to present; Chairman of the Board and Chief Executive Officer, January 1991 to January 1995, President and Chief Executive Officer, July 1990 to January 1991, and President and Chief Operating Officer, July 1988 to June 1990, The Dime Savings Bank of New York, FSB, a financial institution; Pocantico Hills, New York	1989	Citicorp; Philip Morris Companies, Inc.; Time Warner Inc.
Joe K. Pickett, 52	Chairman and Chief Executive Officer, HomeSide Lending, Inc. (successor entity to BancBoston Mortgage Corporation), a mortgage banking company, April 1990 to present; Jacksonville, Florida	1996	Dal-Tile International Inc.
Eli J. Segal(2), 54	President and Chief Executive Officer of The Welfare to Work Partnership, a non-profit organization, February 1997 to present; Assistant to the President of the United States, January 1993 to February 1996; Washington, D.C.	1997	
Antonia Shusta, 48	Chief Executive Officer of Consumer Businesses, Pacific Financial Group, a group of financial services companies, since January 1997; Group Executive, Household International, a financial services company, April 1988 to February 1995; Chairman, President and Chief Executive Officer, Household Bank, F.S.B., a wholly-owned subsidiary of Household International, 1990 to January 1995; Key Biscayne, Florida	1994	
Lawrence M. Small, 56	President and Chief Operating Officer of the Corporation, February 1992 to present; President and Chief Operating Officer-Designate of the Corporation, September 1991 to January 1992; Vice Chairman and Chairman of the Executive Committee, January 1990 to July 1991, Sector Executive, January 1985 to December 1989, Citicorp/Citibank, a financial institution; Washington, D.C.	1991	The Chubb Corporation; Marriott International, Inc.
Kathryn G. Thompson (2), 57	Chairman and Chief Executive Officer, Kathryn G. Thompson Construction Company, a building and development company, 1967 to present; Dana Point, California	1995	

<u>Name and Age</u>	<u>Principal Occupation, Business Experience, and Residence</u>	<u>First Became Director</u>	<u>Other Directorships (1)</u>
José H. Villarreal(2), 44	Partner, Akin, Gump, Strauss, Hauer & Feld, L.L.P., a law firm, August 1994 to present; Partner, McGinnis, Lochridge & Kilgore, L.L.P., a law firm, July 1993 to August 1994; Associate Director, White House Office of Presidential Personnel, April 1993 to June 1993; Presidential Transition Team, November 1992 to March 1993; Deputy Campaign Manager, Clinton Campaign, June 1992 to November 1992; Associate, McGinnis, Lochridge & Kilgore, February 1991 to May 1992; San Antonio, Texas	1993	
Karen Hastie Williams, 53	Partner, Crowell & Moring, a law firm practicing in the District of Columbia, 1982 to present; Washington, D.C.	1988	Continental Airlines, Inc.; Crestar Financial Corporation; SunAmerica Inc.; Washington Gas Company

(1) Companies with a class of securities registered pursuant to Section 12 of the Securities Exchange Act of 1934 or subject to the requirements of Section 15(d) of that Act or any company registered as an investment company under the Investment Company Act of 1940. Certain directorships of other companies are also noted in the occupation column.

(2) Appointed by the President of the United States, who has authority to appoint five directors.

The term of each director will end on the date of the May 1998 annual meeting of stockholders, except that the President of the United States may remove any director that the President appointed for good cause.

Executive Officers

The age and business experience, as of March 31, 1998, of each of the executive officers of the Corporation, are as follows:

James A. Johnson, 54, has been Chairman of the Board of Directors and Chief Executive Officer since February 1991. Mr. Johnson was Vice Chairman of the Board of Directors from January 1990 to January 1991. Mr. Johnson was a Managing Director in Corporate Finance at Shearson Lehman Brothers, Inc. from April 1985 to December 1989.

Lawrence M. Small, 56, has been President and Chief Operating Officer since February 1992. Mr. Small was President and Chief Operating Officer-Designate of the Corporation from September 1991 to January 1992. Prior to his employment with the Corporation, Mr. Small was with Citicorp/Citibank, where he was Vice Chairman and Chairman of the Executive Committee from January 1990 to July 1991.

Jamie S. Gorelick, 47, has been Vice Chair since May 1997. Ms. Gorelick was Deputy Attorney General of the United States from March 1994 to April 1997. Ms. Gorelick served as General Counsel to the United States Department of Defense from May 1993 to March 1994 and was a Partner with Miller, Cassidy, Larroca & Lewin, a law firm, from January 1981 to April 1993.

J. Timothy Howard, 49, has been Executive Vice President and Chief Financial Officer since February 1990.

William E. Kelvie, 50, has been Executive Vice President and Chief Information Officer since November 1992.

Robert J. Levin, 42, has been Executive Vice President—Marketing since June 1990.

Ann D. Logan, 43, has been Executive Vice President and Chief Credit Officer since May 1993. Ms. Logan has been an Executive Vice President since January 1993 and was Senior Vice President—Northeastern Regional Office from June 1989 to January 1993.

Glenn T. Austin, Jr., 49, has been Senior Vice President—Southeastern Regional Office since May 1985.

Kenneth J. Bacon, 43, has been Senior Vice President—Northeastern Regional Office since April 1993. Mr. Bacon was Director of the Office of Securitization at the Resolution Trust Corporation (“RTC”) from February 1991 to April 1993.

John Buckley, 41, has been Senior Vice President—Communications since November 1991.

Donna Callejon, 35, has been Senior Vice President—Corporate Development since July 1996. Ms. Callejon was Senior Vice President—Single-Family Marketing from November 1991 to July 1996.

William G. Ehrhorn, 49, has been Senior Vice President—Mortgage Operations since May 1993.

Elizabeth S. Harshfield, 44, has been Senior Vice President—Western Regional Office since February 1996. Ms. Harshfield was Senior Vice President—Investor Relations from April 1994 to February 1996 and Vice President and Assistant to the Chairman of the Corporation from July 1992 to April 1994.

John R. Hayes, 59, has been Senior Vice President—Midwestern Regional Office since November 1985.

Lynda C. Horvath, 45, has been Senior Vice President—Capital Markets since July 1996. Ms. Horvath was Senior Vice President—Corporate Development from May 1993 to July 1996. Ms. Horvath was Senior Vice President—Mortgage Operations from February 1991 to May 1993.

Louis W. Hoyes, 49, has been Senior Vice President—Multifamily Lending and Investment since July 1995. Prior to his employment with the Corporation, Mr. Hoyes was Managing Director of the residential segment of Citicorp’s Real Estate business in North America, where he held a number of other positions after joining Citicorp/Citibank in 1973.

Anastasia D. Kelly, 48, has been Senior Vice President and General Counsel since November 1996. She was Senior Vice President and Deputy General Counsel from April 1995 to November 1996. Prior to her employment with the Corporation, Ms. Kelly was a partner in the law firm of Wilmer, Cutler & Pickering in Washington, D.C., which she joined in 1985.

Linda K. Knight, 48, has been Senior Vice President and Treasurer since February 1993. Ms. Knight was Vice President and Assistant Treasurer from November 1986 to February 1993.

Thomas A. Lawler, 45, has been Senior Vice President—Portfolio Management since November 1989.

Thomas A. Lund, 39, has been Senior Vice President—Southwestern Regional Office since July 1996. Mr. Lund was Vice President—Marketing in the Southwestern Regional Office from January 1995 to July 1996. Prior to his employment with the Corporation, Mr. Lund was Senior Vice President and General Manager for Negotiated Transactions for the GE Capital Mortgage Corporation from 1990 to 1994.

William R. Maloni, 53, has been Senior Vice President—Government and Industry Relations since November 1995. Mr. Maloni was Senior Vice President—Policy and Public Affairs from March 1989 to November 1995.

Adolfo Marzol, 37, has been Senior Vice President—Single-Family Business Management since July 1996. Mr. Marzol was Senior Vice President—Capital Markets from February 1996 to July 1996. Mr. Marzol was Executive Vice President and Chief Financial Officer of Chase Manhattan Mortgage Corporation, a mortgage company, from July 1993 to January 1996 and Senior Vice President—Interest Rate Risk of that firm from February 1991 to June 1993.

Thomas R. Nides, 37, has been Senior Vice President—Human Resources since November 1997 and was Vice President—Human Resources from May 1997 to November 1997. Mr. Nides was a

Principal with Morgan Stanley from April 1996 to April 1997. Mr. Nides was the Corporation's Vice President—Housing Impact from January 1995 to April 1996. He was Chief of Staff to the United States Trade Representative from May 1993 to December 1994 and Executive Assistant to the Speaker of the House from May 1989 to May 1993.

Michael A. Quinn, 43, has been Senior Vice President—Credit Loss Management since April 1994. Mr. Quinn was Senior Vice President and Controller from March 1991 to April 1994.

Sampath Rajappa, 52, has been Senior Vice President and Controller since April 1994. Mr. Rajappa joined the Corporation in March 1994 as Corporate Controller. Prior thereto, Mr. Rajappa was Senior Vice President and Controller for ITT Residential Capital Corporation, a mortgage banking company, from August 1993 to February 1994.

Jayne J. Shontell, 43, has been Senior Vice President—Investor Relations since February 1996. Ms. Shontell was Senior Vice President—Financial and Information Services from November 1992 to February 1996.

Michael Williams, 40, has been Senior Vice President—Customer Technology Services since February 1996. Mr. Williams was Senior Vice President—Customer Applications and Technology Integration from November 1993 to January 1996.

Barry Zigas, 46, has been Senior Vice President and Executive Director—National Housing Impact Division since February 1996. Mr. Zigas was Senior Vice President—Housing Impact Policy from November 1995 to January 1996, and Vice President—Housing Impact from June 1993 to October 1995.

Additional Information

For information concerning executive compensation, stock ownership of management and directors, certain transactions of executive officers, and any person or group owning more than five percent of the voting stock of the Corporation, reference is made to the Corporation's proxy statement, dated March 24, 1997 for the Corporation's 1997 annual meeting of stockholders and any later proxy statement published prior to the Corporation's publication of a new Information Statement, which are incorporated herein by this reference. The proxy statement for the Corporation's 1998 annual meeting of stockholders will be available in April 1998.

The Corporation will provide without charge a copy of the Corporation's most recent proxy statement to each person to whom this Information Statement has been delivered, upon the written or oral request of such person. Requests for such copies should be directed to the office specified on page 2 of this Information Statement.

ACCOUNTANTS

The financial statements of the Corporation as of December 31, 1997 and 1996 and for each of the years in the three-year period ended December 31, 1997, included herein, have been included in reliance upon the report of KPMG Peat Marwick LLP, independent certified public accountants, and upon the authority of that firm as experts in accounting and auditing.

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**Supplement dated May 15, 1998 to
Information Statement dated March 31, 1998**



This Supplement describes the financial condition of the Federal National Mortgage Association (“Fannie Mae” or the “Corporation”) as of March 31, 1998 and contains unaudited financial statements with respect to the Corporation for the quarter ended March 31, 1998. This Supplement should be read in conjunction with the Corporation’s Information Statement dated March 31, 1998 (the “Information Statement”), which is hereby incorporated by reference. The Information Statement describes the business and operations of the Corporation and contains financial data as of December 31, 1997. Fannie Mae also periodically makes available statistical information on its mortgage purchase and mortgage-backed securities volumes as well as other relevant information about Fannie Mae. Copies of the Corporation’s current Information Statement, any supplements thereto and other available information, including the Corporation’s Proxy Statement dated March 30, 1998, can be obtained without charge from the Office of Investor Relations, Fannie Mae, 3900 Wisconsin Avenue, N.W., Washington, D.C. 20016 (telephone: 202/752-7115).

In connection with its offerings of securities, the Corporation may incorporate this Supplement by reference in one or more other documents describing the securities offered thereby, the selling arrangements therefor and other relevant information. Such other documents may be called an Offering Circular, a Prospectus or otherwise. This Supplement does not offer any securities for sale.

Fannie Mae is a federally chartered corporation. Its principal office is located at 3900 Wisconsin Avenue, N.W., Washington, D.C. 20016 (202/752-7000). Its Internal Revenue Service employer identification number is 52-0883107.

The Corporation’s securities are not required to be registered under the Securities Act of 1933. At the close of business on April 30, 1998, approximately 1,030 million shares of the Corporation’s common stock (without par value) were outstanding.

The delivery of this Supplement at any time shall not under any circumstances create an implication that there has been no change in the affairs of the Corporation since the date hereof or that the information contained herein is correct as of any time subsequent to its date.

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SELECTED FINANCIAL DATA

The following selected financial data for the three months ended March 31, 1998 and 1997 are unaudited and include, in the opinion of management, all adjustments (consisting of normal recurring accruals) necessary for a fair presentation. Certain amounts in 1997 have been reclassified to conform with current presentation. Operating results for the three months ended March 31, 1998 are not necessarily indicative of the results expected for the entire year.

