The American Dream Decade

Meeting the Growing Demand for Homeownership

2001 Annual Report

2001 2002 2003 2004 2005 2006 2007 2008 2009 2010

Fannie Mae 2001 Annual Report

Our Business is The American Dream

At Fannie Mae, we are in the American Dream business. Our Mission is to tear down barriers, lower costs, and increase the opportunities for homeownership and affordable rental housing for all Americans. Because having a safe place to call home strengthens families, communities, and our nation as a whole.

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Financial Highlights

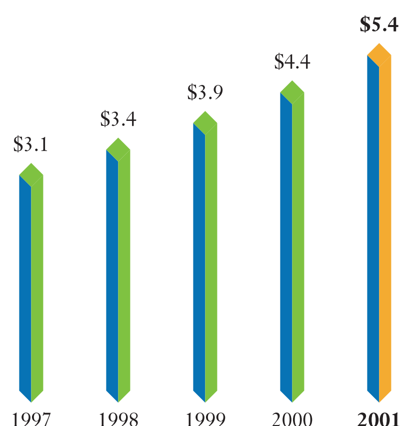
Dollars in millions, except per common share amounts	**2001**	2000	% Change
For the Year			
Operating net income[1]	**$ 5,367**	$ 4,448	21
Operating earnings per diluted common share	**5.20**	4.29	21
Net income	**5,894**	4,448	33
Diluted earnings per common share	**5.72**	4.29	33
Dividends per common share	**1.20**	1.12	7
Mortgage purchases	**270,584**	154,231	75
MBS issues acquired by others	**344,739**	105,407	227
At December 31,			
Mortgage portfolio, net	**$705,167**	$607,399	16
Total assets	**799,791**	675,072	18
Stockholders' equity	**18,118**	20,838	(13)
Core capital	**25,182**	20,827	21
Excess of core capital over minimum capital	**1,000**	533	88
Outstanding MBS[2]	**858,867**	706,684	22

Other Statistics	Year Ended December 31,		
	2001	2000	% Change
Total taxable-equivalent revenues	**$ 10,187**	$ 7,825	30
Average net interest margin	**1.11%**	1.01%	10
Average effective guaranty fee rate	**.190**	.195	(3)
Credit loss ratio	**.006**	.007	(14)
Administrative expense ratio	**.071**	.072	(1)
Efficiency ratio	**10.0**	11.6	(14)
Operating return on average realized common equity	**25.4**	25.2	1

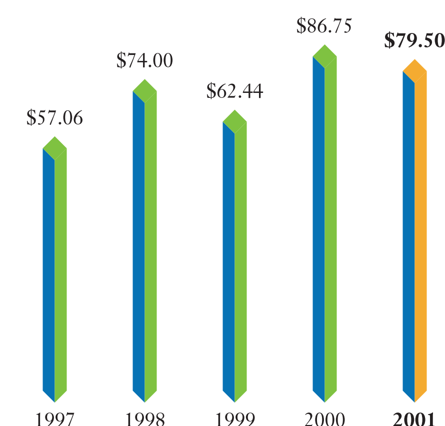
[1] Excludes the cumulative after-tax gain of $168 million from the change in accounting principle upon adoption of FAS 133 on January 1, 2001 and the after-tax loss of $24 million recognized during the year 2001 for the change in fair value of time value of purchased options under FAS 133. Includes after-tax charges of $383 million for the amortization expense of purchased options premiums during the year ended December 31, 2001.
[2] MBS held by investors other than Fannie Mae.

Dividends per Common Share

Operating Net Income
In billions



Stock Price per Common Share
December 31,



Letter to Shareholders

The Power of Housing

Franklin D. Raines
Chairman and Chief Executive Officer

To Our Shareholders:

Congratulations. Together, in 2001, we achieved the single best year for homeownership in America in all of Fannie Mae's 33 years as a private corporation.

In 2001, your company helped a record 5.2 million Americans purchase or refinance homes or obtain affordable rental housing. Fannie Mae helped to expand mortgage consumer rights, broaden homeownership among Americans of color and modest means, and spruce up old neighborhoods all over the country. Along the way, Fannie Mae helped the housing sector of the economy produce its best year in history, which in turn helped to ease the recession, speed the recovery, and fuel economic growth.

Fannie Mae's record-breaking service to the American Dream produced our single best financial performance ever. Our combined book of business grew by 19 percent, taxable equivalent revenues grew by 30 percent, credit losses fell to their lowest level since 1983, and operating earnings per share grew by 21 percent over the previous year. With this performance, Fannie Mae is one of only three companies in the Standard & Poor's 500 index to achieve double-digit growth in operating earnings per share for each of the past 15 years.

Also in 2001, Fannie Mae set an important new standard for corporate best practices by implementing the strongest transparency and disclosure practices of any large financial institution in the country. At a time when the market, shareholders, policy makers, and the public are seeking – and deserve – additional assurance and confidence in their

As a leading provider of low-cost mortgage capital for home buyers to finance their homes, Fannie Mae is at the center of the housing industry, one of the strongest growth sectors in America.

public companies, Fannie Mae is a model for openness, transparency, regulatory oversight, capital protections, and market discipline.

Most important is the future. As a Fannie Mae shareholder, you own a company that not only has a great track record, but we believe has a great decade ahead.

As a leading provider of low-cost mortgage capital for home buyers to finance their homes, Fannie Mae is at the center of the housing industry, one of the strongest growth sectors in America.

During the 1990s, as the U.S. homeownership rate grew to a record level and the country added 11 million new homeowners, Fannie Mae's market – residential mortgage debt – grew an average of 7 percent per year. Indeed, the mortgage market has grown more than 2 percent faster than the nominal Gross Domestic Product for the last 30 years, and it will remain one of the fastest growing markets in America for several reasons.

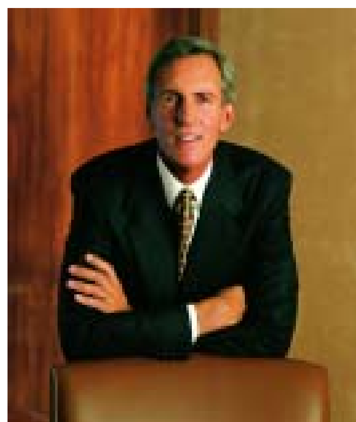
First of all, housing is the leading consumer product in America.

The house is the single most important purchase most Americans will ever make. Making a house a home is a true American pastime. Families spend a quarter of their income on buying, fixing, furnishing, and maintaining their homes.

Housing-related expenditures account for about 21 percent of the nation's Gross Domestic Product, or about one out of every five dollars spent in the U.S. each year. When people buy a new home, they spend almost $9,000 in the first year on furniture, appliances, decorations, and other

Daniel H. Mudd
Vice Chairman and
Chief Operating Officer

Jamie S. Gorelick
Vice Chair



Timothy Howard
Executive Vice President
and Chief Financial Officer

The 1990s was one of the best decades in history for housing, and this decade began with one of the single best years ever. But the best is yet to come.

improvements. If they move into an older home, they'll still spend $6,500 in the first year making it better. Altogether, consumers spent $1.7 trillion in 2001 on housing-related goods and services. That's more than they spent on food, clothing, and education combined.

On top of being the leading consumer product, housing also is the leading consumer investment in America.

The average family invests more in their homes than they invest in the stock market, money market funds, or their retirement savings plans. There is a good reason for that. Housing is a safe, leveraged investment – the only leveraged investment available to most families – and it is one of the best returning investments to make. Even after the longest, strongest bull market in history, over the last 10 years, the average-priced home earned nearly twice the value of the average stock portfolio – $44,000 versus $23,000.

In a recent poll, 39 percent of Americans said they believe that real estate is the best investment they can make, while only 20 percent picked the stock market. While consumers consider stock market gains to be volatile and ephemeral, they regard home value gains as more stable and permanent. Most importantly, unlike others, housing is an investment in which you can live, raise a family, and put down stakes in a community.

Because housing is the leading consumer product and investment, it also is one of the key economic drivers in America.

For example, in 2001, the economy suffered its worst year in a decade. At the same time, housing had one of its best years in history. All told, Americans bought over six million new and existing homes last year, setting a new record.

This record year for housing, in turn, was good for the economy. During the home refinancing boom of 2001, consumers withdrew about $80 billion in equity wealth from their homes, an average of $23,000 per homeowner who refinanced. With this extra wealth, households reduced their revolving debt and pumped $50 billion in spending into the economy, providing a larger economic stimulus than the federal tax rebate.

The boost from housing helps to explain why – even though key industries suffered double-digit declines – the economy overall actually rose slightly. Without the boost from housing, the recession would have started sooner, lasted longer, and been more severe. It is estimated that if housing had slipped as it usually does in a recession, the decline in GDP would have been five times worse, and 350,000 more Americans would have lost their jobs.

The 1990s was one of the best decades in history for housing, and this decade began with one of the single best years ever. But the best is yet to come. According to the demographic and economic predictors of housing needs, a sustained surge in consumer spending and investment in homes will make housing a strong growth market and powerful economic driver for at least the rest of the decade. There are good reasons why.

- The desire to own a home remains quite powerful. Fannie Mae's National Housing Survey shows that owning a home is one of the top three lifetime goals of American families.
- Homeownership is a local and national policy priority. The U.S. Conference of Mayors has placed expansion of affordable housing at the top of its agenda for 2002. And in his 2002 State of the Union address, President George W. Bush called for "broader homeownership, especially among minorities." President Bush also made economic security one of the nation's top priorities, and there is wide recognition that the housing sector is a key element.
- The need for homes is growing steadily. The U.S. population is expected to grow and add 13 to 15 million new households, slightly more than in the 1990s.
- Homeownership is still growing. The U.S. homeownership rate, which reached a record of more than 68 percent in 2001, could rise to 71 percent by 2010 as the Baby Boom generation moves into its highest homeownership years, and two decades' worth of new Americans become homeowners. Plus, minority homeownership rates are still 20 percentage points below the national rate but growing apace.
- Homes will continue to appreciate in value. Home values are expected to rise even faster in this decade than in the 1990s as homes continue to get bigger and better, the growth in households and homeownership rates boost the demand for homes, and the supply of homes will be squeezed by land use and growth restrictions.

Add these factors together, and by the end of the decade, consumers will double their investment in housing, from $11 trillion in 2000 to $22 to $25 trillion by 2010. To finance this increase in housing investment, consumers will need twice as much mortgage capital, from $5 trillion in 2000 to $11 to $14 trillion by the end of the decade.

Fannie Mae's key role in housing America is to help supply the mortgage capital. The demand for the housing capital Fannie Mae provides is – and will be – especially great because we supply the lowest-cost capital on the most consumer friendly, flexible terms in the market.

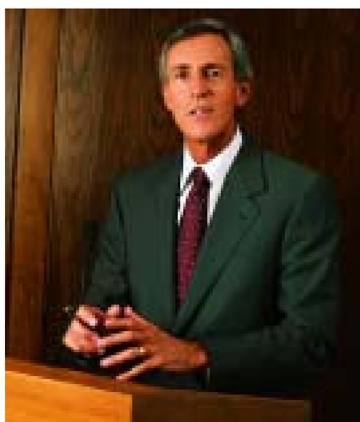
As consumers boost their demand for homeownership and need twice as much mortgage capital to finance it, Fannie Mae's challenge – and opportunity – will be to help meet that need. And to help mortgage lenders bring our capital to more consumers, especially families that remain overlooked or underserved, Fannie Mae will continue to offer a wide range of creative and consumer-friendly mortgage options, technology, and services.

Fannie Mae has developed the partnerships with lenders, mortgage products, technology, international markets, and risk management tools necessary to be the leader in the mortgage market in this decade. Your company will continue to invest to sustain that leadership. Our focus on our mission and business over many years has led to our being recognized as one of only 11 companies in the best-selling book, *Good to Great: Why Some Companies Make the Leap…and Others Don't*. We believe that focus will continue to benefit our shareholders.

Everything Fannie Mae does comes down to helping more Americans achieve their dreams of becoming homeowners. In the coming decade, tens of millions of Americans will pursue that dream. Your company has a lot of work to do, and many great years ahead.

Franklin D. Raines
Chairman and Chief Executive Officer

Shareholder Value



Timothy Howard
Executive Vice President
and Chief Financial Officer

Timothy Howard, Executive Vice President and Chief Financial Officer, talks about Fannie Mae's stellar performance, strong growth prospects, and model safety, soundness, and transparency practices.

How has Fannie Mae achieved such a superior performance record?

Fannie Mae is one of only three companies in the S&P 500 to have produced double-digit growth in operating earnings per share in each of the last 15 years. Fannie Mae's operating earnings per share rose by 21 percent in 2001, and for the past five years we have increased our operating EPS at an average rate of 16 percent per year.

We have been able to achieve this record because we are at the center of a large and growing market – residential mortgages. We are the low-cost provider in that market, and we manage our business risks exceptionally well.

What are Fannie Mae's prospects for long-term growth?

I believe they are excellent. We expect that Fannie Mae's earnings growth in the future will be driven by the same elements that have produced our superior performance record in the past. These are growth in the residential mortgage market that exceeds growth in GDP; growth in our portfolio investment and credit guaranty businesses that together exceed growth in the mortgage market; and

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management of our two risks – interest rate risk and credit risk – in a way that preserves or enhances our business margins.

Our earnings growth is not determined by interest rates, changes in the amount of new mortgages made each year, or the credit cycle. The most important driving factor behind Fannie Mae's earnings growth is growth in the residential mortgage market.

This market, known as mortgage debt outstanding, has increased in every year since the Federal Reserve began tracking it in 1953. Over the past 30 years, mortgage debt growth has averaged 10 percent per year, 2 percentage points faster than GDP. We project that during the current decade, growth in residential mortgages will average between 8 and 10 percent per year, up from 7 percent in the 1990s.

Other economists and analysts have similar projections for growth in this market. If these estimates are correct, the demand for mortgage loans will more than double from $5 trillion at the beginning of this decade to $11 to $14 trillion by 2010.

What is the basis for this optimism about mortgage market growth?

The determinants of mortgage debt growth are quite positive. Economists project that we'll have between 13 and 15 million more households this decade, partly because of increased immigration. In addition, Baby Boomers are aging into their peak homeownership years. Increases in homeownership among minority Americans, which is about 20 percentage points behind the national average, also should pull up the national average.

Home prices typically increase faster than inflation, and we expect this trend to continue. The surge of new Americans over the past two decades will lead to new housing demand. Homes will be larger and offer more amenities, while supply will be squeezed by growth limitations, land scarcity, and product shortages. And homeowners will continue to use their homes as wealth-bearing financial assets, tapping equity when they need it.

How will Fannie Mae be able to meet this growing demand for mortgage capital?

Fannie Mae's efficiency, innovation, and low costs make us the preferred source of funding for fixed-rate mortgage loans. That is why our total book of business has grown faster than the mortgage market in the past. But even with our strong growth relative to the market, Fannie Mae still has plenty of room to further increase our share, and thus to help meet the growing demand for mortgages. At the end of 2001, our mortgage portfolio still accounted for just 11 percent of total outstanding mortgages, while our credit guaranty business made up only 14 percent of the market. This gives us plenty of room for future growth.

Financial companies are thought to be sensitive to economic fluctuations. Why does Fannie Mae perform so well through all economic ups and downs?

Fannie Mae has been able to deliver double-digit growth in operating EPS, year after year, through all types of economic and financial market environments for the last 15 years.

The reason is simple. At Fannie Mae, we are risk *managers*, not passive risk takers. In our credit guaranty business, we

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share credit risk with our mortgage insurance partners and, at times, our lenders. And in our mortgage portfolio, we share the prepayment risk of fixed-rate mortgages with the buyers of our callable debt securities and option-based derivatives.

We also have only two principal risks to manage – interest rate risk and credit risk. We manage those risks on just one asset, residential mortgages, in just one country. We do not engage in commercial lending, credit card issuance, or other types of lending activities. As a consequence, we can and do focus our full attention on the key risks that determine mortgage credit and prepayment performance.

Finally, in interest rate risk management we have the advantage of operating in two of the broadest, deepest, most transparent, and most liquid markets in the world – mortgage-backed securities and agency debt. And in credit risk management, our sole exposure is to an asset type that is backed by solid collateral – the value on the homes we finance – and whose quality arguably is without equal.

How do you manage credit risk?

There are three critical ingredients to our success – accurate and comprehensive underwriting, active management of the nonperforming loan process, and the use of third-party credit enhancements.

The most direct measure of success in credit risk management is the credit loss rate – the ratio of credit losses to mortgages held in portfolio or guaranteed as MBS. Fannie Mae's credit losses of $81 million in 2001 resulted in a credit loss rate of less than a single basis point. This is a very small fraction of the credit loss rate of other financial institutions. With revenues over one hundred times the size of our credit losses, even a doubling in Fannie Mae's credit losses in 2002 – which we do not expect – would reduce our earnings per share growth by less than 1 percentage point.

How do you manage interest rate risk?

In our portfolio business, we purchase mortgages and fund them by selling debt securities that have substantially the same average lives, or durations, as the loans we buy. The mortgages we hold in portfolio earn a "spread"– which is the difference between the average yield on the mortgages and the cost of the debt that funds those mortgages.

Nearly 90 percent of the mortgages in our portfolio are long-term fixed-rate. Borrowers can refinance these mortgages at any time. When interest rates decline and borrowers refinance their fixed-rate mortgages, the average yield on our portfolio declines, because higher-yielding loans pay off and we have to replace them with lower-yielding loans. To keep this from reducing our interest spread, we need to be able to lower our average debt cost in line with the decline in our asset yields. Callable debt allows us to do that. A majority of the debt we issue for the portfolio contains a call feature, which enables us to redeem, or "call", the debt prior to its stated maturity at our option. With callable debt, if interest rates decline, we can redeem our higher-rate debt and replace it with lower-rate debt. And if interest rates go up, we can leave the callable debt on our books until its final maturity.

Fannie Mae operates under one of the most stringent safety and soundness regimes of any financial institution in America.

We have a highly disciplined approach to managing interest rate risk on our mortgage portfolio, and we have a decade and a half record of successful results as testimony to the effectiveness of this approach.

Fannie Mae has been called "a new global model" for financial institution safety, soundness, transparency, and market discipline. Why is that, and why is that important?

Fannie Mae's mission involves raising low-cost capital for U.S. housing from investors across the globe. For this to be done with maximum success, investors need to understand and have confidence in Fannie Mae's financial strength and stability. Regulatory oversight, an ample capital cushion against risk, and maximum transparency and financial disclosure are critical underpinnings of this understanding and confidence.

Fannie Mae operates under one of the most stringent safety and soundness regimes of any financial institution in America. While most financial institutions hold capital to meet a "leverage" ratio – a ratio of capital to assets – Fannie Mae has both a minimum leverage ratio and a risk-based capital standard with a stress test. Under the risk-based standard, we are required to hold enough capital to withstand extraordinarily severe credit conditions and unprecedented interest rate swings assumed to persist for 10 years. We also must hold an additional 30 percent capital cushion on top of that.

Fannie Mae's financial regulator conducts on-site examinations and makes an annual report of these examinations – which other regulators do not do. But Fannie Mae adds to these disclosures. In 2001, we put into place a set of voluntary initiatives to regularly disclose key details about our business and risk management, including regular reports about our credit risk and interest rate risk exposure. We also began issuing subordinated debt, whose price is sensitive to how the market views our financial condition. Fannie Mae now gives more information, more frequently, on more aspects of our financial condition and risk management than any other financial institution in America.

Prepared to Deliver

The Decade *of* The American Dream

The first decade of the 21st century will be a time of unparalleled opportunity for Fannie Mae, our industry partners, and the families and communities we serve. America's housing finance system has continually evolved to meet the needs of our nation's home buyers. By helping

to reduce the cost of homeownership, increasing competition within mortgage finance, helping to make consumer-friendly mortgages available, and reaching out to underserved markets, Fannie Mae has long

been the driving force behind the nation's quest to give all families the chance to own a home of their own. Today, the financial system that provides mortgage capital to lenders throughout America – and fuels the needed production of high-quality rental housing – is strong and capable of meeting the challenges that will

be placed upon it this decade. Working with our partners, Fannie Mae is prepared to deliver a command performance in housing's demanding decade.

Housing

It's *the* Leading Consumer Product

A house. The single most important purchase you'll probably ever make. But the investment didn't end with getting a mortgage and making those monthly payments. Making a house a home is a true American pastime. It's become a weekend ritual right up there with Saturday afternoon soccer games and the Sunday paper. It's the extra touch that the great wallpaper you finally found adds to the living room. It's a load of mulch and fertilizer in the trunk of the car, and the hours devoted to getting the backyard to look like the outfield of Yankee Stadium on opening day. It's the gas grill you and your son assembled out there on the deck. It's the discussion around the dinner table about that remodeling project the entire family has a say in. It's your house, and you never tire of making it your home.

It's *the* Leading Consumer Investment

Your uncle sure was right. Scrimp, save, and stop throwing money down the drain. The car was tempting, but the townhouse was the way to go. Back then, you didn't even know the definition of 'equity,' but it certainly means something to you now. Just like it means so much to millions of other Americans who decided long ago that there was no better place to put their hard-earned money than into a home. For the average family, which invests more in their home than they invest in the stock market, money market funds, and retirement savings, housing represents economic empowerment – their best chance to gain a foothold to a strong financial future. Now, you count yourself among those Americans who believe in the power of an investment you come home to every night.

Housing

It's *a* Leading Economic Driver

Just Sold. Under Contract. Only Three Left. The signs of a strong housing market and its contribution to the economy are everywhere. And that truckload of drywall you're following reminds you that a dynamic housing market depends on thousands and thousands of people doing their part to make a dream come true. The architect with a new vision for the traditional colonial. The builder, deploying an army of skilled craftspeople, hammering, wiring, installing, and landscaping away on a home for some lucky family. And tomorrow morning, you'll troop off to your favorite home improvement store a few miles away, like you do almost every weekend, to make your castle even more comfortable. Cans of paint, crown molding, curtains, and a new mitre saw. A call to the plumber. Jobs created, jobs to do, jobs for others. Housing. The economy's smiling face.

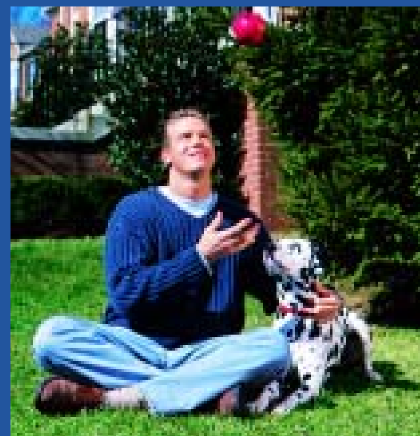
Housing

It's Leading America *to* a Brighter Future

Flags on front porches. Stars and stripes on our bumper stickers. We're proud to live in a country that cherishes freedom, equality, and opportunity…always striving to overcome challenges and build better tomorrows for all of our citizens. Americans have always dreamed big dreams. That's why Fannie Mae is poised to make this the decade of the American Dream for all who aspire to own a place of their own. That means bringing low-cost capital to people and places where it hasn't yet reached… closing the racial gap in homeownership rates through strategic partnerships and new mortgage products…tapping investment dollars globally to finance our nation's growing demand for housing capital…and unleashing the vast power of housing to transform individual lives, revitalize entire communities, and strengthen America.

Fannie Mae 2001 Financials

Financial Performance



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Selected Financial Information: 1999–2001

Dollars in millions, except per common share amounts

Income Statement Data:	Year Ended December 31, 2001	2000	1999	% Change 2001 over 2000	% Change 2000 over 1999
Operating net income[1]	**$ 5,367**	$ 4,448	$ 3,912	**21**	14
Operating earnings per diluted common share	**5.20**	4.29	3.72	**21**	15
Interest income	**$ 49,170**	$ 42,781	$ 35,495	**15**	21
Interest expense	**(41,080)**	(37,107)	(30,601)	**11**	21
Net interest income	**8,090**	5,674	4,894	**43**	16
Guaranty fee income	**1,482**	1,351	1,282	**10**	5
Fee and other income (expense)	**151**	(44)	191	**—**	—
Credit-related expenses	**(78)**	(94)	(127)	**(17)**	(26)
Administrative expenses	**(1,017)**	(905)	(800)	**12**	13
Special contribution	**(300)**	—	—	**—**	—
Purchased options expense	**(37)**	—	—	**—**	—
Income before federal income taxes, extraordinary item and cumulative effect of change in accounting principle	**8,291**	5,982	5,440	**39**	10
Provision for federal income taxes	**(2,224)**	(1,566)	(1,519)	**42**	3
Income before extraordinary item and cumulative effect of change in accounting principle	**6,067**	4,416	3,921	**37**	13
Extraordinary item–(loss) gain on early extinguishment of debt, net of tax effect	**(341)**	32	(9)	**—**	—
Cumulative effect of change in accounting principle, net of tax effect	**168**	—	—	**—**	—
Net income	**$ 5,894**	$ 4,448	$ 3,912	**33**	14
Preferred stock dividends	**(138)**	(121)	(78)	**14**	55
Net income available to common shareholders	**$ 5,756**	$ 4,327	$ 3,834	**33**	13
Basic earnings per common share:					
Earnings before extraordinary item and cumulative effect of change in accounting principle	**$ 5.92**	$ 4.28	$ 3.75	**38**	14
Extraordinary (loss) gain	**(.34)**	.03	—	**—**	—
Cumulative effect of change in accounting principle	**.17**	—	—	**—**	—
Net earnings	**$ 5.75**	$ 4.31	$ 3.75	**33**	15
Diluted earnings per common share:					
Earnings before extraordinary item and cumulative effect of change in accounting principle	**$ 5.89**	$ 4.26	$ 3.73	**38**	14
Extraordinary (loss) gain	**(.34)**	.03	(.01)	**—**	—
Cumulative effect of change in accounting principle	**.17**	—	—	**—**	—
Net earnings	**$ 5.72**	$ 4.29	$ 3.72	**33**	15
Cash dividends per common share	**$ 1.20**	$ 1.12	$ 1.08	**7**	4

Balance Sheet Data:	December 31, 2001	2000	1999	% Change 2001 over 2000	% Change 2000 over 1999
Mortgage portfolio, net	**$705,167**	$607,399	$522,780	**16**	16
Investments	**74,554**	54,968	39,751	**36**	38
Total assets	**799,791**	675,072	575,167	**18**	17
Borrowings:					
Due within one year	**343,492**	280,322	226,582	**23**	24
Due after one year	**419,975**	362,360	321,037	**16**	13
Total liabilities	**781,673**	654,234	557,538	**19**	17
Stockholders' equity	**18,118**	20,838	17,629	**(13)**	18
Core capital[2]	**25,182**	20,827	17,876	**21**	17

Other Data:	Year Ended December 31, 2001	2000	1999	% Change 2001 over 2000	% Change 2000 over 1999
Total taxable-equivalent revenues[3]	**$ 10,187**	$ 7,825	$ 6,975	**30**	12
Average net interest margin	**1.11%**	1.01%	1.01%	**10**	—
Operating return on average realized common equity	**25.4**	25.2	25.0	**1**	1
Ratio of earnings to combined fixed charges and preferred stock dividends[4]	**1.20:1**	1.16:1	1.17:1	**3**	(1)
Mortgage purchases	**$270,584**	$154,231	$195,210	**75**	(21)
MBS issues acquired by others	**344,739**	105,407	174,850	**227**	(40)
Outstanding MBS[5]	**858,867**	706,684	679,169	**22**	4

[1] *Excludes the cumulative after-tax gain of $168 million from the change in accounting principle upon adoption of FAS 133 on January 1, 2001 and the after-tax loss of $24 million recognized during the year 2001 for the change in fair value of time value of purchased options under FAS 133. Includes after-tax charges of $383 million for the amortization expense of purchased options premiums during the year ended December 31, 2001.*

[2] *The sum of (a) the stated value of outstanding common stock, (b) the stated value of outstanding noncumulative perpetual preferred stock, (c) paid-in capital, and (d) retained earnings.*

[3] *Includes revenues net of operating losses and amortization expense of purchased options premiums, plus taxable-equivalent adjustments for tax-exempt income and investment tax credits using the applicable federal income tax rate.*

[4] *"Earnings" consists of (a) income before federal income taxes, extraordinary items and cumulative effect of accounting changes and (b) fixed charges. "Fixed charges" represent interest expense.*

[5] *MBS held by investors other than Fannie Mae.*

Management's Discussion and Analysis of Financial Condition and Results of Operations

2001 Overview

Fannie Mae achieved exceptional operational and financial results in 2001, surpassing its earnings targets and posting its 15th consecutive year of record operating earnings while taking a number of actions to strengthen the company's future financial performance. Despite a weaker economic environment, operating earnings and operating earnings per diluted common share (EPS) increased 21 percent over 2000 to $5.367 billion and $5.20, respectively. The increase in earnings was driven primarily by strong portfolio and net interest margin growth.

