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,				
	1997	**1996**	**1995**	**1994**	**1993**
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	12,447	14,680	15,660	15,899	15,332
Total UPB	$316,678	$287,052	$253,511	$222,057	$190,861
Yield	7.60%	7.69%	7.80%	7.80%	7.79%

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

	1997		1996	
Quarter	**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	$ 3,056	$ 2,725	$ 2,144	$ 2,132	$ 1,873
Preferred stock dividends	(65)	(42)	—	—	—
Net income available to common stockholders	$ 2,991	$ 2,683	$ 2,144	$ 2,132	$ 1,873
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	$ 2.85	$ 2.50	$ 1.97	$ 1.95	$ 1.71
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	$ 2.83	$ 2.48	$ 1.95	$ 1.94	$ 1.71
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	279	216	199
Credit-related losses	$345	$407	$345
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	100%	100%	100%	100%	100%
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	100%	100%	100%	100%	100%
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	100%	100%			
Average current loan-to-value ratio	62%	64%			
Average loan amount (Maximum $214,600 in 1997)	$80,800	$83,200	$99,900	$99,900	$97,400

(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	.62%	.58%	.56%

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	100%	100%	100%

(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	(4)	(3)	(4)
Credit-related losses	$ 7	$ 16	$ 22
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	(114)
Balance, December 31, 1993	841
Provision	155
Net foreclosure losses charged off	(169)
Balance, December 31, 1994	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

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	$70,465	$68,618	$56,598	$1,088	$149	$418	$39,751	$34,928	$24,727
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

	1997	1996	1995
		(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

	1997	1996
	(Dollars in billions)	
Issued during the year	$ 36	$ 44
Percentage of total long-term debt issued	46%	52%
Outstanding at year-end	$136	$127
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.

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				
	Notional(2)	Pay Rate(3)	Receive Rate(3)	Notional(2)	Pay Rate(3)	Receive Rate(3)	Basis Swaps	Total
	(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	6,941	6.59	5.50	10,334	5.67	6.90	20,677	37,952
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	15,955	6.36	5.69	10,656	5.56	6.54	32,929	59,540
Balance at December 31, 1997	$ 96,713	6.77%	5.82%	$29,653	5.63%	6.30%	$22,383	$148,749
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	64,956	7.06	5.86	5,134	5.58	7.44	1,411	71,501
	$ 96,713	6.77%	5.82%	$29,653	5.63%	6.30%	$22,383	$148,749

(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

	December 31,	
	1997	1996
	(Dollars in millions)	
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	$ 1,090	$ 1,307

(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	Fannie Mae Risk	Fannie Mae Originated	Total	Lender Risk (2)	Fannie Mae Risk	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

	1997	1996
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	1,037	$1,000	$593	$1,495	$13,325	$(2,620)	$13,793

(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	(1,691)	(830)	(922)
Net cash provided by operating activities	6,496	6,473	6,449
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	(7,990)	667	(10,937)
Net cash used in investing activities	(36,877)	(32,401)	(42,237)
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	(2,097)	(1,314)	(752)
Net cash provided by financing activities	31,736	26,460	35,875
Net increase in cash and cash equivalents	1,355	532	87
Cash and cash equivalents at beginning of year	850	318	231
Cash and cash equivalents at end of year	$ 2,205	$ 850	$ 318
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

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

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.

2. Mortgage Portfolio, Net

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

	1997	1996
	(Dollars in millions)	
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	268	323
	304,231	272,372
Multifamily mortgages:		
Government insured	3,360	3,673
Conventional	9,087	11,007
	12,447	14,680
Total unpaid principal balance	316,678	287,052
Less:		
Unamortized discount and deferred loan fees, net	86	524
Allowance for losses	276	269
Net mortgage portfolio	$316,316	$286,259

(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.

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.

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	$58,690	$12	$—	$58,702	$53,106	$20	$ 4	$53,122

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	$5,908	$—	$2	$5,906	$3,502	$—	$2	$3,500

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	$64,598	$64,608	6.00%	$56,608	$56,622	5.86%

(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.

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):										
Debentures	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	$175,400	5.76%				$159,900	5.65%			

(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.

Borrowings Due After One Year

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

		1997		1996	
	Maturity Date	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	193	9.99	198	9.99
		195,239	6.67%	171,559	6.66%
Adjustment for foreign currency translation		(865)		(189)	
Total due after one year		$194,374		$171,370	

(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.

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.