(Dollars and shares in millions, except per share amounts)

Income Statement Data for the three months ended March 31:	<u>1998</u>	<u>1997</u>
Interest income	\$ 7,025	\$ 6,329
Interest expense	5,989	5,379
Net interest income	1,036	950
Guaranty fees	321	313
Miscellaneous income, net	56	30
Credit-related expenses	(77)	(106)
Administrative expenses	(170)	(151)
Income before federal income taxes and extraordinary item	1,166	1,036
Provision for federal income taxes	(334)	(302)
Income before extraordinary item	832	734
Extraordinary loss—early extinguishment of debt, net of tax effect	(8)	—
Net income	<u>\$ 824</u>	<u>\$ 734</u>
Preferred stock dividends	(16)	(16)
Net income available to common stockholders	<u>\$ 808</u>	<u>\$ 718</u>
Basic earnings per common share(1):		
Earnings before extraordinary item	\$.79	\$.68
Extraordinary item	(.01)	—
Net earnings	<u>\$.78</u>	<u>\$.68</u>
Diluted earnings per common share(1):		
Earnings before extraordinary item	\$.78	\$.67
Extraordinary item	(.01)	—
Net earnings	<u>\$.77</u>	<u>\$.67</u>
Balance Sheet Data at March 31:		
Mortgage portfolio, net	\$326,909	\$291,441
Investments	67,209	57,117
Total assets	403,993	357,010
Borrowings:		
Due within one year	168,919	159,071
Due after one year	212,174	177,103
Total liabilities	389,922	343,832
Stockholders' equity	14,071	13,178
Capital(2)	14,854	13,926
Other Data for the three months ended March 31:		
Average net interest margin	1.14%	1.17%
Return on average common equity	25.0	24.0
Dividend payout ratio	30.8	31.1
Average effective guaranty fee rate .....	.219	.227
Credit loss ratio(3) .....	.034	.046
Ratio of earnings to combined fixed charges and preferred stock dividends(4) ...	1.19:1	1.19:1
Mortgage purchases	\$ 28,372	\$ 12,996
MBS issued	58,259	30,881
MBS outstanding at period end(5)	730,832	663,668
Weighted-average diluted common shares outstanding	1,045	1,069

(1) Earnings per common share amounts for 1997 have been restated to comply with Statement of Financial Accounting Standards No. 128, *Earnings per Share*.

(2) Stockholders' equity plus general allowance for losses.

(3) Charge-offs and foreclosure expense as a percentage of average net portfolio and net MBS outstanding.

(4) "Earnings" consists of (i) income before federal income taxes and extraordinary item and (ii) fixed charges. "Fixed charges" represents interest expense.

(5) Includes \$138 billion and \$110 billion of MBS in portfolio at March 31, 1998 and 1997, respectively.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS FOR THE THREE MONTHS ENDED MARCH 31, 1998

Results of Operations

In the first quarter of 1998, Fannie Mae reported record earnings of \$824 million, compared with \$734 million in the first quarter of 1997. The 12 percent increase in earnings was primarily due to increases in net interest income and miscellaneous income, and lower credit-related expenses.

Net interest income in the first quarter of 1998 increased 9 percent, compared with the first quarter of 1997. The growth in net interest income was primarily a result of a 12 percent growth in the average investment portfolio, which was partly offset by a 3 basis point decrease in the net interest margin. Management expects that the net interest margin will continue to decline somewhat in 1998.

The following table presents an analysis of net interest income for the three months ended March 31, 1998 and 1997.

Net Interest Income and Average Balances

(Dollars in millions)

	Three Months Ended March 31,	
	1998	1997
Interest income:		
Mortgage portfolio	\$ 6,002	\$ 5,484
Investments and cash equivalents	1,023	845
Total interest income	<u>7,025</u>	<u>6,329</u>
Interest expense (1):		
Short-term debt	965	839
Long-term debt	5,024	4,540
Total interest expense	<u>5,989</u>	<u>5,379</u>
Net interest income	1,036	950
Tax equivalent adjustment (2)	72	67
Net interest income tax equivalent basis	<u>\$ 1,108</u>	<u>\$ 1,017</u>
Average balances:		
Interest-earning assets (3):		
Mortgage portfolio, net	\$319,888	\$287,896
Investments and cash equivalents	70,488	60,085
Total interest-earning assets	<u>\$390,376</u>	<u>\$347,981</u>
Interest-bearing liabilities (1):		
Short-term debt	\$ 71,782	\$ 64,545
Long-term debt	301,083	267,458
Total interest-bearing liabilities	<u>372,865</u>	<u>332,003</u>
Interest-free funds	17,511	15,978
Total interest-bearing liabilities and interest-free funds	<u>\$390,376</u>	<u>\$347,981</u>
Average interest rates (2):		
Interest-earning assets:		
Mortgage portfolio, net	7.55%	7.68%
Investments and cash equivalents	5.84	5.68
Total interest-earning assets	<u>7.24</u>	<u>7.34</u>
Interest-bearing liabilities (1):		
Short-term debt	5.33	5.16
Long-term debt	6.68	6.79
Total interest-bearing liabilities	<u>6.42</u>	<u>6.48</u>
Investment spread .....	.82	.86
Interest-free return (4) .....	.32	.31
Net interest margin (5)	<u>1.14%</u>	<u>1.17%</u>

- (1) Classification of interest expense and interest-bearing liabilities as short-term or long-term is based on effective maturity or repricing date, taking into consideration the effect of interest rate swaps.
- (2) Reflects pro forma adjustments to permit comparison of yields on tax-advantaged and taxable assets.
- (3) Includes average balance of nonperforming loans of \$2.6 billion and \$2.3 billion for the three months ended March 31, 1998 and 1997, respectively.
- (4) Consists primarily of the return on that portion of the investment portfolio funded by equity and non-interest-bearing liabilities.
- (5) Net interest income, on a tax equivalent basis, as a percentage of the average investment portfolio.

The following rate/volume analysis shows the relative contribution of asset and debt growth and interest rate changes to changes in net interest income for the three months ended March 31, 1998 and 1997.

Rate / Volume Analysis

(Dollars in millions)

<u>First Quarter 1998 vs. First Quarter 1997</u>	<u>Increase (Decrease)</u>	<u>Attributable to Changes in (1)</u>	
		<u>Volume</u>	<u>Rate</u>
Interest income:			
Mortgage portfolio	\$518	\$601	\$(83)
Investments and cash equivalents	<u>178</u>	<u>150</u>	<u>28</u>
Total interest income	<u>696</u>	<u>751</u>	<u>(55)</u>
Interest expense:			
Short-term debt	126	96	30
Long-term debt	<u>484</u>	<u>562</u>	<u>(78)</u>
Total interest expense	<u>610</u>	<u>658</u>	<u>(48)</u>
Net interest income	<u>\$ 86</u>	<u>\$ 93</u>	<u>\$ (7)</u>

(1) Combined rate/volume variances, a third element of the calculation, are allocated to the rate and volume variances based on their relative size.

Guaranty fee income increased by \$8 million, or 3 percent, to \$321 million, compared with \$313 million in the first quarter of 1997. This change resulted from a 6 percent increase in average net Mortgage-Backed Securities (“MBS”) outstanding which was partially offset by a .8 basis point decrease in the effective average guaranty fee rate when compared with the first quarter of 1997. The decrease in the effective average guaranty fee rate was due to repayments of loans backing MBS with high fees, and an increase in the guaranty fees associated with MBS purchased for portfolio being included in net interest income.

In the first three months of 1998, miscellaneous income increased 87 percent to \$56 million versus \$30 million in the first three months of 1997. The increase in miscellaneous income was primarily the result of higher technology and special transaction fees.

Administrative expenses for the quarter ended March 31, 1998 increased to \$170 million from \$151 million during the same period in 1997, primarily due to higher compensation costs. Compensation expense was \$107 million in the first quarter of 1998, compared with \$94 million in the first quarter of 1997. The ratio of administrative expenses to the average mortgage portfolio plus average MBS outstanding was .075 percent in the first quarter of 1998 and .072 percent in the first quarter of 1997. The ratio of administrative expenses to revenues (net interest income, guaranty fees and miscellaneous income) was 12.0 percent for the first quarter of 1998, compared with 11.6 percent for the first quarter of 1997.

The effective federal income tax rate for the first three months of 1998 and 1997 was 29 percent.

The Corporation had extraordinary losses of \$13 million (\$8 million after tax) from the repurchase or call of debt in the first quarter of 1998. The Corporation had less than \$1 million in extraordinary losses from the call or repurchase of debt in the first quarter of 1997.

Credit Data

The following table shows the Corporation's serious delinquencies for conventional loans in portfolio and underlying MBS at March 31, 1998 and 1997, and conventional properties acquired and total net recoveries or charge-offs for the three months ended March 31, 1998 and 1997.

	Delinquency Rate (1)		Number of Properties Acquired		Net (Recoveries) / Charge-offs	
	March 31, 1998	March 31, 1997	March 31, 1998	March 31, 1997	March 31, 1998	March 31, 1997
	(Dollars in millions)					
Single-family . . .	.61%	.59%	5,658	5,431	\$(7)	\$30
Multifamily . . . .	.36	.58	4	8	3	1
Total					<u>\$(4)</u>	<u>\$31</u>

- (1) Single-family serious delinquencies consist of those loans in the portfolio or underlying MBS for which the Corporation has the primary risk of loss that are 90 or more days delinquent or in foreclosure. Multifamily serious delinquencies are those loans in the portfolio or underlying MBS that are 60 days or more delinquent for which the Corporation has primary risk of loss. The single-family and multifamily percentages are based on the number of such single-family loans and dollar amount of such multifamily loans, respectively, in the portfolio and underlying MBS.

Total credit-related losses, which include loan charge-offs, net of recoveries, and foreclosed property expenses, were \$78 million for the three months ended March 31, 1998, compared with \$97 million for the same period in 1997. The change in credit-related losses was the result of a decrease in charge-offs slightly offset by an increase in foreclosure expenses. The decrease in charge-offs was due to net recoveries on foreclosed properties in the first quarter of 1998 versus net charge-offs in the first quarter of 1997. In addition to the Corporation's loss mitigation efforts, a strong economy, strong housing market, and deeper mortgage insurance requirements on higher loan-to-value ratio loans have contributed to reducing credit-related losses.

The inventory of single-family properties was 9,614 as of March 31, 1998, compared with 9,582 as of March 31, 1997. The inventory of multifamily properties was 17 as of March 31, 1998, compared with 27 as of March 31, 1997.

Total credit-related expenses, which include foreclosed property expenses and the provision for losses, were \$77 million in the first quarter of 1998, compared with \$106 million in the first quarter of 1997. This decrease was due to a negative \$5 million provision recorded in the first quarter of 1998, compared to a \$40 million loss provision recorded in the first quarter of 1997.

The allowance for losses increased to \$802 million at March 31, 1998 from \$789 million at December 31, 1997. Management anticipates that the provision for losses will be adjusted periodically in line with its analysis of actual and expected loss experience.

Balance Sheet Analysis

Mortgage Portfolio

The Corporation purchased \$28 billion of mortgages at an average yield of 6.79 percent in the first quarter of 1998, compared with \$13 billion of mortgages at an average yield of 7.58 percent in the first quarter of 1997. The increase in mortgage purchases was primarily due to the availability of mortgages offered for sale in the secondary market.

Mortgage loan repayments during the first quarter of 1998 totaled \$17 billion, compared with \$7 billion in the first quarter of 1997. The increase in loan repayments was primarily due to an

increased level of refinance activity. Sales from portfolio were insignificant for the first three months of 1998 and 1997.

As of March 31, 1998, the net mortgage portfolio totaled \$327 billion with a yield (before deducting the allowance for losses) of 7.50 percent, compared with \$316 billion at 7.60 percent at December 31, 1997, and \$291 billion at 7.68 percent at March 31, 1997. The decrease in yield was primarily due to increased prepayments of higher coupon mortgages and a decrease in conventional mortgage purchase yields as interest rates declined. The portfolio growth during the first quarter of 1998 was generated by the purchase of a combination of whole loans, MBS and REMICs. For the remainder of 1998, the Corporation expects that a high level of fixed-rate mortgage originations will lead to attractive portfolio investment opportunities and growth in the net mortgage portfolio.

At March 31, 1998, the Corporation had mandatory delivery commitments and lender option commitments outstanding to purchase \$12.6 billion and \$1.6 billion of mortgage loans, respectively, compared with \$3.6 billion and \$1.6 billion, respectively, of such commitments outstanding at December 31, 1997.

Financing and Other Activities

During the first three months of 1998, the Corporation issued \$218 billion of debt at an average cost of 5.62 percent and redeemed \$207 billion at an average cost of 5.75 percent. Debt issued in the first three months of 1997 totaled \$183 billion at an average cost of 5.48 percent, and debt redeemed was \$178 billion at an average cost of 5.45 percent. The average cost of debt outstanding at March 31, 1998, December 31, 1997, and March 31, 1997 was 6.38 percent, 6.46 percent and 6.50 percent, respectively.

The following table presents the amount of callable debt and the notional amount of callable swaps issued and outstanding at March 31, 1998 and March 31, 1997.

<u>(Dollars in billions)</u>	Three Months Ended	
	March 31,	
	<u>1998</u>	<u>1997</u>
Issued during the period	\$ 19	\$ 7
Percentage of total long-term debt issued(1)	54%	55%
Outstanding at end of period	\$140	\$130
Percentage of total long-term debt outstanding(1)	46%	48%

(1) Includes the notional amount of callable swaps, and excludes long-term debt with a repricing frequency of one year or less.

The following table summarizes the Corporation's interest rate swap activity, the notional amount of, and weighted-average interest rates to be received and paid on, interest rate swaps outstanding for the quarter ended March 31, 1998 together with the expected maturities and weighted-average interest rates to be received and paid on swaps outstanding at March 31, 1998.