2001 performance highlights include:

- ***30 percent increase in total taxable-equivalent revenues***
- ***19 percent growth in the average net mortgage portfolio***
- ***19 percent increase in the total book of business***
- ***10 basis point increase in the average net interest margin***
- ***9 percent decline in credit losses to the lowest level since 1983***

Fannie Mae's *portfolio investment business* generated operating net income of $3.489 billion in 2001, an increase of 27 percent over 2000. The portfolio investment business manages the interest rate risk within the company's mortgage portfolio and other investments. It includes the management of asset purchases and funding activities for Fannie Mae's mortgage and investment portfolios. Income is derived primarily from the difference, or spread, between the yield on mortgage loans and investments and the borrowing costs related to those loans and investments. The portfolio investment business capitalized on opportunities presented by the decline in interest rates during 2001 to grow the average net mortgage portfolio by 19 percent and raise the average adjusted net interest margin by 10 basis points to 1.11 percent. A sharp decline in short-term interest rates relative to long-term interest rates enabled Fannie Mae to reprice maturing debt more quickly than assets, temporarily reducing Fannie Mae's debt cost relative to its asset yield. In addition, lower rates boosted originations of fixed-rate mortgages in the primary market and increased the supply of fixed-rate mortgages in the secondary market, producing wide spreads between mortgage yields and Fannie Mae's debt costs. Results of this business segment are largely reflected in adjusted net interest income, which is discussed further in Management's Discussion and Analysis (MD&A) under "Results of Operations for 2001."

Fannie Mae's *credit guaranty business* produced a 10 percent increase in operating net income to $1.878 billion in 2001. The credit guaranty business manages the company's credit risk and derives income from guaranteeing the timely payment of principal and interest on the book of business to investors. Guaranty fee income increased 10 percent while credit losses on Fannie Mae's total book of business fell 9 percent to the lowest level since 1983, when the book of business was less than a tenth of its current size. Results of this business segment are captured primarily in guaranty fee income and credit-related expenses, which are discussed further in MD&A under "Results of Operations for 2001."

Additional information on Fannie Mae's business segments can be found in the Notes to Financial Statements under Note 10, "Line of Business Reporting."

Fannie Mae's financial statements are based on the application of generally accepted accounting principles, which are described in the Notes to Financial Statements under Note 1, "Summary of Significant Accounting Policies." The application of certain accounting policies involves uncertainties and requires significant management judgment, including the use of assumptions and estimates. Changes in these assumptions and estimates could have a material impact on Fannie Mae's financial position and results of operations. Fannie Mae identifies in its MD&A the accounting policies it believes are the most subjective, involve significant uncertainty, and require complex management judgment. Management believes Fannie Mae's critical accounting policies include determining the adequacy of the allowance for losses, the amortization of purchase discounts or premiums and other deferred price adjustments on mortgages and mortgage-backed securities (MBS), and the amortization of upfront guaranty fee adjustments. Further discussion of these critical policies, including the uncertainties involved and management's analysis process, is provided in MD&A under "Credit Risk Management-Allowance for Losses," "Balance Sheet Analysis-Mortgage Portfolio," and "Mortgage-Backed Securities."

Fannie Mae also tracks performance based on operating net income and operating EPS which are adjusted for certain items related to the January 1, 2001 adoption of Financial Accounting Standard No. 133 (FAS 133), *Accounting for Derivative Instruments and Hedging Activities*. Management believes operating net income is a more meaningful measure of Fannie Mae's performance because it adjusts for elements of earnings volatility related to FAS 133 and is comparable with income reported in prior periods. FAS 133 may result in earnings volatility because it requires that Fannie Mae record the change in the fair value of the time value of purchased

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 annual report) includes certain forward-looking statements based on management's estimates of trends and economic factors in markets in which Fannie Mae is active, as well as the corporation's business plans. In light of securities law developments, including the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995, Fannie Mae 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 Fannie Mae. The "Forward-Looking Information" section in Fannie Mae's Information Statement dated March 29, 2002 discusses certain factors that may cause such differences to occur.

options in the income statement, but not the options in callable debt or mortgages. Prior to the adoption of FAS 133, Fannie Mae amortized premiums on purchased options into interest expense on a straight-line basis over the life of the option. Without these adjustments, net income and diluted EPS grew 33 percent to $5.894 billion and $5.72, respectively. Table 1 reconciles 2001 net income to operating net income.

TABLE 1: RECONCILIATION OF NET INCOME TO OPERATING NET INCOME

Dollars in millions	Year Ended December 31, 2001
Net income	**$5,894**
Cumulative after-tax gain upon adoption of FAS 133	**(168)**
After-tax expense from the change in the fair value of the time value of purchased options	**24**
After-tax amortization expense of purchased options premiums	**(383)**
Operating net income	**$5,367**

Fannie Mae had several other key accomplishments during 2001:

- implementing voluntary safety and soundness initiatives to enhance market discipline, liquidity, and capital;
- surpassing all statutory housing goals and significantly exceeding all annual corporate purchasing goals for Fannie Mae's ten-year, $2 trillion American Dream Commitment[SM];
- providing record liquidity to the housing market in conjunction with lending partners to help ensure the housing finance system operated smoothly following the events of September 11; the September 11 terrorist attacks did not significantly disrupt Fannie Mae's business operations or impact its financial results;
- contributing $10 million to relief funds for the victims and the families of victims affected by the events of September 11 and $300 million in Fannie Mae common stock to the Fannie Mae Foundation;
- working with lending partners to launch several new products, processes, and partnerships that deliver mortgage credit to people previously underserved, through products such as Expanded Approval/Timely Payment Rewards[SM]; and
- launching of a major initiative to re-engineer Fannie Mae's core technology infrastructure that will increase its ability to meet the needs of its customers by significantly enhancing transaction processing, product development, and risk management.

Results of Operations for 2001

Taxable-Equivalent Revenues

Taxable-equivalent revenues represent total revenues adjusted to reflect the benefits of tax-exempt income and investment tax credits based on applicable federal income tax rates.

In 2001, Fannie Mae generated taxable-equivalent revenue of $10.187 billion, a 30 percent increase over 2000. The increase in taxable-equivalent revenues was largely attributable to strong growth in the mortgage portfolio and net interest margin, which boosted net interest income. Table 2 compares 2001 and 2000 taxable-equivalent revenues and its components.

TABLE 2: TAXABLE-EQUIVALENT REVENUES

	Year Ended December 31,	
Dollars in millions	**2001**	2000
Net interest income	**$ 8,090**	$5,674
Purchased options premium amortization	**(590)**	–
Adjusted net interest income	**7,500**	5,674
Guaranty fee income	**1,482**	1,351
Fee and other income (expense)	**151**	(44)
Total adjusted revenues	**9,133**	6,981
Taxable-equivalent adjustments:		
Investment tax credits	**584**	430
Tax-exempt investments	**470**	414
Total taxable-equivalent revenues[1]	**$10,187**	$7,825

[1] *Taxable-equivalent revenues include: (a) revenues net of amortization expense of purchased options premiums that would have been recorded prior to the adoption of FAS 133, (b) operating losses on certain tax-advantaged investments, and (c) taxable-equivalent adjustments for tax-exempt income and investment tax credits using the applicable federal income tax rate of 35 percent.*

Net Interest Income

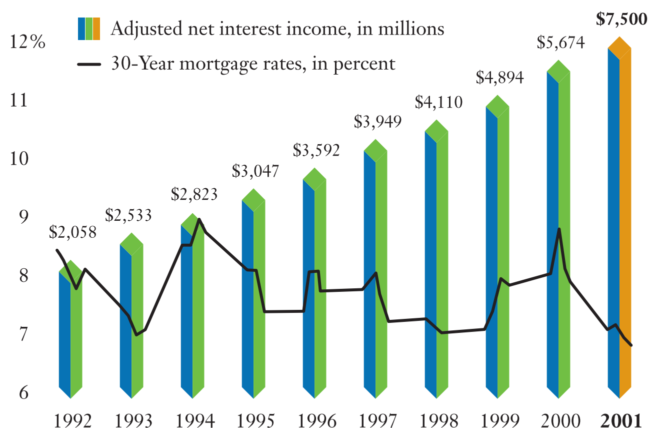
Net interest income is the difference between interest income and interest expense. Adjusted net interest income includes reported net interest income less amortization expense related to purchased options premiums. Prior to the adoption of FAS 133, reported net interest income included the amortization expense of purchased options premiums on a straight line basis over the life of the option. With the adoption of FAS 133, this expense is now included in the change in the fair value of the time value of purchased options that is reported in the income statement in the category "purchased options expense." Management believes adjusted net interest income is a more meaningful measure of performance and is comparable with reported net interest income in prior periods.

Adjusted net interest income increased 32 percent to $7.500 billion in 2001, as Fannie Mae grew the average net mortgage portfolio 19 percent and the average net interest margin by 10 basis points. Mortgage portfolio and net interest margin growth was driven primarily by the sharp decline in intermediate-term and short-term interest rates during the year. Lower interest rates and a steepened yield curve allowed Fannie Mae to:

- **Reduce debt costs**: The sharp decline in short-term interest rates relative to long-term interest rates provided an opportunity for Fannie Mae to call or retire debt at a pace that exceeded the increase in mortgage liquidations, which temporarily reduced Fannie Mae's debt costs relative to its asset yield.
- **Purchase mortgages at attractive spreads**: The decline in intermediate-term rates reduced mortgage rates to the lowest levels in 30 years, creating a surge in mortgage refinancings and originations to record levels and increasing the supply of mortgages for sale in the secondary market. This supply surge boosted mortgage-to-debt spreads on mortgage acquisitions. Mortgage-to-debt spread is the difference between the yield on a mortgage and the cost of debt that funds mortgage purchases.

The following graph compares Fannie Mae's adjusted net interest income to average mortgage rates over the past ten years.

Adjusted Net Interest Income versus Mortgage Rates



Additional information on mortgage portfolio volumes and yields, the cost of debt, and derivative instruments is presented in MD&A under "Balance Sheet Analysis."

Guaranty Fee Income

Guaranty fees compensate Fannie Mae for the assumption of credit risk associated with its guarantee of the timely payment of principal and interest to MBS investors. Guaranty fee income excludes fees received on MBS that Fannie Mae holds in its portfolio and the costs of managing the administration of outstanding MBS.

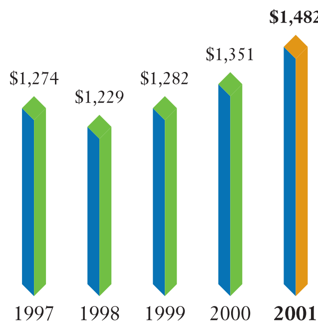
Guaranty fee income increased 10 percent to $1.482 billion in 2001, driven primarily by 12 percent growth in average outstanding MBS (or MBS held by investors other than Fannie Mae). Record mortgage originations more than doubled the growth rate in average outstanding MBS over the 4 percent growth rate in 2000. The increase in average outstanding MBS more than offset a .5 basis point decline in the average guaranty fee rate to 19.0 basis points that resulted from the increased liquidation of older, higher fee-rate business as mortgage refinances increased. Table 3 presents the average effective guaranty fee rate for the past three years.

TABLE 3: GUARANTY FEE DATA

	Year Ended December 31,		
Dollars in millions	**2001**	2000	1999
Guaranty fee income	**$ 1,482**	$ 1,351	$ 1,282
Average balance of outstanding MBS	**779,647**	694,165	664,672
Average effective guaranty fee rate	**.190%**	.195%	.193%

Additional information on Fannie Mae's MBS, guaranty fees, and guaranty obligation is presented in MD&A under "Mortgage-Backed Securities."

MBS Guaranty Fee Income
In Millions



Fee and Other Income (Expense)

Fee and other income (expense) consists of technology fees, transaction fees, multifamily fees, and other miscellaneous items and is net of operating losses from certain tax-advantaged investments in affordable housing projects. These tax-advantaged investments represent equity interests in limited partnerships that own rental housing and generate tax credits, which reduce Fannie Mae's effective federal income tax rate and are accounted for under the equity method. Fannie Mae does not guarantee any obligations of these partnerships, and exposure is limited to the amount of Fannie Mae's investment. Fannie Mae records the tax benefit related to these investments as a reduction in the provision for federal income taxes and as an increase in taxable-equivalent revenues.

Fannie Mae recorded $151 million of fee and other income in 2001, up from $44 million of expense in 2000. The $195 million increase in fee and other income (expense) was due primarily to the following:

- a $146 million increase in technology and transaction fees resulting largely from greater usage of Fannie Mae's Desktop Underwriter® and Desktop Originator® systems due to record business volumes and
- absence of a hedging loss on an anticipated Benchmark Notes® issuance that occurred in April 2000.

Credit-Related Expenses

Credit-related expenses include foreclosed property expenses and the provision for losses.

Credit-related expenses declined $16 million to $78 million in 2001 despite significant growth in Fannie Mae's total book of business and weaker economic conditions. As a percentage of Fannie Mae's average book of business, credit-related losses, which include foreclosed property expenses and charge-offs (net of recoveries), decreased slightly to .6 basis points in 2001 from .7 basis points in 2000.

While the 2001 economic slowdown may increase delinquency rates, defaults, and losses in subsequent years, Fannie Mae's credit performance and future credit outlook remain favorable. The combination of high-quality underwriting, low loan-to-value ratios, significant third-party credit enhancements, and highly effective credit loss management processes effectively positions Fannie Mae to manage the credit impact of an economic downturn. Specific strategies that have strengthened the credit risk profile of the current book of business and proven successful in limiting losses include:

- expanded use of Desktop Underwriter, Fannie Mae's automated loan underwriting system,
- substantial use of both primary mortgage insurance and other credit enhancements to cover loans with higher risk of default and loss,
- use of Risk Profiler℠ technology over the life of the loan to identify loans most at risk of default and loss and to enable early servicing intervention,
- comprehensive and well-executed loss mitigation strategies to prevent defaults and minimize losses on loans that default, and
- centralized foreclosure management operations at Fannie Mae's National Property Disposition Center in Dallas to achieve higher net proceeds from the sale of real estate owned and reduce property disposition costs.

The reduction in credit-related expenses was largely due to a 10 percent decrease in foreclosed property expense to $193 million despite a slight increase in the number of foreclosed single-family property acquisitions to 14,486 in 2001 from 14,351 in 2000. Fannie Mae's current policy is to record a negative provision for losses because of the recent experience of net recoveries on charged-off properties stemming from credit enhancements and recent home price appreciation. Fannie Mae recorded a negative provision of $115 million in 2001, compared with a negative provision of $120 million in 2000.

Additional information on Fannie Mae's credit profile is presented in MD&A under "Risk Management – Credit Risk Management."

Administrative Expenses

Administrative expenses include those costs incurred to run the daily operations of Fannie Mae, such as personnel costs and technology expenses.

Administrative expenses increased 12 percent to $1.017 billion in 2001, primarily due to the following:

- 11 percent increase in compensation expense to $602 million in 2001, resulting primarily from an 8 percent increase in the number of employees as well as annual salary increases,
- increased costs related to a multi-year project to re-engineer the company's core infrastructure systems, and
- $10 million contribution in 2001 to support victims and families of victims affected by the September 11 tragedy.

Despite the increase in administrative expenses, Fannie Mae's efficiency ratio — the ratio of administrative expenses to taxable-equivalent revenues — improved to 10.0 percent in 2001 from 11.6 percent in 2000. The ratio of administrative expenses to the average book of business was .071 percent in 2001, compared with .072 percent in 2000.

Special Contribution

Special contribution expense reflects a contribution by Fannie Mae to the Fannie Mae Foundation.

Fannie Mae made a commitment during the fourth quarter of 2001 to contribute $300 million of Fannie Mae common stock to the Fannie Mae Foundation. The Fannie Mae Foundation creates affordable homeownership and housing opportunities through innovative partnerships and initiatives that build healthy, vibrant communities across the United States. It is a separate, private nonprofit organization that is not consolidated by Fannie Mae, but is supported solely by Fannie Mae. The 2001 contribution to the Fannie Mae Foundation is expected to reduce the Foundation's need for contributions over the next several years. Fannie Mae acquired the shares through open market purchases and contributed the shares to the Foundation in the first quarter of 2002.

Purchased Options Expense

Purchased options expense includes the change in the fair value of the time value of purchased options in accordance with FAS 133. The change in the fair value of the time value of purchased options will vary from period to period with changes in interest rates and market views on interest rate volatility. However, the total expense included in earnings from the purchase date until the exercise or expiration date of an option will equal the initial option premium paid because Fannie Mae generally holds such options to maturity.

In 2001, Fannie Mae recorded $37 million in purchased options expense related to the change in the fair value of purchased options. This amount reflects fluctuations in the market value of purchased options from period to period that result primarily from changes in expected interest rate volatility. Prior to the adoption of FAS 133 on January 1, 2001, Fannie Mae amortized premiums on purchased options into interest expense on a straight-line basis over the life of the option. The purchased options premium amortization for 2001 that would have been included in interest expense pre-FAS 133 totaled $590 million.

Income Taxes

The provision for federal income taxes, net of the tax impact from debt extinguishments and the cumulative effect of change in accounting principle, increased to $2.131 billion in 2001 from $1.583 billion in 2000. The effective 2001 federal income tax rate on operating net income remained at the 2000 level of 26 percent. Fannie Mae's effective tax rate on net income was 27 percent in 2001, compared with 26 percent in 2000.

Extraordinary Item

Fannie Mae strategically repurchases or calls debt and related interest rate swaps as part of its interest rate risk management efforts to reduce future debt costs. The sharp decline in short-term interest rates during 2001 created an opportunity for Fannie Mae to call over $173 billion of high-coupon debt and notional principal of interest rate swaps. In addition, Fannie Mae repurchased $9 billion of debt. The weighted-average cost of redeemed debt and interest rate swaps was 6.23 percent. Fannie Mae recognized an extraordinary loss of $524 million ($341 million after tax) in 2001 on the call and repurchase of debt. During 2000, Fannie Mae called or repurchased $18 billion in debt and notional principal of interest rate swaps carrying a weighted-average cost of 7.10 percent and recognized an extraordinary gain of $49 million ($32 million after tax).

Cumulative Effect of Change in Accounting Principle

Effective January 1, 2001, Fannie Mae adopted FAS 133 as amended by Financial Accounting Standard No. 138, *Accounting for Derivative Instruments and Certain Hedging Activities — an amendment of FASB Statement No. 133*. The adoption of FAS 133 on January 1, 2001 resulted in a cumulative after-tax increase to income of $168 million ($258 million pre-tax). The cumulative effect on earnings from the change in accounting principle is primarily attributable to recording the fair value of the time value of purchased options, which are used as a substitute for callable debt, at adoption of FAS 133 on January 1, 2001.

Risk Management

Fannie Mae is subject to three major areas of risk: interest rate risk, credit risk, and operations 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 Fannie Mae's strategies to manage these three risks.

Interest Rate Risk Management

Fannie Mae is exposed to interest rate risk because changes in interest rates may affect mortgage portfolio cash flows in a way that will adversely affect earnings or long-term value. Fannie Mae's interest rate risk is concentrated primarily in its mortgage portfolio, where exposure to changes in interest rates is managed to achieve stable earnings growth and a competitive return on equity over time.

Fannie Mae's overall objective in managing interest rate risk is to deliver consistent earnings growth and target returns on capital in a wide range of interest rate environments. 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 rebalancing actions in the context of a well-defined risk management process.

(1) Funding of mortgage assets with liabilities that have similar cash flow patterns through time and across different interest rate paths.

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 and interest rate derivatives are frequently used to alter the durations of liabilities. The duration of callable debt, like that of a mortgage, shortens when interest rates decrease and lengthens when interest rates increase. Fannie Mae also uses derivative financial instruments, including interest rate swaps and other derivatives with embedded interest rate options, to achieve its desired liability structure and to better match the prepayment risk of the mortgage portfolio. These instruments are close substitutes for callable and noncallable debt.

(2) Regularly assessing the portfolio's exposure to changes in interest rates using a diverse set of analyses and measures.

Because the assets in Fannie Mae's mortgage portfolio are not perfectly matched with the liabilities funding those assets, the portfolio's projected performance changes with movements in interest rates. Fannie Mae uses various analyses and measures—including net interest income at risk, duration and convexity analysis, portfolio value analyses, and stress testing—to project the portfolio's future performance. Risk measures and assumptions are regularly evaluated and modeling tools are enhanced as management deems appropriate. Net interest income at risk, duration, convexity, and portfolio value analyses all provide key information about risk across a wide range of interest rates. Because future events may not be consistent with recent experience, Fannie Mae has constructed a further series of tests using highly stressful assumptions of changes in interest rates.

Using stochastic interest rate simulations based on historical interest rate volatility, Fannie Mae projects portfolio net interest income over a wide range of interest rate environments, including specific rising and falling interest rate paths. Stochastic simulations generate probability distributions of future interest rates based on historic behavior. These analyses generally include assumptions about new business activity to provide a more realistic assessment of possible portfolio performance. Fannie Mae also regularly conducts narrower assessments of interest rate risk by analyzing the interest rate sensitivity of only the existing mortgage portfolio (assuming no new business).

The duration and convexity of the portfolio, along with net interest income and portfolio value-at-risk analyses, are the primary risk assessment tools used to analyze the existing portfolio. The portfolio duration gap—the difference between the durations of portfolio assets and liabilities—summarizes for management the extent to which estimated cash flows for assets and liabilities are matched, on average, through time and across interest rate scenarios. A positive duration gap indicates more of an exposure to rising interest rates, and a negative duration gap indicates more of an exposure to declining interest rates. The portfolio's convexity—or the difference between the duration sensitivities of the portfolio's assets and liabilities—provides management with information on how quickly and by how much the portfolio's duration gap will change in different interest rate environments. Management regularly monitors the portfolio's duration and convexity under current market conditions and for a series of hypothetical interest rate shocks. In addition, management tracks the portfolio's long-term value and the amount of value that is at risk over a broad range of potential interest rate scenarios.

Many of the projections of mortgage cash flows depend on prepayment models. While Fannie Mae is highly confident in the quality of these models, management recognizes that the models are based on historical patterns that may not continue in the future. The models contain many assumptions, including some regarding the refinanceability of mortgages and relocation rates. Other assumptions are implicit in the projections of interest rates and include projections of the shape of the yield curve and volatility. Fannie Mae constructs "worst-case" assumptions of dramatic changes in interest rates, combined with substantial adverse changes in prepayments, volatility, and the shape of the yield curve. The stress tests provide extreme measures of potential risk in highly improbable environments and contribute to the evaluation of risk strategies.

(3) Setting the parameters for rebalancing actions to help attain 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 them. Senior management is responsible for ensuring that appropriate long-term strategies are in place to achieve the goals and objectives. Management establishes reference points for the 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. Management regularly reports these measures and reference points to the Board of Directors.

One of the primary reference points for interest rate risk management is the target range established for the duration gap of plus or minus six months. This range for the duration gap is generally consistent with a level of interest rate risk that does not require portfolio rebalancing actions. As the duration gap begins to move outside of this target range, management considers actions to bring the duration gap back within the range in a manner that is consistent with achieving the company's earnings objectives. As the duration gap moves further outside the target range, significantly greater emphasis is placed on reducing the risk exposure and significantly less emphasis is placed on meeting earnings objectives. While no time horizon has been established over which rebalancing actions must take place, management closely monitors the repricing differences between assets and liabilities that are driving any duration gap mismatch. This analysis provides management with information on the time horizon over which rebalancing actions may be taken.

The Portfolio Investment Committee, which includes the company's senior mortgage portfolio managers and the Chief Financial Officer, meets weekly and reviews current financial market conditions, portfolio risk measures, and performance targets. The Committee develops and monitors near-term strategies and the portfolio's standing relative to its long-term objectives. The results of Portfolio Investment Committee meetings are reported to the weekly Asset and Liability Management Committee, which is comprised of senior management and includes the company's Chief Executive Officer.

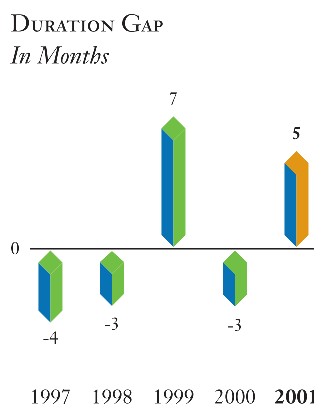
Fannie Mae was successful in meeting its interest rate risk management objectives in 2001 despite significant interest rate moves and unprecedented levels of interest rate volatility.

2001 was a year of significant interest rate movements coupled with unprecedented levels of interest rate volatility. Fannie Mae's three-month cost of debt declined over 450 basis points during 2001. Fannie Mae's ten-year cost of debt reached a low in November that was 120 basis points below year-end 2000 levels before rising 100 basis points to end the year 20 basis points lower than the prior year end. In addition, the pattern of interest rates during 2001 resulted in two mortgage refinancing waves, one in the first quarter and the second in the third and fourth quarters. Fannie Mae's disciplined risk management process was the cornerstone to management's success in meeting the company's interest rate risk objectives throughout this challenging environment.

Duration Gap

Fannie Mae's duration gap was a positive five months at December 31, 2001, versus negative three months at December 31, 2000. The significant changes in both the level of interest rates and the shape of the yield curve in 2001 combined with extreme levels of interest rate volatility resulted in the monthly duration gap being outside of the plus or minus six month target range three times in 2001—slightly better than the historical average of approximately one-third of the time. After thorough analysis, Fannie Mae periodically took rebalancing actions during the year when deemed appropriate in a manner that effectively reduced the portfolio's risk exposure while minimizing the costs associated with rebalancing.

Duration Gap
In Months



Convexity

Fannie Mae also effectively managed convexity to optimize the earnings potential of its portfolio while remaining within corporate risk guidelines. Fannie Mae took advantage of the opportunity to lower its debt costs by redeeming significant amounts of callable debt, particularly during the first quarter of 2001, in response to the sharp decline in short-term interest rates. These redemptions initially reduced the total amount of option-embedded debt and increased the portfolio's convexity exposure. After thorough analysis, Fannie Mae reduced this exposure by aggressively increasing the amount of option protection purchased during the remainder of the year through the issuance of callable debt and the purchase of option-embedded interest rate derivatives. By the end of the year, option-embedded debt as a percentage of the retained mortgage portfolio was 54 percent, versus 46 percent at year-end 2000.

Net Interest Income at Risk

Net interest income at risk is a measure that Fannie Mae uses to estimate the impact of changes in interest rates on projected net interest income relative to a base case scenario. Presented below in Table 4 is Fannie Mae's net interest income at risk based on instantaneous plus and minus 100 basis point changes in interest rates followed by a stochastic interest rate distribution. This risk measurement is an extension of Fannie Mae's monthly net interest income at risk disclosure and is based on the same data, assumptions, and methodology.

Fannie Mae had moderate exposure to an instantaneous 100 basis point increase in interest rates at December 31, 2001. At year-end 2001, Fannie Mae's net interest income at risk for both the one-year and four-year horizons is estimated not to exceed ten percent. Conversely, Fannie Mae's risk exposure at year-end 2001 to a 100 basis point instantaneous decline in rates was low as net interest income is estimated to benefit over the one-year horizon while the net interest income exposure is estimated not to exceed three percent over the four-year horizon. The changes in the profile of net interest income at risk from December 31, 2000 to December 31, 2001 are driven by the changes in the shape and level of interest rates, changes in the composition of the portfolio, and changes in forecast assumptions. Actual portfolio net interest income may differ from these estimates because of specific interest rate movements, changing business conditions, changing prepayments, and management actions.

TABLE 4: NET INTEREST INCOME AT RISK

	December 31, 2001		December 31, 2000	
	1-Year Portfolio Net Interest Income at Risk	**4-Year Portfolio Net Interest Income at Risk**	1-Year Portfolio Net Interest Income at Risk	4-Year Portfolio Net Interest Income at Risk
Assuming a 100 basis point increase in interest rates	**10%**	**10%**	2%	5%
Assuming a 100 basis point decrease in interest rates	**(1)**	**3**	2	9

Interest Rate Sensitivity of Net Asset Value

Another indicator of the interest rate exposure of Fannie Mae's existing business is the sensitivity of the fair value of net assets (net asset value) to changes in interest rates. Table 5 presents Fannie Mae's estimated net asset value as of December 31, 2001, and two estimates of net asset value that are based on hypothetical plus and minus 100 basis point instantaneous shocks in interest rates.

Changes in 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 interest rate derivatives.

TABLE 5: INTEREST RATE SENSITIVITY OF NET ASSET VALUE

	December 31, 2001		December 31, 2000	
Dollars in millions	**Net Asset Value**	**Percentage of Net Asset Value**	Net Asset Value	Percentage of Net Asset Value
December 31, 2001	**$23,044**	**–**	$20,677	–
Assuming a 100 basis point increase in interest rates	**20,876**	**91%**	20,204	98%
Assuming a 100 basis point decrease in interest rates	**17,756**	**77**	14,882	72

As indicated in Table 5, the net asset value of Fannie Mae's December 31, 2001 book of business would decline an estimated 9 percent from an instantaneous 100 basis point increase in interest rates and decline an estimated 23 percent from an instantaneous 100 basis point decrease in interest rates. These sensitivities at December 31, 2001 differ from Fannie Mae's duration gap and net interest income at risk exposures primarily due to inclusion of the guaranty fee business on a run-off basis in the net asset value sensitivity analysis but not the other interest rate risk measures.