Call Date	Year of Maturity	Amount Outstanding	Average Cost
	(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	1,624	6.28
		150,053	6.55
Other redeemable debt and swaps	1998-2002	527	6.77
Total		$150,580	6.55%

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:

	Total Debt by Year of Maturity (1)	Assuming Callable Debt Redeemed at Initial Call Date (1)
	(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.

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.

7. Earnings per Common Share

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

	1997	1996	1995
	(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	(65)	(42)	—
Numerator for basic and diluted earnings per common share—income available to common stockholders	$2,991	$2,683	$2,144
Denominator:			
Denominator for basic earnings per common share—weighted-average common shares	1,049	1,071	1,091
Dilutive potential common shares(1)	7	9	7
Denominator for diluted earnings per common share—adjusted weighted-average common shares	1,056	1,080	1,098
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	2.83	2.48	1.95

(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.

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.

	1997	1996	1995
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
Expected life	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.

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	22,777	$27.15	23,910	$22.24	24,249	$18.90
Options vested, December 31	13,275	$20.30	11,767	$17.65	9,271	$15.05

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

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	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	3,022	9.9	51.28	58	42.79
Total	22,777	7.2 yrs.	$27.15	13,275	$20.30

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

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.

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	$1,847	$1,209	$ 3,056	$1,662	$1,063	$ 2,725	$1,369	$1,003	$(228)	$2,144

(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.

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.

	Issue Date	Shares Issued and Outstanding	Stated Value Per Share	Annual Dividend Rate	Redeemable On or After
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	5,000,000	50	6.45	September 20, 2001
Total		20,000,000			

(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

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

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.

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.

	1997	1996
	(Dollars in billions)	
MBS outstanding(1)	$ 709.1	$ 650.3
MBS in portfolio	(130.4)	(102.6)
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.

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.

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

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

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.

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.

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

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

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.

Gross UPB at December 31,	Fixed-Rate Loans by Note Rate(1) Under 7.00%	7.00% to 7.99%	8.00% to 8.99%	9.00% to 9.99%	10.00% to 10.99%	11.00% and over	Total
	(Dollars in billions)						
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

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

	December 31, 1997		December 31, 1996	
	Cost	Fair Value	Cost	Fair Value
	(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	8,556	6,489	7,326	4,604
	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	391,673	402,163	351,041	355,933

Liabilities and Net Assets

	December 31, 1997		December 31, 1996	
	Cost	Fair Value	Cost	Fair Value
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	108,675	108,706	95,883	101,822
	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	377,880	386,181	338,268	341,377
Net assets, net of tax effect	$ 13,793	$ 15,982	$ 12,773	$ 14,556

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.

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

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	5,848	5,658	5,544	5,379
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	(167)	(159)	(159)	(151)
Income before federal income taxes and extraordinary item	1,145	1,096	1,060	1,036
Provision for federal income taxes	(339)	(319)	(309)	(302)
Income before extraordinary item	806	777	751	734
Extraordinary item—early extinguishment of debt (net of tax effect)	(12)	(2)	2	—
Net income	$ 794	$ 775	$ 753	$ 734
Preferred stock dividends	(16)	(16)	(17)	(16)
Net income available to common stockholders	$ 778	$ 759	$ 736	$ 718
Basic earnings per common share (1):				
Earnings before extraordinary item	$ .76	$ .73	$ .70	$ .68
Extraordinary item	(.01)	—	—	—
Net earnings	$ .75	$ .73	$ .70	$ .68
Diluted earnings per common share (1):				
Earnings before extraordinary item	$ .75	$ .72	$ .69	$ .67
Extraordinary item	(.01)	—	—	—
Net earnings	$ .74	$ .72	$ .69	$ .67
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	$ 713	$ 691	$ 667	$ 654
Preferred stock dividends	(17)	(12)	(11)	(2)
Net income available to common stockholders	$ 696	$ 679	$ 656	$ 652
Basic earnings per common share (1):				
Earnings before extraordinary item	$ .66	$ .64	$ .62	$ .62
Extraordinary item	—	—	(.01)	(.02)
Net earnings	$ .66	$ .64	$ .61	$ .60
Diluted earnings per common share (1):				
Earnings before extraordinary item	$ .65	$ .63	$ .61	$ .61
Extraordinary item	—	—	—	(.01)
Net earnings	$ .65	$ .63	$ .61	$ .60
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)

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

(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:

Name and Age	Principal Occupation, Business Experience, and Residence	First Became Director	Other Directorships (1)
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	

Name and Age	Principal Occupation, Business Experience, and Residence	First Became Director	Other Directorships (1)
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	

Name and Age	Principal Occupation, Business Experience, and Residence	First Became Director	Other Directorships (1)
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.

FannieMae