Interest Rate Swap Activity and Maturity Data

	Generic-pay fixed/ receive variable (1)			Basis Swaps	Other (4)	Total
	Notional (2)	Pay Rate (3)	Receive Rate (3)			
	(Dollars in millions)					
Balance at December 31, 1997	\$96,713	6.77%	5.82%	\$22,383	\$29,653	\$148,749
Additions	—	—	—	3,585	7,436	11,021
Maturities	<u>6,993</u>	<u>6.74</u>	<u>5.85</u>	<u>4,370</u>	<u>5,351</u>	<u>16,714</u>
Balance at March 31, 1998	<u>\$89,720</u>	<u>6.77%</u>	<u>5.73%</u>	<u>\$21,598</u>	<u>\$31,738</u>	<u>\$143,056</u>
Balance at March 31, 1997	<u>\$99,085</u>	<u>6.75%</u>	<u>5.59%</u>	<u>\$37,897</u>	<u>\$21,176</u>	<u>\$158,158</u>
Future Maturities(5)						
1998	\$ 6,780	5.30%	5.75%	\$11,007	\$ 9,234	\$ 27,021
1999	5,575	6.65	5.35	7,901	8,810	22,286
2000	3,817	6.08	5.78	1,300	5,000	10,117
2001	7,600	6.65	5.68	—	2,650	10,250
2002	4,675	6.30	5.74	79	725	5,479
Thereafter	<u>61,273</u>	<u>7.04</u>	<u>5.76</u>	<u>1,311</u>	<u>5,319</u>	<u>67,903</u>
	<u>\$89,720</u>	<u>6.77%</u>	<u>5.73%</u>	<u>\$21,598</u>	<u>\$31,738</u>	<u>\$143,056</u>

- (1) Included in the notional amounts are callable swaps of \$22 billion, \$23 billion and \$27 billion with weighted-average pay rates of 6.60 percent, 6.58 percent and 6.68 percent and weighted-average receive rates of 5.82 percent, 5.89 percent and 5.61 percent, as of March 31, 1998, December 31, 1997 and March 31, 1997, respectively.
- (2) The notional value indicates only the amount on which swap payments are being calculated and does not represent the amount at risk of loss.
- (3) The weighted-average interest rate receivable and payable is as of the date indicated. Where the pay rate or receive rate is variable, the rate may change as prevailing interest rates change.
- (4) Amounts principally consist of generic-pay variable/receive fixed swaps.
- (5) Based on the swap's stated maturity. Assumes that variable interest rates remain constant at March 31, 1998 levels.

The contract amounts of other off-balance-sheet financial instruments, which included futures contracts and derivative instruments that simulate the short sale of Treasury securities to provide a hedge against interest rate fluctuations, credit enhancements and other guarantees, were \$13.1 billion at March 31, 1998 and \$11.5 billion at December 31, 1997.

The exposure to credit loss for interest rate swaps and other off-balance-sheet financial instruments was estimated by calculating the cost, on a present value basis, to replace at current market rates all those off-balance-sheet financial instruments outstanding for which the Corporation was in a gain position. The Corporation's net exposure at March 31, 1998 was \$42 million, compared with \$26 million at December 31, 1997. The exposure to credit loss can be expected to fluctuate significantly due to changes in interest rates.

Capital Resources

The Corporation's stockholders' equity at March 31, 1998 was \$14.1 billion, compared with \$13.8 billion at December 31, 1997, and \$13.2 billion at March 31, 1997. Pursuant, in part, to the capital restructuring program described in the Information Statement under "Management's Discussion and Analysis of Financial Condition and Results of Operations—Balance Sheet Analy-

sis—Liquidity and Capital Resources,” the Corporation repurchased 6.1 million common shares at a weighted-average cost of \$62.32 per common share during the first quarter of 1998 and issued 3.2 million common shares for employee and other stock compensation plans. As of March 31, 1998, there were approximately 1,034 million common shares outstanding.

On April 21, 1998, the Board of Directors approved a dividend for the quarter ended March 31, 1998 of \$0.24 per common share, and dividends of \$0.80125 per Series A preferred share, \$0.81250 per Series B preferred share and \$0.80625 per Series C preferred share for the period from and including March 31, 1998 to but excluding June 30, 1998.

As discussed in the Information Statement under “Management’s Discussion and Analysis of Financial Condition and Results of Operations—Balance Sheet Analysis—Regulatory Capital Requirements,” the Corporation is subject to capital standards. The Corporation met the applicable capital standards as of March 31, 1998, and management expects that growth in retained earnings will ensure continued compliance with the applicable standards.

Mortgage-Backed Securities

The Corporation issued \$58 billion of MBS during the first three months of 1998, compared with \$31 billion in the first three months of 1997. The increase in MBS issued during the first quarter of 1998, compared with the first quarter of 1997, was primarily due to an increase in mortgage origination and refinance activity in a lower interest rate environment. REMIC issuances decreased to \$16 billion in the first quarter of 1998 from \$18 billion in the first quarter of 1997.

The following table summarizes MBS activity for the three months ended March 31, 1998 and 1997.

Summary of MBS Activity

(Dollars in millions)

Three Months Ended March 31,	Issued				Outstanding(1)		
	Lender Originated (1)				Lender Risk (2)	Fannie Mae Risk	Total (3)
	Lender Risk	Fannie Mae Risk	Fannie Mae Originated	Total			
1998	\$13,202	\$44,771	\$286	\$58,259	\$103,343	\$627,489	\$730,832
1997	3,694	26,231	956	30,881	72,155	591,513	663,668

- (1) This table classifies lender originated MBS issued and MBS outstanding based on primary default risk category; however, Fannie Mae bears the ultimate risk of default on all MBS. MBS outstanding includes MBS that have been pooled to back Megas, SMBS, or REMICs.
- (2) Included in lender risk are \$67 billion and \$34 billion at March 31, 1998 and 1997, respectively, on which the lender or a third party agreed to bear default risk limited to a certain portion or percentage of the loans delivered and, in some cases, the lender has pledged collateral to secure that obligation.
- (3) Included are \$138 billion and \$110 billion at March 31, 1998 and 1997, respectively, of Fannie Mae MBS held in portfolio.

INDEPENDENT ACCOUNTANTS' REVIEW REPORT

To the Board of Directors and Stockholders of Fannie Mae:

We have reviewed the accompanying condensed balance sheet of Fannie Mae as of March 31, 1998 and the related condensed statements of income, changes in stockholders' equity, and cash flows for the three-months ended March 31, 1998 and 1997. These condensed financial statements are the responsibility of Fannie Mae's management.

We conducted our review in accordance with standards established by the American Institute of Certified Public Accountants. A review of interim financial information consists principally of applying analytical procedures to financial data and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the condensed financial statements referred to above for them to be in conformity with generally accepted accounting principles.

We have previously audited, in accordance with generally accepted auditing standards, the balance sheet of Fannie Mae as of December 31, 1997 (presented herein in condensed form) and the related statements of income, changes in stockholders' equity and cash flows for the year then ended (not presented herein); and in our report dated January 14, 1998, we expressed an unqualified opinion on those financial statements. In our opinion, the information set forth in the accompanying condensed balance sheet as of December 31, 1997, is fairly stated, in all material respects, in relation to the balance sheet from which it has been derived.

KPMG PEAT MARWICK LLP

Washington, D.C.
April 8, 1998

FANNIE MAE
INTERIM FINANCIAL STATEMENTS
CONDENSED STATEMENTS OF INCOME
(Unaudited)

	Three Months Ended March 31,	
	1998	1997
	(Dollars in millions, except per share amounts)	
Interest income	\$7,025	\$6,329
Interest expense	5,989	5,379
Net interest income	1,036	950
Guaranty fees	321	313
Miscellaneous income, net	56	30
Credit-related expenses	(77)	(106)
Administrative expenses	(170)	(151)
Income before federal income taxes and extraordinary item	1,166	1,036
Provision for federal income taxes	(334)	(302)
Income before extraordinary item	832	734
Extraordinary loss—early extinguishment of debt (net of tax effect)	(8)	—
Net income	<u>\$ 824</u>	<u>\$ 734</u>
Preferred dividends	(16)	(16)
Net income available to common stockholders	<u>\$ 808</u>	<u>\$ 718</u>
Basic earnings per common share:		
Earnings before extraordinary item	\$.79	\$.68
Extraordinary item	(.01)	—
Net earnings	<u>\$.78</u>	<u>\$.68</u>
Diluted earnings per common share:		
Earnings before extraordinary item	\$.78	\$.67
Extraordinary item	(.01)	—
Net earnings	<u>\$.77</u>	<u>\$.67</u>

CONDENSED BALANCE SHEETS
(Unaudited)

	March 31,	December 31,
	1998	1997
	(Dollars in millions)	
Assets		
Mortgage portfolio, net	\$326,909	\$316,316
Investments	67,209	64,596
Other assets	9,875	10,761
Total assets	<u>\$403,993</u>	<u>\$391,673</u>
Liabilities		
Debentures, notes, and bonds, net		
Due within one year	\$168,919	\$175,400
Due after one year	212,174	194,374
Other liabilities	8,829	8,106
Total liabilities	389,922	377,880
Stockholders' equity	14,071	13,793
Total liabilities and stockholders' equity	<u>\$403,993</u>	<u>\$391,673</u>

See Notes to Interim Financial Statements

FANNIE MAE
CONDENSED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
(Unaudited)

	Number of Common Shares Outstanding	Preferred Stock	Common Stock	Additional Paid-in Capital (Dollars and shares in millions)	Retained Earnings	Accumulated Other Comprehensive Income	Treasury Stock	Total Stockholders' Equity
Balance, December 31, 1996 ..	1,061	\$1,000	\$593	\$1,451	\$11,215	\$ (1)	\$ (1,485)	\$12,773
Comprehensive income:								
Net income	—	—	—	—	734	—	—	734
Other comprehensive income, net of tax—Unrealized losses on securities, net	—	—	—	—	—	(3)	—	(3)
Total comprehensive income								731
Dividends	—	—	—	—	(239)	—	—	(239)
Shares repurchased	(5)	—	—	—	—	—	(200)	(200)
Treasury stock issued for stock options and benefit plans	4	—	—	35	—	—	78	113
Balance, March 31, 1997	<u>1,060</u>	<u>\$1,000</u>	<u>\$593</u>	<u>\$1,486</u>	<u>\$11,710</u>	<u>\$ (4)</u>	<u>\$ (1,607)</u>	<u>\$13,178</u>
 Balance, December 31, 1997 ..	 1,037	 \$1,000	 \$593	 \$1,495	 \$13,326	 \$ (1)	 \$ (2,620)	 \$13,793
Comprehensive income:								
Net income	—	—	—	—	824	—	—	824
Other comprehensive income, net of tax—Unrealized losses on securities, net	—	—	—	—	—	2	—	2
Total comprehensive income								826
Dividends	—	—	—	—	(265)	—	—	(265)
Shares repurchased	(6)	—	—	—	—	—	(377)	(377)
Treasury shares issued for stock option and benefit plans	3	—	—	10	—	—	84	94
Balance, March 31, 1998	<u>1,034</u>	<u>\$1,000</u>	<u>\$593</u>	<u>\$1,505</u>	<u>\$13,885</u>	<u>\$ 1</u>	<u>\$ (2,913)</u>	<u>\$14,071</u>

FANNIE MAE
CONDENSED STATEMENTS OF CASH FLOWS
(Unaudited)

	Three Months Ended March 31,	
	1998	1997
	(Dollars in millions)	
Net cash provided by operating activities	\$ 1,703	\$ 2,131
Cash flows from investing activities:		
Purchases of mortgages	(28,603)	(13,079)
Proceeds from sales of mortgages	396	97
Mortgage principal repayments	17,844	8,054
Net increase in investments	<u>(2,613)</u>	<u>(511)</u>
Net cash used by investing activities	<u>(12,976)</u>	<u>(5,439)</u>
Cash flows from financing activities:		
Cash proceeds from issuance of debt	216,462	178,980
Cash payments to retire debt	(206,479)	(175,182)
Other	<u>(562)</u>	<u>(354)</u>
Net cash provided by financing activities	<u>9,421</u>	<u>3,444</u>
Net (decrease) increase in cash and cash equivalents	(1,852)	136
Cash and cash equivalents at beginning of period	<u>2,205</u>	<u>850</u>
Cash and cash equivalents at end of period	<u>\$ 353</u>	<u>\$ 986</u>

NOTES TO INTERIM FINANCIAL STATEMENTS
(Unaudited)

Basis of Presentation

The accompanying unaudited condensed financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Certain amounts in 1997 have been reclassified to conform with the current presentation. Operating results for the three months ended March 31, 1998 are not necessarily indicative of the results that may be expected for the year ending December 31, 1998. The unaudited interim financial statements should be read in conjunction with the audited financial statements and notes to financial statements that are presented in the Information Statement dated March 31, 1998.

New Accounting Standard

Financial Accounting Standard No. 130, *Reporting Comprehensive Income* ("FAS 130") became effective in the first quarter of 1998. FAS 130 requires reporting of comprehensive income by its components and in total in the financial statements. "Comprehensive income" is defined as the change in equity of a business enterprise during a period from transactions and other events and circumstances from nonowner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners. "Other comprehensive income" refers to revenues, expenses, gains, and losses that under generally accepted accounting policies are

included in comprehensive income but excluded from net income (e.g., unrealized gains and losses on securities classified as available-for-sale).

Line of Business Reporting

The following table sets forth the Corporation's financial information by line of business for the three months ended March 31, 1998 and 1997. Significant changes from period to period were due to the same factors discussed under "Results of Operations."