The net asset value of Fannie Mae on December 31, 2001, as presented in Table 5, is the same as that disclosed in the Notes to Financial Statements under Note 16, "Disclosures of Fair Value of Financial Instruments." The net asset values for the hypothetical interest rate scenarios were derived in a manner consistent with the estimation procedures described

in that note. The net asset value sensitivities do not necessarily represent the changes in Fannie Mae's net asset value that would actually occur for the given interest rate scenarios because the sensitivities neither reflect the effects of new business nor consider prospective asset/liability rebalancing or other hedging actions Fannie Mae might take in the future. Consequently, net interest income at risk more closely reflects the near-term interest rate risk exposure that Fannie Mae faces as a going concern.

Additional information on interest rate risk management is presented in MD&A under "Balance Sheet Analysis – Derivative Instruments."

Credit Risk Management

Fannie Mae actively manages credit risk because credit losses could have a significant impact on financial performance. Fannie Mae's primary credit risk is the possibility of failing to recover amounts due from borrowers on mortgages in its portfolio or mortgages underlying guaranteed MBS. Fannie Mae's secondary credit risk is that counterparties in transactions, such as derivatives, mortgage insurance, lender recourse, liquidity investments, or mortgage servicing, may be unable to meet their contractual obligations.

Fannie Mae's overall objective in managing credit risk is to deliver consistent earnings growth and target returns on capital for the risks it retains and manages.

Fannie Mae regularly measures its exposure to credit losses under alternative economic scenarios, implements a broad range of risk mitigation strategies, monitors credit risk trends, and routinely explores risk management opportunities. Analytical tools are used extensively to measure credit risk exposures and evaluate risk management alternatives. Fannie Mae continually refines its methods of measuring credit risk, setting risk and return targets, and transferring risk to third parties. Fannie Mae's Credit Risk Policy Committee has primary oversight and approval of credit risk management strategy. The committee ensures that Fannie Mae's credit risks are appropriately identified, measured, and managed in a consistent manner. Fannie Mae's Chief Credit Officer chairs the committee. Each Fannie Mae business unit has a credit policy function and a dedicated business unit credit officer. Those business unit credit officers and the leaders of Fannie Mae's Credit Policy team serve on the Credit Risk Policy Committee.

Three main credit risk management teams support the Chief Credit Officer and the committee:

- Policy and Standards – Establishes and monitors credit policies, standards, and delegation of credit authority throughout the organization.
- Credit Research and Portfolio Management – Responsible for understanding and managing the aggregate risk exposure, risk sensitivity, and usage of risk capital. Has primary accountability for the strategy and execution of credit risk sharing transactions. Also responsible for translating key elements of loan performance and credit pricing methodologies into financial models and applications.
- Counterparty Risk Management – Responsible for company-wide identification and measurement of exposures to contractual counterparties. Has responsibility to aggregate Fannie Mae's overall counterparty risk position and develop counterparty risk management policies and acceptable exposure limits.

These credit risk management teams work in concert with designated credit officers in the following business units: Mortgage Portfolio, eBusiness, Single Family, and Multifamily, as well as other units of Housing and Community Development. The business unit credit officers help ensure that the management of credit risk and return is effectively integrated into Fannie Mae's business activities. The business unit credit officers have credit approval authority up to certain thresholds for specific transactions in their respective lines of business. The credit officer for the Single Family business unit is the Chief Credit Officer. The other business unit credit officers report to both the business unit leaders and the Chief Credit Officer.

The credit risk management teams also work closely with Fannie Mae's regional offices. The regional offices are responsible for managing Fannie Mae's customer relationships. The regional offices, together with headquarters staff, ensure that Fannie Mae's transactions with lender partners meet established policies and standards, are appropriately priced, and are effectively managed. The Regional Senior Vice Presidents have credit authority up to certain thresholds to develop customized mortgage product solutions for lenders while maintaining Fannie Mae's track record for prudent credit risk management.

The Credit Risk Policy Committee works in concert with the other primary decision committees of Fannie Mae—the Portfolios and Capital Committee and the Operations, Transactions and Investments (OTI) Committee. In some instances, certain credit transactions may be referred to the OTI Committee for further review and consideration.

Single-Family Credit Risk Management

Fannie Mae actively manages single-family mortgage credit risk, beginning with mortgage underwriting and through liquidation, to reduce the risk that it will not recover amounts due from borrowers.

Fannie Mae establishes sound underwriting policies to ensure that purchased and securitized mortgages perform in accordance with the level of compensation received for the credit risk of the loans. Fannie Mae also deploys portfolio management and loss mitigation strategies to control credit risk throughout the life of mortgages owned or guaranteed by Fannie Mae.

Fannie Mae has developed an automated underwriting tool, Desktop Underwriter, to help lenders consistently and objectively apply Fannie Mae's underwriting standards to prospective borrowers. Desktop Underwriter provides a comprehensive analysis of the unique characteristics of a borrower and mortgage, including such factors as a borrower's credit history and property value. Over 59 percent of newly originated mortgages sold to Fannie Mae in 2001 were evaluated through Desktop Underwriter, up from 56 percent in 2000. Management expects the use of Desktop Underwriter by lenders to continue to increase in 2002.

Fannie Mae continues to explore new ways of using its enhanced credit analytics such as Desktop Underwriter to grow its total book of business while carefully balancing the risk and return of mortgage purchases and securitizations.

As the precision of Fannie Mae's risk assessment capabilities has increased, loans to borrowers formerly obtaining financing in higher-cost markets (for example, Alternative A loans or A minus loans) have become eligible for purchase by Fannie Mae. In many instances, sale of these loans to Fannie Mae requires payment of risk-based guaranty fees or price adjustments by lenders as additional credit risk compensation. Management plans to continue investing in research and technology to produce tools that help Fannie Mae and lenders assess and manage credit risk, thereby expanding homeownership opportunities.

Fannie Mae works closely with its lender partners to minimize credit losses.

Many loan servicers employ Risk Profiler[SM], a default prediction model created by Fannie Mae, to enhance their loss mitigation efforts on loans serviced for Fannie Mae. Risk Profiler uses credit risk indicators such as updated borrower credit data, current property values, and mortgage product characteristics to predict the likelihood that a loan will default. Currently, servicers are using Risk Profiler to evaluate close to 82 percent of the loans Fannie Mae owns or guarantees. In addition, Fannie Mae employs Risk Profiler to monitor default probability trends in its total book of business.

In the event mortgages become at risk to default, Fannie Mae employs strategies to reduce loss exposure through resolutions other than foreclosure. Fannie Mae encourages early intervention by its mortgage servicers to cure delinquencies and keep borrowers in their homes. High-risk borrowers who cannot cure a default may be offered a workout alternative—such as a repayment plan, temporary forbearance, or modification of terms—if the alternative is expected to reduce the likelihood of foreclosure and loss. If these workout options prove inappropriate, the servicer may arrange a preforeclosure sale to minimize credit-related costs. The benefits of a preforeclosure sale include avoidance of the costs of foreclosure and a tendency for the property to sell at a higher price because the home is usually occupied. In 2001, loan workouts outpaced foreclosed property acquisitions for the third year in a row. If a loan modification or preforeclosure sale is not possible, Fannie Mae's goal is to handle the foreclosure process expeditiously and cost-effectively to maximize the proceeds from the sale of the property and to minimize the time it retains a nonearning asset.

Fannie Mae makes frequent updates of critical data on every mortgage to ascertain the current level of credit risk in its total book of business, and to manage that risk effectively through credit enhancement.

Fannie Mae reviews such elements as the current estimated market value of the property, the property value in relation to Fannie Mae's outstanding loan, the credit strength of the borrower, and the potential volatility of those measures to ascertain the current level of credit risk in the total book of business. Fannie Mae uses updated data to analyze the sensitivity of mortgages it owns or guarantees to a wide range of projected changes in interest rates and home prices. Based on the sensitivity analysis and loan performance analytics, Fannie Mae employs various credit enhancement contracts to protect itself against losses on higher risk loans, including loans with high loan-to-value ratios. Fannie Mae reassesses the efficiency and effectiveness of its credit enhancement contracts and rebalances credit risk to optimize risk management and financial performance.

Credit enhancements include primary loan-level mortgage insurance, pool mortgage insurance, recourse arrangements with lenders, and other customized contracts, which together provided protection against credit losses on 33 percent of the number of single-family mortgages at the end of 2001, compared with 38 percent at the end of 2000. The percentage of loans with credit enhancement declined in 2001, primarily reflecting a decrease in the proportion of the outstanding portfolio with primary mortgage insurance, pool

insurance, and recourse. The decline in the proportion of loans with primary mortgage insurance is attributable to an increase in loans with loan-to-value ratios below 80 percent. In 2001, Fannie Mae had more refinance loan acquisitions, which traditionally have a greater proportion of loans with loan-to-value ratios below 80 percent. Fannie Mae does not require primary mortgage insurance on loans with loan-to-value ratios below 80 percent. In addition, rising property values enabled some borrowers with Fannie Mae loans to cancel their outstanding mortgage insurance subject to Fannie Mae's mortgage insurance cancellation requirements. The proportion of loans with pool insurance and recourse credit enhancements declined in 2001 because these transactions were less prevalent in the market in 2001 than in prior periods. Credit enhancements, however, absorbed a higher percentage of single-family credit losses in 2001 than in 2000. During 2001, credit enhancements absorbed $435 million, or 85 percent, of $512 million in gross single-family losses. In comparison, credit enhancements absorbed $349 million, or 80 percent, of $435 million in gross single-family credit losses during 2000.

The application of various credit risk management strategies throughout a loan's life helped reduce credit-related losses in 2001 despite deteriorating economic conditions.

As shown in Table 6, single family credit-related losses decreased $9 million, and Fannie Mae's credit loss ratio (the ratio of credit-related losses to the average amount of mortgages owned or guaranteed) on its single-family book of business decreased by .1 basis point in 2001 to .6 basis points despite weaker economic conditions.

TABLE 6: SINGLE-FAMILY CREDIT-RELATED LOSSES

	Year Ended December 31,		
Dollars in millions	**2001**	2000	1999
Recoveries, net	**$(112)**	$(127)	$(126)
Foreclosed property expenses	**189**	213	244
Credit-related losses	**$ 77**	$ 86	$ 118
Credit loss ratio	**.006%**	.007%	.011%

The reduction in single-family credit-related losses in 2001 was mainly due to an 11 percent or $24 million decline in foreclosed property expenses. Although the number of acquired properties increased slightly to 14,486 from 14,351 in 2000, average credit-related losses per foreclosed single-family property acquisition fell to $3,500 from $3,800 in 2000.

As part of its voluntary safety and soundness initiatives, Fannie Mae discloses on a quarterly basis the sensitivity of its future credit losses to an immediate 5 percent decline in home prices. At September 30, 2001, the present value of Fannie Mae's sensitivity of net future credit losses to an immediate 5 percent decline in home prices was $467 million, taking into account the beneficial effect of third-party credit enhancements. This amount reflects a gross credit loss sensitivity of $1.349 billion before the effect of credit enhancements, and is net of projected credit risk-sharing proceeds of $882 million. The sensitivity of future credit losses is calculated based on the present value of the difference between credit losses in a baseline scenario and credit losses assuming an immediate 5 percent decline in home prices, followed by an increase in home prices at the rate projected by Fannie Mae's credit pricing models.

The risk profile for conventional single-family mortgages in Fannie Mae's portfolio and underlying MBS at the end of 2001 suggests Fannie Mae is well-positioned to manage through an economic slowdown.

Fannie Mae tracks various trends in its total book of business to monitor credit risk, including delinquencies, geographical concentrations, loan-to-value ratios, mortgage product mix, and loan age. Fannie Mae's conventional single-family serious delinquency rate increased to .49 percent at December 31, 2001 from .45 percent at December 31, 2000. The serious delinquency rate is based on the number of single-family mortgages in Fannie Mae's net portfolio or mortgages underlying MBS for which it retains the primary risk of loss and that are 90 or more days delinquent or in foreclosure. The comparable serious delinquency rate for all commercial banks was .79 percent and for Federal Housing Administration loans was 2.83 percent. Table 7 summarizes the single-family serious delinquency rates by region on loans where Fannie Mae bears the primary risk.

TABLE 7: SINGLE-FAMILY SERIOUS DELINQUENCIES[1]

	December 31,		
	2001	2000	1999
Northeast	**.58%**	.57%	.67%
Southeast	**.54**	.49	.50
Midwest	**.49**	.39	.37
Southwest	**.47**	.40	.41
West	**.38**	.38	.46
Total	**.49%**	.45%	.48%

[1] *Single-family loans where Fannie Mae bears the primary risk.*

The average current loan-to-value ratio on loans owned or guaranteed by Fannie Mae was estimated at 59 percent at year-end 2001, compared with 58 percent at year-end 2000. Fannie Mae derived this estimate by using the current outstanding loan balance on 11.7 million loans and estimating the value of the underlying homes based on Fannie Mae's proprietary home price indices. The greater the excess of property values over Fannie Mae's outstanding

loan balance in homes underlying mortgages, the lower the incidence and severity of default. Fannie Mae's conventional single-family book of business is predominantly composed of long-term and intermediate-term fixed-rate loans, which have a lower incidence of default than adjustable-rate mortgages. At year-end 2001, 94 percent of Fannie Mae's conventional single-family book of business was long-term or intermediate-term fixed-rate loans, compared with 93 percent at year-end 2000. Table 8 provides a detailed overview of the distribution of Fannie Mae's conventional single-family mortgages by product type and loan-to-value ratios.

TABLE 8: DISTRIBUTION OF CONVENTIONAL SINGLE-FAMILY LOANS

	Outstanding at December 31,		Business Volumes		
	2001	2000	**2001**	2000	1999
Product:					
Long-term, fixed-rate	**75%**	74%	**76%**	73%	76%
Intermediate-term, fixed-rate[1]	**19**	19	**19**	11	19
Adjustable-rate	**6**	7	**5**	16	5
Total	**100%**	100%	**100%**	100%	100%
Original loan-to-value ratio:					
Greater than 90%	**13%**	14%	**13%**	17%	15%
81% to 90%	**14**	15	**13**	15	14
71% to 80%	**42**	41	**44**	44	42
61% to 70%	**14**	14	**13**	11	14
Less than 61%	**17**	16	**17**	13	15
Total	**100%**	100%	**100%**	100%	100%
Average original loan-to-value ratio	**74%**	75%	**74%**	77%	75%
Current loan-to-value ratio[2]:					
Greater than 90%	**4%**	3%			
81% to 90%	**7**	6			
71% to 80%	**23**	17			
61% to 70%	**17**	23			
Less than 61%	**49**	51			
Total	**100%**	100%			
Average current loan-to-value ratio	**59%**	58%			
Average loan amount (Maximum loan amount $275,000 in 2001)	**$100,813**	$92,800	**$134,718**	$118,100	$115,700

[1] *Contractual maturities of 20 years or less at purchase for portfolio loans and 15 years or less at issue date for MBS issuances.*
[2] *Includes only Fannie Mae primary risk loans.*

Multifamily Credit Risk Management

Fannie Mae has dedicated multifamily underwriting and due diligence teams that evaluate certain loans prior to acquisition and portfolio monitoring and loss mitigation teams that manage credit risk throughout the life of multifamily loans.

There are two primary sources of risk from a mortgage on a multifamily property. First, the underlying property cash flows may be insufficient to service the loan. Second, the proceeds from the sale or refinancing of a property may be insufficient to repay the loan at maturity.

To manage these risks, Fannie Mae centralizes responsibility for managing credit risk in the multifamily portfolio within the multifamily business unit. The business unit ensures that the aggregate risk is properly identified and managed and promotes consistent application of risk management policies and procedures. Specific areas of responsibility, which are subject to review and oversight by the Chief Credit Officer and Credit Risk Policy Committee, include portfolio credit risk management, lender assessment, counterparty risk evaluation, regular asset management of earning assets, special asset management of problem transactions, and contract compliance monitoring for structured transactions.

Fannie Mae maintains rigorous loan underwriting guidelines and extensive real estate due diligence examinations for the loans it acquires or guarantees. The loan underwriting guidelines include specific occupancy rate, loan-to-value, and debt service coverage criteria. The due diligence examinations typically include property condition and property valuation reviews as well as investigations into the quality of property management. Because of the size of multifamily loans, management generally requires servicers

to submit periodic operating information and property condition reviews to monitor the performance of individual loans. Fannie Mae uses this information to evaluate the credit quality of the portfolio, identify potential problem loans, and initiate appropriate loss mitigation activities.

Fannie Mae manages credit risk throughout the life of a multifamily loan through dedicated due diligence, portfolio monitoring, and loss mitigation teams. The due diligence team specializes in assessing transactions prior to purchase or securitization, particularly with large loans or structured transactions, and performs post-purchase reviews when the underwriting has been delegated to lenders. Under the Delegated Underwriting and Servicing (DUS) product line, Fannie Mae purchases or securitizes mortgages under $20 million from approved risk sharing lenders without prior review of the mortgages by Fannie Mae. The portfolio monitoring team performs detailed portfolio loss reviews, addresses borrower and geographic concentration risks, assesses lender qualifications, evaluates counterparty risk, and tracks property performance and contract compliance. Fannie Mae is enhancing its quantitative tools to provide earlier indications of any deterioration in the credit quality of the multifamily portfolio. The loss mitigation team manages troubled assets from default through foreclosure and property disposition, if necessary.

Fannie Mae's multifamily credit risk management efforts include substantial use of various forms of credit enhancement on the majority of loans purchased or guaranteed. Fannie Mae has shared risk arrangements where lenders in its DUS product line bear losses on the first 5 percent of unpaid principal balance (UPB) and share in remaining losses up to a prescribed limit. On structured transactions, Fannie Mae generally has full or partial recourse to lenders or third parties for loan losses. Letters of credit, investment agreements, or pledged collateral may secure the recourse. Third-party recourse providers for structured and other transactions include government and private mortgage insurers. Table 9 presents the credit risk-sharing profile, by UPB, of multifamily loans in portfolio and underlying MBS at December 31, 2001, 2000, and 1999.

TABLE 9: MULTIFAMILY RISK PROFILE

	December 31,		
	2001	2000	1999
Fannie Mae risk	**17%**	13%	12%
Shared risk[1]	**64**	59	56
Recourse[2]	**19**	28	32
Total	**100%**	100%	100%

[1] *Includes loans in which the lender initially bears losses of up to 5 percent of UPB and shares any remaining losses with Fannie Mae up to a prescribed limit.*

[2] *Includes loans not included in "shared risk" that have government mortgage insurance, or full or partial recourse to lenders or third parties.*

The economic slowdown during 2001 had only a modest impact on multifamily credit performance as occupancy rates and multifamily property values remained strong. Multifamily credit-related losses increased to $4 million in 2001 from $3 million in 2000. However, there were no primary risk (including those with shared risk) multifamily properties in Fannie Mae's inventory of foreclosed properties at December 31, 2001, compared with four properties at the end of 2000. Management anticipates an increase in multifamily credit losses in 2002 because of the growth of the portfolio in recent years and weakened economic conditions. Table 10 provides a detailed breakdown of credit-related losses and the ratio of credit-related losses to average UPB outstanding for multifamily loans in portfolio and underlying MBS.

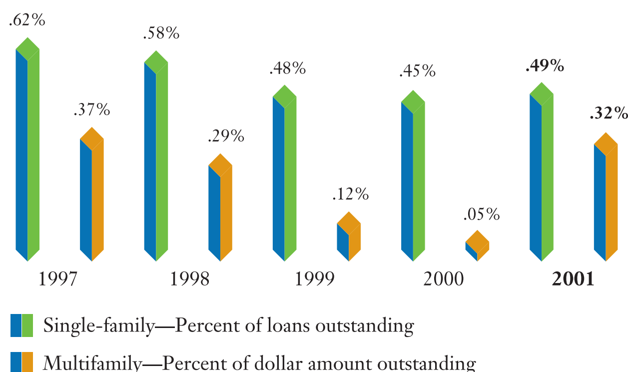
TABLE 10: MULTIFAMILY CREDIT-RELATED LOSSES

	Year Ended December 31,		
Dollars in millions	**2001**	2000	1999
Charge-offs, net	**$ —**	$2	$4
Foreclosed property expense, net	**4**	1	3
Credit-related losses	**$ 4**	$3	$7
Credit loss ratio	**.008%**	.007%	.015%

Multifamily serious delinquencies were .32 percent at year-end 2001. Two loans under forbearance agreements at December 31, 2001 totaling $118 million on properties in New York City that were affected by the World Trade Center disaster are included in the multifamily serious delinquency rate. The multifamily serious delinquency rate excluding these two properties was .10 percent at December 31, 2001, up from a record low of .05 percent at year-end 2000. Multifamily serious delinquencies represent loans for which Fannie Mae has primary risk of loss and that are 60 days or more delinquent. The multifamily serious delinquency percentage is based on the UPB of delinquent loans compared with the total amount of multifamily loans in portfolio and underlying MBS for which Fannie Mae is at risk.

Serious Delinquencies

Conventional Single-Family and Multifamily Loans



Allowance for Losses

Fannie Mae establishes an allowance for losses on mortgages in its portfolio and mortgages underlying MBS outstanding. The allowance for losses is a critical accounting policy that requires management judgment and assumptions. Fannie Mae considers delinquency levels, loss experience, economic conditions in areas of geographic concentration, and mortgage characteristics in establishing the allowance for losses. Management sets the allowance for losses at a level it believes is adequate to cover estimated losses inherent in the total book of business. The allowance for losses is established by recording an expense for the provision for losses and may be reduced by recording a negative provision. The allowance for losses is subsequently reduced through charge-offs and increased through recoveries, including those related to credit enhancements and the resale of properties. Senior management reviews the adequacy of the allowance for losses on a quarterly basis.

The allowance for losses was $806 million at December 31, 2001, compared with $809 million at December 31, 2000. The allowance for losses declined as a percentage of Fannie Mae's total book of business to .052 percent in 2001 from .062 percent in 2000. The decrease in the allowance as a percentage of the total book of business reflects Fannie Mae's excellent credit performance resulting from the combination of a strong housing market and Fannie Mae's strategy and expertise in credit loss management. Over the last three years, Fannie Mae has experienced a decrease in its credit loss ratio in each year—from .011 percent in 1999 to .006 in 2001. Although the economic downturn increased Fannie Mae's serious delinquency rates in 2001 and could result in higher credit losses in 2002, management believes that the allowance for losses is adequate to cover losses inherent in Fannie Mae's book of business at December 31, 2001 because:

- Fannie Mae had approximately 40 percent equity in its single-family book of business based upon the average outstanding loan amounts relative to the average market value of homes. The average loan-to-value ratio on conventional single-family loans, where Fannie Mae bears the primary risk, was 59 percent at the end of 2001, virtually unchanged from 58 percent at the end of 2000.

- Approximately 33 percent of the single-family mortgages Fannie Mae owns or guarantees benefit from some form of third-party enhancement, helping to ensure that a substantial portion of credit losses are absorbed by others. Absorption of single-family credit losses by others increased to 85 percent in 2001 from 80 percent in 2000.

Non-Derivative Counterparty Risk

Fannie Mae actively manages the counterparty credit risk that arises from several sources, including mortgage insurance, lender recourse, the Liquid Investment Portfolio, and mortgage servicing transactions.

Fannie Mae bears the risk that counterparties in these transactions will not fulfill their contractual obligations to make payments due to Fannie Mae or to perform other contractual obligations. Fannie Mae has a dedicated Counterparty Risk Management team that is responsible for quantifying aggregate counterparty risk exposures across business activities, maintaining a corporate credit policy framework for managing counterparty risk, and directly managing the counterparty risk associated with mortgage insurance companies. Fannie Mae generally requires that its counterparties have an investment grade credit rating (a rating of BBB-/Baa- or higher by Standard & Poor's and Moody's Investor Services, respectively) with the exception of its recourse and mortgage servicing counterparties. Fannie Mae does not require an investment grade rating for its recourse and mortgage servicing counterparties because the risk is much lower. Fannie Mae has ongoing, extensive mortgage purchase and mortgage servicing relationships with these counterparties and, in some instances, holds collateral. Individual business units are responsible for managing the counterparty exposures routinely associated with their business activities. The Counterparty Risk Management team reviews business unit policies, procedures, and approval authorities, and the Credit Risk Policy Committee approves these internal controls.

The primary credit risk presented by Fannie Mae's private mortgage insurance counterparties is that they will be unable to meet their contractual obligations to pay claims to Fannie Mae on insured mortgages. Before approving a mortgage insurance company, Fannie Mae conducts a comprehensive counterparty analysis, which generally includes a review of the mortgage insurer's business plan, insurance portfolio characteristics, master insurance policies, reinsurance treaties, and ratings on ability to pay claims. Fannie Mae monitors approved insurers through a reporting and analysis process performed quarterly. If an insurer cannot provide mortgage insurance in accordance with Fannie Mae's requirements, most Fannie Mae mortgages provide that if the borrower pays separate sums for premiums (which is typical), then those sums may be used to pay for other substantially equivalent mortgage insurance. If this insurance is unavailable, such sums may be retained by Fannie Mae and, in its discretion, used for other credit enhancement. These payments therefore serve as collateral backing Fannie Mae's exposure to mortgage insurance counterparties. At year-end 2001, Fannie Mae was the beneficiary of primary mortgage insurance coverage on

$314 billion of single-family loans in portfolio or underlying MBS. Seven mortgage insurance companies, all rated AA or higher by Standard & Poor's, provided 96 percent of the total coverage.

The primary credit risk associated with recourse transactions is that lenders will be unable to fulfill their obligations to absorb losses on mortgage loans that default. At December 31, 2001, the unpaid balance of single-family loans where Fannie Mae has recourse to lenders for losses totaled an estimated $42 billion. The quality of these counterparties is high. Fifty-nine percent of the $42 billion is covered by recourse agreements with investment grade counterparties. Fannie Mae also mitigates the risk associated with recourse transactions through various means, including requiring some lenders to pledge collateral to secure their obligations. Fannie Mae held $247 million in collateral directly or through custodians on single-family lender recourse at December 31, 2001. In addition, Fannie Mae can protect itself against losses from a lender's nonperformance by terminating a lender's contractual status as a Fannie Mae seller/servicer, selling these rights to service Fannie Mae loans, and retaining sale proceeds. Lenders with recourse obligations had servicing rights on $1.288 trillion of mortgages.

The primary credit risk associated with the Liquid Investment Portfolio is that issuers will not repay Fannie Mae in accordance with contractual terms. The level of credit risk in the portfolio is low because these investments are primarily high-quality, short-term investments, such as asset-backed securities, commercial paper, and federal funds. The majority of asset-backed securities in the Liquid Investment Portfolio are rated AAA by Standard & Poor's. Unsecured investments in the portfolio are generally rated A or higher by Standard & Poor's. At December 31, 2001, 96 percent of the Liquid Investment Portfolio had a credit rating of A or higher.

The primary credit risk associated with mortgage servicers is that they will not fulfill their contractual servicing obligations. On behalf of Fannie Mae, mortgage servicers collect mortgage and escrow payments from borrowers, pay taxes and insurance costs from escrow accounts, monitor and report delinquencies, and perform other required activities. A servicing contract breach could result in credit losses for Fannie Mae, or Fannie Mae could incur the cost of finding a replacement servicer. Fannie Mae mitigates this risk by requiring mortgage servicers to maintain a minimum servicing fee rate that Fannie Mae can retain or transfer to compensate a replacement servicer in the event of a servicing contract breach. Fannie Mae also manages this risk by requiring servicers to follow specific servicing guidelines and by monitoring each servicer's performance using loan-level data. Fannie Mae conducts on-site reviews of compliance with servicing guidelines and mortgage servicing performance. Fannie Mae also works on-site with nearly all of its major servicers to facilitate loan loss mitigation efforts and improve the default management process. In addition, Fannie Mae reviews quarterly financial information on servicers. At year-end 2001, Fannie Mae's ten largest mortgage servicers serviced 71 percent of its single-family book of business.

Information on derivative counterparty credit risk is included in MD&A under "Balance Sheet—Derivative Instruments." Additional information on non-derivative counterparty risk is presented in the Notes to Financial Statements under Note 14, "Financial Instruments with Off-Balance-Sheet Risk," and Note 15, "Concentrations of Credit Risk."

Operations Risk Management

Fannie Mae actively manages its operations risk through various measures, such as key performance indicators, to monitor and identify trends.

Operations risk is the risk of potential loss resulting from a breakdown in established controls and procedures, examples of which include circumvention of internal controls, fraud, human error, and systems malfunction or failure. Fannie Mae has established extensive policies and procedures to decrease the likelihood of such occurrences. Fannie Mae's Office of Auditing tests the adequacy of and adherence to internal controls and established policies and procedures. Financial system data are regularly reconciled to source documents to ensure the accuracy of financial system outputs. In addition, Fannie Mae has a comprehensive disaster recovery plan that is designed to restore critical operations with minimal interruption in the event of a disaster. Although the attacks of September 11, 2001 temporarily reduced mortgage commitments and slowed portfolio growth, Fannie Mae was able to remain open for business during every day of the week of the tragedy with only minimal disruption to operations.

The use of financial forecast models is another potential operations risk. To mitigate the risk associated with the use of financial models, Fannie Mae regularly reconciles forecasted results to actual results and recalibrates models for the differences.

Fannie Mae evaluates key performance indicators for elements of operations risk to monitor trends and identify early warning signals. Each key performance indicator is

based on clearly defined and quantifiable performance thresholds. Senior managers are responsible for monitoring key performance indicators, addressing the monthly results, and taking corrective actions as necessary. The OTI Committee also reviews the results and actions taken.

Balance Sheet Analysis

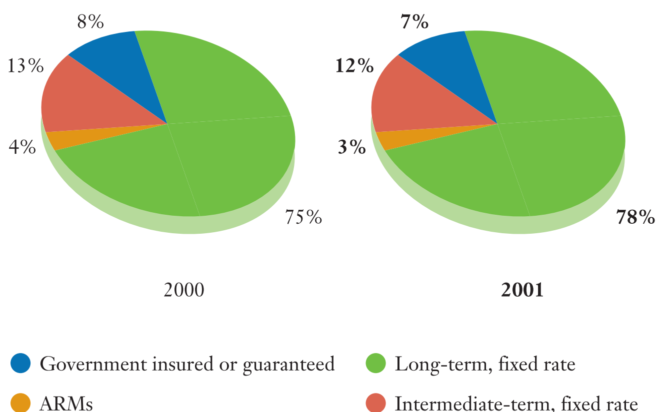
Fannie Mae's primary balance sheet activities are purchasing mortgages and other investments with proceeds from debt issuances and repayments of mortgages and other investments. Fannie Mae's liquidity and capital resources are critical to its activities and its regulatory capital requirements. The following analysis describes trends in these aspects of Fannie Mae's business activities.

Mortgage Portfolio

Fannie Mae's net mortgage portfolio grew 16 percent to $705 billion at December 31, 2001 from $607 billion at December 31, 2000. The volume of mortgage originations reached record levels in 2001 as mortgage interest rates fell to historic lows during the year. The drop in interest rates, combined with a historically high fixed-rate share of total mortgage originations, caused the supply of mortgages in the secondary market to be unusually high, resulting in attractive mortgage-to-debt spreads and increased purchase commitments by the portfolio business.

During the second half of 2001, an unusually large number of portfolio commitments were made for settlement a number of months forward. Fannie Mae ended 2001 with $55 billion in outstanding mortgage purchase commitments, compared with $16 billion at December 31, 2000. Delayed settlement of these commitments in 2002 is expected to add over 5 percentage points to portfolio growth in 2002.

Mortgage Portfolio Composition
at December 31,



Additional information on mortgage portfolio composition is presented in the Notes to Financial Statements under Note 2, "Mortgage Portfolio, Net."

The average yield on Fannie Mae's net mortgage portfolio decreased to 7.11 percent during 2001 from 7.16 percent during 2000. The decrease in yield resulted largely from the general decline in mortgage rates on loans sold into the secondary market and an increase in the level of liquidations on older, higher-rate loans. The liquidation rate on mortgages in portfolio (excluding sales) more than doubled in 2001, increasing to 25 percent from 10 percent in 2000. Total mortgage liquidations increased to $164 billion in 2001 from $57 billion in 2000 largely because of extensive refinancing in response to falling mortgage interest rates.

Net unamortized premiums, discounts, and other deferred purchase price adjustments in Fannie Mae's mortgage portfolio totaled $2.1 billion and $2.5 billion at December 31, 2001 and 2000, respectively. Fannie Mae applies the interest method to amortize purchase price adjustments over the estimated life of the loans. Calculating the constant effective yield necessary to apply the interest method in the amortization of mortgage purchase discounts or premiums and other deferred purchase price adjustments is a critical accounting policy that requires estimating future mortgage prepayments. Estimating prepayments requires significant judgment and assumptions that involve some degree of uncertainty regarding factors such as the forecast of movements in interest rates and predicting borrower patterns.

Fannie Mae tracks and monitors actual prepayments received against anticipated prepayments and regularly assesses the sensitivity of prepayments to changes in interest rates on a monthly basis. Based upon this analysis, Fannie Mae determines whether it should change the estimated prepayment rates used in the amortization calculation. If changes are necessary, Fannie Mae recalculates the constant effective yield and adjusts the net mortgage investment balance to reflect the amount that would have been recorded had the new effective yield been applied since acquisition of the mortgages or MBS. Fannie Mae's premium, discount, and deferred price adjustment prepayment sensitivity analysis at December 31, 2001 indicates that a 100 basis point increase in interest rates would result in a decrease in projected net interest income of approximately 1 percent and a 100 basis point decrease in interest rates would result in an increase in projected net interest income of approximately 2 percent over a one-year horizon. This is one component of Fannie Mae's overall net interest income at risk assessment. A comprehensive analysis of the impact of interest rate

changes on projected net interest income is presented in MD&A in the "Net Interest Income at Risk" section under "Risk Management - Interest Rate Risk Management."

Table 11 summarizes mortgage portfolio activity on a gross basis and average yields from 1999 through 2001.

TABLE 11: MORTGAGE PORTFOLIO ACTIVITY

	Purchases			Sales			Repayments[1]		
Dollars in millions	**2001**	2000	1999	**2001**	2000	1999	**2001**	2000	1999
Single-family:									
Government insured or guaranteed	**$ 6,001**	$ 6,940	$ 23,575	**$ —**	$ 521	$ 360	**$ 8,125**	$ 3,423	$ 4,092
Conventional:									
Long-term, fixed-rate	**226,516**	113,444	146,679	**7,621**	9,219	5,779	**120,787**	35,208	52,707
Intermediate-term, fixed-rate	**26,146**	11,607	15,315	**442**	599	9	**23,391**	13,105	17,878
Adjustable-rate	**3,777**	17,683	6,073	**228**	374	—	**9,937**	4,293	3,829
Total single-family	**262,440**	149,674	191,642	**8,291**	10,713	6,148	**162,240**	56,029	78,506
Multifamily	**8,144**	4,557	3,568	**690**	269	—	**2,172**	1,204	1,244
Total	**$270,584**	$154,231	$195,210	**$8,981**	$10,982	$6,148	**$164,412**	$57,233	$79,750
Average net yield	**6.56%**	7.62%	6.88%				**7.23%**	7.18%	7.39%
Repayments as a percentage of average mortgage portfolio							**24.7**	10.3	16.9

[1] *Includes mortgage loan prepayments, scheduled amortization, and foreclosures.*

Investments

Fannie Mae's investments increased 36 percent to $75 billion at December 31, 2001, from $55 billion at December 31, 2000. The Liquid Investment Portfolio accounts for the majority of Fannie Mae's investments and consists primarily of high-quality short-term investments in nonmortgage assets, such as asset-backed securities, commercial paper, and federal funds. The Liquid Investment Portfolio serves as a source of liquidity and an investment vehicle for Fannie Mae's surplus capital. These investments totaled $65 billion at December 31, 2001, compared with $52 billion at the end of the prior year. The increase in liquid investments at December 31, 2001 was primarily a result of the delayed settlement of purchase commitments at year-end, excess capital, and opportunities in the market. The average yield on liquid investments decreased to 4.63 percent in 2001 from 6.60 percent in 2000, as a result of the sharp drop in average short-term interest rates.

Additional information on investment composition is presented in the Notes to Financial Statements under Note 4, "Investments."

Financing Activities

Total debt outstanding increased 19 percent to $763 billion at December 31, 2001, from $643 billion at December 31, 2000. Fluctuations in interest rate volatility and market pricing during 2001 gave Fannie Mae a valuable opportunity to repurchase $9 billion of debt that was trading at historically wide spreads to other fixed-income securities.

In addition, Fannie Mae called $173 billion of debt in response to the sharp decline in short- and intermediate-term interest rates. Fannie Mae reissued much of this debt with short-term maturities in anticipation of an increase in mortgage liquidations. These asset-liability management strategies had the following impact on the debt portfolio:

- The average cost of debt outstanding decreased to 6.00 percent in 2001 from 6.35 percent in 2000.
- Effective long-term debt, which takes into consideration the effect of derivative instruments on the maturity of long- and short-term debt, decreased to 82 percent of total debt outstanding at December 31, 2001 from 85 percent at year-end 2000.
- Effective long-term debt as a percentage of the net mortgage portfolio decreased to 89 percent at December 31, 2001 from 90 percent at the end of 2000.
- The weighted-average maturity of effective long-term, fixed-rate debt outstanding decreased to 78 months at year-end 2001 from 79 months at year-end 2000.

To hedge against future increases in interest rates, Fannie Mae used interest rate swaps to lengthen the final maturity of Fannie Mae's debt by 26 months at December 31, 2001, versus 24 months at December 31, 2000.

Table 12 provides a summary of debt issuances and repayments during 2001 compared with the previous two years as well as the average cost of debt outstanding at year-end.

TABLE 12: SHORT-TERM AND LONG-TERM DEBT ACTIVITY

Dollars in millions	2001	2000	1999
Issued during the year:			
Short-term[1]:			
Amount	**$1,756,691**	$1,143,131	$1,136,001
Average cost	**3.69%**	6.27%	5.17%
Long-term[1]:			
Amount	**$ 249,352**	$ 110,215	$ 139,020
Average cost	**4.83%**	6.92%	6.07%
Repaid during the year:			
Short-term[1]:			
Amount	**$1,691,240**	$1,106,956	$1,125,748
Average cost	**4.22%**	6.15%	5.10%
Long-term[1]:			
Amount	**$ 196,610**	$ 50,335	$ 61,790
Average cost	**6.03%**	6.33%	6.51%
Outstanding at year-end:			
Due within one year:			
Net amount	**$ 343,492**	$ 280,322	$ 226,582
Average cost[2]	**2.81%**	6.40%	5.80%
Due after one year:			
Net amount	**$ 419,975**	$ 362,360	$ 321,037
Average cost[2]	**5.52%**	6.46%	6.22%
Total debt:			
Net amount	**$ 763,467**	$ 642,682	$ 547,619
Average cost[3]	**5.49%**	6.47%	6.18%

[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 effects of currency and debt swaps and amortization of premiums, discounts, issuance costs and hedging results.*

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

The total amount of option-embedded debt outstanding as a percentage of the net mortgage portfolio increased to 54 percent at year-end 2001 versus 46 percent at the end of 2000. Table 13 presents option-embedded debt instruments as a percentage of mortgage purchases and the net mortgage portfolio for the past three years. Option-embedded debt instruments include derivative instruments.

TABLE 13: OPTION-EMBEDDED DEBT INSTRUMENTS

Dollars in billions	2001	2000	1999
Issued during the year	**$286**	$ 65	$114
Percentage of total mortgage purchases	**106%**	42%	58%
Outstanding at year-end	**$378**	$280	$247
Percentage of total net mortgage portfolio	**54%**	46%	47%

Additional information on the usage of derivatives is presented in MD&A under "Balance Sheet Analysis – Derivative Instruments."

Fannie Mae's Benchmark Securities℠ program continued to grow in 2001. The Benchmark Securities program encompasses large issues of noncallable and callable debt designed to provide liquidity and performance to investors while reducing Fannie Mae's relative cost of debt. The Benchmark Securities program has served to consolidate much of Fannie Mae's debt issuances from a large number of small, unscheduled issues to a smaller number of larger, more liquid scheduled issues.

During 2001, Fannie Mae issued Benchmark Notes and Benchmark Bonds® in each month. Benchmark Bills℠ served as Fannie Mae's weekly source for all of its three-month and six-month discount debt securities during the year. One-year Benchmark Bills, which were introduced in October 2000, were issued regularly on a biweekly schedule during 2001. Fannie Mae reintroduced its Callable Benchmark Notes in June 2001 and issued $10 billion of these securities during 2001. Callable Benchmark Notes are intended to provide investors and other market participants with callable structures that are brought to market in a scheduled manner. As part of its voluntary safety and soundness initiatives, Fannie Mae began issuing Subordinated Benchmark Notes in the first quarter of 2001 on a periodic basis to create a new, liquid class of fixed income assets for investors. At December 31, 2001, Fannie Mae had $5 billion of outstanding Subordinated Benchmark Notes.

Derivative Instruments

Derivative instruments are important tools that Fannie Mae uses to manage interest rate risk. Fannie Mae uses derivatives to help match the duration of its debt with the duration of its mortgage assets. This duration matching reduces the risk of mortgage assets held in portfolio. Fannie Mae also uses derivative instruments to convert debt issued in foreign currencies to U.S. dollars and to hedge certain debt prior to issuance. Fannie Mae acts only as an end user of derivatives and does not broker or speculate in them.

Fannie Mae uses only the most straightforward types of derivative instruments such as interest-rate swaps, basis swaps, swaptions, and caps, whose values are relatively easy to model and predict. Swaps provide for the exchange of fixed and variable interest payments based on contractual notional principal amounts. These may include callable swaps, which give counterparties or Fannie Mae the right to terminate interest rate swaps before their stated maturities, and foreign currency swaps, in which Fannie Mae and counterparties exchange payments in different types of currencies. Basis swaps provide for the exchange of variable payments that have maturities similar to hedged debt, but have payments based on different interest rate indices. Interest rate caps provide ceilings on the interest rates of variable-rate debt. The use of purchased options also is an important risk management tool. The reason is that American homeowners have "options" to pay off their mortgages at any time. When holding mortgage loans in portfolio, Fannie Mae must manage this option risk with options of its own. Fannie Mae obtains these options by issuing callable debt or by purchasing stand-alone options and linking them to debt. Swaptions are an example of an option. Swaptions give Fannie Mae the option to enter into swaps at a future date, thereby mirroring the economic effect of callable debt.

Fannie Mae primarily uses derivatives as a substitute for notes and bonds it issues in the cash debt markets. When Fannie Mae purchases mortgage assets, it funds the purchases with a combination of equity and debt. The debt issued is a mix that typically consists of short- and long-term bullet and callable debt. The varied maturities and flexibility of these debt combinations allow Fannie Mae to match the durations of its assets and liabilities. A close though not perfect match of asset and liability cash flows and durations helps Fannie Mae maintain a relatively stable net interest margin.

Fannie Mae can use a mix of cash debt issuances and derivatives to achieve the same duration matching achieved with all cash market debt issuances. The following is an example of funding alternatives that Fannie Mae could use to achieve similar economic results:

- Rather than issuing a ten-year bullet note, Fannie Mae could issue short-term debt and enter into a ten-year interest rate swap with a highly rated counterparty. The derivative counterparty would pay a floating rate of interest to Fannie Mae on the swap, and Fannie Mae would pay the counterparty a fixed rate of interest on the swap, thus achieving the economics of a ten-year note issue.
- Similarly, instead of issuing a ten-year callable note, Fannie Mae could issue a three-year note and enter into a swaption which would have the same economics of a ten-year callable note.

The ability to either issue debt in the cash market or modified debt through the derivatives market increases the funding flexibility of the company and reduces overall funding costs. Table 14 gives an example of equivalent funding alternatives for a mortgage purchase with all cash funding versus a blend of cash and derivatives.

TABLE 14: EQUIVALENT CASH AND DERIVATIVE FUNDING

Fund With:[1]			
All Cash Funding		Cash and Derivative Funding	
Percentage	Type of Debt	Percentage	Type of Debt
10	short-term debt	10	short-term debt
15	3-year bullet	15	3-year bullet
25	10-year bullet	25	short-term debt plus 10 year swap
50	10-year callable in 3 years	50	3-year bullet plus pay-fixed swaption

[1] *This example indicates the possible funding mix and does not represent how an actual purchase would necessarily be funded.*

As illustrated by Table 14, Fannie Mae can achieve similar economic results by using either all cash funding or cash and derivatives funding. Frequently, it is less expensive to use the cash and derivatives alternative to achieve a given funding mix.

Fannie Mae occasionally issues debt in a foreign currency. Because all of Fannie Mae's assets are denominated in U.S. dollars, Fannie Mae enters into currency swaps to effectively convert the foreign currency debt into U.S. dollars.

Fannie Mae also hedges against fluctuations in interest rates on planned debt issuances with derivative instruments. The hedging of anticipated debt issuances enables Fannie Mae to maintain an orderly and cost-effective debt issuance schedule so it can fund daily loan purchase commitments without significantly increasing its interest rate risk or exposure to changes in the spread of its funding costs versus benchmark interest rates.

Table 15 summarizes the notional balances of Fannie Mae's derivatives for the years ended December 31, 2001 and 2000 by derivative category, along with the fair values of its derivatives at year-end 2001.

TABLE 15: DERIVATIVE ACTIVITY AND MATURITY DATA

	Generic-Pay Fixed/Receive Variable Swaps[2]							
Dollars in millions	Amount	Pay Rate[3]	Receive Rate[3]	Pay Variable/ Receive Fixed Swaps	Basis Swaps	Caps and Swaptions	Other[4]	Total
Notional Amounts[1]								
Notional balance on January 1, 2000	$139,404	6.55%	6.03%	$31,622	$19,544	$ 48,115	$12,219	$250,904
Additions	37,170	6.83	6.74	48,482	14,600	42,163	4,550	146,965
Maturities	22,837	5.75	6.63	20,930	19,585	7,750	2,027	73,129
Notional balance on December 31, 2000	153,737	6.74	6.79	59,174	14,559	82,528	14,742	324,740
Additions	90,787	5.39	3.95	33,230	46,150	168,350	100	338,617
Maturities	30,844	6.41	4.20	53,335	13,655	30,935	1,449	130,218
Notional balance on December 31, 2001	$213,680	6.21%	2.47%	$39,069	$47,054	$219,943	$13,393	$533,139
Fair Value on December 31, 2001[5]	$ (9,792)			$ 899	$ 1	$ 6,267	$ (1,490)	$ (4,115)
Future Maturities of Notional Amounts[6]								
2002	$ 26,545	5.54%	2.70%	$16,118	$33,704	$ 45,600	$ 4,705	$126,672
2003	25,730	5.07	2.46	7,389	13,050	43,643	458	90,270
2004	19,470	6.02	2.37	2,755	150	8,200	1,200	31,775
2005	15,675	6.52	2.44	1,225	—	4,900	594	22,394
2006	21,975	6.21	2.31	3,635	100	4,750	—	30,460
Thereafter	104,285	6.66	2.47	7,947	50	112,850	6,436	231,568
Total	$213,680	6.21%	2.47%	$39,069	$47,054	$219,943	$13,393	$533,139

[1] *Dollars represent notional amounts that indicate only the amount on which payments are being calculated and do not represent the amount at risk of loss.*

[2] *Included in the notional amounts are callable swaps of $32 billion and $35 billion with weighted-average pay rates of 6.72 percent and 6.67 percent and weighted-average receive rates of 2.54 percent and 6.83 percent at December 31, 2001 and December 31, 2000, respectively.*

[3] *The weighted-average interest rate payable and receivable is as of the date indicated. The interest rates of the swaps may be variable-rate, so these rates may change as prevailing interest rates change.*

[4] *Includes foreign currency swaps, futures contracts, and derivative instruments that provide a hedge against interest rate fluctuations.*

[5] *Based on fair value at December 31, 2001, estimated by calculating the cost, on a net present value basis, to settle at current market rates all outstanding derivative contracts.*

[6] *Based on stated maturities. Assumes that variable interest rates remain constant at December 31, 2001 levels.*

Over 99 percent of the notional amount of Fannie Mae's outstanding derivative transactions were with counterparties rated A or better by Standard & Poor's at December 31, 2001 (one counterparty was downgraded below an A rating after the contract was entered into). Fannie Mae's derivative instruments were diversified among 23 counterparties at year-end 2001 to lower credit risk concentrations. At year-end 2001, eight counterparties represented approximately 78 percent of the total notional amount of outstanding derivatives transactions, and each had a credit rating of A or better.

Fannie Mae's primary credit exposure on a derivative transaction is that a counterparty might default on payments due, which could result in Fannie Mae having to replace the derivative with a different counterparty at a higher cost. The exposure to counterparty default after offsetting arrangements, such as master netting agreements and the value of related collateral, is thus the appropriate measure of the actual credit risk of derivative contracts.

The risk of loss to Fannie Mae on its derivatives book is extremely low for two primary reasons:

1) ***Fannie Mae's counterparties are of very high credit quality.***
2) ***Fannie Mae has a conservative collateral management policy with provisions for requiring collateral on its derivative contracts in gain positions.***

Fannie Mae has never experienced a loss on a derivative transaction due to credit default by a counterparty. Fannie Mae's credit risk on derivative transactions is extremely low because Fannie Mae's counterparties are of very high credit quality. These counterparties consist of large banks, broker-dealers, and other financial institutions that have a significant presence in the derivatives market, most of whom are based in the United States. Fannie Mae manages derivative counterparty credit risk by contracting only with experienced counterparties that have high credit ratings. Fannie Mae initiates derivative contracts only with counterparties rated A or higher. As an additional precaution, Fannie Mae has a conservative collateral management policy with provisions for requiring collateral on its derivative contracts in gain positions.

Fannie Mae regularly monitors credit exposures on its derivatives by valuing derivative positions via internal pricing models and dealer quotes. Fannie Mae enters into master agreements that provide for netting of amounts due to Fannie Mae and amounts due to counterparties under those agreements. All of Fannie Mae's master derivatives agreements are governed by New York law.

The estimated total notional balance of the global derivatives market was $119 trillion in June 2001 based on combined data from the Bank for International Settlements for over-the-counter derivatives and published figures for exchange-traded derivatives. Fannie Mae's outstanding notional principal balance of $533 billion at December 31, 2001 represents less than one-half of one percent of the total estimated derivatives market. Although notional principal is a commonly used measure of volume in the derivatives market, it is not a meaningful measure of market or credit risk since the notional amount typically does not change hands. The notional amounts of derivative instruments are used to calculate contractual cash flows to be exchanged and are significantly greater than the potential market or credit loss that could result from such transactions. The fair value gains on derivatives is a more meaningful measure of the potential market exposure on derivatives.

The exposure to credit loss on derivative instruments can be estimated by calculating the cost, on a present value basis, to replace at current market rates all outstanding derivative contracts in a gain position. Fannie Mae's exposure on derivative contracts (taking into account master settlement agreements that allow for netting of payments and excluding collateral received) was $766 million at December 31, 2001, compared with $182 million at December 31, 2000. Fannie Mae expects the credit exposure on derivative contracts to fluctuate as interest rates change. Fannie Mae held $656 million of collateral through custodians for derivative instruments at December 31, 2001 and $70 million of collateral at December 31, 2000. Assuming the highly unlikely event that all of Fannie Mae's derivative counterparties to which Fannie Mae was exposed at December 31, 2001 were to default simultaneously, it would have cost an estimated $110 million to replace the economic value of those contracts. This replacement cost represents less than 2 percent of Fannie Mae's 2001 pre-tax income.

Table 16 provides a summary of counterparty credit ratings for the exposure on derivatives in a gain position at December 31, 2001.

TABLE 16: DERIVATIVE CREDIT LOSS EXPOSURE[1]

	Years to Maturity						
Dollars in millions	Less than 1 Year	1 to 5 Years	Over 5 Years	Maturity Distribution Netting[2]	Exposure	Collateral Held	Exposure Net of Collateral
Credit Rating							
AAA	$—	$—	$ 136	$(136)	$ —	$ —	$ —
AA	—	43	671	(528)	186	95	91
A	—	43	826	(289)	580	561	19
Total	$—	$ 86	$1,633	$(953)	$766	$656	$110

[1] *Represents the exposure to credit loss on derivative instruments, which is estimated by calculating the cost, on a present value basis, to replace all outstanding derivative contracts in a gain position. Reported on a net-by-counterparty basis where a legal right of offset exists under an enforceable master settlement agreement. Derivative gains and losses with the same counterparty in the same maturity category are presented net within the maturity category.*

[2] *Represents impact of netting of derivatives in a gain position and derivatives in a loss position for the same counterparty across maturity categories.*

The majority of Fannie Mae's credit exposure of $1.719 billion based on these maturity categories was offset by $953 million of exposure that counterparties had to Fannie Mae, resulting in net exposure, excluding collateral held, of $766 million to counterparties. At December 31, 2001, 100 percent of Fannie Mae's exposure on derivatives excluding collateral held was with counterparties rated A or better by Standard & Poor's, and 83 percent of Fannie Mae's exposure net of collateral held was with counterparties rated AA by Standard & Poor's. Five counterparties accounted for approximately 98 percent of exposure on derivatives (excluding collateral held) to counterparties at year-end 2001, and each had a credit rating of A or better.

Fannie Mae mitigates its net exposure on derivative transactions through its collateral management policy, which consists of four primary components: (1) minimum collateral thresholds; (2) collateral valuation percentages; (3) overcollateralization based on rating downgrades; and (4) frequent monitoring procedures.

Minimum Collateral Thresholds

Derivative counterparties are obligated to post collateral when Fannie Mae is exposed to credit losses exceeding agreed-upon thresholds, which are based on counterparty credit ratings. The amount of collateral to be posted is determined based on counterparty credit ratings and the level of credit exposure and must equal the excess of

Fannie Mae's exposure over the threshold amount. Table 17 presents Fannie Mae's general ratings-based collateral thresholds.

TABLE 17: FANNIE MAE RATINGS-BASED COLLATERAL THRESHOLDS

Dollars in millions

Credit Rating		Exposure	
S&P	Moody's	Threshold	
AAA	Aaa	Mutually agreed on	
AA+	Aa1	$100	
AA	Aa2	50	
AA-	Aa3	50	
A+	A1	25	
A	A2	10	
A- or below	A3 or below	0	(see Table 18)

Collateral Valuation Percentages

Fannie Mae requires its counterparties to post specific types of collateral to meet their collateral requirements. All of the collateral posted by Fannie Mae counterparties was in the form of cash or U.S. Treasury securities at December 31, 2001. Each type of collateral is given a specific valuation percentage based on its relative risk. For example, counterparties receive a 100 percent valuation for cash but may receive only a 98 percent valuation percentage for certain U.S. Treasury instruments. In cases where the valuation percentage for a certain type of collateral is less than 100 percent, counterparties must post an additional amount of collateral to meet their collateral requirements to Fannie Mae.

Overcollateralization Based on Low Credit Ratings

Fannie Mae further reduces its net exposure on derivatives by generally requiring overcollateralization from counterparties whose credit ratings have dropped below predetermined levels. Counterparties falling below these levels must post additional collateral (beyond the collateral requirements previously noted) to meet their overall collateral requirements. Table 18 presents Fannie Mae's standard valuation percentages for overcollateralization based on counterparty credit ratings.

TABLE 18: FANNIE MAE STANDARD COLLATERAL VALUATION PERCENTAGES

Credit Rating	Additional Percentage of Collateral to be Posted
A/A2 or above	0%
A-/A3 to BBB+/Baa1	10
BBB/Baa2 or below	25

Frequent Monitoring Procedures

Fannie Mae marks its collateral position against exposure using internal valuation models and market prices and compares the calculations to its counterparties' valuations. Fannie Mae and its derivative counterparties transfer collateral within one business day based on the agreed-upon valuation. Fannie Mae marks to market daily when interest rate movements or credit issues make it appropriate, and never less frequently than weekly. Pursuant to Fannie Mae's collateral agreements, Fannie Mae reserves the right to value exposure and collateral adequacy at any time. All of the collateral posted to Fannie Mae is held by a New York-based third-party custodian, which monitors the value of posted collateral on a daily basis.

Additional information on derivative instruments is presented in MD&A under "Risk Management-Interest Rate Risk Management" and in the Notes to Financial Statements under Note 13, "Derivative Instruments and Hedging Activities."

Liquidity and Capital Resources

Fannie Mae's statutory mission requires that it provide ongoing assistance to the secondary market for mortgages. Fannie Mae therefore must continually raise funds to support its mortgage purchase activity. As a result of Fannie Mae's credit quality, efficiency, and standing in the capital market, Fannie Mae has had ready access to funding. However, the U.S. government does not guarantee, directly or indirectly, Fannie Mae's debt.

One of the components of Fannie Mae's voluntary initiatives was a commitment to obtain an annual "risk to the government" credit rating or financial strength rating from a nationally recognized rating agency. In February 2001, Standard & Poor's assigned a AA-"risk to the government" rating to Fannie Mae. In February 2002, Moody's Investors Service assigned an A- Bank Financial Strength Rating to Fannie Mae. The highest possible levels for these ratings are AAA from Standard & Poor's and A from Moody's. Fannie Mae also committed to maintain a portfolio of high-quality, liquid, non-mortgage securities, equal to at least 5 percent of total assets, as part of its voluntary safety and soundness initiatives. At December 31, 2001, Fannie Mae's ratio of liquid assets to total assets was 9.5 percent, compared with 8.2 percent at December 31, 2000.