Three Months Ended March 31,	1998			1997		
	Portfolio Investment	Credit Guaranty	Total	Portfolio Investment	Credit Guaranty	Total
	(Dollars in millions)					
Net interest income	\$ 894	\$ 142	\$1,036	\$ 848	\$ 102	\$ 950
Guaranty fees	(197)	518	321	(189)	502	313
Miscellaneous, net	16	40	56	8	22	30
Credit-related expenses	—	(77)	(77)	—	(106)	(106)
Administrative expenses	(37)	(133)	(170)	(36)	(115)	(151)
Federal income taxes	(186)	(148)	(334)	(177)	(125)	(302)
Extraordinary item—early extinguishment of debt	(8)	—	(8)	—	—	—
Net income	<u>\$ 482</u>	<u>\$ 342</u>	<u>\$ 824</u>	<u>\$ 454</u>	<u>\$ 280</u>	<u>\$ 734</u>

The Portfolio Investment business represented \$389 billion, or 96 percent of total assets, at March 31, 1998 and \$346 billion, or 97 percent of total assets, at March 31, 1997.

Commitments and Contingencies

The Corporation had outstanding commitments to purchase mortgages and to issue MBS as shown below:

	March 31, 1998
	(Dollars in billions)
Commitments to purchase mortgages:	
Mandatory delivery	\$12.6
Lender option (1)	1.6
Average net yield on mandatory delivery	6.77%
Master commitments:	
Mandatory delivery (2)	\$39.6
Lender option	56.9

(1) Excludes commitments attached to master commitments, which are included in the total for master commitments.

(2) Under a mandatory master commitment, a lender must either deliver under an MBS contract at a specified guaranty fee or enter into a mandatory portfolio commitment with the yield established upon executing the portfolio commitment.

The Corporation also guarantees timely payment of principal and interest on outstanding MBS and provides credit enhancements or other guarantees as summarized below:

	March 31, 1998
	(Dollars in billions)
MBS outstanding (1)	\$731
Amount for which the Corporation has primary foreclosure loss risk (2)	627
Credit enhancements	6.1
Other guarantees	2.9

(1) Includes \$138 billion of MBS held in portfolio.

(2) The Corporation, however, assumes the ultimate risk of loss on all MBS.

COMPUTATION OF EARNINGS PER COMMON SHARE
(Unaudited)

	Three Months Ended March 31,	
	1998	1997
	(In millions, except per share data)	
Numerator:		
Net income before extraordinary loss	\$ 832	\$ 734
Extraordinary loss	(8)	—
Preferred stock dividends	(16)	(16)
Basic and diluted earnings per common share-income available to common stockholders	\$ 808	\$ 718
Denominator:		
Basic earnings per common share-weighted-average common shares	1,037	1,062
Dilutive potential common shares(1)	8	7
Diluted earnings per common share-adjusted weighted average common shares ..	1,045	1,069
Basic earnings per common share:		
Earnings before extraordinary item	\$.79	\$.68
Net earnings .....	.78	.68
Diluted earnings per common share:		
Earnings before extraordinary item	\$.78	\$.67
Net earnings .....	.77	.67

(1) Dilutive potential common shares consist primarily of the dilutive effect from employee stock options and other stock compensation plans.

MANAGEMENT

At a Special Meeting of the Board of Directors on April 14, 1998, the Board of Directors designated Franklin D. Raines as Chairman of the Board and Chief Executive Officer effective January 1, 1999, subject to his election by the stockholders as a director at the Corporation's annual meeting of stockholders on May 21, 1998, and nominated Kenneth M. Duberstein for election to its Board of Directors. They have been nominated to fill the seats that will be vacated by Antonia Shusta and Richard D. Parsons when Ms. Shusta's and Mr. Parsons' respective terms expire at the annual meeting of stockholders. From May 21, 1998 to December 31, 1998, Mr. Raines will serve as Chairman of the Board and Chief Executive Officer—Designate. Mr. Johnson will continue to serve as Chairman of the Board and Chief Executive Officer through December 31, 1998, subject to his election by the stockholders as a director at the annual meeting. Mr. Johnson will continue as Chairman of the Executive Committee through December 31, 1999.

Mr. Raines, 49, has been Director of the Office of Management and Budget since September 1996 and was Vice-Chairman and a director of the Corporation from September 1991 to August 1996.

Mr. Duberstein, 54, has been Chairman and Chief Executive Officer of The Duberstein Group, an independent strategic planning and consulting company, since July 1989. He served as Chief of Staff to the President of the United States from 1988 to 1989. Mr. Duberstein also serves as a director of The Boeing Company, Cinergy Corporation, and USF&G Corporation. He is serving his third term as a member of the Board of Governors of the American Stock Exchange.

In April 1998, the Corporation announced that eleven directors currently on the Board of Directors and whose terms expire at the annual meeting of stockholders on May 21, 1998 have been nominated for reelection.

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**Supplement dated August 13, 1998 to
Information Statement dated March 31, 1998**



This Supplement describes the financial condition of the Federal National Mortgage Association ("Fannie Mae" or the "Corporation") as of June 30, 1998 and contains unaudited financial statements with respect to the Corporation for the quarter and six months ended June 30, 1998. This Supplement should be read in conjunction with the Corporation's Information Statement dated March 31, 1998 (the "Information Statement") and the Supplement dated May 15, 1998 thereto (the "May 15 Supplement"), which are hereby incorporated by reference. The Information Statement describes the business and operations of the Corporation and contains financial data as of December 31, 1997. The May 15 Supplement describes the financial condition of the Corporation as of March 31, 1998 and contains unaudited financial statements with respect to the Corporation for the quarter ended March 31, 1998. Fannie Mae also periodically makes available statistical information on its mortgage purchase and mortgage-backed securities volumes as well as other relevant information about Fannie Mae. Copies of the Corporation's current Information Statement, any supplements thereto and other available information can be obtained without charge from the Office of Investor Relations, Fannie Mae, 3900 Wisconsin Avenue, N.W., Washington, D.C. 20016 (telephone: 202/752-7115).

In connection with its securities offerings, the Corporation may incorporate this Supplement by reference in one or more other documents describing the securities offered thereby, the selling arrangements therefor and other relevant information. Such other documents may be called an Offering Circular, a Prospectus or otherwise. This Supplement does not offer any securities for sale.

Fannie Mae is a federally chartered corporation. Its principal office is located at 3900 Wisconsin Avenue, N.W., Washington, D.C. 20016 (202/752-7000). Its Internal Revenue Service employer identification number is 52-0883107.

The Corporation's securities are not required to be registered under the Securities Act of 1933. At the close of business on July 31, 1998, approximately 1,026 million shares of the Corporation's common stock (without par value) were outstanding.

The delivery of this Supplement at any time shall not under any circumstances create an implication that there has been no change in the affairs of the Corporation since the date hereof or that the information contained herein is correct as of any time subsequent to its date.

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SELECTED FINANCIAL DATA

The following selected financial data for the three- and six-month periods ended June 30, 1998 and 1997 are unaudited and include, in the opinion of management, all adjustments (consisting of normal recurring accruals) necessary for a fair presentation. Certain amounts in 1997 have been reclassified to conform with the current presentation. Operating results for the periods ended June 30, 1998 are not necessarily indicative of the results expected for the entire year.

(Dollars in millions, except per common share amounts)

	Three Months Ended June 30,		Six Months Ended June 30,	
	1998	1997	1998	1997
Income Statement Data:				
Interest income	\$ 7,351	\$ 6,514	\$14,376	\$12,843
Interest expense	6,320	5,544	12,309	10,923
Net interest income	1,031	970	2,067	1,920
Guaranty fees	323	317	644	630
Fee and other income, net	79	32	135	62
Credit-related expenses	(69)	(101)	(146)	(207)
Administrative expenses	(174)	(158)	(344)	(309)
Income before federal income taxes and extraordinary item	1,190	1,060	2,356	2,096
Provision for federal income taxes	(339)	(308)	(673)	(610)
Income before extraordinary item	851	752	1,683	1,486
Extraordinary gain/ (loss), net of tax effect	(3)	1	(11)	1
Net income	<u>\$ 848</u>	<u>\$ 753</u>	<u>\$ 1,672</u>	<u>\$ 1,487</u>
Preferred stock dividends	(16)	(16)	(32)	(32)
Net income available to common stockholders	<u>\$ 832</u>	<u>\$ 737</u>	<u>\$ 1,640</u>	<u>\$ 1,455</u>
Basic earnings per common share(1):				
Earnings before extraordinary item	\$.81	\$.70	\$ 1.60	\$ 1.38
Extraordinary item	—	—	(.01)	—
Net earnings	<u>\$.81</u>	<u>\$.70</u>	<u>\$ 1.59</u>	<u>\$ 1.38</u>
Diluted earnings per common share(1):				
Earnings before extraordinary item	\$.80	\$.69	\$ 1.59	\$ 1.37
Extraordinary item	—	—	(.01)	—
Net earnings	<u>\$.80</u>	<u>\$.69</u>	<u>\$ 1.58</u>	<u>\$ 1.37</u>
Balance Sheet Data at June 30:				
	1998	1997		
Mortgage portfolio, net	\$349,282	\$296,799		
Investments	69,643	59,282		
Total assets	429,448	365,997		
Borrowings:				
Due within one year	174,942	167,682		
Due after one year	231,220	177,780		
Total liabilities	415,263	352,733		
Stockholders' equity	14,185	13,264		
Capital(2)	14,973	14,019		
Other Data:				
	1998	1997	1998	1997
Average net interest margin	1.07%	1.17%	1.10%	1.17%
Return on average common equity	25.6	24.4	25.3	24.3
Dividend payout ratio	29.7	29.9	30.3	30.5
Average effective guaranty fee rate .....	.215	.227	.217	.227
Credit loss ratio(3) .....	.030	.047	.032	.046
Ratio of earnings to combined fixed charges and preferred stock dividends(4)	1.19:1	1.19:1	1.19:1	1.19:1
Mortgage purchases	\$ 44,007	\$ 14,425	\$ 72,379	\$27,421
MBS issued	83,880	30,446	142,139	61,327
MBS outstanding at period end(5)	761,359	673,931		
Weighted-average diluted common shares outstanding, in millions	1,037	1,061	1,041	1,064

(1) Earnings per common share amounts for 1997 have been restated to comply with Statement of Financial Accounting Standards No. 128, *Earnings per Share*.

(2) Stockholders' equity plus general allowance for losses.

(3) Charge-offs and foreclosure expense as a percentage of average net portfolio and net MBS outstanding.

(4) "Earnings" consists of (i) income before federal income taxes and extraordinary item and (ii) fixed charges. "Fixed charges" represents interest expense.

(5) Includes \$156 billion and \$116 billion of MBS held in portfolio at June 30, 1998 and 1997, respectively.

**MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION
AND RESULTS OF OPERATIONS FOR THE THREE-MONTH AND
SIX-MONTH PERIODS ENDED JUNE 30, 1998**

Results of Operations

In the second quarter of 1998, Fannie Mae again reported record earnings as net income increased 13 percent, or \$95 million, to \$848 million, compared with the results for the second quarter of 1997. For the first six months of 1998, net income increased \$185 million, or 12 percent, to \$1.672 billion compared with \$1.487 billion for the first half of 1997. The growth in net income for the three- and six-month periods ended June 30, 1998 was mainly attributable to increases in net interest income, fee and other income, and lower credit-related expenses.

Net interest income in the second quarter of 1998 increased 6 percent compared with the second quarter of 1997 as a result of 16 percent growth in the average investment portfolio, which was partly offset by a ten basis point decrease in the average net interest margin. Net interest income in the first six months of 1998 increased 8 percent compared with the first six months of 1997. This increase was the result of a 14 percent growth in the average investment portfolio, which was partly offset by a 7 basis point decrease in the average net interest margin. The decline in the net interest margin stemmed, in part, from an increase in the refinancing of high-coupon mortgages, growth in lower spread liquid investments, a rise in tax advantaged investments, and an increase in common share repurchases. Management expects that continued portfolio growth will have a positive impact on net interest income and that the net interest margin will continue to decline somewhat over the remainder of the year.

The following table presents an analysis of net interest income and average balances for the three- and six-month periods ended June 30, 1998 and 1997.

Net Interest Income and Average Balances

(Dollars in millions)

	Three Months Ended June 30,		Six Months Ended June 30,	
	1998	1997	1998	1997
Interest income:				
Mortgage portfolio	\$ 6,222	\$ 5,621	\$ 12,224	\$ 11,105
Investments and cash equivalents	1,129	893	2,152	1,738
Total interest income	<u>7,351</u>	<u>6,514</u>	<u>14,376</u>	<u>12,843</u>
Interest expense(1):				
Short-term debt	1,131	908	2,096	1,747
Long-term debt	5,189	4,636	10,213	9,176
Total interest expense	<u>6,320</u>	<u>5,544</u>	<u>12,309</u>	<u>10,923</u>
Net interest income	1,031	970	2,067	1,920
Tax equivalent adjustment(2)	76	72	148	138
Net interest income tax equivalent basis ...	<u>\$ 1,107</u>	<u>\$ 1,042</u>	<u>\$ 2,215</u>	<u>\$ 2,058</u>
Average balances:				
Interest-earning assets(3):				
Mortgage portfolio, net	\$336,064	\$294,953	\$327,976	\$291,425
Investments and cash equivalents	78,360	61,978	74,424	61,031
Total interest-earning assets	<u>\$414,424</u>	<u>\$356,931</u>	<u>\$402,400</u>	<u>\$352,456</u>
Interest-bearing liabilities(1):				
Short-term debt	\$ 83,455	\$ 68,389	\$ 77,619	\$ 66,467
Long-term debt	313,083	272,522	307,082	269,990
Total interest-bearing liabilities	396,538	340,911	384,701	336,457
Interest-free funds	17,886	16,020	17,699	15,999
Total interest-bearing liabilities and interest-free funds	<u>\$414,424</u>	<u>\$356,931</u>	<u>\$402,400</u>	<u>\$352,456</u>
Average interest rates(2):				
Interest-earning assets:				
Mortgage portfolio, net	7.45%	7.68%	7.50%	7.68%
Investments and cash equivalents	5.80	5.82	5.82	5.75
Total interest-earning assets	<u>7.14</u>	<u>7.36</u>	<u>7.19</u>	<u>7.35</u>
Interest-bearing liabilities(1):				
Short-term debt	5.36	5.29	5.35	5.23
Long-term debt	6.63	6.80	6.66	6.80
Total interest-bearing liabilities	<u>6.37</u>	<u>6.50</u>	<u>6.39</u>	<u>6.49</u>
Investment spread .....	.77	.86	.80	.86
Interest-free return(4) .....	.30	.31	.30	.31
Net interest margin(5)	<u>1.07%</u>	<u>1.17%</u>	<u>1.10%</u>	<u>1.17%</u>

(1) Classification of interest expense and interest-bearing liabilities as short-term or long-term is based on effective maturity or repricing date, taking into consideration the effect of interest rate swaps.