Fannie Mae's primary sources of cash are issuances of debt obligations, mortgage repayments, interest income, and MBS guaranty fees. Fannie Mae had cash and cash equivalents and short-term investments totaling $76 billion at December 31, 2001, compared with $56 billion at December 31, 2000. Primary uses of cash include the purchase of mortgages and other securities, repayment of debt, interest payments, administrative expenses, taxes, and fulfillment of its MBS guaranty obligation. Additional

information on MBS is presented in MD&A in the "Mortgage-Backed Securities" section.

At December 31, 2001, Fannie Mae had $55 billion in outstanding mandatory commitments and $2 billion in outstanding optional commitments for the purchase and delivery of mortgages in 2002 that were funded in 2001. At December 31, 2000, Fannie Mae had $16 billion in outstanding mandatory commitments and $2 billion in outstanding optional commitments for the purchase and delivery of mortgages in 2001.

Fannie Mae's core capital (defined by its regulator, Office of Federal Housing Enterprise Oversight [OFHEO], as the stated value of outstanding common stock, the stated value of outstanding noncumulative perpetual preferred stock, paid-in capital, and retained earnings) grew to $25.2 billion at December 31, 2001 from $20.8 billion at December 31, 2000. Fannie Mae's core capital, which excludes accumulated other comprehensive income (AOCI), is a more accurate reflection of its capital resources than total stockholder's equity. Core capital excludes AOCI because AOCI incorporates unrealized gains (losses) on derivatives and certain investment securities, but not the unrealized losses (gains) on the remaining mortgages and securities or liabilities used to fund the purchase of these items.

At December 31, 2001, AOCI totaled negative $7 billion, compared with a positive balance of $10 million at December 31, 2000. Upon adoption of FAS 133 on January 1, 2001, Fannie Mae recorded a $3.9 billion reduction in AOCI, which was primarily attributable to recording derivatives (mostly interest rate swaps used as substitutes for non-callable debt) that qualify as cash flow hedges on the balance sheet at fair value. The balance of the decline in AOCI was attributable to a decline in the fair value of these derivatives during the year with the reduction in interest rates. FAS 133 requires a mark-to-market through AOCI for derivatives that qualify as cash flow hedges to the extent they are effective hedges.

Fannie Mae had approximately 997 million common shares outstanding, net of shares held in treasury, as of December 31, 2001, versus 999 million common shares outstanding at the end of the prior year. Common stock issuances during 2001 totaled 4.5 million shares for employee and other stock compensation plans. Fannie Mae repurchased 6.0 million shares of stock at a weighted average cost of $76.95 per share as part of the continuation of its capital restructuring program. In 2000, Fannie Mae repurchased 25 million shares of common stock. The stock repurchases were made pursuant to the Board's approval to repurchase up to 6 percent of outstanding common shares as of December 27, 1995 (adjusted for a stock split) and to repurchase shares to offset the dilutive effect of common shares issued in conjunction with various stock compensation plans.

Fannie Mae raised $400 million in additional equity in 2001 by issuing noncumulative preferred stock. In April 2001, Fannie Mae issued 8.0 million shares of Series H preferred stock at a stated value of $50 per share and initial rate of 5.81 percent. On March 1, 2001, Fannie Mae redeemed all of the outstanding shares of its 6.41 percent Series A preferred stock at a redemption price of $50.53 per share, which included dividends of $.53417 per share for the period commencing December 31, 2000, up to, but excluding, March 1, 2001. On February 28, 2002, Fannie Mae redeemed all outstanding shares of its 6.5 percent non-cumulative preferred stock, Series B at $50.51458 per share, which represents the stated redemption price of $50.00 per share plus an amount equal to the dividend for the quarterly dividend period ending March 31, 2002, accrued to, but excluding, the redemption date of February 28, 2002.

In January 2002, the Board of Directors approved a quarterly common stock dividend for 2002 of $.33 per common share. In 2001, the quarterly dividend rate was $.30 per common share. The Board of Directors also approved preferred stock dividends for the period commencing December 31, 2001, up to, but excluding, March 31, 2002, as identified in Table 19.

TABLE 19: PREFERRED STOCK DIVIDENDS

Preferred Stock Series	Dividend per Share
Series B[1]	$.81250
Series C	.80625
Series D	.65625
Series E	.63750
Series F	.78690
Series G	.75290
Series H	.72630

[1] *Fannie Mae redeemed all of the outstanding shares of its 6.50 percent Series B preferred stock on February 28, 2002 at $50.5148 per share. The redemption price included dividends of $.5148 per share for the period commencing December 31, 2001, up to, but excluding, February 28, 2002.*

During 2001, Fannie Mae issued $5 billion of subordinated debt that received a rating of AA from Standard & Poor's and Aa2 from Moody's Investors Service. Fannie Mae's subordinated debt serves as a supplement to Fannie Mae's equity capital, although it is not a component of core capital. It provides a risk-absorbing layer to supplement core capital for the benefit of senior debt holders and serves as a

consistent and early market signal of credit risk for investors. By the end of 2003, Fannie Mae intends to issue sufficient subordinated debt to bring the sum of total capital and outstanding subordinated debt to at least 4 percent of on-balance sheet assets, after providing adequate capital to support off-balance sheet MBS. Total capital and outstanding subordinated debt represented 3.4 percent of on-balance sheet assets at December 31, 2001.

Fannie Mae's Portfolios and Capital Committee, chaired by the Chief Financial Officer, determines interest rate risk and credit risk pricing thresholds, formulates corporate hedging strategies, and ensures compliance with economic and regulatory risk-based capital requirements. Fannie Mae assesses capital adequacy using an internally developed stress test methodology. The stress test model calculates the amount of capital required under different economic scenarios based on the company's statutory standard. Fannie Mae also uses this model to estimate the potential amount of capital needed to carry out the company's mission during a period of economic distress. Based on the results of this model and other factors, Fannie Mae makes decisions on the risk structure of its business.

Regulatory Environment

Fannie Mae is subject to capital adequacy standards established by the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (1992 Act) and continuous examination by OFHEO, which was also established by the 1992 Act. The capital adequacy standards require that Fannie Mae's core capital equal or exceed a minimum capital standard and a critical capital standard. Table 20 shows Fannie Mae's core capital at year-end 2001 and 2000 compared with the requirements.

TABLE 20: CAPITAL REQUIREMENTS

	December 31,	
Dollars in millions	**2001**	2000
Core capital[1]	**$25,182**	$20,827
Required minimum capital[2]	**24,182**	20,294
Excess of core capital over minimum capital	**$ 1,000**	$ 533
Required critical capital[3]	**$12,324**	$10,337
Excess of core capital over required critical capital	**12,859**	10,490

[1] The sum of (a) the stated value of outstanding common stock; (b) the stated value of outstanding noncumulative perpetual preferred stock; (c) paid-in capital; and (d) retained earnings. Core capital excludes accumulated other comprehensive income (AOCI).

[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, which may be adjusted by the Director of OFHEO under certain circumstances (See 12 CFR 1750.4 for existing adjustments made 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, which may be adjusted by the Director of OFHEO under certain circumstances.

The 1992 Act also established risk-based capital requirements for Fannie Mae and required OFHEO to adopt regulations establishing a risk-based capital test. On September 13, 2001, OFHEO published a final risk-based capital rule in the Federal Register. On February 20, 2002, OFHEO finalized amendments to the final rule. Under the 1992 Act, the final regulations are enforceable one year after publication in the Federal Register. Management is continuing its review and analysis of the final rule and the finalized amendments. Results of Fannie Mae's interim risk-based capital stress test, which Fannie Mae discloses under its voluntary safety and soundness initiatives, indicate that Fannie Mae is in full compliance with its capital requirements.

Mortgage-Backed Securities

Outstanding MBS held by investors other than Fannie Mae grew 22 percent to $859 billion at December 31, 2001 from $707 billion at December 31, 2000. MBS issues acquired by other investors increased $240 billion to $345 billion from $105 billion in 2000, while liquidations of outstanding MBS acquired by other investors increased $112 billion to $201 billion. The increase in MBS issuances and liquidations in 2001 was attributable to the decline in mortgage interest rates during the year.

Total MBS outstanding, including MBS held in Fannie Mae's portfolio, grew 22 percent to $1.290 trillion at year-end 2001 from $1.058 trillion at year-end 2000. Total MBS issues, including MBS held in Fannie Mae's portfolio, increased 150 percent to $528 billion from $212 billion in 2000, while total MBS liquidations grew 158 percent to $296 billion from $115 billion in 2000.

Total MBS Outstanding
In Billions

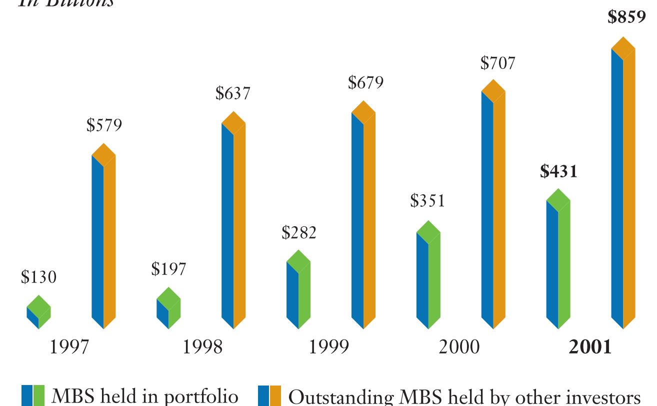


Table 21 summarizes the risk distribution for MBS issued and outstanding for the years ended December 31, 2001, 2000, and 1999.

TABLE 21: MBS RISK DISTRIBUTION

	Total Issued[1]				Total MBS Outstanding[1]			
Dollars in millions	Fannie Mae Risk	Lender or Shared Risk	Total	MBS Issues Acquired by Others	Fannie Mae Risk	Lender or Shared Risk[2]	Total[3]	Outstanding MBS Held by Other Investors
2001	**$482,956**	**$42,365**	**$525,321**	**$344,739**	**$1,091,631**	**$198,720**	**$1,290,351**	**$858,867**
2000	183,016	27,295	210,311	105,407	837,538	220,212	1,057,750	706,684
1999	225,161	75,187	300,348	174,850	751,693	209,190	960,883	679,169

[1] *Based on primary default risk category. Includes MBS that have been pooled to back Fannie Megas, SMBS, or REMICs. Total issued includes $181 billion, $105 billion, and $125 billion of Fannie Mae MBS purchased by portfolio in 2001, 2000 and 1999, respectively. Total issued excludes $3 billion and $2 billion of Fannie Mae originated MBS in 2001 and 2000, respectively.*

[2] *Included in lender risk are $154 billion, $173 billion, and $163 billion at December 31, 2001, 2000, and 1999, respectively, on which the lender or a third party has agreed to bear default risk limited to a certain portion or percentage of the loans delivered and, in some cases, on which the lender has pledged collateral to secure that obligation. Fannie Mae is ultimately responsible for bearing default risk if the lender or third party fails to fulfill its obligation.*

[3] *Included are $431 billion, $351 billion, and $282 billion at December 31, 2001, 2000, and 1999, respectively, of MBS in Fannie Mae's portfolio.*

Fannie Mae issues MBS that are backed by mortgage loans from a single lender or from multiple lenders, or that are transferred from Fannie Mae's mortgage portfolio. Single-lender MBS are issued through lender swap transactions whereby a lender exchanges pools of mortgages for MBS. Multiple-lender MBS allow several lenders to pool mortgages and receive, in return, MBS (called Fannie Majors®) representing a proportionate share of a larger pool. Lenders may retain the MBS or sell them to other investors. MBS are not assets of Fannie Mae except when acquired for investment purposes, nor are they recorded as liabilities. In some instances, Fannie Mae buys mortgage loans and concurrently enters into a forward sale commitment. These loans are designated as held for sale when acquired and sold from the portfolio as MBS.

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. Fannie Mae receives a guaranty fee for assuming the credit risk and guaranteeing timely payment of principal and interest to MBS investors. 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. Fannie Mae ultimately is responsible for guaranteeing timely payment of principal and interest to MBS investors whether or not Fannie Mae shares primary default risk on loans underlying MBS. Fannie Mae accrues a liability on its balance sheet for its guarantee obligation based on the probability that mortgages underlying MBS will not perform according to contractual terms and the level of credit risk it has assumed. At December 31, 2001, Fannie Mae had an accrued liability of $598 million for estimated losses on its guaranty of MBS, compared with $603 million at December 31, 2000.

Fannie Mae may adjust the monthly MBS guaranty fee rate through an upfront cash payment or receipt at securitization. Fannie Mae applies the interest method to amortize the guaranty fee adjustment over the estimated life of the loans underlying the MBS. Calculating the constant effective yield method necessary to apply the interest method is a critical accounting policy that requires estimating future mortgage prepayments. Estimating prepayments requires significant judgment and assumptions that involve some degree of uncertainty regarding factors such as the forecast of movements in interest rates and predicting borrower patterns.

Fannie Mae tracks and monitors actual prepayments received against anticipated prepayments and regularly assesses the sensitivity of prepayments to changes in interest rates on a monthly basis. Based upon this analysis, Fannie Mae determines if changes in the estimated prepayment rates used in the amortization calculation are necessary. If so, Fannie Mae recalculates the constant effective yield and adjusts the deferred guaranty fee balance to reflect the amount that would have been recorded if the new effective yield had been applied since the initial date of the guaranty fee adjustment. Fannie Mae's MBS prepayment sensitivity analysis at December 31, 2001 indicates that a 100 basis point increase in interest rates would result in an increase in projected guaranty fee income of approximately 2 percent and a 100 basis point decrease in interest rates would result in a decrease in projected guaranty fee income of approximately 4 percent over a one-year horizon.

Fannie Mae also issues Real Estate Mortgage Investment Conduits (REMICs) backed by MBS, Stripped MBS (SMBS), Government National Mortgage Association (Ginnie Mae) mortgage-backed securities, other REMIC securities, or whole loans. REMICs backed by MBS or SMBS provide an additional source of fee income from issuances that do not subject Fannie Mae to added credit risk. REMIC issuances totaled $124 billion in 2001, up from $34 billion in 2000. Fannie Mae REMIC issuances rebounded in 2001 with the rest of the REMIC market. REMIC market volumes increased primarily because of the steeper yield curve, which made the REMIC market more attractive. In addition, lower interest rates contributed to higher MBS issuances and increased collateral available for REMICs. The outstanding balance of REMICs at December 31, 2001 was $346 billion, compared with $292 billion at December 31, 2000. REMICs are not assets of Fannie Mae except when acquired for investment purposes, nor are they recorded as liabilities.

Housing Goals

The 1992 Act gives the Secretary of the U.S. Department of Housing and Urban Development (HUD) the authority to establish low- and moderate-income, underserved areas, and special affordable housing goals for Fannie Mae. By regulation, HUD has established the low- and moderate-income housing goal at 50 percent of Fannie Mae's conventional mortgage business, the underserved areas housing goal at 31 percent, and the special affordable housing goal, a more targeted measure, at 20 percent. In addition, HUD has established Fannie Mae's targeted multifamily subgoal at $2.85 billion. Each of these goals applies annually during 2001 through 2003. The goals also include certain provisions that reduce penalties for missing data and provide incentive points for serving small multifamily and owner-occupied rental housing.

Although the 2001 goals represent a significant increase above Fannie Mae's historic level of performance, Fannie Mae achieved these goals in 2001. Table 22 shows Fannie Mae's housing goals and results for 2001 and 2000.

TABLE 22: HOUSING GOALS

	Year Ended December 31,			
	2001		2000	
Dollars in billions	Goal[1]	Result	Goal[1]	Result
Low- and moderate-income housing	**50.0%**	**51.6%**	42.0%	49.5%
Underserved areas	**31.0**	**32.5**	24.0	31.0
Special affordable housing	**20.0**	**21.6**	14.0	22.3
Targeted multifamily	**$2.85**	**$7.40**	$1.30	$3.78

[1] *Goals are expressed as a percentage of the units financed through Fannie Mae's conventional mortgage business during the period, except for the targeted multifamily goal.*

Performance Outlook

Fannie Mae is optimistic in its outlook for future performance because of anticipated growth in the housing market, Fannie Mae's disciplined interest rate risk and credit risk management strategies, and the strong credit quality of the current book of business. With operating EPS growth of 21 percent in 2001, Fannie Mae is on track to achieve its five-year goal of doubling operating EPS to $6.46 by the end of 2003. Management expects the company's exceptional financial performance to continue in 2002 with operating EPS growth to be significantly above the very positive long-term EPS trend projected for the company for the following reasons:

- The carryover effects of the very high levels of business activity during the second half of 2001 are expected to have a beneficial impact on 2002.
  - Fannie Mae ended 2001 with $55 billion in outstanding commitments to purchase mortgages, an increase of $39 billion over the prior year-end. The settlement of these additional commitments will add over 5 percentage points to portfolio growth in 2002.
  - With outstanding MBS at year-end 2001 up 10 percent over the average outstanding MBS balance for 2001, Fannie Mae is positioned to produce double-digit growth in guaranty fee income in 2002.
- The recent sharp rebound in long-term interest rates is expected to significantly lower the volume of liquidations over the first half of 2002. As a result, management anticipates that Fannie Mae's net interest margin—which benefited from the call and refunding of a large volume of debt during 2001—will remain at elevated levels for a longer period than previously anticipated.
- Management expects that weaker economic conditions will result in only modest increases in credit-related expenses and Fannie Mae's credit loss ratio. Fannie Mae believes its current book of business is better positioned to withstand the effects of an economic slowdown than in prior slowdowns because of improved loan underwriting through the automated Desktop Underwriter, lower loan-to-value ratios, less geographic concentration, more third-party credit enhancements, and superior credit loss mitigation efforts.

- Revenue growth should more than offset higher than normal administrative costs in 2002 associated with Fannie Mae's initiative to upgrade the technology underlying its core operating infrastructure and systems.

The demand for the American dream will grow even stronger in 2002, and so will Fannie Mae's determination to meet that demand. In furthering its mission to increase homeownership, Fannie Mae has several strategic initiatives that it will continue to pursue in 2002, including:

- The $2 trillion American Dream Commitment[SM], which involves a six-point plan to invest $2 trillion and serve 18 million households over ten years to close homeownership gaps, strengthen communities and stabilize neighborhoods, and fight discrimination and unfair practices in the mortgage marketplace.
- E-commerce strategies and core infrastructure project to:
  - allow for rapid acquisition and risk assessment of mortgage assets through multiple channels,
  - facilitate new revenue generating products, and
  - generate cost reductions for the consumer, Fannie Mae partners, and the company.

Management expects that the fundamental economic drivers behind the demand for housing—household formation, homeownership rates, home price appreciation, and debt-to-value ratios—will remain strong throughout the next decade and expand the volume of mortgage debt outstanding. Fannie Mae expects that the continued growth in residential mortgage debt throughout the decade will positively impact Fannie Mae's long-term earnings trend.

Comparison of 2000 with 1999

The following discussion and analysis compares Fannie Mae's results of operations for the years ended December 31, 2000 and 1999.

Results of Operations

Operating net income increased 14 percent to $4.448 billion in 2000 from $3.912 billion in 1999. Diluted operating EPS rose 15 percent to $4.29, up from $3.72 in 1999.

Total taxable-equivalent revenues grew 12 percent to $7.825 billion in 2000 from $6.975 billion in 1999. The growth was attributable largely to solid increases in net interest income.

Net interest income increased 16 percent to $5.674 billion in 2000 because of 18 percent growth in the net mortgage portfolio combined with a stable average net interest margin.

Guaranty fee income increased 5 percent to $1.351 billion in 2000 from $1.282 billion in 1999. Guaranty fee income grew due to the combination of 4 percent growth in average net Fannie Mae MBS outstanding and a slight increase in the average effective guaranty fee rate.

Fee and other income (expense) declined to an expense of $44 million in 2000 from income of $191 million in 1999. The $235 million decrease was primarily due to an increase in net operating losses from certain tax-advantaged investments and a hedging loss on an anticipated Benchmark note issuance.

Credit-related expenses decreased $33 million to $94 million in 2000 from $127 million in 1999 despite continued growth in Fannie Mae's book of business. Credit-related losses fell as a percentage of the average book of business to .7 basis points in 2000 from 1.1 basis points in 1999. The provision for losses remained stable at negative $120 million in conjunction with Fannie Mae's current policy of recording a negative loss provision in line with net recoveries.

Administrative expenses grew 13 percent to $905 million in 2000 from $800 million in 1999 primarily due to increased expenses associated with eBusiness technology, Single-Family Mortgage Business infrastructure, and housing and community development initiatives.

The provision for federal income taxes, net of the tax impact from debt extinguishments, increased to $1.583 billion in 2000 from $1.514 billion in 1999. The effective federal income tax rate decreased to 26 percent in 2000 from 28 percent in 1999. The reduction in the 2000 effective federal income tax rate was attributable primarily to increased tax credits from a higher volume of affordable housing investments.

During 2000, Fannie Mae called or repurchased $18 billion in debt and notional principal of interest rate swaps carrying a weighted-average cost of 7.10 percent. The comparable amount in 1999 was $42 billion, with a weighted-average cost of 6.80 percent. As a result of repurchase and call activity, Fannie Mae recognized net extraordinary gains of $49 million ($32 million after tax) in 2000, compared with net extraordinary losses of $14 million ($9 million after tax) in 1999.

Statements of Income

Dollars and shares in millions, except per common share amounts	Year Ended December 31, 2001	2000	1999
Interest income:			
Mortgage portfolio	**$46,478**	$39,403	$32,672
Investments and cash equivalents	**2,692**	3,378	2,823
Total interest income	**49,170**	42,781	35,495
Interest expense:			
Short-term debt	**5,897**	4,204	3,952
Long-term debt	**35,183**	32,903	26,649
Total interest expense	**41,080**	37,107	30,601
Net interest income	**8,090**	5,674	4,894
Other income:			
Guaranty fees	**1,482**	1,351	1,282
Fee and other income (expense)	**151**	(44)	191
Total other income	**1,633**	1,307	1,473
Other expenses:			
Provision for losses	**(115)**	(120)	(120)
Foreclosed property	**193**	214	247
Administrative	**1,017**	905	800
Special contribution	**300**	—	—
Purchased options expense	**37**	—	—
Total other expenses	**1,432**	999	927
Income before federal income taxes, extraordinary item and cumulative effect of change in accounting principle	**8,291**	5,982	5,440
Provision for federal income taxes	**2,224**	1,566	1,519
Income before extraordinary item and cumulative effect of change in accounting principle	**6,067**	4,416	3,921
Extraordinary item-(loss) gain on early extinguishment of debt (net of tax benefit of $183 million in 2001, tax expense of $17 million in 2000, and tax benefit of $5 million in 1999)	**(341)**	32	(9)
Cumulative effect of change in accounting principle, net of tax effect	**168**	—	—
Net income	**$ 5,894**	$ 4,448	$ 3,912
Preferred stock dividends	**138**	121	78
Net income available to common stockholders	**$ 5,756**	$ 4,327	$ 3,834
Basic earnings per common share:			
Earnings before extraordinary item and cumulative effect of change in accounting principle	**$ 5.92**	$ 4.28	$ 3.75
Extraordinary (loss) gain	**(.34)**	.03	—
Cumulative effect of change in accounting principle	**.17**	—	—
Net earnings	**$ 5.75**	$ 4.31	$ 3.75
Diluted earnings per common share:			
Earnings before extraordinary item and cumulative effect of change in accounting principle	**$ 5.89**	$ 4.26	$ 3.73
Extraordinary (loss) gain	**(.34)**	.03	(.01)
Cumulative effect of change in accounting principle	**.17**	—	—
Net earnings	**$ 5.72**	$ 4.29	$ 3.72
Cash dividends per common share	**$ 1.20**	$ 1.12	$ 1.08
Weighted-average common shares outstanding:			
Basic	**1,000**	1,003	1,024
Diluted	**1,006**	1,009	1,031

See Notes to Financial Statements.

Balance Sheets

Dollars in millions, except share stated values	December 31, 2001	2000
Assets		
Mortgage portfolio, net	**$705,167**	$607,399
Investments:		
Held-to-maturity	**38,671**	33,832
Available-for-sale	**35,883**	21,136
Cash and cash equivalents	**1,518**	617
Accrued interest receivable	**4,705**	4,529
Acquired property and foreclosure claims, net	**684**	636
Derivatives in gain positions	**954**	—
Other	**12,209**	6,923
Total assets	**$799,791**	$675,072
Liabilities and Stockholders' Equity		
Liabilities:		
Debentures, notes and bonds, net:		
Due within one year	**$343,492**	$280,322
Due after one year	**419,975**	362,360
Total	**763,467**	642,682
Accrued interest payable	**8,529**	8,236
Derivatives in loss positions	**5,069**	—
Other	**4,608**	3,316
Total liabilities	**781,673**	654,234
Stockholders' Equity:		
Preferred stock, $50 stated value, 100 million shares authorized—46 million shares issued	**2,303**	2,278
Common stock, $.525 stated value, no maximum authorization—1,129 million shares issued	**593**	593
Additional paid-in capital	**1,651**	1,588
Retained earnings	**26,175**	21,619
Accumulated other comprehensive income (loss)	**(7,065)**	10
	23,657	26,088
Less: Treasury stock, at cost, 132 million shares in 2001 and 130 million shares in 2000	**5,539**	5,250
Total stockholders' equity	**18,118**	20,838
Total liabilities and stockholders' equity	**$799,791**	$675,072

See Notes to Financial Statements.

Statements of Changes in Stockholders' Equity

Dollars and shares in millions	Net Common Shares Outstanding	Preferred Stock	Common Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total Stockholders' Equity
Balance, January 1, 1999	1,025	$1,150	$593	$1,533	$15,689	$ (13)	$(3,499)	$15,453
Comprehensive income:								
Net income	—	—	—	—	3,912	—	—	3,912
Other comprehensive income, net of tax effect:								
Unrealized losses on available-for-sale securities	—	—	—	—	—	(233)	—	(233)
Total comprehensive income								3,679
Dividends	—	—	—	—	(1,184)	—	—	(1,184)
Shares repurchased	(10)	—	—	—	—	—	(653)	(653)
Preferred stock issued	—	150	—	(2)	—	—	—	148
Treasury stock issued for stock options and benefit plans	4	—	—	54	—	—	132	186
Balance, December 31, 1999	1,019	1,300	593	1,585	18,417	(246)	(4,020)	17,629
Comprehensive income:								
Net income	—	—	—	—	4,448	—	—	4,448
Other comprehensive income, net of tax effect:								
Unrealized losses on available-for-sale securities	—	—	—	—	—	256	—	256
Total comprehensive income								4,704
Dividends	—	—	—	—	(1,246)	—	—	(1,246)
Shares repurchased	(25)	—	—	—	—	—	(1,406)	(1,406)
Preferred stock issued	—	978	—	(10)	—	—	—	968
Treasury stock issued for stock options and benefit plans	5	—	—	13	—	—	176	189
Balance, December 31, 2000	999	2,278	593	1,588	21,619	10	(5,250)	20,838
Comprehensive income:								
Net income	—	—	—	—	5,894	—	—	5,894
Other comprehensive income, net of tax effect:								
Transition adjustment from the adoption of FAS 133	—	—	—	—	—	(3,972)	—	(3,972)
Unrealized gain on securities transferred to available-for-sale upon adoption of FAS 133	—	—	—	—	—	86	—	86
Net cash flow hedging losses	—	—	—	—	—	(3,387)	—	(3,387)
Unrealized gains on available-for-sale securities	—	—	—	—	—	198	—	198
Total comprehensive loss								(1,181)
Dividends	—	—	—	—	(1,338)	—	—	(1,338)
Shares repurchased	(6)	—	—	—	—	—	(464)	(464)
Preferred stock issued	—	400	—	(4)	—	—	—	396
Preferred stock redeemed	—	(375)	—	—	—	—	—	(375)
Treasury stock issued for stock options and benefit plans	4	—	—	67	—	—	175	242
Balance, December 31, 2001	997	$2,303	$593	$1,651	$26,175	$(7,065)	$(5,539)	$18,118

See Notes to Financial Statements.

Statements of Cash Flows

Dollars in millions	Year Ended December 31, 2001	2000	1999
Cash flows from operating activities:			
Net income	**$ 5,894**	$ 4,448	$ 3,912
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Amortization of discount/premium	**11,561**	10,025	7,730
Negative provision for losses	**(115)**	(120)	(120)
Gain (loss) on early extinguishment of debt	**524**	(49)	14
Cumulative effect of change in accounting principle (net of tax)	**(168)**	—	—
Purchased options expense	**37**	—	—
Other (decreases) increases, net	**(3,032)**	(913)	1,307
Net cash provided by operating activities	**14,701**	13,391	12,843
Cash flows from investing activities:			
Purchases of mortgages	**(270,609)**	(152,075)	(193,434)
Proceeds from sales of mortgages	**8,967**	10,599	5,950
Mortgage principal repayments	**164,408**	56,568	77,402
Net proceeds from disposition of foreclosed properties	**2,035**	2,019	2,462
Net (increase) decrease in held-to-maturity investments	**(4,839)**	(12,172)	20,639
Net (increase) in available-for-sale investments	**(14,770)**	(3,057)	(1,847)
Net cash used in investing activities	**(114,808)**	(98,118)	(88,828)
Cash flows from financing activities:			
Proceeds from issuance of long-term debt	**249,454**	110,298	138,491
Payments to redeem long-term debt	**(196,931)**	(50,320)	(62,464)
Proceeds from issuance of short-term debt	**1,746,381**	1,130,698	1,129,246
Payments to redeem short-term debt	**(1,690,805)**	(1,104,694)	(1,125,754)
Net payments to purchase or settle hedge instruments	**(5,569)**	(1,245)	(629)
Net payments from stock activities	**(1,522)**	(1,492)	(1,549)
Net cash provided by financing activities	**101,008**	83,245	77,341
Net increase (decrease) in cash and cash equivalents	**901**	(1,482)	1,356
Cash and cash equivalents at beginning of year	**617**	2,099	743
Cash and cash equivalents at end of year	**$ 1,518**	$ 617	$ 2,099
Supplemental disclosures of cash flow information:			
Cash paid during the year for:			
Interest	**$ 40,361**	$ 34,863	$ 28,447
Income taxes	**2,088**	1,595	1,276

See 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 Fannie Mae conform with accounting principles generally accepted in the United States of America. Certain amounts in prior years' financial statements have been reclassified to conform to the current presentation.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America 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 Fannie Mae has the ability and positive intent to hold to maturity are classified as "held-to-maturity" and are carried at their unpaid principal balance (UPB) adjusted for unamortized purchase discount or premium and other deferred price adjustments. Mortgage loans held for sale are carried at the lower of cost or fair value, determined on a portfolio basis, with any unrealized losses included in current period earnings. Mortgage-backed securities that Fannie Mae 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 a component of accumulated other comprehensive income (AOCI), net of deferred taxes, in stockholders' equity.

Fannie Mae 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 purchase discount or premium and other deferred price adjustments. 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.

Interest income is not accrued on nonperforming loans. Conventional single-family and multifamily loans are classified as nonperforming and previously accrued interest is reversed against current period income when payment on the loan is 90 days or more delinquent. Once loans become performing (payment on the loan is less than 90 days delinquent), they are placed on accrual status and all reversed income is recognized in the period the loans become performing.

Investments

Investments consist of Fannie Mae's Liquid Investment Portfolio and other investments. Investments are classified as either held-to-maturity or available-for-sale. Investments classified as held-to-maturity are carried at historical cost, adjusted for unamortized discount or premium. Investments classified as available-for-sale are carried at fair value as of the balance sheet date, with any valuation adjustments reported as a component of AOCI, net of deferred taxes, in stockholders' equity. 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

Fannie Mae guarantees the timely payment of principal and interest on most Fannie Mae Mortgage-Backed Securities (MBS). These securities represent beneficial interests in pools of mortgages or other MBS held in trust by Fannie Mae. The pools of mortgages or MBS are not assets of Fannie Mae, except when acquired for investment purposes, nor are the related outstanding securities liabilities; accordingly, neither are reflected on the accompanying balance sheets. Fannie Mae receives monthly guaranty fees for each MBS mortgage 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 Fannie Mae's portfolio, the guaranty fee is reflected as interest income.

Allowance for Losses

The allowance for losses is determined based on an analysis of portfolio loans and MBS outstanding and provides for known probable losses and losses inherent in the mortgage portfolio and MBS. Management's analysis considers current delinquency levels, historical loss experience, current economic conditions, payment performance in areas of geographic concentration, and mortgage characteristics. The allowance for losses is established by recording an expense for the provision for losses and may be reduced by recording a negative provision if management believes the allowance amount exceeds expected losses. The allowance for losses is subsequently reduced through charge-offs and is increased

through recoveries, including those related to credit enhancements and the resale of properties. In management's judgment, the allowance for losses is adequate to provide for expected losses. The primary components of the allowance for losses are an allowance for losses on loans in the retained mortgage portfolio, which is included in the balance sheet under "Mortgage portfolio, net," and an allowance for losses on loans underlying guaranteed MBS, which is included in the balance sheet under "Other liabilities."

Acquired Property

Foreclosed assets are carried at the lower of cost or fair value less estimated costs to sell. Cost is determined based on the fair value of the collateral at the date of the 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 the estimated fair value of the collateral at foreclosure and the principal owed on the underlying loan is recorded as either a charge-off or recovery against the allowance for losses at foreclosure. Subsequent changes in the fair value of the collateral and foreclosure, holding, and disposition costs are charged directly to earnings.

Derivative Instruments and Hedging Activities

Effective January 1, 2001, Fannie Mae adopted Financial Accounting Standard No. 133 (FAS 133), *Accounting for Derivative Instruments and Hedging Activities*, as amended by Financial Accounting Standard No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*. FAS 133 requires that all derivatives be recognized as either assets or liabilities on the balance sheet at their fair value. Subject to certain qualifying conditions, a derivative may be designated as either a hedge of the cash flows of a variable-rate instrument or anticipated transaction (cash flow hedge) or a hedge of the fair value of a fixed-rate instrument (fair value hedge). For a derivative qualifying as a cash flow hedge, fair value gains or losses are reported in a separate component of AOCI, net of deferred taxes, in stockholders' equity to the extent the hedge is perfectly effective and then recognized in earnings during the period(s) in which the hedged item affects earnings. For a derivative qualifying as a fair value hedge, fair value gains or losses on the derivative are reported in earnings along with fair value gains or losses on the hedged item attributable to the risk being hedged. For a derivative not qualifying as a hedge, or components of a derivative that are excluded from any hedge effectiveness assessment, fair value gains and losses are reported in earnings.

If a derivative no longer qualifies as a cash flow or fair value hedge, Fannie Mae discontinues hedge accounting prospectively. The derivative continues to be carried on the balance sheet at fair value with fair value gains and losses recorded in earnings until the derivative is settled. For discontinued cash flow hedges, the gains or losses previously deferred in AOCI are recognized in earnings in the same period(s) that the hedged item impacts earnings. For discontinued fair value hedges, the hedged asset or liability is no longer adjusted for changes in its fair value and previous fair value adjustments to the basis of the hedged item are subsequently amortized to earnings over the remaining life of the hedged item using the effective yield method.

The adoption of FAS 133 on January 1, 2001, resulted in a cumulative after-tax increase to income of $168 million and an after-tax reduction in AOCI of $3.9 billion. In addition, investment securities and MBS with an amortized cost of approximately $20 billion were reclassified from held-to maturity to available-for-sale upon the adoption of FAS 133. At the time of this non-cash transfer, these securities had gross unrealized gains and losses of $164 million and $32 million, respectively.

Cash and Cash Equivalents

Fannie Mae 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 fair 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 generally recognized when recorded on the tax return.

Comprehensive Income

Comprehensive income is defined as the change in equity of a business enterprise, on a net of tax basis, from transactions and other events and circumstances from nonowner sources during a period. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners.

2. Mortgage Portfolio, Net

The mortgage portfolio consisted of the following at December 31, 2001 and 2000.

Dollars in millions	**2001**	2000
Single-family mortgages:		
Government insured or guaranteed	**$ 42,181**	$ 44,166
Conventional:		
Long-term, fixed-rate	**552,463**	454,349
Intermediate-term, fixed-rate[1]	**69,412**	67,099
Adjustable-rate	**20,765**	27,135
	684,821	592,749
Multifamily mortgages:		
Government insured	**8,032**	7,184
Conventional	**14,623**	10,189
	22,655	17,373
Total unpaid principal balance	**707,476**	610,122
Less:		
Unamortized discount and deferred price adjustments, net	**2,104**	2,520
Allowance for losses	**205**	203
Net mortgage portfolio	**$705,167**	$607,399

[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 $542 billion and $455 billion of MBS and other mortgage-related securities at December 31, 2001 and 2000, respectively, with fair values of $549 billion and $459 billion, respectively. MBS held in portfolio at December 31, 2001 and 2000 included $129 billion and $114 billion, respectively, of Real Estate Mortgage Investment Conduits (REMICs) and Stripped MBS (SMBS). REMICs and SMBS backed by MBS do not subject Fannie Mae to added credit risk but generally have different interest rate risks than MBS. At December 31, 2001, these securities had aggregate gross unrealized losses of $819 million and gross unrealized gains of $2.6 billion. At December 31, 2000, the aggregate gross unrealized losses and gains on these securities were $716 million and $1.8 billion, respectively.

Mortgage securities classified as available-for-sale were $32 billion with unrealized gains of $462 million at December 31, 2001 and $11 billion with unrealized losses of $3 million at December 31, 2000.

3. Allowance for Losses

Changes in the allowance for the years 1999 through 2001 are summarized below.

Dollars in millions	Total
Balance, January 1, 1999	$ 802
Provision	(120)
Net recoveries	122
Balance, December 31, 1999	804
Provision	(120)
Net recoveries	125
Balance, December 31, 2000	809
Provision	(115)
Net recoveries	112
Balance, December 31, 2001	**$ 806**

At December 31, 2001, $205 million of the allowance for losses was included in the balance sheet under "Mortgage portfolio, net," which represents the allocation for portfolio loan losses; $598 million was included in liabilities under "Other" for estimated losses on MBS; and the remainder, or $3 million, which relates to unrecoverable losses on Federal Housing Administration loans, was included in "Acquired property and foreclosure claims, net." The corresponding amounts at December 31, 2000 were $203 million, $603 million, and $3 million, respectively.

The UPB of impaired loans at December 31, 2001 was $320 million, of which $213 million had a specific loss allowance of $13 million. At December 31, 2000, the UPB of impaired loans was $186 million, of which $67 million had a specific loss allowance of $2 million. The average balance of impaired loans during 2001 and 2000 was $204 million and $210 million, respectively. During 2001, Fannie Mae established $18 million of specific allowances for impaired loans, compared with $11 million in 2000. A loan is impaired when, based on current information and events, it is probable that all of the contractual principal and interest payments will not be collected as scheduled in the loan agreement. All of Fannie Mae's impaired loans are multifamily loans as single-family loans are exempt from Financial Accounting Standard No. 114, *Accounting by Creditors for Impairment of a Loan*.

Nonperforming loans outstanding totaled $3.7 billion at the end of 2001, compared with $1.9 billion at the end of 2000. If nonperforming loans had been fully performing at year end, they would have contributed an additional $70 million to net interest income in 2001, $43 million in 2000, and $108 million in 1999.

4. Investments

Presented below are the amortized cost and fair value of the Liquid Investment Portfolio and other investments classified as held-to-maturity at December 31, 2001 and 2000.

	2001						2000					
Dollars in millions	**Amortized Cost**	**Unrealized Gains**	**Unrealized Losses**	**Fair Value**	**Average Maturity in Months**	**% Rated A or Better**	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value	Average Maturity in Months	% Rated A or Better
Held-to-maturity investments:												
Eurodollar time deposits	**$11,185**	**$ —**	**$ —**	**$11,185**	**.3**	**100.0%**	$ 4,046	$—	$—	$ 4,046	1.2	100.0%
Repurchase agreements	**9,380**	**—**	**—**	**9,380**	**.5**	**100.0**	2,722	—	—	2,722	.5	100.0
Asset-backed securities[1]	**6,065**	**88**	**—**	**6,153**	**10.6**	**100.0**	9,043	23	—	9,066	22.6	100.0
Federal funds	**4,904**	**—**	**—**	**4,904**	**.4**	**100.0**	3,493	—	—	3,493	2.1	100.0
Commercial paper	**2,844**	**1**	**—**	**2,845**	**.6**	**100.0**	8,893	2	—	8,895	.7	90.1
Auction rate preferred stock	**2,127**	**—**	**—**	**2,127**	**1.7**	**100.0**	1,812	—	—	1,812	1.9	98.6
Other	**2,166**	**73**	**—**	**2,239**	**16.7**	**56.4**	3,823	29	—	3,852	17.6	100.0
Total	**$38,671**	**$162**	**$ —**	**$38,833**	**3.0**	**97.5%**	$33,832	$54	$—	$33,886	8.7	97.3%

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

Presented below are the amortized cost and fair value of the Liquid Investment Portfolio and other investments classified as available-for-sale at December 31, 2001 and 2000.

	2001						2000					
Dollars in millions	**Amortized Cost**	**Unrealized Gains[2]**	**Unrealized Losses[3]**	**Fair Value**	**Average Maturity in Months**	**% Rated A or Better**	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value	Average Maturity in Months	% Rated A or Better
Available-for-sale investments:												
Asset-backed securities[1]	**$14,876**	**$ —**	**$ 4**	**$14,872**	**26.2**	**99.9%**	$ 8,469	$—	$—	$ 8,469	49.6	100.0%
Floating rate notes[1]	**12,114**	**—**	**33**	**12,081**	**18.2**	**84.3**	12,237	—	13	12,224	18.5	99.7
Commercial paper	**8,879**	**1**	**—**	**8,880**	**.9**	**100.0**	443	—	—	443	.6	100.0
Other	**50**	**—**	**—**	**50**	**9.5**	**100.0**	—	—	—	—	—	—
Total	**$35,919**	**$ 1**	**$37**	**$35,883**	**17.2**	**94.7%**	$21,149	$—	$13	$21,136	30.6	99.8%

[1] As of December 31, 2001, 100 percent of asset-backed securities and floating rate notes reprice at intervals of 90 days or less.
[2] Gross realized gains of $9.9 million, $6.6 million, and $1.1 million were recorded in 2001, 2000, and 1999, respectively.
[3] Gross realized losses of $6.1 million, $4.3 million, and $1.9 million were recorded in 2001, 2000, and 1999, respectively.

The following table shows the amortized cost, fair value, and yield of the Liquid Investment Portfolio and other investments at December 31, 2001 and 2000 by remaining maturity.

	2001			2000		
Dollars in millions	**Amortized Cost**	**Fair Value**	**Yield**	Amortized Cost	Fair Value	Yield
Due within one year	**$42,190**	**$42,210**	**2.41%**	$27,026	$27,010	6.85%
Due after one year through five years	**11,459**	**11,481**	**3.01**	10,443	10,477	7.12
	53,649	**53,691**	**2.54**	37,469	37,487	6.93
Asset-backed securities[1]	**20,941**	**21,025**	**3.07**	17,512	17,535	6.84
Total	**$74,590**	**$74,716**	**2.69%**	$54,981	$55,022	6.90%

[1] Contractual maturity of asset-backed securities is not a reliable indicator of their expected life because borrowers generally 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, 2001 and 2000 are summarized below. Amounts are net of unamortized discount and premium.

	2001					2000				
	Outstanding at December 31		**Average Outstanding During Year**		**Maximum Outstanding at Any**	Outstanding at December 31		Average Outstanding During Year		Maximum Outstanding at Any
Dollars in millions	**Amount**	**Cost[1]**	**Amount**	**Cost[1]**	**Month-end**	Amount	Cost[1]	Amount	Cost[1]	Month-end
Short-term notes	**$256,905**	**2.58%**	**$247,060**	**4.31%**	**$265,953**	$178,292	6.50%	$150,242	6.33%	$178,292
Other short-term debt	**29,891**	**1.96**	**31,479**	**4.40**	**43,811**	42,157	6.58	37,880	6.36	42,157
Current portion of borrowings due after one year[2]:										
Universal Standard debt	**34,413**	**3.67**				51,185	6.02			
Universal Benchmark debt	**21,987**	**5.31**				6,984	5.71			
Universal Retail debt	**—**	**—**				785	6.62			
Other	**296**	**4.96**				919	6.57			
Total due within one year	**$343,492**	**2.81%**				$280,322	6.38%			

[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 at December 31, 2001 and 2000 consisted of the following:

		2001		2000	
Dollars in millions	Maturity Date	**Amount Outstanding**	**Average Cost[1]**	Amount Outstanding	Average Cost[1]
Universal Benchmark debt, net of $896 of discount for 2001 ($1,106 for 2000)	2002–2030	**$251,448**	**5.88%**	$185,771	6.42%
Universal Standard debt, net of $332 of discount for 2001 ($404 for 2000)	2002–2038	**156,738**	**4.85**	165,680	6.42
Universal Retail debt, net of $62 of discount for 2001 ($52 for 2000)	2002–2021	**7,098**	**5.87**	7,083	6.82
Long-term other, net of $12,653 of discount for 2001 ($14,749 for 2000)	2002–2018	**4,543**	**7.93**	4,788	8.58
		419,827	**5.52%**	363,322	6.46%
Adjustment for FAS 133[2]		**1,423**		—	
Adjustment for foreign currency translation		**(1,275)**		(962)	
Total due after one year		**$419,975**		$362,360	

[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] *Represents losses on hedged debt in fair value hedges.*

Universal debt represents a consolidation of Fannie Mae's outstanding debt agreements for its various funding programs into one comprehensive offering document, the Universal Debt Facility, which supersedes and replaces the Global Debt Facility, Medium-Term Notes, Short-Term Notes and Debenture Programs and applies to debt settling after January 3, 2000.

Debentures, notes, and bonds at December 31, 2001 included $140 billion of callable debt, which generally is redeemable, in whole or in part, at the option of Fannie Mae any time on or after a specified date. At December 31, 2001, debentures, notes, and bonds did not include any 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, callable swaps, and receive-fixed swaptions, excluding $15 billion of callable debt that was swapped to variable-rate debt and the notional amount of pay-fixed swaptions and caps. Universal debt that is redeemable at Fannie Mae's option is also included in the table.

Dollars in millions	Call Date	Year of Maturity	Amount Outstanding	Average Cost
Callable debt, callable swaps, and receive-fixed swaptions:				
	Currently callable	2002–2008	$ 295	5.88%
	2002	2002–2027	110,920	5.56
	2003	2003–2031	39,173	5.94
	2004	2004–2021	42,853	6.43
	2005	2008–2014	10,632	6.60
	2006	2008–2031	19,995	6.30
	2007 and later	2012–2030	8,725	7.20
			232,593	5.96%
Pay-fixed swaptions			69,650	
Caps			75,893	
Total option-embedded financial instruments			$378,136	

Principal amounts at December 31, 2001 of total debt payable in the years 2003-2007, assuming callable debt is paid at maturity and assuming callable debt is redeemed at the initial call date, were as follows:

Dollars in millions	Total Debt by Year of Maturity[1]	Assuming Callable Debt Redeemed at Initial Call Date[1]
2003	$83,791	$86,396
2004	71,839	51,572
2005	39,470	27,719
2006	53,238	30,514
2007	24,604	17,991

[1] *Includes $15 billion of callable debt that was swapped to variable-rate debt.*

Fannie Mae repurchased or called $183 billion of debt and notional principal amount of interest rate swaps with an average cost of 6.23 percent in 2001 and $18 billion with an average cost of 7.10 percent in 2000. Fannie Mae recorded extraordinary losses of $524 million ($341 million after tax) in 2001, extraordinary gains of $49 million ($32 million after tax) in 2000, and extraordinary losses of $14 million ($9 million after tax) in 1999 on the early extinguishment of debt.

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

6. Income Taxes

Components of the provision for federal income taxes for the years ended December 31, 2001, 2000, and 1999 were as follows:

Dollars in millions	**2001**	2000	1999
Current	**$2,429**	$1,412	$1,289
Deferred	**(205)**	154	230
	2,224	1,566	1,519
Tax (benefit) expense of extraordinary (loss) gain	**(183)**	17	(5)
Tax expense of cumulative effect of change in accounting principle	**90**	—	—
Net federal income tax provision	**$2,131**	$1,583	$1,514

The preceding table does not reflect the tax effects of unrealized gains and losses on available-for-sale securities and derivatives. The unrealized gains and losses on these items are recorded in AOCI, net of deferred taxes. The cumulative tax impact of these items was $3,804 million in tax savings at December 31, 2001, tax expense of $6 million at December 31, 2000, and $133 million in tax savings at December 31, 1999.

The tax effects of temporary differences that gave rise to significant portions of the deferred tax assets and deferred tax liabilities at December 31, 2001 and 2000 consisted of the following:

Dollars in millions	**2001**	2000
Deferred tax assets:		
Derivatives in loss positions	**$3,679**	$ —
MBS guaranty and REMIC fees	**915**	633
Allowance for losses	**314**	317
Unrealized gains on available-for-sale securities	**(158)**	(6)
Other items, net	**143**	124
Deferred tax assets	**4,893**	1,068
Deferred tax liabilities:		
Debt-related expenses	**536**	576
Purchase discount and deferred fees	**356**	490
Benefits from tax-advantaged investments	**125**	108
Other items, net	**57**	43
Deferred tax liabilities	**1,074**	1,217
Net deferred tax asset (liability)	**$3,819**	$(149)

Management anticipates 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.

Fannie Mae's effective tax rates differed from statutory federal rates for the years ended December 31, 2001, 2000, and 1999 as follows:

	2001	2000	1999
Statutory corporate rate	**35%**	35%	35%
Tax-exempt interest and dividends received deductions	**(4)**	(5)	(4)
Equity investments in affordable housing projects	**(4)**	(4)	(3)
Effective rate	**27%**	26%	28%

Fannie Mae 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.

Dollars and shares in millions, except per share amounts	Year Ended December 31, 2001 Basic	2001 Diluted	2000 Basic	2000 Diluted	1999 Basic	1999 Diluted
Net income before extraordinary item and cumulative effect of change in accounting principle	**$6,067**	**$6,067**	$4,416	$4,416	$3,921	$3,921
Extraordinary (loss) gain	**(341)**	**(341)**	32	32	(9)	(9)
Cumulative effect of change in accounting principle	**168**	**168**	—	—	—	—
Preferred stock dividend	**(138)**	**(138)**	(121)	(121)	(78)	(78)
Net income available to common stockholders	**$5,756**	**$5,756**	$4,327	$4,327	$3,834	$3,834
Weighted average common shares	**1,000**	**1,000**	1,003	1,003	1,024	1,024
Dilutive potential common shares[1]	**—**	**6**	—	6	—	7
Average number of common shares outstanding used to calculate earnings per common share	**1,000**	**1,006**	1,003	1,009	1,024	1,031
Earnings per common share before extraordinary item and cumulative effect of change in accounting principle	**$ 5.92**	**$ 5.89**	$ 4.28	$ 4.26	$ 3.75	$ 3.73
Extraordinary (loss) gain	**(.34)**	**(.34)**	.03	.03	—	(.01)
Cumulative effect of change in accounting principle	**.17**	**.17**	—	—	—	—
Net earnings per common share	**$ 5.75**	**$ 5.72**	$ 4.31	$ 4.29	$ 3.75	$ 3.72

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

For additional disclosures regarding Fannie Mae's stock compensation plans and the outstanding preferred stock, refer to Notes 8 and 12, respectively.

8. Stock Compensation Plans

At December 31, 2001, Fannie Mae had five stock-based compensation plans, which are described below. Financial Accounting Standard 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 the 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. Thus, no compensation expense has been recognized for the nonqualified stock options and Employee Stock Purchase Plan. Fannie Mae's reported net income and reported diluted earnings per common share were $5.894 billion and $5.72, $4.448 billion and $4.29, and $3.912 billion and $3.72 for the years ended December 31, 2001, 2000, and 1999, respectively. If compensation expense had been recognized for benefits under all five plans, based on their fair value at grant date and consistent with FAS 123, Fannie Mae's net income, net income available to common stockholders, and diluted earnings per common share would have been $5.653 billion, $5.515 billion, and $5.62; $4.187 billion, $4.066 billion, and $4.15; and $3.840 billion, $3.762 billion, and $3.65 for the years ended December 31, 2001, 2000, and 1999, respectively.

Fannie Mae determined the fair value of benefits under its stock-based plans using a Black-Scholes pricing model.

The following table summarizes the major assumptions used in the model.

	2001	2000	1999
Risk-free rate[1]	**3.62–4.99%**	4.97–6.81%	4.56–6.02%
Volatility	**34–37**	29–34	27–29
Forfeiture	**15**	15	15
Dividend[2]	**$1.20**	$1.12	$1.08
Expiration	**1–10 yrs.**	1–10 yrs.	1–10 yrs.

[1] *The closing yield on the comparable 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
Fannie Mae has an Employee Stock Purchase Plan that allows issuance of up to 41 million shares of common stock to qualified employees at a price equal to 85 percent of the fair market value on the grant date. This plan meets the definition of a noncompensatory plan under APB Opinion 25. Therefore, Fannie Mae does not recognize any compensation expense for grants under the plan. Employees have the option of either receiving cash through a Cashless Exercise Program or purchasing shares directly. In 2001, Fannie Mae granted each qualified employee, excluding certain officers and other highly compensated employees, the right to purchase up to 321 shares of common stock in January 2002. Under the 2001 offering, 1,274,396 shares were purchased at $66.00 per share, compared with 1,522,869 common shares purchased at $50.68 per share under the 2000 offering. The Board of Directors approved a 2002 offering under the plan, granting each qualified employee the right to purchase 310 common shares at $68.46 per share in January 2003.

Employee Stock Ownership Plan
Fannie Mae has an Employee Stock Ownership Plan (ESOP) for qualified employees. Fannie Mae 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. Vested benefits are based on years of service. Eligible employees are 100 percent vested in their ESOP accounts either upon attainment of age 65 or more than five years of service. Employees who are at least 55 years of age, and have at least 10 years of participation in the ESOP, may qualify to diversify vested ESOP shares into the same types of funds available under the Retirement Savings Plan, without losing the tax deferred status of the money in the ESOP. At December 31, 2001, 2000, and 1999, 1,397,339 common shares, 1,366,170 common shares, and 1,345,388 common shares, respectively, were outstanding under the ESOP.

Performance Shares
Fannie Mae's Stock Compensation Plan of 1993 authorizes 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 Fannie Mae attains the goals set for the award period. At the end of such time, the awards generally are payable in common stock in either two or three installments over a period not longer than three years. The outstanding contingent grants made for the 2002-2004, 2001-2003, and 2000-2002 periods were 492,868 common shares, 447,000 common shares, and 375,910 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 for employees and on the grant date for nonmanagement directors and generally expire ten years from the grant date. The exercise 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. Therefore, Fannie Mae does not record compensation expense for grants under this plan.

Under the Stock Compensation Plan of 1993, Fannie Mae's Board of Directors approved the EPS Challenge Option Grant in January 2000 for all regular full-time and part-time Fannie Mae employees. All employees, other than management group employees, received an option grant of 350 shares at a price of $62.50 per share, the fair market value of the stock on the grant date. Management group employees received option grants equivalent to a percentage of their November 1999 stock grants. Vesting for options granted is tied to achievement of an earnings per share (EPS) goal, which is $6.46 by the end of 2003. If Fannie Mae's EPS for 2003 is $6.46 or greater, then 100 percent of the EPS Challenge options will vest in January 2004. If Fannie Mae does not reach an EPS of $6.46 by the end of 2003, vesting is delayed one year and then begins at a rate of 25 percent per year. The Board of Directors may choose, at its discretion, to offset future option grants or other forms of compensation if the goal is not reached. Options expire January 18, 2010.

The following table summarizes nonqualified stock option activity for the years 1999-2001.

Options in thousands	**2001** Options	**2001** Weighted-Average Exercise Price	2000 Options	2000 Weighted-Average Exercise Price	1999 Options	1999 Weighted-Average Exercise Price
Balance, January 1	**25,310**	**$50.86**	22,349	$40.90	21,994	$34.55
Granted	**4,173**	**80.37**	7,741	66.79	3,224	71.20
Exercised	**(2,611)**	**31.92**	(4,003)	23.88	(2,499)	22.52
Forfeited	**(638)**	**66.93**	(777)	61.98	(370)	51.85
Balance, December 31,	**26,234**	**$57.05**	25,310	$50.86	22,349	$40.90
Options vested, December 31,	**13,919**	**$44.10**	13,551	$36.83	14,727	$29.26

The following table summarizes information about nonqualified stock options outstanding at December 31, 2001.

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number of Options[1]	Weighted-Average Remaining Contractual Life	Weighted-Average Exercise Price	Number of Options[1]	Weighted-Average Exercise Price
$18.00 – $35.00	5,543	3.0 yrs.	$22.45	5,543	$22.45
35.01 – 52.00	3,961	5.4	45.72	3,954	45.71
52.01 – 70.00	7,335	7.5	63.63	2,426	66.59
70.01 – 87.00	9,395	9.0	77.11	1,996	73.71
Total	26,234	6.8 yrs.	$57.05	13,919	$44.10

[1] *Options in thousands.*

Restricted Stock

In 2001, 117,447 shares of restricted stock were awarded, issued, and placed in escrow under the Stock Compensation Plan of 1993 (192,301 shares in 2000); 105,560 shares were released as vesting of participants occurred (92,141 shares in 2000).

Options Available for Future Issuance

At December 31, 2001, 4,757,107 and 12,935,066 shares remained available for grant under the Employee Stock Purchase Plan and the Stock Compensation Plan of 1993, respectively.