(2) Reflects pro forma adjustments to permit comparison of yields on tax-advantaged and taxable assets.

(3) Includes average balance of nonperforming loans of \$2.6 billion for the three- and six-month periods ended June 30, 1998 and \$2.2 billion for the three-month period ended June 30, 1997 and \$2.3 billion for the six-month period ended June 30, 1997.

(4) Consists primarily of the return on that portion of the investment portfolio funded by equity and non-interest-bearing liabilities.

(5) Net interest income, on a tax equivalent basis, as a percentage of the average investment portfolio.

The following rate/volume analysis shows the relative contribution of asset and debt growth and interest rate changes to changes in net interest income for the three- and six-month periods ended June 30, 1998 and 1997.

Rate / Volume Analysis

(Dollars in millions)

	Second Quarter 1998 vs. Second Quarter 1997			First Six Months 1998 vs. First Six Months 1997		
	Increase (Decrease)	Attributable to Changes in (1)		Increase (Decrease)	Attributable to Changes in (1)	
		Volume	Rate		Volume	Rate
Interest income:						
Mortgage portfolio	\$601	\$ 765	\$(164)	\$1,119	\$1,367	\$(248)
Investments and cash equivalents	236	236	—	414	387	27
Total interest income	<u>837</u>	<u>1,001</u>	<u>(164)</u>	<u>1,533</u>	<u>1,754</u>	<u>(221)</u>
Interest expense:						
Short-term debt	223	204	19	349	300	49
Long-term debt	553	675	(122)	1,037	1,237	(200)
Total interest expense	<u>776</u>	<u>879</u>	<u>(103)</u>	<u>1,386</u>	<u>1,537</u>	<u>(151)</u>
Net interest income	<u>\$ 61</u>	<u>\$ 122</u>	<u>\$(61)</u>	<u>\$ 147</u>	<u>\$ 217</u>	<u>\$(70)</u>

(1) Combined rate/volume variances, a third element of the calculation, are allocated to the rate and volume variances based on their relative size.

Guaranty fee income increased by \$6 million, or 2 percent, to \$323 million, compared with \$317 million in the second quarter of 1997. This change resulted from an 8 percent increase in average net Mortgage-Backed Securities (“MBS”) outstanding, which was partially offset by a 1 basis point decrease in the average effective guaranty fee rate when compared with the second quarter of 1997. For the first half of 1998, guaranty fee income increased by \$14 million to \$644 million compared with the first half of 1997. The increase was the result of an increase in average net MBS outstanding of 7 percent, partially offset by a 1 basis point decrease in the average effective guaranty fee rate. The decrease in the average effective guaranty fee rate was due to repayments of loans backing MBS with high fees, an increase in MBS purchased for portfolio for which the guaranty fees are included in net interest income, and an increase in MBS issues incorporating loss sharing arrangements with lower fee rates.

Fee and other income increased 147 percent to \$79 million for the second quarter of 1998 compared with \$32 million in the second quarter of 1997. For the first half of 1998, fee and other income increased 118 percent to \$135 million versus \$62 million in the first half of 1997. The increase in both periods was largely the result of increases in multifamily fees, structured transaction fees and technology fees. Management expects fee and other income to be strong over the remainder of 1998, but at levels somewhat lower than the second quarter of 1998.

Administrative expenses for the second quarter of 1998 were \$174 million, compared with \$158 million during the same period in 1997. For the first half of 1998, administrative expenses were \$344 million, compared with \$309 million for the same period in 1997. The increase was primarily due to higher compensation costs, including costs associated with year 2000 conversion efforts. The ratio of administrative expenses to the average mortgage portfolio plus average MBS outstanding was .074 percent and .075 percent for the three- and six-month periods ended June 30, 1998, respectively, compared with .075 percent and .073 percent for the comparable periods in 1997. The ratio of administrative expenses to revenues (net interest income, guaranty fees and fee and other income) was 12.2 percent for the second quarter of 1998, compared with 12.0 percent for the second quarter of 1997, and was 12.1 percent for the first half of 1998, compared with 11.8 percent for the first half of 1997.

The effective federal income tax rate was 29 percent for the three and six months ended June 30, 1998, and for the three and six months ended June 30, 1997.

In the second quarter of 1998, the Corporation had an extraordinary net loss of \$4 million (\$3 million after tax) from the repurchase or call of debt compared with a gain of \$2 million (\$1 million after tax) in the second quarter of 1997. An extraordinary net loss of \$16 million (\$11 million after tax) was reported in the first half of 1998 from the repurchase or call of debt compared with a gain of \$2 million (\$1 million after tax) in the first half of 1997.

Credit Data

The following table shows the Corporation's serious delinquencies for conventional loans in portfolio and underlying MBS at June 30, 1998 and 1997, and conventional properties acquired and total net charge-offs for the three- and six-month periods ended June 30, 1998 and 1997.

	Serious Delinquency Rate (1)		Number of Properties Acquired				Net Charge-offs (Dollars in millions)			
			Three Months Ended June 30,		Six Months Ended June 30,		Three Months Ended June 30,		Six Months Ended June 30,	
	1998	1997	1998	1997	1998	1997	1998	1997	1998	1997
Single-family. . . . .	.57%	.58%	5,365	5,717	11,023	11,148	\$(11)	\$34	\$(18)	\$64
Multifamily. . . . .	.36	.47	1	10	5	18	1	5	4	6
Total.							\$(10)	\$39	\$(14)	\$70

(1) Single-family serious delinquencies consist of those loans in the portfolio or underlying MBS for which the Corporation has the primary risk of loss that are 90 or more days delinquent or in foreclosure. Multifamily serious delinquencies are those loans in the portfolio or underlying MBS that are 60 days or more delinquent for which the Corporation has primary risk of loss. The single-family and multifamily percentages are based on the number of such single-family loans and dollar amount of such multifamily loans, respectively, in the portfolio and underlying MBS.

Total credit-related losses, which include loan charge-offs, net of recoveries, and foreclosed property expenses, were \$69 million for the three months ended June 30, 1998, compared with \$100 million for the same period in 1997. Total credit-related losses for the six months ended June 30, 1998 and 1997 were \$147 million and \$197 million, respectively. The change in credit-related losses was the result of a decrease in charge-offs slightly offset by an increase in foreclosure expenses. The decrease in charge-offs was due to net recoveries on foreclosed properties in the second quarter and first half of 1998 versus net charge-offs in the second quarter and first half of 1997. In addition to the Corporation's loss mitigation efforts, a strong economy, a strong housing market, particularly in California, and deeper mortgage insurance requirements on higher loan-to-value ratio loans have contributed to reducing credit-related losses.

The inventory of single-family properties was 9,408 as of June 30, 1998, compared with 9,514 as of June 30, 1997. The inventory of multifamily properties was 13 as of June 30, 1998, compared with 19 as of June 30, 1997.

Total credit-related expenses, which include foreclosed property expenses and the provision for losses, were \$69 million in the second quarter of 1998, compared with \$101 million in the second quarter of 1997. Total credit-related expenses for the six months ended June 30, 1998 and 1997 were \$146 million and \$207 million, respectively. The decreases were due to a negative \$10 million and negative \$15 million loss provision recorded in the second quarter and first half of 1998, respectively, compared with a \$40 million and \$80 million loss provision recorded in the second quarter and first half of 1997, respectively.

The allowance for losses was \$802 million at June 30, 1998, compared with \$803 million at December 31, 1997 and \$790 million at June 30, 1997. Management anticipates that the provision for losses will be adjusted periodically in line with its analysis of actual and expected loss experience.

Balance Sheet Analysis

Mortgage Portfolio

The Corporation purchased \$44 billion of mortgages at an average yield of 6.73 percent in the second quarter of 1998, compared with \$14 billion of mortgages at an average yield of 7.71 percent in the second quarter of 1997. During the first six months of 1998, mortgage purchases were \$72 billion at an average yield of 6.75 percent, compared with \$27 billion at an average yield of 7.65 percent for the first six months of 1997. The increase in mortgage purchases was due primarily to the increased availability of mortgages offered for sale in the secondary market.

Mortgage loan repayments during the second quarter of 1998 totaled \$21 billion, compared with \$8 billion in the second quarter of 1997. During the first half of 1998, mortgage loan repayments were \$38 billion compared with \$16 billion in the first half of 1997.

As of June 30, 1998, the net mortgage portfolio totaled \$349 billion with a yield (before deducting the allowance for losses) of 7.41 percent, compared with \$316 billion at 7.60 percent as of December 31, 1997 and \$297 billion at 7.68 percent as of June 30, 1997. The decrease in yield was due primarily to increased prepayments of higher coupon mortgages and a decrease in conventional mortgage purchase yields as interest rates declined. The portfolio growth during the second quarter and first half of 1998 was generated by the purchase of a combination of whole loans, MBS and REMICs. For the remainder of 1998, the Corporation expects that a high level of fixed-rate mortgage originations will lead to attractive portfolio investment opportunities and growth in the net mortgage portfolio.

At June 30, 1998, the Corporation had mandatory delivery commitments and lender option commitments outstanding to purchase \$14.1 billion and \$1.6 billion of mortgage loans, respectively, compared with \$3.6 billion and \$1.6 billion, respectively, of such commitments outstanding at December 31, 1997.

Financing and Other Activities

During the second quarter of 1998, the Corporation issued \$218 billion of debt at an average cost of 5.63 percent and redeemed \$193 billion at an average cost of 5.71 percent. Debt issued in the second quarter of 1997 totaled \$229 billion at an average cost of 5.64 percent and redeemed \$219 billion at an average cost of 5.58 percent. During the first six months of 1998, \$437 billion of debt was issued at an average cost of 5.63 percent and \$400 billion was redeemed at an average cost of 5.73 percent. In the first six months of 1997, the Corporation issued \$411 billion of debt at an average cost of 5.57 percent and redeemed \$397 billion at an average cost of 5.52 percent. The average cost of debt outstanding at June 30, 1998, December 31, 1997 and June 30, 1997 was 6.33 percent, 6.46 percent and 6.50 percent, respectively.

The following table presents the amount of callable debt and the notional amount of callable swaps issued and outstanding for the three- and six-month periods ended June 30, 1998 and June 30, 1997.

<u>(Dollars in billions)</u>	Three Months Ended June 30,		Six Months Ended June 30,	
	1998	1997	1998	1997
Issued during the period	\$ 23	\$ 7	\$42	\$14
Percentage of total long-term debt issued(1)	67%	44%	60%	49%
Outstanding at end of period	\$149	\$131		
Percentage of total long-term debt outstanding(1)	47%	48%		

(1) Includes the notional amount of callable swaps, and excludes long-term debt with a repricing frequency of one year or less.

The increase in the percentage of callable debt and callable swaps issued relative to long-term debt issued for the three months ended June 30, 1998, compared with the three months ended June 30, 1997, is due to routine portfolio restructuring and the replacement of callable debt redeemed during the quarter.

The following table summarizes the Corporation's interest rate swap activity, the notional amount of, and weighted-average interest rates to be received and paid on, interest rate swaps outstanding for the quarters ended March 31, 1998 and June 30, 1998, the balance outstanding at June 30, 1997 and the expected maturities for the interest rate swaps outstanding at June 30, 1998.

Interest Rate Swap Activity Table

(Dollars in millions)	Generic—pay fixed / receive variable (1)			Basis Swaps	Other (4)	Total
	Notional (2)	Pay Rate (3)	Receive Rate (3)			
Balance at December 31, 1997	\$96,713	6.77%	5.82%	\$22,383	\$29,653	\$148,749
Additions	—	—	—	3,585	7,436	11,021
Maturities	<u>6,993</u>	<u>6.74</u>	<u>5.85</u>	<u>4,370</u>	<u>5,351</u>	<u>16,714</u>
Balance at March 31, 1998 ...	89,720	6.77	5.73	21,598	31,738	143,056
Additions	675	6.04	5.83	4,450	12,653	17,778
Maturities	<u>5,424</u>	<u>6.88</u>	<u>5.84</u>	<u>5,455</u>	<u>5,884</u>	<u>16,763</u>
Balance at June 30, 1998	<u>\$84,971</u>	<u>6.76%</u>	<u>5.70%</u>	<u>\$20,593</u>	<u>\$38,507</u>	<u>\$144,071</u>
Balance at June 30, 1997	<u>\$96,611</u>	<u>6.78%</u>	<u>5.82%</u>	<u>\$30,882</u>	<u>\$25,521</u>	<u>\$153,014</u>
Future Maturities (5)						
1998	\$ 6,280	5.24%	5.66%	\$ 6,142	\$ 5,475	\$ 17,897
1999	5,450	6.64	5.33	12,352	14,260	32,062
2000	3,817	6.08	5.73	1,200	7,125	12,142
2001	7,300	6.62	5.70	—	3,893	11,193
2002	4,950	6.28	5.70	79	400	5,429
Thereafter	<u>57,174</u>	<u>7.04</u>	<u>5.74</u>	<u>820</u>	<u>7,354</u>	<u>65,348</u>
	<u>\$84,971</u>	<u>6.76%</u>	<u>5.70%</u>	<u>\$20,593</u>	<u>\$38,507</u>	<u>\$144,071</u>

(1) Included in the notional amounts are callable swaps of \$22 billion, \$22 billion, and \$26 billion, with weighted-average pay rates of 6.00 percent, 6.60 percent and 6.67 percent, and weighted-average receive rates of 5.79 percent, 5.82 percent and 5.82 percent at June 30, 1998, March 31, 1998, and June 30, 1997, respectively.