9. Employee Retirement Benefits

Retirement Savings Plan

All regular employees of Fannie Mae scheduled to work 1,000 hours or more in a calendar year are eligible to participate in the company's Retirement Savings Plan, which includes a 401(k) option. In 2001, employees could contribute up to the lesser of 15 percent of their base salary or the current annual dollar cap established and revised annually by the Internal Revenue Service. Fannie Mae amended the plan for 2002 to allow employees to contribute up to the lesser of 25 percent of their base salary or the current annual dollar cap established and revised annually by the Internal Revenue Service. Fannie Mae matches employee contributions up to 3 percent of base salary in cash. Employees may allocate investment balances to a variety of investment options under the plan. As of December 31, 2001, there was no option to invest balances in the plan directly in stock of Fannie Mae.

Postretirement Benefit Plans

All regular employees of Fannie Mae 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. Fannie Mae'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 are made in cash and reflect benefits attributed to employees' service to date and compensation expected to be paid in the future. No contribution was made to the corporate plan in 2001. Corporate plan assets consist primarily of listed stocks, fixed-income securities, and other liquid assets. Plan assets do not directly include any shares of Fannie Mae stock.

At December 31, 2001 and 2000, the projected benefit obligations for services rendered were $319 million and $263 million, respectively, while the plan assets were $237 million and $261 million, respectively. The pension liability (included in liabilities under "Other") at December 31, 2001 and 2000 was $65 million and $51 million, respectively. Net periodic pension costs were $14 million, $5 million, and $8 million for the years ended December 31, 2001, 2000, and 1999, respectively. Fannie Mae uses the straight-line method of amortization for prior service costs.

At December 31, 2001 and 2000, 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 assumptions used in determining the net periodic pension costs were as follows:

	2001	2000	1999
Weighted-average discount rate	**7.75%**	8.00%	7.13%
Average rate of increase in future compensation levels	**6.50**	6.50	5.75
Expected long-term weighted-average rate of return on plan assets	**9.50**	9.00	9.25

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

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 subsidized benefits as follows: (1) for employees hired prior to January 1, 1998, if they retire from Fannie Mae after reaching age 55 with five or more years of service; or (2) for employees hired January 1, 1998, or later, if they retire from Fannie Mae after reaching age 55 with ten or more years of service. Employees hired January 1, 1998 or later who retire with less than ten years of service may purchase coverage by paying the full premium. 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 Fannie Mae, eligibility for and date of retirement, and a defined dollar benefit cap. Fannie Mae does not fund this plan.

Fannie Mae's accrued postretirement health care cost liability for the years ending December 31, 2001 and 2000 was $52 million and $46 million, respectively. The net postretirement health care costs were $9 million, $8 million, and $9 million for the years ended December 31, 2001, 2000, and 1999, respectively. In determining the net postretirement health care cost for 2001, a 4.75 percent annual rate of increase in the per capita cost of covered health care claims was assumed with the rate decreasing over the next year to 4.50 percent and remaining at that level thereafter. In determining the net postretirement health care cost for 2000, a 5.00 percent annual rate of increase in the per capita cost of covered health care claims was assumed with the rate decreasing gradually over the next two years to 4.50 percent and remaining at that level thereafter. In determining the net postretirement health care cost for 1999, a 5.25 percent annual rate of increase in the per capita cost of covered health care claims was assumed with the rate decreasing gradually over the next three years to 4.50 percent and remaining at that level thereafter. The health care cost trend rate assumption has a significant effect on the amounts reported. 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, 2001 by $8 million and the aggregate of the service and interest cost components of net postretirement health care cost for the year by $2 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, 2001, 7.75 percent at December 31, 2000, and 8.00 percent at December 31, 1999.

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 Fannie Mae's mortgage portfolio and investment portfolio. Income is derived primarily from the difference, or spread, between the yield on mortgage loans and 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 book of business 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 it is net of interest charges paid to the Portfolio Investment business for delinquent loans.

Fannie Mae 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 lines of business through an assessment of the interest rate and credit risk associated with each business.

The following table sets forth Fannie Mae's financial performance by line of business for the years ended December 31, 2001, 2000, and 1999.

	2001			2000			1999		
Dollars in millions	**Portfolio Investment**	**Credit Guaranty**	**Total**	Portfolio Investment	Credit Guaranty	Total	Portfolio Investment	Credit Guaranty	Total
Net interest income	**$ 7,369**	**$ 721**	**$ 8,090**	$ 5,055	$ 619	$ 5,674	$4,317	$ 577	$ 4,894
Guaranty fee income	**(1,109)**	**2,591**	**1,482**	(1,079)	2,430	1,351	(974)	2,256	1,282
Fee and other income (expense)	**211**	**(60)**	**151**	27	(71)	(44)	120	71	191
Credit-related expenses	**—**	**(78)**	**(78)**	—	(94)	(94)	—	(127)	(127)
Administrative expenses	**(302)**	**(715)**	**(1,017)**	(254)	(651)	(905)	(233)	(567)	(800)
Special contribution	**(192)**	**(108)**	**(300)**	—	—	—	—	—	—
Purchased options expense	**(590)**	**—**	**(590)**	—	—	—	—	—	—
Federal income taxes	**(1,557)**	**(473)**	**(2,030)**	(1,036)	(530)	(1,566)	(906)	(613)	(1,519)
Extraordinary item — (loss) gain on early extinguishment of debt	**(341)**	**—**	**(341)**	32	—	32	(9)	—	(9)
Operating net income[1]	**$ 3,489**	**$1,878**	**$ 5,367**	$ 2,745	$1,703	$ 4,448	$2,315	$1,597	$ 3,912

[1] *Excludes the cumulative after-tax gain of $168 million from the change in accounting principle upon adoption of FAS 133 on January 1, 2001 and the after-tax loss of $24 million recognized during the year 2001 for the change in fair value of time value of purchased options under FAS 133. Includes after-tax charges of $383 million for the amortization expense of purchased options premiums during the year ended December 31, 2001.*

11. Dividend Restrictions

Fannie Mae'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 Fannie Mae's capital to fall below specified capital levels.

Fannie Mae 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 is also subject to payment of dividends on preferred stock outstanding.

12. Preferred Stock

The following table presents preferred stock outstanding as of December 31, 2001.

	Issue Date	Shares Issued and Outstanding	Stated Value per Share	Annual Dividend Rate	Redeemable on or After
Series B[1]	April 12, 1996	7,500,000	$50	6.50%	April 12, 2001
Series C	September 20, 1996	5,000,000	50	6.45	September 20, 2001
Series D	September 30, 1998	3,000,000	50	5.25	September 30, 1999
Series E	April 15, 1999	3,000,000	50	5.10	April 15, 2004
Series F	March 20, 2000	13,800,000	50	6.30[2]	March 31, 2002[4]
Series G	August 8, 2000	5,750,000	50	6.02[3]	September 30, 2002[4]
Series H	April 6, 2001	8,000,000	50	5.81	April 6, 2006
Total		46,050,000			

[1] *Fannie Mae redeemed all of the outstanding shares of its 6.50 percent Series B preferred stock on February 28, 2002 at $50.51 per share. The redemption price included dividends of $.51458 per share for the period commencing December 31, 2001, up to, but excluding, February 28, 2002.*

[2] *Initial rate. Variable dividend rate that resets every two years thereafter at the Constant Maturity U.S. Treasury Rate minus .16 percent with a cap of 11 percent per year.*

[3] *Initial rate. Variable dividend rate that resets every two years thereafter at the Constant Maturity Treasury Rate minus .18 percent with a cap of 11 percent per year.*

[4] *Initial call date and every two years thereafter.*

Holders of preferred stock are entitled to receive noncumulative, quarterly dividends when, and if, declared by Fannie Mae'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 Fannie Mae. All outstanding preferred stock is nonvoting.

13. Derivative Instruments and Hedging Activities

Fannie Mae issues various types of debt to finance the acquisition of mortgages. Fannie Mae typically uses derivative instruments, such as interest rate swaps, swaptions, interest rate caps, deferred rate-setting agreements, and foreign currency swaps, to hedge against the impact of interest rate movements on its debt costs to preserve its mortgage-to-debt interest spreads. Fannie Mae does not engage in trading or other speculative use of derivative instruments.

Swaps provide for the exchange of fixed and variable interest payments based on contractual notional principal amounts. These may include callable swaps, which give counterparties or Fannie Mae the right to terminate interest rate swaps before their stated maturities, and foreign currency swaps, in which Fannie Mae and counterparties exchange payments in different types of currencies. Basis swaps provide for the exchange of variable payments that have maturities similar to hedged debt, but the payments are based on different interest rate indices. Swaptions give Fannie Mae the option to enter into swaps at a future date, thereby mirroring the economic effect of callable debt. Interest rate caps provide ceilings on the interest rates of variable-rate debt.

Fannie Mae formally documents all relationships between hedging instruments and the hedged items, including the risk-management objective and strategy for undertaking various hedge transactions. Fannie Mae links all derivatives to specific assets and liabilities on the balance sheet or to specific forecasted transactions and designates them as cash flow or fair value hedges. Fannie Mae also formally assesses, both at the hedge's inception and on an ongoing basis, whether the derivatives that are used in hedging transactions are highly effective in offsetting changes in the cash flows or fair values of the hedged items.

The following table reflects the hedge classification of the notional balances of derivatives by type that were held by Fannie Mae at December 31, 2001.

	2001		
Dollars in millions	Fair Value Hedges	Cash Flow Hedges	Total
Interest rate swaps:			
Pay-fixed	$ 7,063	$206,617	$213,680
Receive-fixed & basis	10,989	75,134	86,123
Interest rate caps	—	75,893	75,893
Swaptions:			
Pay-fixed	—	69,650	69,650
Receive-fixed	74,400	—	74,400
Other[1]	8,843	4,550	13,393
Total	$101,295	$431,844	$533,139

[1] *Includes foreign currency swaps, forward starting swaps, and asset swaps.*

Fannie Mae discontinues hedge accounting prospectively when (1) it determines that the derivative is no longer effective in offsetting changes in the cash flows or fair value of a hedged item; (2) the derivative expires or is sold, terminated, or exercised; (3) the derivative is dedesignated as a hedge instrument because it is unlikely that a forecasted transaction will occur; or (4) it determines that designation of the derivative as a hedge instrument is no longer appropriate.

Cash Flow Hedges

Objectives and Context

Fannie Mae employs cash flow hedges to lock in the interest spread on purchased assets by hedging existing variable-rate debt and forecasted issuances of debt through its Benchmark Program. The issuance of short-term Discount Notes and variable-rate long-term debt during periods of rising interest rates can result in a mismatch of cash flows relative to fixed-rate mortgage assets. Management minimizes the risk of mismatched cash flows by converting variable-rate interest expense to fixed-rate interest expense to lock-in Fannie Mae's funding costs.

Risk Management Strategies and Policies

To meet these objectives, Fannie Mae enters into interest rate swaps, swaptions, and caps to hedge the variability of cash flows resulting from changes in interest rates. Fannie Mae enters into pay-fixed interest rate swaps to hedge the interest rate risk associated with issuing debt after committing to purchase assets.

Fannie Mae enters into pay-fixed interest rate swaps and swaptions, as well as interest rate caps to change the variable-rate cash flow exposure on its short-term Discount Notes and long-term variable-rate debt to fixed-rate cash flows. Under the swap agreements, Fannie Mae receives variable interest payments and makes fixed interest payments, thereby effectively creating fixed-rate debt. Fannie Mae also purchases swaptions that give it the option to enter into a pay-fixed, receive variable interest rate swap at a future date. Under interest rate cap agreements, Fannie Mae reduces the variability of cash flows on its variable-rate debt by purchasing the right to receive cash if interest rates rise above a specified level.

Fannie Mae continually monitors changes in interest rates and identifies interest rate exposures that may adversely impact expected future cash flows on its mortgage and debt portfolios. Fannie Mae uses analytical techniques, including cash flow sensitivity analysis, to estimate the expected impact of changes in interest rates on Fannie Mae's future cash flows. Fannie Mae did not discontinue any cash flow hedges during the year because it was no longer probable that the hedged debt would be issued. Fannie Mae had no open positions for hedging the forecasted issuance of long-term debt at December 31, 2001.

Financial Statement Impact

Consistent with FAS 133, Fannie Mae records changes in the fair value of derivatives used as cash flow hedges in AOCI to the extent they are perfectly effective hedges. Fair value gains or losses in AOCI are amortized into the income statement and are reflected as either a reduction or increase in interest expense over the life of the hedged item. The income or expense associated with derivatives has historically been recognized in interest expense as an adjustment to the effective cost on the hedged debt. Fannie Mae estimates it will amortize approximately $4.7 billion out of AOCI and into interest expense during the next 12 months. The amortization of the $4.7 billion into interest expense from AOCI does not produce a different result in the income statement versus prior periods. Actual results in 2002 will likely differ from the amortization estimate because actual swap yields during 2002 will change from the swap yield curve assumptions at December 31, 2001.

The reconciliation below reflects the change in AOCI, net of taxes, during the year ended December 31, 2001 associated with FAS 133:

Dollars in millions	Year Ended December 31, 2001
Transition adjustment to adopt FAS 133, January 1, 2001	$(3,972)
Losses on cash flow hedges, net	(5,530)
Less: reclassifications to earnings, net	2,143
Balance at December 31, 2001	$(7,359)

If there is any hedge ineffectiveness or derivatives do not qualify as cash flow hedges, Fannie Mae records the ineffective portion in the fee and other income (expense) line item on the income statement. For the year ended December 31, 2001, fee and other income (expense) includes a pre-tax loss of $3 million related to the ineffective portion of cash flow hedges.

Fannie Mae includes only changes in the intrinsic value of pay-fixed swaptions and interest rate caps in its assessment of hedge effectiveness. Therefore, Fannie Mae excludes changes in the time value of these contracts from the assessment of hedge effectiveness and recognizes them as purchased options expense on the income statement. For the year ended December 31, 2001, Fannie Mae recorded a pre-tax loss of $34 million in purchased options expense for the change in time value of options designated as cash flow hedges.

Fair Value Hedges

Objectives and Context

Fannie Mae employs fair value hedges to preserve its mortgage-to-debt interest spreads when there is a decrease in interest rates by converting its fixed-rate debt to variable-rate debt. A decline in interest rates increases the risk of mortgage assets repricing at lower yields while fixed-rate debt remains at above-market costs. Management limits the interest rate risk inherent in its fixed-rate debt instruments by using fair value hedges to convert its fixed-rate debt to variable-rate debt.

Risk Management Strategies and Policies

Fannie Mae enters into various types of derivative instruments, such as receive-fixed interest rate swaps and swaptions, to convert its fixed-rate debt to floating-rate debt and preserve its mortgage-to-debt interest spreads when interest rates decrease. Under receive-fixed interest rate swaps, Fannie Mae receives fixed interest payments and makes variable interest payments, thereby creating floating-rate debt. Receive-fixed swaptions give Fannie Mae the option to enter into an interest rate swap at a future date

where Fannie Mae will receive fixed interest payments and make variable interest payments, effectively creating callable debt that reprices at a lower interest rate.

Financial Statement Impact

Fannie Mae records changes in the fair value of derivatives used as fair value hedges in the fee and other income (expense) line item on the income statement along with offsetting changes in the fair value of the hedged items attributable to the risk being hedged. Fannie Mae's fair value hedges produced no hedge ineffectiveness during the year ended December 31, 2001.

Fannie Mae only includes changes in the intrinsic value of receive-fixed swaptions in its assessment of hedge effectiveness. Fannie Mae excludes changes in the time value of receive-fixed swaptions used as fair value hedges from the assessment of hedge effectiveness and records them in purchased options expense on the income statement. For the year ended December 31, 2001, Fannie Mae recorded pre-tax purchased options expense of $3 million in the income statement for the change in time value of these contracts.

Credit Risk Associated with Derivative Activities

The primary credit risk associated with Fannie Mae's derivative transactions is that a counterparty might default on its payments to Fannie Mae, which could result in Fannie Mae having to replace derivatives with a different counterparty at a higher cost. Fannie Mae reduces credit risk on derivatives by dealing only with experienced counterparties of high credit quality, generally executing master agreements that provide for netting of certain amounts payable by each party, requiring that counterparties post collateral if the value of Fannie Mae's gain positions exceeds an agreed-upon threshold, and diversifying these derivative instruments across counterparties. Fannie Mae regularly monitors the exposures on its derivative instruments by valuing the positions via dealer quotes and internal pricing models. The exposure to credit loss for derivative instruments can be estimated by calculating the cost, on a present value basis, to replace at current market rates all those derivative instruments outstanding for which Fannie Mae was in a gain position.

Fannie Mae's exposure (taking into account master agreements) was $766 million at December 31, 2001, and $182 million at December 31, 2000. Fannie Mae expects the credit exposure to fluctuate as interest rates change. Fannie Mae mitigates this credit exposure by requiring collateral from counterparties based on counterparty credit ratings and the level of credit exposure. Fannie Mae generally requires overcollateralization from counterparties whose credit ratings have dropped below predetermined levels. Fannie Mae held $656 million of collateral through custodians for derivative instruments at December 31, 2001 and $70 million of collateral at December 31, 2000. Fannie Mae's exposure, net of collateral, was $110 million at year-end 2001 and $112 million at year-end 2000.

The following table provides a summary of counterparty credit ratings for the exposure on derivatives in a gain position at December 31, 2001.

Dollars in millions	Years to Maturity[1] Less than 1 Year	1 to 5 Years	Over 5 Years	Maturity Distribution Netting[2]	Exposure	Collateral Held	Exposure Net of Collateral
Derivative Credit Loss Exposure:							
Credit Rating							
AAA	$—	$—	$ 136	$(136)	$ —	$ —	$ —
AA	—	43	671	(528)	186	95	91
A	—	43	826	(289)	580	561	19
Total	$—	$ 86	$1,633	$(953)	$766	$656	$110

[1] *Represents the exposure to credit loss on derivative instruments, which is estimated by calculating the cost, on a present value basis, to replace all outstanding derivative contracts in a gain position. Reported on a net-by-counterparty basis where a legal right of offset exists under an enforceable master settlement agreement. Derivative gains and losses with the same counterparty in the same maturity category are presented net within the maturity category.*

[2] *Represents impact of netting of derivatives in a gain position and derivatives in a loss position for the same counterparty across maturity categories.*

At December 31, 2001, over 99 percent of the notional amount of Fannie Mae's outstanding derivative transactions was with counterparties rated A or better by Standard & Poor's (73 percent with counterparties rated AA or better). At December 31, 2001, eight counterparties represented approximately 78 percent of the total notional amount of outstanding derivative transactions, and each had a credit rating of A or better (70 percent of this notional amount was held by counterparties with a credit rating of AA or better).

At December 31, 2001, 100 percent of Fannie Mae's exposure on derivatives in a gain position excluding collateral held was with counterparties rated A or better by Standard & Poor's. 83 percent of Fannie Mae's exposure, net of collateral,

is with counterparties rated AA or better. At December 31, 2001, five out of twenty-three counterparties comprised approximately 98 percent of exposure on derivatives in a gain position excluding collateral held. Each of these five counterparties had a credit rating of A or better. Of these five counterparties, 23 percent of the exposure on derivatives in a gain position excluding collateral held, was with counterparties rated AA or better.

14. Financial Instruments with Off-Balance-Sheet Risk

Fannie Mae is a party to transactions involving financial instruments with off-balance-sheet risk. Fannie Mae 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 guaranteed MBS, commitments to purchase mortgages or to issue and guarantee MBS, and credit enhancements. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of amounts recognized on the balance sheet.

Guaranteed Mortgage-Backed Securities

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

Fannie Mae'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 company as recourse or the borrower, lender, or Fannie Mae purchases other credit enhancements, such as mortgage insurance, to protect against the risk of loss from borrower default. Lenders that keep recourse 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. Accordingly, Fannie Mae accrues a liability on its balance sheet for its guarantee obligation based on the probability that mortgages underlying MBS will not perform according to contractual terms and the level of credit risk it has assumed.

Commitments

Fannie Mae enters into master delivery commitments with lenders on either a mandatory or an 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.

Fannie Mae will also 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.

Credit Enhancements

Fannie Mae provides credit enhancement and, in some cases, liquidity support 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 MBS, pledges an interest in certain mortgages it owns, or otherwise provides contractual assurance of payment to a trustee for the bonds or another credit party in the transaction. Fannie Mae's direct 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 contractual or notional amount of off-balance-sheet financial instruments at December 31, 2001 and 2000.

Dollars in billions	**2001**	2000
Contractual amounts:		
Total MBS outstanding[1]	**$1,290**	$1,057
MBS in portfolio	**(431)**	(351)
Outstanding MBS[2]	**$ 859**	$ 706
Master commitments:		
Mandatory	**$ 24**	$ 25
Optional	**16**	10
Portfolio commitments:		
Mandatory	**55**	16
Optional	**2**	2
Other investments	**2**	2
Notional amounts[3]:		
Credit enhancements	**10**	9
Other guarantees	**6**	5

[1] *Net of allowance for losses. Includes $199 billion and $223 billion of MBS with lender or third-party recourse at December 31, 2001 and 2000, respectively.*

[2] *MBS held by investors other than Fannie Mae.*

[3] *Notional amounts do not necessarily represent the credit risk of the positions.*

15. 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.

Many servicers employ Risk Profiler℠, a default prediction model created by Fannie Mae, to enhance their loss mitigation efforts on loans serviced for Fannie Mae. Risk Profiler uses credit risk indicators such as updated borrower credit data, current property values, and mortgage product characteristics to predict the likelihood that a loan will default.

In the event mortgages become at risk to default, Fannie Mae employs strategies to reduce loss exposure through resolutions other than foreclosure. Fannie Mae encourages early intervention, workout alternatives, and preforeclosure sales. If a loan modification or preforeclosure sale is not possible, Fannie Mae's goal is to handle the foreclosure process expeditiously and cost effectively to maximize the proceeds from the sale of the property and to minimize the time it retains a nonearning asset.

Fannie Mae reviews such elements as the current estimated market value of the property, the property value in relation to Fannie Mae's outstanding loan, the credit strength of the borrower, and the potential volatility of those measures to ascertain the current level of credit risk in the total book of business. Based on the sensitivity analysis and loan performance analytics, Fannie Mae employs various credit enhancement contracts to protect itself against losses on higher risk loans, including loans with high loan-to-value ratios.

The following table presents the regional geographic distribution of properties underlying mortgages in the portfolio and underlying MBS outstanding by primary default risk at December 31, 2001 and 2000.

2001		**Geographic Distribution**					
Dollars in millions	**Gross UPB**	**Northeast**	**Southeast**	**Midwest**	**Southwest**	**West**	**Total**
Fannie Mae risk	**$1,323,622**	**19%**	**20%**	**19%**	**16%**	**26%**	**100%**
Lender or shared risk	**242,721**	**15**	**22**	**21**	**17**	**25**	**100**
Total	**$1,566,343**	**18%**	**21%**	**19%**	**16%**	**26%**	**100%**

2000		Geographic Distribution					
Dollars in millions	Gross UPB	Northeast	Southeast	Midwest	Southwest	West	Total
Fannie Mae risk	$ 1,049,657	19%	20%	19%	16%	26%	100%
Lender or shared risk	267,149	14	20	22	17	27	100
Total	$ 1,316,806	19%	20%	19%	16%	26%	100%

No significant concentration existed at the state level at December 31, 2001, except for California where 18 percent of the gross UPB of mortgages in portfolio and underlying MBS were located, the same level as December 31, 2000.

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

At December 31, 2001, $314 billion in UPB of single-family conventional mortgage loans in portfolio and underlying MBS outstanding was covered by primary mortgage insurance at acquisition. Seven mortgage insurance companies, all rated AA or higher by Standard & Poor's, provided approximately 96 percent of the total coverage. Fannie Mae monitors the performance and financial strength of its mortgage insurers on a regular basis.

The following table presents the distribution of conventional single-family loans in portfolio and underlying MBS outstanding by original LTV and primary default risk at December 31, 2001 and 2000.

2001 **Dollars in millions**	**Gross UPB**	**60% or less**	**61–70%**	**71–75%**	**76–80%**	**81–90%**	**Over 90%**	**Total**
		LTV Ratio						
Fannie Mae risk	**$1,260,770**	**19%**	**15%**	**15%**	**29%**	**11%**	**11%**	**100%**
Lender or shared risk	**187,998**	**5**	**7**	**11**	**35**	**21**	**21**	**100**
Total	**$1,448,768**	**17%**	**14%**	**14%**	**29%**	**13%**	**13%**	**100%**

2000 Dollars in millions	Gross UPB	60% or less	61–70%	71–75%	76–80%	81–90%	Over 90%	Total
		LTV Ratio						
Fannie Mae risk	$ 1,003,068	19%	15%	15%	26%	14%	11%	100%
Lender or shared risk	208,464	5	8	11	34	22	20	100
Total	$ 1,211,532	16%	14%	15%	27%	15%	13%	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-rate mortgage loans will prepay at a slower rate. The following table presents the distribution of fixed-rate, single-family loans in the mortgage portfolio or underlying MBS by note rate at December 31, 2001 and 2000.

Gross UPB at December 31, Dollars in billions	Under 7.00%	7.00% to 7.99%	8.00% to 8.99%	9.00% to 9.99%	10.00% and over	Total
	Fixed-Rate Loans by Note Rate[1]					
2001	**$478**	**$641**	**$159**	**$24**	**$10**	**$1,312**
Percent of total	**36%**	**49%**	**12%**	**2%**	**1%**	**100%**
2000	$285	$536	$218	$28	$10	$ 1,077
Percent of total	26%	50%	20%	3%	1%	100%

[1] *Excludes housing revenue bonds and non-Fannie Mae securities.*

16. 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, 2001 and 2000. 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 Fannie Mae would realize in a market transaction. The accompanying Fair Value Balance Sheets do not represent an estimate of the overall market value of Fannie Mae as a going concern, which would take into account future business opportunities.

Fair Value Balance Sheets

Dollars in millions	December 31, 2001 Carrying Amount	December 31, 2001 Estimated Fair Value	December 31, 2000 Carrying Amount	December 31, 2000 Estimated Fair Value
Assets				
Mortgage portfolio, net	**$705,167**	**$720,174**	$607,399	$613,095
Investments	**74,554**	**74,716**	54,968	55,022
Cash and cash equivalents	**1,518**	**1,518**	617	617
Other assets	**17,598**	**12,822**	12,088	9,418
Derivatives in gain positions	**954**	**954**	—	518
	799,791	**810,184**	675,072	678,670
Off-balance-sheet items:				
Guaranty fee income, net	**—**	**6,451**	—	5,915
Total assets	**$799,791**	**$816,635**	$675,072	$684,585
Liabilities and Net Assets				
Liabilities:				
Noncallable debt:				
Due within one year	**$336,670**	**$337,144**	$252,537	$252,619
Due after one year	**287,229**	**301,046**	217,735	226,764
Callable debt:				
Due within one year	**6,822**	**6,834**	27,785	22,412
Due after one year	**132,746**	**133,458**	144,625	148,277
	763,467	**778,482**	642,682	650,072
Other liabilities	**13,137**	**10,040**	11,552	10,169
Derivatives in loss positions	**5,069**	**5,069**	—	3,667
Total liabilities	**781,673**	**793,591**	654,234	663,908
Net assets, net of tax effect	**$ 18,118**	**$ 23,044**	$ 20,838	$ 20,677

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 Fannie Mae's mortgage portfolio considered such variables as interest rates, credit quality, and loan collateral. Because an active market does not exist for a 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 securitization business would charge for a pool of loans with similar characteristics was subtracted from the weighted-average coupon 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."

Fannie Mae then employed an option-adjusted spread (OAS) approach to estimate fair values for both notional MBS and MBS held in portfolio. The OAS approach represents the risk premium or incremental interest spread over Fannie Mae debt 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 Fannie Mae'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 and net currency swap receivables, approximates their carrying amount. The fair value of net currency swap receivables was estimated based on either the expected cash flows or quoted market values of these instruments.

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

Derivatives

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

In addition, Fannie Mae enters into swaptions and interest rate caps. Under a swaption, Fannie Mae has the option to enter into a swap, as described above, at a future date. Fannie Mae uses interest rate caps to effectively manage its interest expense in a period of rising interest rates by entering into an agreement whereby a counterparty makes payments to the company for interest rates above a specified rate. The fair values of these derivative instruments were estimated based on either the expected cash flows or the quoted market values of these instruments, net of tax.

Guaranty Fee Income, Net

MBS are not assets owned by Fannie Mae, except when acquired for investment purposes, nor are MBS recorded as liabilities of Fannie Mae. Fannie Mae receives a guaranty fee calculated on the outstanding principal balance of the related mortgages for guaranteed MBS held by third-party investors. The guaranty fee represents a future income stream for Fannie Mae. 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.

Fannie Mae estimates the credit loss exposure attached to the notional amount of guaranteed MBS held by third-party investors where Fannie Mae has the primary risk of default. Fannie Mae deducts estimated credit losses from the projected guaranty fee cash flows to arrive at the fair value. Estimated credit losses were calculated with an internal forecasting model based on actual historical loss experience for the company. The net guaranty fee cash flows were then valued through an OAS method similar to that described under “Mortgage Portfolio, Net.”

Noncallable and Callable Debt

The fair value of Fannie Mae’s noncallable debt was estimated by using quotes for selected debt securities of the company 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 guaranteed 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, net currency swap payables, and credit loss exposure for guaranteed MBS, which is included as a component of the net MBS guaranty fee, approximates their carrying amount. The fair value of net currency swap payables was estimated based on either the expected cash flows or quoted market values of these instruments.

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, 2001 and 2000, 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, 2001. 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 auditing standards generally accepted in the United States of America. 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, 2001 and 2000, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2001, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 13 to the financial statements, the Company changed its method of accounting for derivative instruments and hedging activities in 2001 in accordance with the adoption of Financial Accounting Standard No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

We also have audited in accordance with auditing standards generally accepted in the United States of America the supplemental fair value balance sheets of Fannie Mae as of December 31, 2001 and 2000, included in Note 16 to the financial statements. As described in Note 16, 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 accounting principles generally accepted in the United States of America. 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 16 present fairly, in all material respects, the information set forth therein.

KPMG LLP

Washington, DC

January 10, 2002

Report of Management

To the Stockholders of Fannie Mae:

The management of Fannie Mae is responsible for the preparation, integrity, and fair presentation of the accompanying financial statements and other information appearing elsewhere in this report. In our opinion, the financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America appropriate in the circumstances, and the other financial information in this report is consistent with such statements. In preparing the financial statements and in developing the other financial information, it has been necessary to make informed judgments and estimates of the effects of business events and transactions. We believe that these judgments and estimates are reasonable, that the financial information contained in this report reflects in all material respects the substance of all business events and transactions to which the corporation was a party, and that all material uncertainties have been appropriately accounted for or disclosed.

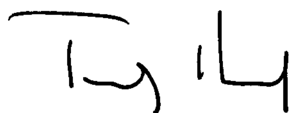
The management of Fannie Mae is also responsible for maintaining internal control over financial reporting that provides reasonable assurance that transactions are executed in accordance with appropriate authorization, permits preparation of financial statements in conformity with accounting principles generally accepted in the United States of America, and establishes accountability for the assets of the corporation.

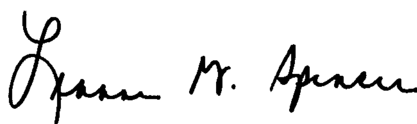
Internal control over financial reporting includes controls for the execution, documentation, and recording of transactions, and an organizational structure that provides an effective segregation of duties and responsibilities. Fannie Mae has an internal Office of Auditing whose responsibilities include monitoring compliance with established controls and evaluating the corporation's internal controls over financial reporting. Organizationally, the internal Office of Auditing is independent of the activities it reviews.

Fannie Mae's financial statements are audited by KPMG LLP, the corporation's independent auditors, whose audit is performed in accordance with auditing standards generally accepted in the United States of America. In addition, KPMG LLP obtained an understanding of our internal controls over financial reporting and conducted such tests and other auditing procedures as they considered necessary to express the opinion on the financial statements in their report that follows.

The Board of Directors of Fannie Mae exercises its oversight of financial reporting and related controls through an Audit Committee, which is composed solely of directors who are not officers or employees of the corporation. The Audit Committee meets with management and the internal Office of Auditing periodically to review the work of each and to evaluate the effectiveness with which they discharge their respective responsibilities. In addition, the committee meets periodically with KPMG LLP, who has free access to the committee, without management present. The appointment of the independent auditors is made annually by the Board of Directors subject to ratification by the stockholders.

Management recognizes that there are inherent limitations in the effectiveness of any internal control environment. However, management believes that, as of December 31, 2001, Fannie Mae's internal control environment, as described herein, provided reasonable assurance as to the integrity and reliability of the financial statements and related financial information.





Timothy Howard
Executive Vice President and
Chief Financial Officer

Leanne G. Spencer
Senior Vice President and
Controller

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.

Dollars in millions, except per common share amounts	2001 Quarter Ended			
	December	September	June	March
Operating net income[1]	$ 1,438	$ 1,377	$ 1,314	$ 1,238
Operating earnings per diluted common share	1.40	1.33	1.27	1.20
Interest income	$12,510	$12,447	$12,218	$11,995
Interest expense	10,106	10,368	10,318	10,288
Net interest income	2,404	2,079	1,900	1,707
Guaranty fee income	398	384	357	343
Fee and other income	51	49	24	27
Provision for losses	30	30	30	25
Foreclosed property expenses	(46)	(45)	(48)	(54)
Administrative expenses	(251)	(273)	(254)	(239)
Special contribution	(300)	—	—	—
Purchased options income (expense)	578	(413)	36	(238)
Income before federal income taxes and extraordinary item and cumulative effect of change in accounting principle	2,864	1,811	2,045	1,571
Provision for federal income taxes	(836)	(447)	(550)	(391)
Income before extraordinary item and cumulative effect of change in accounting principle	2,028	1,364	1,495	1,180
Extraordinary item-loss on early extinguishment of debt, net of tax effect	(59)	(135)	(92)	(55)
Cumulative effect of change in accounting principle, net of tax effect	—	—	—	168
Net income	$ 1,969	$ 1,229	$ 1,403	$ 1,293
Preferred stock dividends	(35)	(35)	(35)	(33)
Net income available to common stockholders	$ 1,934	$ 1,194	$ 1,368	$ 1,260
Basic earnings per common share[2]:				
Earnings before extraordinary item and cumulative effect of change in accounting principle	$ 1.99	$ 1.33	$ 1.46	$ 1.15
Extraordinary loss	(.06)	(.14)	(.09)	(.06)
Cumulative effect of change in accounting principle	—	—	—	.17
Net earnings	$ 1.93	$ 1.19	$ 1.37	$ 1.26
Diluted earnings per common share[2]:				
Earnings before extraordinary item and cumulative effect of change in accounting principle	$ 1.98	$ 1.32	$ 1.45	$ 1.14
Extraordinary loss	(.06)	(.13)	(.09)	(.06)
Cumulative effect of change in accounting principle	—	—	—	.17
Net earnings	$ 1.92	$ 1.19	$ 1.36	$ 1.25
Cash dividends per common share	$ .30	$ .30	$ .30	$ .30

Dollars in millions, except per common share amounts	2000 Quarter Ended			
	December	September	June	March
Interest income	$11,581	$10,862	$10,365	$ 9,973
Interest expense	10,096	9,434	8,966	8,611
Net interest income	1,485	1,428	1,399	1,362
Guaranty fee income	339	341	339	332
Fee and other income (expense)	1	1	(46)	—
Provision for losses	30	30	30	30
Foreclosed property expenses	(51)	(52)	(51)	(60)
Administrative expenses	(232)	(232)	(224)	(217)
Income before federal income taxes and extraordinary item	1,572	1,516	1,447	1,447
Provision for federal income taxes	(405)	(393)	(383)	(385)
Income before extraordinary item	1,167	1,123	1,064	1,062
Extraordinary item–(loss) gain on early extinguishment of debt, net of tax effect	(2)	1	33	—
Net income	$ 1,165	$ 1,124	$ 1,097	$ 1,062
Preferred stock dividends	(36)	(33)	(32)	(20)
Net income available to common stockholders	$ 1,129	$ 1,091	$ 1,065	$ 1,042
Basic earnings per common share[2]:				
Earnings before extraordinary item	$ 1.13	$ 1.09	$ 1.03	$ 1.03
Extraordinary gain	—	—	.03	—
Net earnings	$ 1.13	$ 1.09	$ 1.06	$ 1.03
Diluted earnings per common share[2]:				
Earnings before extraordinary item	$ 1.13	$ 1.09	$ 1.02	$ 1.02
Extraordinary (loss) gain	(.01)	—	.03	—
Net earnings	$ 1.12	$ 1.09	$ 1.05	$ 1.02
Cash dividends per common share	$ .28	$ .28	$ .28	$ .28

[1] Excludes the cumulative after-tax gain of $168 million from the change in accounting principle upon adoption of FAS 133 on January 1, 2001 and the after-tax loss of $24 million recognized during the year 2001 for the change in fair value of time value of purchased options under FAS 133. Includes after-tax charges of $383 million for the amortization expense of purchased options premiums during the year ended December 31, 2001.

[2] The total of the four quarters may 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.

Net Interest Income and Average Balances (Unaudited)

Dollars in millions	2001	2000	1999
Interest income:			
Mortgage portfolio	**$ 46,478**	$ 39,403	$ 32,672
Investments and cash equivalents	**2,692**	3,378	2,823
Total interest income	**49,170**	42,781	35,495
Interest expense[1]:			
Short-term debt	**5,897**	4,204	3,952
Long-term debt	**35,183**	32,903	26,649
Total interest expense	**41,080**	37,107	30,601
Net interest income	**8,090**	5,674	4,894
Taxable-equivalent adjustment[2]	**470**	414	341
Amortization of purchased options	**(590)**	—	—
Adjusted net interest income taxable-equivalent basis	**$ 7,970**	$ 6,088	$ 5,235
Average balances:			
Interest-earning assets[3]:			
Mortgage portfolio, net	**$658,195**	$553,531	$468,320
Investments and cash equivalents	**58,811**	51,490	51,459
Total interest-earning assets	**$717,006**	$605,021	$519,779
Interest-bearing liabilities[4]:			
Short-term debt	**$137,078**	$ 73,351	$ 81,028
Long-term debt	**556,298**	511,075	419,538
Total interest-bearing liabilities	**693,376**	584,426	500,566
Interest-free funds	**23,630**	20,595	19,213
Total interest-bearing liabilities and interest-free funds	**$717,006**	$605,021	$519,779
Average interest rates[2]:			
Interest-earning assets:			
Mortgage portfolio, net	**7.11%**	7.16%	7.04%
Investments and cash equivalents	**4.63**	6.60	5.52
Total interest-earning assets	**6.90**	7.11	6.89
Interest-bearing liabilities[5]:			
Short-term debt	**4.28**	5.70	4.84
Long-term debt	**6.43**	6.44	6.35
Total interest-bearing liabilities	**6.00**	6.35	6.11
Investment spread[6]	**.90**	.76	.78
Interest-free return[7]	**.21**	.25	.23
Net interest margin[8]	**1.11%**	1.01%	1.01%

[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 derivative financial instruments. The cost of debt includes expense for the amortization of purchased options in 2000 and 1999.*

[2] *Reflects pro forma adjustments to permit comparison of yields on tax-advantaged and taxable assets.*

[3] *Includes average balance of nonperforming loans of $2.6 billion in 2001, $2.1 billion in 2000, and $3.1 billion in 1999.*

[4] *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 derivative financial instruments.*

[5] *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 derivative financial instruments. The cost of debt includes expense for the amortization of purchased options.*

[6] *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.*

[7] *Consists primarily of the return on that portion of the investment portfolio funded by equity and non-interest-bearing liabilities.*

[8] *Net interest income, on a taxable-equivalent basis, as a percentage of the average investment portfolios.*

Rate/Volume Analysis (Unaudited)

Dollars in millions	Increase (Decrease)	Attributable to Changes in[1] Volume	Rate
2001 vs. 2000			
Interest income:			
Mortgage portfolio	**$7,075**	**$7,393**	**$ (318)**
Investments and cash equivalents	**(686)**	**434**	**(1,120)**
Total interest income	**6,389**	**7,827**	**(1,438)**
Interest expense[2]:			
Short-term debt	**1,693**	**2,945**	**(1,252)**
Long-term debt	**2,280**	**2,868**	**(588)**
Total interest expense	**3,973**	**5,813**	**(1,840)**
Net interest income	**$2,416**	**$2,014**	**$ 402**
2000 vs. 1999			
Interest income:			
Mortgage portfolio	$ 6,731	$ 6,053	$ 678
Investments and cash equivalents	555	2	553
Total interest income	7,286	6,055	1,231
Interest expense[2]:			
Short-term debt	252	(398)	650
Long-term debt	6,254	5,889	365
Total interest expense	6,506	5,491	1,015
Net interest income	$ 780	$ 564	$ 216

[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 derivative financial instruments.*

Financial and Statistical Summary (Unaudited)

For the Year

Dollars in millions, except per common share amounts	2001	2000	1999	1998	1997
Operating net income[1]	**$ 5,367**	$ 4,448	$ 3,912	$ 3,418	$ 3,056
Operating earnings per diluted common share	**5.20**	4.29	3.72	3.23	2.83
Summary Statements of Income:					
Interest income	**$ 49,170**	$ 42,781	$ 35,495	$ 29,995	$ 26,378
Interest expense	**41,080**	37,107	30,601	25,885	22,429
Net interest income	**8,090**	5,674	4,894	4,110	3,949
Guaranty fee income	**1,482**	1,351	1,282	1,229	1,274
Fee and other income (expense)	**151**	(44)	191	275	125
Provision for losses	**115**	120	120	50	(100)
Foreclosed property expenses	**(193)**	(214)	(247)	(311)	(275)
Administrative expenses	**(1,017)**	(905)	(800)	(708)	(636)
Special contribution	**(300)**	—	—	—	—
Purchased options expense	**(37)**	—	—	—	—
Income before federal income taxes, extraordinary item and cumulative effect of change in accounting principle	**8,291**	5,982	5,440	4,645	4,337
Provision for federal income taxes	**(2,224)**	(1,566)	(1,519)	(1,201)	(1,269)
Income before extraordinary item and cumulative effect of change in accounting principle	**6,067**	4,416	3,921	3,444	3,068
Extraordinary item–(loss) gain on early extinguishment of debt, net of tax effect	**(341)**	32	(9)	(26)	(12)
Cumulative effect of change in accounting principle, net of tax effect	**168**	—	—	—	—
Net income	**$ 5,894**	$ 4,448	$ 3,912	$ 3,418	$ 3,056
Preferred stock dividends	**(138)**	(121)	(78)	(66)	(65)
Net income available to common stockholders	**$ 5,756**	$ 4,327	$ 3,834	$ 3,352	$ 2,991
Basic earnings per common share:					
Earnings before extraordinary item and cumulative effect of change in accounting principle	**$ 5.92**	$ 4.28	$ 3.75	$ 3.28	$ 2.87
Extraordinary (loss) gain	**(.34)**	.03	—	(.02)	(.02)
Cumulative effect of change in accounting principle	**.17**	—	—	—	—
Net earnings	**$ 5.75**	$ 4.31	$ 3.75	$ 3.26	$ 2.85
Diluted earnings per common share:					
Earnings before extraordinary item and cumulative effect of change in accounting principle	**$ 5.89**	$ 4.26	$ 3.73	$ 3.26	$ 2.84
Extraordinary (loss) gain	**(.34)**	.03	(.01)	(.03)	(.01)
Cumulative effect of change in accounting principle	**.17**	—	—	—	—
Net earnings	**$ 5.72**	$ 4.29	$ 3.72	$ 3.23	$ 2.83
Cash dividends per common share	**$ 1.20**	$ 1.12	$ 1.08	$ .96	$ .84
Mortgages purchased:					
Single-family:					
Government insured or guaranteed	**$ 6,001**	$ 6,940	$ 23,575	$ 6,016	$ 5,539
Conventional:					
Long-term, fixed-rate	**226,516**	113,444	146,679	147,615	55,925
Intermediate-term, fixed-rate	**26,146**	11,607	15,315	28,725	6,030
Adjustable-rate	**3,777**	17,683	6,073	3,507	1,977
Total single-family	**262,440**	149,674	191,642	185,863	69,471
Multifamily	**8,144**	4,557	3,568	2,585	994
Total mortgages purchased	**$ 270,584**	$ 154,231	$ 195,210	$188,448	$ 70,465
Average net yield on mortgages purchased	**6.56%**	7.62%	6.88%	6.61%	7.40%
Debt issued:					
Short-term debt	**$1,756,691**	$1,143,131	$1,136,001	$695,495	$755,281
Long-term debt	**249,352**	110,215	139,020	147,430	86,325
Total	**$2,006,043**	$1,253,346	$1,275,021	$842,925	$841,606
Average cost of debt issued	**3.97%**	6.34%	5.33%	5.49%	5.63%
MBS issues acquired by others	**$ 344,739**	$ 105,407	$ 174,850	$220,723	$108,120
Financial ratios:					
Return on average assets	**.78%**	.71%	.73%	.78%	.81%
Operating return on average realized common equity	**25.4**	25.2	25.0	25.2	24.6
Dividend payout	**20.9**	26.0	28.8	29.5	29.4
Average equity to average asset	**2.3**	3.1	3.1	3.3	3.6

[1] *Excludes the cumulative after-tax gain of $168 million from the change in accounting principle upon adoption of FAS 133 on January 1, 2001 and the after-tax loss of $24 million recognized during the year 2001 for the change in fair value of time value of purchased options under FAS 133. Includes after-tax charges of $383 million for the amortization expense of purchased options premiums during the year ended December 31, 2001.*

Financial and Statistical Summary (Unaudited)

At December 31,

Dollars in millions, except per common share amounts	**2001**	2000	1999	1998	1997
Summary Balance Sheets:					
Mortgage portfolio, net:					
Single-family:					
Government insured or guaranteed	**$ 42,181**	$ 44,166	$ 41,029	$ 21,805	$ 19,478
Conventional:					
Long-term, fixed-rate	**552,463**	454,349	385,321	297,106	211,541
Intermediate-term, fixed-rate	**69,412**	67,099	69,195	71,766	61,839
Adjustable-rate	**20,765**	27,135	14,107	11,873	11,373
Total single-family	**684,821**	592,749	509,652	402,550	304,231
Multifamily	**22,655**	17,373	14,289	11,965	12,447
Total unpaid principal balance	**707,476**	610,122	523,941	414,515	316,678
Less unamortized discount (premium), price adjustments, and allowance for losses	**2,309**	2,723	1,161	(708)	362
Net mortgage portfolio	**705,167**	607,399	522,780	415,223	316,316
Other assets	**94,624**	67,673	52,387	69,791	75,357
Total assets	**$799,791**	$675,072	$575,167	$485,014	$391,673
Debentures, notes, and bonds, net:					
Due within one year	**$343,492**	$280,322	$226,582	$205,413	$175,400
Due after one year	**419,975**	362,360	321,037	254,878	194,374
Total debentures, notes, and bonds, net	**763,467**	642,682	547,619	460,291	369,774
Other liabilities	**18,206**	11,552	9,919	9,270	8,106
Total liabilities	**781,673**	654,234	557,538	469,561	377,880
Stockholders' equity	**18,118**	20,838	17,629	15,453	13,793
Total liabilities and stockholders' equity	**$799,791**	$675,072	$575,167	$485,014	$391,673
Core capital	**$ 25,182**	$ 20,827	$ 17,876	$ 15,465	$ 13,793
Excess core capital over minimum required	**1,000**	533	106	131	1,090
Yield on net mortgage portfolio	**6.95%**	7.24%	7.08%	7.12%	7.60%
Yield on total interest earning assets	**6.53**	7.21	7.01	6.95	7.32
Cost of debt outstanding	**5.49**	6.47	6.18	6.10	6.46
Book value per common share	**$ 15.86**	$ 18.58	$ 16.02	$ 13.95	$ 12.34
Common shares outstanding	**997**	999	1,019	1,025	1,037
Outstanding MBS	**$858,867**	$706,684	$679,169	$637,143	$579,138

Glossary

Book of business: The total unpaid principal balance of mortgage loans in Fannie Mae's net mortgage portfolio and backing MBS outstanding.

Callable debt: A debt security whose issuer has the right to redeem the security at a specified price on or after a specified date, prior to its stated final maturity.

Charge-off: The write-off of the portion of principal and interest due on a loan that is determined to be uncollectible.

Common stock: A security that represents ownership in a company but gives no legal claim to a definite dividend or to a return of capital.

Conventional mortgage: A mortgage loan that is not insured or guaranteed by the federal government.

Credit loss ratio: The ratio of credit-related losses to the total dollar amount of MBS outstanding and mortgages held in portfolio.

Credit-related expenses: The sum of foreclosed property expenses plus the provision for losses.

Credit-related losses: The sum of foreclosed property expenses plus charge-offs.

Debt security: A security in which the issuing company agrees to repay the principal (typically, the original amount borrowed) and make interest payments according to an agreed-upon schedule.

Default: The failure of a borrower to comply with the terms of a note or the provisions of a mortgage or contract.

Delinquency: An instance in which payment on a mortgage loan has not been made by the due date.

Derivative: A financial instrument which derives its value from an underlying index and a notional amount of principal.

Duration: The weighted-average life of the present value of a security's future cash flows. It measures the sensitivity of a security's value to interest rate changes.

Earnings per share (EPS): The net earnings of a corporation over a period of time, divided by the average number of shares of its common stock outstanding during that same period. A common method of expressing a corporation's profitability.

Efficiency ratio: Total administrative expenses divided by total taxable-equivalent revenues. A common method of expressing a corporation's operating efficiency.

Forbearance: The lender's postponement of legal action when a borrower is delinquent in payment. It is usually granted when a borrower makes satisfactory arrangements to bring overdue mortgage payments up to date.

Foreclosure: The legal process by which property that is mortgaged as security for a loan may be sold to pay a defaulting borrower's loan.

Guaranty fee income: Compensation paid by a lender to Fannie Mae for the guarantee of timely payments of principal and interest to MBS security holders.

Interest rate swap: A derivative transaction between two parties in which each agrees to exchange payments tied to different interest rates or indices for a specified period of time, generally based on a notional amount of principal.

Loan servicing: The tasks a lender performs to protect a mortgage investment, including collecting monthly payments from borrowers and dealing with delinquencies.

Loan-to-value (LTV) ratio: The relationship between the dollar amount of a borrower's mortgage loan divided by the value of the property.

Loss mitigation: Activities designed to reduce either the likelihood of the corporation suffering financial losses on a loan or the final dollar value of those losses in the event of a borrower default.

Mandatory delivery commitment: An agreement that a lender will deliver loans or securities by a certain date at agreed-upon terms.

Mortgage: A legal document that pledges property to a lender as security for the repayment of the loan. The term also is used to refer to the loan itself.

Mortgage-Backed Security (MBS): A Fannie Mae security that represents an undivided interest in a group of mortgages. Interest payments and principal repayments from the individual mortgage loans are grouped and paid out to the MBS holders.

Multifamily housing: A building with more than four residential rental units, or a group of such buildings constituting a single property.

Nonperforming asset: An asset such as a mortgage that is not currently accruing interest or on which interest is not being paid.

Notional principal amount: The hypothetical amount on which derivative transactions are based. The notional principal amount in a derivative transaction generally is not paid or received by either party.

Option-embedded debt: Callable debt or debt instruments linked with derivatives that create effectively callable debt.

Preferred stock: Stock that takes priority over common stock with regard to dividends and liquidation rights. Preferred stockholders typically have no voting rights.

Preforeclosure sale: A procedure in which the borrower is allowed to sell his or her property for an amount less than what is owed on it to avoid a foreclosure. The sale proceeds are paid to the lender and fully satisfy the borrower's debt.

Real Estate Mortgage Investment Conduit (REMIC): A security that represents a beneficial interest in a trust having multiple classes of securities. The securities of each class entitle investors to cash flows structured differently from the payments on the underlying mortgages.

Risk-based capital: The amount of capital required to absorb losses throughout a hypothetical ten-year period marked by severely adverse credit and interest rate conditions, plus an additional amount for management and operations risk.

Secondary mortgage market: The market in which residential mortgages or mortgage securities are bought and sold.

Security: A financial instrument showing ownership of equity (such as common stock), indebtedness (such as a debt security), a group of mortgages (such as MBS), or potential ownership (such as an option).

Serious delinquency: A single-family mortgage that is 90 days or more past due, or a multifamily mortgage that is two months or more past due.

Stockholders' equity: The sum of proceeds from the issuance of stock, accumulated other comprehensive income (net of tax), and retained earnings less amounts paid to repurchase common or preferred shares.

Stripped MBS (SMBS): Securities created by "stripping" or separating the principal and interest payments from an underlying pool of mortgages into two classes of securities, with each receiving a different proportion of the principal and interest payments.

Taxable-equivalent revenues: Total revenues adjusted to reflect the benefits of tax-exempt income and investment tax credits based on applicable federal income tax rates.

Underwriting: The process of evaluating a loan application to determine the risk involved for the lender. It involves an analysis of the borrower's ability and willingness to repay the debt, and of the value of the property.

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(as of March 19, 2002)

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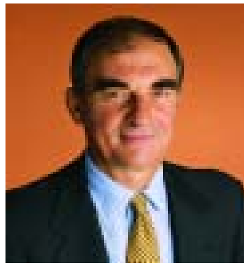

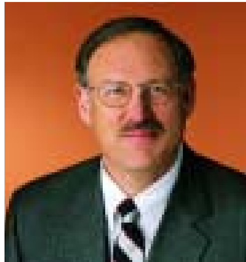

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Common Stock Information (unaudited)

About Fannie Mae Common Stock

Fannie Mae common stock (FNM) is publicly traded on the New York, Chicago, and Pacific stock exchanges.

At December 31, 2001, approximately 997.2 million shares were outstanding. At December 31, 2001, Fannie Mae had approximately 26,000 common shareholders of record. Based on the number of requests for proxies and quarterly reports, the corporation estimates that approximately 380,000 additional shareholders held shares through banks, brokers, and nominees.

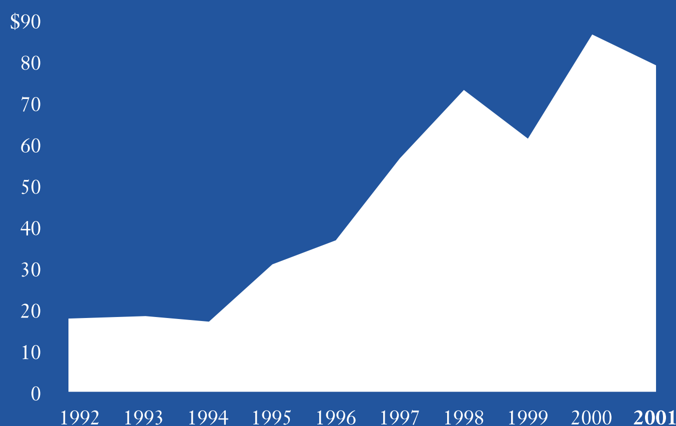
Common Stock Performance

(New York Stock Exchange Composite Price)

Quarterly stock performance data for 2001 and 2000 are provided in the following table.

	2001		2000	
Quarter	**High**	**Low**	High	Low
1st	$87.94	$72.08	$64.88	$47.88
2nd	87.87	74.00	65.63	51.25
3rd	87.10	73.71	72.88	48.13
4th	85.14	75.19	89.38	66.13

Ten-Year Common Stock Performance



Dividends

Fannie Mae considers a number of factors when reviewing its dividend policy, including available capital under applicable capital requirements, reinvestment opportunities, market expectations, and the dividend policies of other large companies with similar growth prospects. Since 1994, Fannie Mae has increased its dividend annually in the first quarter.

Shareholder Information

Investors can learn more about Fannie Mae by visiting *www.fanniemae.com/ir* where both current and historical financial information such as annual reports, and quarterly and monthly financials is available. The Web site includes a section for investors who are interested in Fannie Mae's current issues, Fannie Mae's executive speeches, and direct investment in Fannie Mae stock.

Another section of the site enables investors to access "Fannie Mae at a Glance" which is a presentation that provides an overview of Fannie Mae's business and our industry. Other related links include a calendar of events, FAS 133 accounting standards, and our six voluntary initiatives.

Investor questions about Fannie Mae can be e-mailed to Fannie Mae's investor relations department at *investor_relations1@fanniemae.com*. For written correspondence, contact Jayne Shontell, Senior Vice President, Corporate Development and Investor Relations, Fannie Mae, 3900 Wisconsin Avenue, NW, Washington, DC 20016. You also may call 202-752-7000 for more information.

Fannie Mae will provide, without charge, copies of its most recent Information Statement upon request. Call 1-800-FNM-2-YOU (1-800-366-2968) for a hard copy of investor-related material.

Direct Stock Purchase Program

The DirectSERVICE™ Investment Program for Fannie Mae provides an easy and affordable alternative for current shareholders and first-time investors to invest in Fannie Mae stock.

To request program materials, visit our Web site at: *www.fanniemae.com/ir/direct*, or call 1-888-BUY-FANNIE. The DirectSERVICE Investment Program is offered and administered by Equiserve Trust Company N.A.

Transfer Agent and Registrar

For DirectSERVICE Investment Program account information, or to inquire about replacing dividend checks, address changes, stock transfers, and other account matters, call 1-800-910-8277. Or contact our Transfer Agent and Registrar at The DirectSERVICE Program for Shareholders of Fannie Mae, c/o Equiserve, P.O. Box 2598, Jersey City, New Jersey, 07303-2598.

Notice of Annual Meeting

Formal notice of the annual meeting, the proxy statement, and the proxy will be mailed to each shareholder of record entitled to vote at the meeting.

3900 Wisconsin Avenue, NW
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