(2) The notional value only indicates the amount on which swap payments are being calculated and does not represent the amount at risk of loss.

(3) The weighted-average interest rate receivable and payable is as of the date indicated. The interest rates of the swaps may be floating rate, so these rates may change as prevailing interest rates change.

(4) Amounts principally consist of generic-pay variable/receive fixed swaps, caps and swaptions.

(5) Assumes that variable interest rates remain constant at June 30, 1998 levels.

The contract amounts of other off-balance-sheet financial instruments, which included futures contracts and derivative instruments that simulate the short sale of Treasury securities to provide a hedge against interest rate fluctuations, credit enhancements and other guarantees, were \$10.4 billion at June 30, 1998, compared with \$11.5 billion at December 31, 1997.

The exposure to credit loss for interest rate swaps and other off-balance-sheet financial instruments can be estimated by calculating the cost, on a present value basis, to replace at current market rates all of those off-balance-sheet financial instruments outstanding for which the Corporation was in a net gain position. The Corporation's net exposure at June 30, 1998 was \$9 million, compared with \$26 million at December 31, 1997. The exposure to credit loss can be expected to fluctuate significantly due to changes in interest rates.

Capital Resources

The Corporation's stockholders' equity at June 30, 1998 was \$14.2 billion, compared with \$13.8 billion at December 31, 1997, and \$13.3 billion at June 30, 1997. Pursuant, in part, to the

capital restructuring program described in the Information Statement under “Management’s Discussion and Analysis of Financial Condition and Results of Operations—Balance Sheet Analysis—Liquidity and Capital Resources,” the Corporation repurchased 8.6 million common shares at a weighted-average cost of \$60.11 per common share during the second quarter of 1998 and issued .5 million common shares for employee and other stock compensation plans. At June 30, 1998, year-to-date common stock repurchases totaled 14.7 million shares at a weighted-average cost of \$61.02 per common share and common stock issuances totaled 3.7 million common shares for employee and other stock compensation plans. As of June 30, 1998, there were 1,026 million common shares outstanding.

On July 21, 1998, the Board of Directors approved a dividend for the quarter ended June 30, 1998 of \$0.24 per common share, and dividends of \$0.80125 per Series A preferred share, \$0.81250 per Series B preferred share and \$0.80625 per Series C preferred share for the period from and including June 30, 1998 to, but excluding, September 30, 1998.

As discussed in the Information Statement under “Management’s Discussion and Analysis of Financial Condition and Results of Operations—Balance Sheet Analysis—Regulatory Capital Requirements,” the Corporation is subject to capital standards. The Corporation met the applicable capital standards as of June 30, 1998, and management expects that growth in retained earnings will ensure continued compliance with the applicable standards.

Mortgage-Backed Securities

The Corporation issued \$84 billion of MBS during the second quarter of 1998, compared with \$30 billion in the second quarter of 1997. MBS issued in the first half of 1998 totaled \$142 billion, compared with \$61 billion in the first half of 1997. The increase in MBS issued during the first six months of 1998 was primarily due to an increase in mortgage origination and refinance activity in a lower interest rate environment. REMIC issuances were \$25 billion in the second quarter of 1998 and \$42 billion in the first six months of 1998, compared with \$17 billion and \$35 billion, respectively, for the comparable periods for 1997.

The following table summarizes MBS activity for the three-month and six-month periods ended June 30, 1998 and 1997.

Summary of MBS Activity

(Dollars in millions)

Three Months Ended June 30,	Issued				Outstanding (1)		
	Lender Originated (1)				Lender Risk (2)	Fannie Mae Risk	Total (3)
	Lender Risk	Fannie Mae Risk	Fannie Mae Originated	Total			
1998.	\$21,935	\$ 61,945	\$ —	\$ 83,880	\$118,451	\$642,908	\$761,359
1997.	6,983	22,479	984	30,446	76,859	597,072	673,931
Six Months Ended June 30,							
1998.	\$35,137	\$106,716	\$ 286	\$142,139			
1997.	10,677	48,710	1,940	61,327			

- (1) This table classifies lender originated MBS issued and MBS outstanding based on primary default risk category; Fannie Mae, however, bears the ultimate risk of default on all MBS. MBS outstanding includes MBS that have been pooled to back Megas, SMBS or REMICs.
- (2) Included in lender risk are \$82 billion and \$40 billion at June 30, 1998 and 1997, respectively, on which the lender or a third party agreed to bear default risk limited to a certain portion or percentage of the loans delivered and, in some cases, the lender has pledged collateral to secure that obligation.
- (3) Included are \$156 billion and \$116 billion at June 30, 1998 and June 30, 1997, respectively, of Fannie Mae MBS in portfolio.

New Accounting Standard

In the second quarter of 1998, the Financial Accounting Standards Board issued Financial Accounting Standards No. 133 ("FAS 133"), *Accounting for Derivative Instruments and Hedging Activities*, which becomes effective for Fannie Mae on January 1, 2000. FAS 133 requires all derivatives to be recognized as either assets or liabilities on the balance sheet at fair value. Subject to certain qualifying conditions, a derivative may be designated as either a hedge of the fair value of a fixed-rate instrument ("fair value hedge") or as a hedge of the cash flows of a variable-rate instrument or anticipated transaction ("cash flow hedge"). For derivatives qualifying as a fair value hedge, fair value gains or losses would be reported in earnings along with offsetting fair value gains or losses, attributable to the risk being hedged. For derivatives qualifying as a cash flow hedge, fair value gains or losses associated with the risk being hedged would be reported in a separate component of stockholders' equity and then amortized into earnings in the period(s) in which the hedged item affects income. For a derivative instrument not qualifying as a hedge, fair value gains and losses would be reported in earnings. Management currently is evaluating the impact that this standard will have on its internal operations. If the Corporation continues with its current business strategies, this standard will not have a significant effect on net income, although it may have a material effect on the "other comprehensive income" component of stockholders' equity.

MATTERS SUBMITTED TO STOCKHOLDERS

At the 1998 Annual Meeting of Stockholders of Fannie Mae held on May 21, 1998, the following matters were presented for a vote: (i) election of 13 members to the Board of Directors, each for a term ending on the date of the next Annual Meeting of Stockholders of the Corporation; (ii) ratification of the appointment of KPMG Peat Marwick LLP as auditors of the Corporation for 1998; and (iii) a stockholder proposal to reinstate cumulative voting for directors. The Board of Directors recommended that stockholders vote against the stockholder proposal for cumulative voting. Under the stockholder proposal relating to cumulative voting, the Board of Directors would have been requested to take the necessary steps to provide for cumulative voting in the election of directors, which would mean that each stockholder would be entitled to as many votes as the number of common shares the stockholder owns multiplied by the number of directors to be elected, and the stockholder could cast all such votes for a single candidate or distribute them among several nominees.

Of the 1,034,195,738 shares of common stock outstanding on the record date for the meeting, 899,663,623 shares were present in person or by proxy at the meeting.

The following persons were elected as directors of Fannie Mae by the respective votes indicated following their names: Stephen B. Ashley (895,751,750 votes for; 3,900,593 votes withheld); Roger E. Birk (895,471,554 votes for; 4,180,789 votes withheld); Kenneth M. Duberstein (899,286,736 votes for; 10,365,607 votes withheld); Stephen Friedman (895,717,483 votes for; 3,934,860 votes withheld); Thomas P. Gerrity (895,623,106 votes for; 4,029,237 votes withheld); Jamie S. Gorelick (895,614,338 votes for; 4,038,005 votes withheld); James A. Johnson (895,677,998 votes for; 3,974,345 votes withheld); Vincent A. Mai (895,746,669 votes for; 3,905,674 votes withheld); Ann McLaughlin (895,168,618 votes for; 4,483,725 votes withheld); Joe K. Pickett (889,358,173 votes for; 10,294,170 votes withheld); Franklin D. Raines (895,597,336 votes for; 4,055,007 votes withheld); Lawrence M. Small (895,693,099 votes for; 3,959,244 votes withheld); Karen Hastie Williams (895,244,258 votes for; 4,408,085 votes withheld).

Messrs. Raines and Duberstein were the only new directors elected and filled the seats vacated by Antonia Shusta and Richard D. Parsons when their terms expired at the May 1998 Annual Meeting. See the May 15 Supplement and the Proxy Statement for the May 1998 Annual Meeting for further information regarding Messrs. Raines and Duberstein.

As noted under "Management," the President of the United States has the authority to appoint five directors. The President has not finalized the selection of these directors.

The ratification of KPMG Peat Marwick LLP as auditors was approved by a vote of 898,157,754 for ratification and 697,362 against ratification. The holders of 797,227 shares of common stock abstained from voting on ratification.

The stockholder proposal relating to cumulative voting was defeated by a vote of 162,745,879 for the proposal and 513,201,536 against the proposal. The holders of 127,788,273 shares abstained from voting on this stockholder proposal and broker non-votes represented 95,916,655 shares of common stock.

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INDEPENDENT ACCOUNTANTS' REVIEW REPORT

To the Board of Directors and Stockholders of Fannie Mae:

We have reviewed the accompanying condensed balance sheet of Fannie Mae as of June 30, 1998 and the related condensed statements of income, changes in stockholders' equity, and cash flows for the three- and six-month periods ended June 30, 1998 and 1997. These condensed financial statements are the responsibility of Fannie Mae's management.

We conducted our review in accordance with standards established by the American Institute of Certified Public Accountants. A review of interim financial information consists principally of applying analytical procedures to financial data and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based upon our review, we are not aware of any material modifications that should be made to the condensed financial statements referred to above for them to be in conformity with generally accepted accounting principles.

We have previously audited, in accordance with generally accepted auditing standards, the balance sheet of Fannie Mae as of December 31, 1997 (presented herein in condensed form) and the related statements of income, changes in stockholders' equity, and cash flows for the year then ended (not presented herein); and in our report dated January 14, 1998, we expressed an unqualified opinion on those financial statements. In our opinion, the information set forth in the accompanying condensed balance sheet as of December 31, 1997, is fairly stated, in all material respects, in relation to the balance sheet from which it has been derived.

KPMG PEAT MARWICK LLP

Washington, DC
July 14, 1998

FANNIE MAE
INTERIM FINANCIAL STATEMENTS
CONDENSED STATEMENTS OF INCOME
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	1998	1997	1998	1997
	(Dollars in millions, except per common share amounts)			
Interest income	\$7,351	\$6,514	\$14,376	\$12,843
Interest expense	6,320	5,544	12,309	10,923
Net interest income	1,031	970	2,067	1,920
Guaranty fees	323	317	644	630
Fee and other income, net	79	32	135	62
Credit-related expenses	(69)	(101)	(146)	(207)
Administrative expenses	(174)	(158)	(344)	(309)
Income before federal income taxes and extraordinary item	1,190	1,060	2,356	2,096
Provision for federal income taxes	(339)	(308)	(673)	(610)
Income before extraordinary item	851	752	1,683	1,486
Extraordinary (loss) gain—early extinguishment of debt (net of tax effect)	(3)	1	(11)	1
Net income	<u>\$ 848</u>	<u>\$ 753</u>	<u>\$ 1,672</u>	<u>\$ 1,487</u>
Preferred dividends	(16)	(16)	(32)	(32)
Net income available to common stockholders	<u>\$ 832</u>	<u>\$ 737</u>	<u>\$ 1,640</u>	<u>\$ 1,455</u>
Basic earnings per common share:				
Earnings before extraordinary item	\$.81	\$.70	\$ 1.60	\$ 1.38
Extraordinary item	—	—	(.01)	—
Net earnings	<u>\$.81</u>	<u>\$.70</u>	<u>\$ 1.59</u>	<u>\$ 1.38</u>
Diluted earnings per common share:				
Earnings before extraordinary item	\$.80	\$.69	\$ 1.59	\$ 1.37
Extraordinary item	—	—	(.01)	—
Net earnings	<u>\$.80</u>	<u>\$.69</u>	<u>\$ 1.58</u>	<u>\$ 1.37</u>

CONDENSED BALANCE SHEETS
(Unaudited)

	June 30, 1998	December 31, 1997
	(Dollars in millions)	
Assets		
Mortgage portfolio, net	\$349,282	\$316,316
Investments	69,643	64,596
Other assets	10,523	10,761
Total assets	<u>\$429,448</u>	<u>\$391,673</u>
Liabilities		
Debentures, notes, and bonds, net:		
Due within one year	\$174,942	\$175,400
Due after one year	231,220	194,374
Other liabilities	9,101	8,106
Total liabilities	415,263	377,880
Stockholders' equity	14,185	13,793
Total liabilities and stockholders' equity	<u>\$429,448</u>	<u>\$391,673</u>

See Notes to Interim Financial Statements

FANNIE MAE
CONDENSED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	1998	1997	1998	1997
	(Dollars in millions)			
Balance, beginning of period	\$14,071	\$13,178	\$13,793	\$12,773
Comprehensive income:				
Net income	848	753	1,672	1,487
Other comprehensive income, net of tax—Unrealized gains/(losses) on securities, net	—	—	2	(3)
Total comprehensive income	848	753	1,674	1,484
Dividends	(264)	(237)	(529)	(476)
Shares repurchased	(518)	(453)	(895)	(653)
Treasury stock issued for stock options and benefit plans	48	23	142	136
Balance, end of period	<u>\$14,185</u>	<u>\$13,264</u>	<u>\$14,185</u>	<u>\$13,264</u>

FANNIE MAE
CONDENSED STATEMENTS OF CASH FLOWS
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	1998	1997	1998	1997
	(Dollars in millions)			
Net cash provided by operating activities.	\$ 1,937	\$ 985	\$ 3,641	\$ 3,116
Cash flows from investing activities:				
Purchases of mortgages	(44,152)	(14,386)	(72,755)	(27,465)
Proceeds from sales of mortgages	—	34	396	131
Mortgage principal repayments	22,013	9,249	39,857	17,303
Net increase in investments	(2,434)	(2,165)	(5,047)	(2,676)
Net cash used in investing activities	<u>(24,573)</u>	<u>(7,268)</u>	<u>(37,549)</u>	<u>(12,707)</u>
Cash flows from financing activities:				
Cash proceeds from issuance of debt	213,139	225,529	429,601	404,509
Cash payments to redeem debt	(189,284)	(217,644)	(395,764)	(392,826)
Other	(771)	(667)	(1,332)	(1,021)
Net cash provided by financing activities ...	<u>23,084</u>	<u>7,218</u>	<u>32,505</u>	<u>10,662</u>
Net increase (decrease) in cash and cash equivalents	448	935	(1,403)	1,071
Cash and cash equivalents at beginning of period	354	986	2,205	850
Cash and cash equivalents at end of period ...	<u>\$ 802</u>	<u>\$ 1,921</u>	<u>\$ 802</u>	<u>\$ 1,921</u>

See Notes to Interim Financial Statements

NOTES TO INTERIM FINANCIAL STATEMENTS
(Unaudited)

Basis of Presentation

The accompanying unaudited condensed financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Certain amounts in 1997 have been reclassified to conform with the current presentation. Operating results for the three- and six-month periods ended June 30, 1998 are not necessarily indicative of the results that may be expected for the year ending December 31, 1998. The unaudited interim financial statements should be read in conjunction with the audited financial statements and notes to financial statements that are presented in the Information Statement dated March 31, 1998.

Line of Business Reporting

The following tables set forth the Corporation's financial information by line of business for the three and six months ended June 30, 1998 and 1997. Significant changes from period to period were due to the same factors discussed under "Results of Operations."

<u>Three months ended June 30,</u>	<u>1998</u>			<u>1997</u>		
	<u>Portfolio Investment</u>	<u>Credit Guaranty</u>	<u>Total</u>	<u>Portfolio Investment</u>	<u>Credit Guaranty</u>	<u>Total</u>
	(Dollars in millions)					
Net interest income	\$ 862	\$ 169	\$1,031	\$ 859	\$ 111	\$ 970
Guaranty fees	(203)	526	323	(191)	508	317
Fee and other income, net	16	63	79	4	28	32
Credit-related expenses	—	(69)	(69)	—	(101)	(101)
Administrative expenses	(38)	(136)	(174)	(37)	(121)	(158)
Federal income taxes	(170)	(169)	(339)	(176)	(132)	(308)
Extraordinary item—early extinguishment of debt	(3)	—	(3)	1	—	1
Net income	<u>\$ 464</u>	<u>\$ 384</u>	<u>\$ 848</u>	<u>\$ 460</u>	<u>\$ 293</u>	<u>\$ 753</u>

<u>Six months ended June 30,</u>	<u>1998</u>			<u>1997</u>		
	<u>Portfolio Investment</u>	<u>Credit Guaranty</u>	<u>Total</u>	<u>Portfolio Investment</u>	<u>Credit Guaranty</u>	<u>Total</u>
	(Dollars in millions)					
Net interest income	\$1,755	\$ 312	\$2,067	\$1,707	\$ 213	\$1,920
Guaranty fees	(400)	1,044	644	(380)	1,010	630
Fee and other income, net	32	103	135	12	50	62
Credit-related expenses	—	(146)	(146)	—	(207)	(207)
Administrative expenses	(74)	(270)	(344)	(73)	(236)	(309)
Federal income taxes	(356)	(317)	(673)	(353)	(257)	(610)
Extraordinary item—early extinguishment of debt	(11)	—	(11)	1	—	1
Net income	<u>\$ 946</u>	<u>\$ 726</u>	<u>\$1,672</u>	<u>\$ 914</u>	<u>\$ 573</u>	<u>\$1,487</u>

The Portfolio Investment business represented \$419 billion, or 98 percent of total assets, at June 30, 1998 and \$351 billion, or 96 percent of total assets, at June 30, 1997.

NOTES TO INTERIM FINANCIAL STATEMENTS (Continued)

Commitments and Contingencies

The Corporation had outstanding commitments to purchase mortgages and to issue MBS as shown below:

	June 30, 1998
	(Dollars in billions)
Commitments to purchase mortgages:	
Mandatory delivery	\$14.1
Optional delivery (1)	1.6
Average net yield on mandatory delivery	6.74%
Commitments to issue MBS:	
Mandatory delivery (1)	\$ —
Optional delivery (1) .....	.1
Master commitments:	
Mandatory delivery (2)	45.3
Optional delivery	69.7

(1) Excludes commitments attached to master commitments, which are included in the total for master commitments.

(2) Under a mandatory master commitment, a lender must either deliver under an MBS contract at a specified guaranty fee or enter into a mandatory portfolio commitment with the yield established upon executing the portfolio commitment.

The Corporation also guarantees timely payment of principal and interest on outstanding MBS and provides credit enhancements or other guarantees as summarized below:

	June 30, 1998
	(Dollars in billions)
MBS(1)	\$761
MBS for which the Corporation has primary foreclosure loss risk	643
Credit enhancements	5.7
Other guarantees	2.8

(1) Includes \$156 billion of MBS held in portfolio and net of \$542 million in allowance for losses. The Corporation assumes the ultimate risk of loss on all MBS.

COMPUTATION OF EARNINGS PER COMMON SHARE

(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	1998	1997	1998	1997
(In millions, except per common share data)				
Numerator:				
Net income before extraordinary loss	\$851	\$752	\$1,683	\$1,486
Extraordinary gain (loss)	(3)	1	(11)	1
Preferred stock dividends	(16)	(16)	(32)	(32)
Basic and diluted earnings per common share-income available to common stockholders	<u>\$832</u>	<u>\$737</u>	<u>\$1,640</u>	<u>\$1,455</u>
Denominator:				
Basic earnings per common share-weighted-average common shares	1,029	1,051	1,033	1,056
Dilutive potential common shares(1)	<u>8</u>	<u>10</u>	<u>8</u>	<u>8</u>
Diluted earnings per common share-adjusted weighted average common shares	<u>1,037</u>	<u>1,061</u>	<u>1,041</u>	<u>1,064</u>
Basic earnings per common share:				
Earnings before extraordinary item.....	\$.81	\$.70	\$ 1.60	\$ 1.38
Net earnings .....	.81	.70	1.59	1.38
Diluted earnings per common share:				
Earnings before extraordinary item.....	\$.80	\$.69	\$ 1.59	\$ 1.37
Net earnings .....	.80	.69	1.58	1.37

(1) Dilutive potential common shares consist primarily of the dilutive effect from employee stock options and other stock compensation plans.

MANAGEMENT

As discussed under “Matters Submitted to Stockholders,” at the Annual Meeting of Stockholders in May 1998, thirteen directors, including two new directors, were elected to serve a one-year term ending on the date of the May 1999 Annual Meeting. The President of the United States has the authority to appoint five directors. As of August 12, 1998, the President of the United States had not finalized the selection of these directors.

In June 1998, two executive vice presidents accepted new responsibilities. Robert Levin became Executive Vice President—Housing and Community Development, a new position responsible for the Corporation’s National Housing Impact Division, multifamily lending, the American Communities Fund, 31 Partnership Offices and the Housing Impact Fund. Ann Logan became Executive Vice President—Single-Family Mortgage Business, responsible for the Corporation’s single-family business, credit product development and management, pricing, the Corporation’s sales force, credit loss management and, in concert with the Corporation’s Executive Vice President and Chief Information Officer, technology products marketing.

In July 1998, the Board elected Adolfo Marzol Executive Vice President and Chief Credit Officer. Mr. Marzol was Senior Vice President—Single-Family Business from July 1996 and Senior Vice President—Capital Markets from February 1996 to July 1996. Prior to joining the Corporation, Mr. Marzol was Executive Vice President and Chief Financial Officer from July 1993 to January 1996 of Chase Manhattan Mortgage Corporation, a mortgage company. Management also announced that Kenneth J. Bacon, Senior Vice President—Northeastern Regional Office since May 1993, will become the head of the Community Development Capital Corporation which consists of the American Communities Fund and the Housing Impact Fund.

**CERTIFICATE OF DESIGNATION OF TERMS OF
% NON-CUMULATIVE PREFERRED STOCK, SERIES D**

1. Designation, Par Value and Number of Shares.

The designation of the series of preferred stock of the Federal National Mortgage Association (the "Corporation") created by this resolution shall be " % Non-Cumulative Preferred Stock, Series D" (the "Series D Preferred Stock"), and the number of shares constituting the Series D Preferred Stock is Million (,000,000). Shares of Series D Preferred Stock will have no par value and a stated value and liquidation preference of \$50 per share. The Board of Directors of the Corporation, or a duly authorized committee thereof, in its sole discretion, may reduce the number of shares of Series D Preferred Stock, provided such reduction is not below the number of shares of Series D Preferred Stock then outstanding.

2. Dividends.

(a) Holders of record of Series D Preferred Stock (each individually a "Holder", or collectively the "Holders") will be entitled to receive, when, as and if declared by the Board of Directors of the Corporation, or a duly authorized committee thereof, in its sole discretion out of funds legally available therefor, non-cumulative, quarterly cash dividends which will accrue from and including , 1998, and will be payable on March 31, June 30, September 30 and December 31 of each year (each, a "Dividend Payment Date"), commencing December 31, 1998, at the annual rate of \$ per share or % of the stated value and liquidation preference of \$50 per share (without taking into account any adjustments referred to in clause (b) below). Dividends on the Series D Preferred Stock will be payable to the Holders as they appear on the books and records of the Corporation on the relevant record date fixed by the Board of Directors, or a duly authorized committee thereof, which may not be earlier than 45 days or later than 10 days prior to the applicable Dividend Payment Date. If declared, the initial dividend, which will be for the period from and including , 1998 to but excluding December 31, 1998, will be \$. per share. Thereafter, the dividend period relating to a Dividend Payment Date will be the period from and including the preceding Dividend Payment Date to but excluding such Dividend Payment Date. If a Dividend Payment Date is not a Business Day, dividends (if declared) on the Series D Preferred Stock will be paid on the succeeding Business Day, without interest. A "Business Day" shall mean any day other than a Saturday, Sunday or other day on which banking institutions in New York, New York are authorized or required by law to close. Dividends payable on the Series D Preferred Stock for any period greater or less than a full dividend period will be computed on the basis of a 360-day year consisting of twelve 30-day months and the actual number of days elapsed in any period of less than one month. Dividends payable on the Series D Preferred Stock for each full dividend period will be computed by dividing the per annum dividend rate by four.

(b) No dividend (other than dividends or distributions paid in shares of, or options, warrants or rights to subscribe for or purchase shares of, the common stock of the Corporation or any other stock of the Corporation ranking, as to the payment of dividends and the distribution of assets upon dissolution, liquidation or winding up of the Corporation, junior to the Series D Preferred Stock) may be declared or paid or set apart for payment on the Corporation's common stock (or on any other stock of the Corporation ranking, as to the payment of dividends, junior to the Series D Preferred Stock) unless dividends have been declared and paid or set apart (or ordered to be set apart) on the Series D Preferred Stock for the then-current quarterly dividend period; provided, however, that the foregoing dividend preference shall not be cumulative and shall not in any way create any claim or right in favor of the Holders of Series D Preferred Stock in the event that dividends have not been declared or paid or set apart (or ordered to be set apart) on the Series D Preferred Stock in respect of any prior dividend period. If the full dividend on the Series D Preferred Stock is not paid for any quarterly dividend period, the Holders of Series D Preferred Stock will have no claim in respect of the unpaid amount so long as no dividend (other than those referred to above) is paid on the

Corporation's common stock (or any other stock of the Corporation ranking, as to the payment of dividends, junior to the Series D Preferred Stock) for such dividend period.

(c) The Board of Directors of the Corporation, or a duly authorized committee thereof, may, in its discretion, choose to pay dividends on the Series D Preferred Stock without the payment of any dividends on the Corporation's common stock (or any other stock of the Corporation ranking, as to the payment of dividends, junior to the Series D Preferred Stock).

(d) No full dividends shall be declared or paid or set apart for payment on any stock of the Corporation ranking, as to the payment of dividends, on a parity with the Series D Preferred Stock for any period unless full dividends have been declared and paid or set apart for payment on the Series D Preferred Stock for the then-current quarterly dividend period. When dividends are not paid in full upon the Series D Preferred Stock and all other classes or series of stock of the Corporation, if any, ranking, as to the payment of dividends, on a parity with the Series D Preferred Stock, all dividends declared upon shares of Series D Preferred Stock and all such other stock of the Corporation will be declared pro rata so that the amount of dividends declared per share of Series D Preferred Stock and all such other stock will in all cases bear to each other the same ratio that accrued dividends per share of Series D Preferred Stock but without accumulation of unpaid dividends on the Series D Preferred Stock for prior dividend periods) and such other stock bear to each other.

(e) No dividends may be declared or paid or set apart for payment on any shares of Series D Preferred Stock if at the same time any arrears exist or default exists in the payment of dividends on any outstanding class or series of stock of the Corporation ranking, as to the payment of dividends, prior to the Series D Preferred Stock.

(f) Holders of Series D Preferred Stock will not be entitled to any dividends, whether payable in cash or property, other than as herein provided and will not be entitled to interest, or any sum in lieu of interest, in respect of any dividend payment.

3. Optional Redemption.

(a) On or after _____, 1999, the Corporation, at its option, may redeem the Series D Preferred Stock, in whole or in part, at any time or from time to time, out of funds legally available therefor, at the redemption price of \$50.00 per share plus an amount equal to the dividend (whether or not declared) for the then-current quarterly dividend period accrued to but excluding the date of such redemption, but without accumulation of unpaid dividends on the Series D Preferred Stock for prior dividend periods. If less than all of the outstanding shares of Series D Preferred Stock are to be redeemed, the Corporation will select the shares to be redeemed from the outstanding shares not previously called for redemption by lot or pro rata (as nearly as possible) or by any other method that the Board of Directors of the Corporation, or a duly authorized committee thereof, in its sole discretion deems equitable.

(b) In the event the Corporation shall redeem any or all of the Series D Preferred Stock as aforesaid, the Corporation will give notice of any such redemption to Holders of Series D Preferred Stock not less than 30 days prior to the date fixed by the Board of Directors of the Corporation, or duly authorized committee thereof, for such redemption. Each such notice will state: (1) the number of shares of Series D Preferred Stock to be redeemed and, if fewer than all of the shares of Series D Preferred Stock held by a Holder are to be redeemed, the number of shares to be redeemed from such Holder; (2) the redemption price; (3) the redemption date; and (4) the place at which a Holder's certificate(s) representing shares of Series D Preferred Stock must be presented upon such redemption. Failure to give notice, or any defect in the notice, to any Holder of Series D Preferred Stock shall not affect the validity of the proceedings for the redemption of shares of any other Holder of Series D Preferred Stock being redeemed.

(c) Notice having been given as herein provided, from and after the redemption date, dividends on the Series D Preferred Stock called for redemption shall cease to accrue and such Series D Preferred Stock called for redemption will no longer be deemed outstanding, and all rights of the Holders thereof as registered holders of such shares of Series D Preferred Stock will cease. Upon

surrender in accordance with said notice of the certificate(s) representing shares of Series D Preferred Stock so redeemed (properly endorsed or assigned for transfer, if the Board of Directors of the Corporation, or a duly authorized committee thereof, shall so require and the notice shall so state), such shares shall be redeemed by the Corporation at the redemption price aforesaid. Any shares of Series D Preferred Stock that shall at any time have been redeemed shall, after such redemption, be cancelled and not reissued. In case fewer than all the shares represented by any such certificate are redeemed, a new certificate shall be issued representing the unredeemed shares without cost to the Holder thereof.

(d) The Series D Preferred Stock will not be subject to any mandatory redemption, sinking fund or other similar provisions. In addition, Holders of Series D Preferred Stock will have no right to require redemption of any shares of Series D Preferred Stock.

4. Liquidation Rights.

(a) Upon any voluntary or involuntary dissolution, liquidation or winding up of the Corporation, after payment or provision for the liabilities of the Corporation and the expenses of such dissolution, liquidation or winding up, the Holders of outstanding shares of the Series D Preferred Stock will be entitled to receive out of the assets of the Corporation or proceeds thereof available for distribution to stockholders, before any payment or distribution of assets is made to holders of the Corporation's common stock (or any other stock of the Corporation ranking, as to the distribution of assets upon dissolution, liquidation or winding up of the Corporation, junior to the Series D Preferred Stock), the amount of \$50.00 per share plus an amount equal to the dividend (whether or not declared) for the then-current quarterly dividend period accrued to but excluding the date of such liquidation payment, but without accumulation of unpaid dividends on the Series D Preferred Stock for prior dividend periods.

(b) If the assets of the Corporation available for distribution in such event are insufficient to pay in full the aggregate amount payable to Holders of Series D Preferred Stock and holders of all other classes or series of stock of the Corporation, if any, ranking, as to the distribution of assets upon dissolution, liquidation or winding up of the Corporation, on a parity with the Series D Preferred Stock, the assets will be distributed to the Holders of Series D Preferred Stock and holders of all such other stock pro rata, based on the full respective preferential amounts to which they are entitled, but without accumulation of unpaid dividends on the Series D Preferred Stock for prior dividend periods.

(c) Notwithstanding the foregoing, Holders of Series D Preferred Stock will not be entitled to be paid any amount in respect of a dissolution, liquidation or winding up of the Corporation until holders of any classes or series of stock of the Corporation ranking, as to the distribution of assets upon dissolution, liquidation or winding up of the Corporation, prior to the Series D Preferred Stock have been paid all amounts to which such classes or series are entitled.

(d) Neither the sale, lease or exchange (for cash, shares of stock, securities or other consideration) of all or substantially all of the property and assets of the Corporation, nor the merger, consolidation or combination of the Corporation into or with any other corporation or the merger, consolidation or combination of any other corporation into or with the Corporation, shall be deemed to be a dissolution, liquidation or winding up, voluntary or involuntary, for the purposes of this Section 4.

(e) After payment of the full amount of the distribution of assets upon dissolution, liquidation or winding up of the Corporation to which they are entitled pursuant to paragraphs (a), (b) and (c) of this Section 4, the Holders of Series D Preferred Stock will not be entitled to any further participation in any distribution of assets by the Corporation.

5. No Conversion or Exchange Rights.

The Holders of shares of Series D Preferred Stock will not have any rights to convert such shares into or exchange such shares for shares of any other class or classes, or of any other series of any class or classes, of stock or obligations of the Corporation.

6. No Pre-emptive Rights.

No Holder of Series D Preferred Stock shall be entitled as a matter of right to subscribe for or purchase, or have any pre-emptive right with respect to, any part of any new or additional issue of stock of any class whatsoever, or of securities convertible into any stock of any class whatsoever, whether now or hereafter authorized and whether issued for cash or other consideration or by way of dividend.

7. Voting Rights; Amendments.

(a) Except as provided below, the Holders of Series D Preferred Stock will not be entitled to any voting rights, either general or special.

(b) Without the consent of the Holders of Series D Preferred Stock, the Corporation will have the right to amend, alter, supplement or repeal any terms of the Series D Preferred Stock (i) to cure any ambiguity, or to cure, correct or supplement any defective provision contained in this Certificate of Designation or (ii) to make any other provision with respect to matters or questions arising with respect to the Series D Preferred Stock that is not inconsistent with the provisions of this Certificate of Designation so long as such action does not materially and adversely affect the interests of the Holders of Series D Preferred Stock; provided, however, that any increase in the amount of authorized or issued Series D Preferred Stock or the creation and issuance, or an increase in the authorized or issued amount, of any other class or series of stock of the Corporation, whether ranking prior to, on a parity with or junior to the Series D Preferred Stock, as to the payment of dividends or the distribution of assets upon dissolution, liquidation or winding up of the Corporation, or otherwise, will not be deemed to materially and adversely affect the interests of the Holders of Series D Preferred Stock.

(c) Except as set forth in paragraph (b) of this Section 7, the terms of the Series D Preferred Stock may be amended, altered, supplemented or repealed only with the consent of the Holders of at least two-thirds of the shares of Series D Preferred Stock then outstanding, given in person or by proxy, either in writing or at a meeting of stockholders at which the Holders of Series D Preferred Stock shall vote separately as a class. On matters requiring their consent, Holders of Series D Preferred Stock will be entitled to one vote per share.

(d) The rules and procedures for calling and conducting any meeting of Holders (including, without limitation, the fixing of a record date in connection therewith), the solicitation and use of proxies at such a meeting, the obtaining of written consents, and any other aspect or matter with regard to such a meeting or such consents shall be governed by any rules that the Board of Directors of the Corporation, or a duly authorized committee thereof, in its discretion, may adopt from time to time, which rules and procedures shall conform to the requirements of any national securities exchange on which the Series D Preferred Stock are listed at the time.

8. Additional Classes or Series of Stock.

The Board of Directors of the Corporation, or a duly authorized committee thereof, shall have the right at any time in the future to authorize, create and issue, by resolution or resolutions, one or more additional classes or series of stock of the Corporation, and to determine and fix the distinguishing characteristics and the relative rights, preferences, privileges and other terms of the shares thereof. Any such class or series of stock may rank prior to, on a parity with or junior to the Series D Preferred Stock as to the payment of dividends or the distribution of assets upon dissolution, liquidation or winding up of the Corporation, or otherwise.

9. Priority.

For purposes of this Certificate of Designation, any stock of any class or series of the Corporation shall be deemed to rank:

(a) Prior to the shares of Series D Preferred Stock, either as to the payment of dividends or the distribution of assets upon dissolution, liquidation or winding up of the Corporation, if the holders of

such class or series shall be entitled to the receipt of dividends or of amounts distributable upon dissolution, liquidation or winding up of the Corporation, as the case may be, in preference or priority to the Holders of shares of Series D Preferred Stock.

(b) On a parity with shares of Series D Preferred Stock, either as to the payment of dividends or the distribution of assets upon dissolution, liquidation or winding up of the Corporation, whether or not the dividend rates or amounts, dividend payment dates or redemption or liquidation prices per share, if any, be different from those of the Series D Preferred Stock, if the holders of such class or series shall be entitled to the receipt of dividends or of amounts distributable upon dissolution, liquidation or winding up of the Corporation, as the case may be, in proportion to their respective dividend rates or amounts or liquidation prices, without preference or priority, one over the other, as between the holders of such class or series and the Holders of shares of Series D Preferred Stock.

(c) Junior to shares of Series D Preferred Stock, either as to the payment of dividends or the distribution of assets upon dissolution, liquidation or winding up of the Corporation, if such class shall be common stock of the Corporation or if the Holders of shares of Series D Preferred Stock shall be entitled to the receipt of dividends or of amounts distributable upon dissolution, liquidation or winding up of the Corporation, as the case may be, in preference or priority over the holders of such class or series.

(d) The shares of Preferred Stock of the Corporation designated “6.41% Non-Cumulative Preferred Stock, Series A” (the “Series A Preferred Stock”), “6.50% Non-Cumulative Preferred Stock, Series B” (the “Series B Preferred Stock”) and the “6.45% Non-Cumulative Preferred Stock, Series C” (“the Series C Preferred Stock”) shall be deemed to rank on a parity with shares of Series D Preferred Stock as to the payment of dividends and the distribution of assets upon dissolution, liquidation or winding up of the Corporation. Accordingly, the holders of record of Series A Preferred Stock, the holders of record of Series B Preferred Stock, the Holders of Series C Preferred Stock, and the Holders of Series D Preferred Stock shall be entitled to the receipt of dividends and of amounts distributable upon dissolution, liquidation or winding up of the Corporation, as the case may be, in proportion to their respective dividend rates or amounts or liquidation prices, without preference or priority, one over the other.

10. Transfer Agent, Dividend Disbursing Agent and Registrar.

The Corporation hereby appoints First Chicago Trust Company of New York as its initial transfer agent, dividend disbursing agent and registrar for the Series D Preferred Stock. The Corporation may at any time designate an additional or substitute transfer agent, dividend disbursing agent and registrar for the Series D Preferred Stock.

11. Notices.

Any notice provided or permitted by this Certificate of Designation to be made upon, or given or furnished to, the Holders of Series D Preferred Stock by the Corporation shall be made by first-class mail, postage prepaid, to the addresses of such Holders as they appear on the books and records of the Corporation. Such notice shall be deemed to have been sufficiently made upon deposit thereof in the United States mail. Notwithstanding anything to the contrary contained herein, in the case of the suspension of regular mail service or by reason of any other cause it shall be impracticable, in the Corporation’s judgment, to give notice by mail, then such notification may be made, in the Corporation’s discretion, by publication in a newspaper of general circulation in The City of New York or by hand delivery to the addresses of Holders as they appear on the books and records of the Corporation.

RECEIPT AND ACCEPTANCE OF A SHARE OR SHARES OF THE SERIES D PREFERRED STOCK BY OR ON BEHALF OF A HOLDER SHALL CONSTITUTE THE UNCONDITIONAL ACCEPTANCE BY SUCH HOLDER (AND ALL OTHERS HAVING BENEFICIAL OWNERSHIP OF SUCH SHARE OR SHARES) OF ALL OF THE TERMS AND PROVISIONS

OF THIS CERTIFICATE OF DESIGNATION. NO SIGNATURE OR OTHER FURTHER MANIFESTATION OF ASSENT TO THE TERMS AND PROVISIONS OF THIS CERTIFICATE OF DESIGNATION SHALL BE NECESSARY FOR ITS OPERATION OR EFFECT AS BETWEEN THE CORPORATION AND THE HOLDER (AND ALL SUCH OTHERS).