Information Statement

This Information Statement describes the business and operations of the Federal National Mortgage Association ("Fannie Mae") as of April 1, 2002 and its financial condition as of December 31, 2001. It contains Fannie Mae's audited financial statements for the year ended December 31, 2001.

In connection with offerings of securities, Fannie Mae distributes offering circulars, prospectuses, or other offering documents that describe securities offered, their selling arrangements and other information. The Information Statement does not offer any securities for sale; however, it is typically incorporated by reference into selling documents. Any incorporation of this Information Statement by reference includes all supplements hereto. You may obtain copies of the current Information Statement, any supplements, and other available information from Fannie Mae as provided under "Available Information" on page 2. Fannie Mae updates its Information Statement quarterly.

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

Fannie Mae's securities are not required to be registered under the Securities Act of 1933. At the close of business on February 28, 2002, approximately 995.8 million shares of Fannie Mae's common stock (without par value) were outstanding.

The delivery of this Information Statement does not imply, at any time under any circumstances, that there has been no change in the affairs of Fannie Mae since its date or that the information contained in it is correct as of any time subsequent to its date.

April 1, 2002

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DOCUMENTS INCORPORATED BY REFERENCE

Fannie Mae's Proxy Statement for the May 2002 Annual Meeting of Shareholders is incorporated by reference herein under "Management—Additional Information." Fannie Mae will supplement this Information Statement to reflect its quarterly financial results and other events and information as Fannie Mae determines. References to the "Information Statement" include any documents incorporated by reference and any amendments or supplements. If Fannie Mae modifies or updates information in the Information Statement in a later supplement or in a document incorporated by reference in this Information Statement, the information as modified or updated replaces the information initially reported by Fannie Mae in this Information Statement.

AVAILABLE INFORMATION

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

BUSINESS

General

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

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

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

In addition, Fannie Mae offers various services to lenders and others for a fee. These services include issuing certain types of MBS and credit enhancements and providing technology services for originating and underwriting loans. For information regarding Fannie Mae's mortgage loan, MBS, and other activities in 2001, see "Management's Discussion and Analysis of Financial Condition and Results of Operations."

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

Mortgage Loan Portfolio

Mortgage Loans Purchased

Fannie Mae purchases primarily single-family, conventional (*i.e.*, not federally insured or guaranteed), fixed- or adjustable-rate, first lien mortgage loans. It also purchases other types of residential mortgage loans for its portfolio, including mortgage loans insured by the Federal Housing Administration ("FHA"), mortgage loans guaranteed by the Department of Veterans Affairs ("VA") or the Rural Housing Service, manufactured housing loans, multifamily mortgage loans, and subordinate mortgage loans (*i.e.*, loans secured by second liens, etc.). Fannie Mae's purchases have a variety of maturities and are designed to provide a secondary market for a variety of loans. Fannie Mae's mortgage loan purchases for its portfolio include purchases of mortgage-backed securities.

The composition of Fannie Mae's mortgage portfolio at the end of each of the last five years is shown in the table under "Portfolio Composition." The composition of its purchases during the last three years is shown in Table 11 of "Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A")—Balance Sheet Analysis—Mortgage Portfolio."

Principal Balance Limits. Maximum principal balance limits apply to Fannie Mae's mortgage loan purchases. For 2001, Fannie Mae could not purchase conventional mortgage loans on single-unit dwellings if the loan's original principal balance exceeded $275,000, except for loans secured by properties in Alaska, Hawaii, Guam and the Virgin Islands. Higher principal balance limits apply to loans secured by properties in those areas or secured by two- to four-family dwellings. The maximum principal balance limits applicable to conventional mortgage loans secured by one- to four-family

dwellings can be adjusted by Fannie Mae annually based on the national average price of a single-unit dwelling as surveyed by the Federal Housing Finance Board. In November 2001, the maximum principal balance limit for 2002 was increased to $300,700.

Mortgage loans insured by the FHA or guaranteed by the Rural Housing Service are subject to statutory maximum amount limitations. Fannie Mae will not purchase VA-guaranteed mortgage loans in excess of principal amounts that Fannie Mae specifies from time to time. There are no statutory limits on the maximum principal balance of multifamily mortgage loans that Fannie Mae purchases; however, most purchases are within limits established by Fannie Mae based on per unit dollar amounts set forth in the National Housing Act.

Maturity/Balloon Payments. Fannie Mae currently purchases conventional, single-family fixed- and adjustable-rate mortgages (''ARMs'') with original maturities of up to 30 years and 40 years, respectively. Only a small portion of ARMs purchased have maturities of more than 30 years. The multifamily mortgage loans that Fannie Mae currently purchases for its portfolio generally are conventional fixed-rate loans that have maturities of up to 30 years.

The major portion of fixed-rate mortgage loans purchased by Fannie Mae provide for level monthly installments of principal and interest. Some of these loans have balloon payments due 5, 7 or 10 years after origination, but with monthly payments based on longer (*e.g.* 30-year) amortization schedules. Most of the 7-year balloon single-family mortgage loans permit the borrower to refinance the balloon payment at maturity with a 23-year fixed-rate mortgage loan if certain requirements are satisfied. Many of the multifamily mortgage loans have balloon payments due 5, 7, 10 or 15 years after origination, but with payments based on 25- or 30-year amortization schedules.

Adjustable Rate. The interest rates on ARMs are determined by formulas providing for automatic adjustment, up or down, at specified intervals in accordance with changes in specified indices. Fixed-period ARMs have a fixed interest rate for the first three to ten years, which then is adjusted at specified intervals thereafter. Substantially all ARMs provide for monthly installments of interest or principal and interest with the total amount of monthly installments adjusted (up or down) after the interest rate on the loan is adjusted because of changes in the applicable index. Fannie Mae currently purchases single-family ARMs only if the ARMs have a cap on the amount the interest rate may change over the life of the loan. A substantial number of the ARMs purchased provide the borrower with the option, at specified times or during specified periods of time, to convert the ARM to a fixed-rate mortgage loan with the payment of a small fee.

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

Prepayments

Substantially all of the single-family mortgage loans in Fannie Mae's portfolio are prepayable by the borrower without penalty. Therefore, Fannie Mae bears the risk that prepayments may increase when interest rates decline significantly or as a result of other factors. Fannie Mae manages this risk as described in ''MD&A—Risk Management—Interest Rate Risk Management.'' Most multifamily loans in Fannie Mae's portfolio provide for defeasance of the loan or require a prepayment premium that is calculated under a formula intended to protect Fannie Mae from loss of yield on its investment if the mortgage loan is prepaid.

Portfolio Composition

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

Mortgage Portfolio Composition

	December 31,				
	2001	2000	1999	1998	1997
	(Dollars in millions)				
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
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
Weighted-average yield	6.95%	7.24%	7.08%	7.12%	7.60%

Commitments

Fannie Mae issues commitments to purchase a specified dollar amount of mortgage loans during a specified term. Fannie Mae purchases mortgage loans through standard product commitments with posted yields and through negotiated commitments.

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

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

Fannie Mae also issues to lenders negotiated optional commitments that commit Fannie Mae to purchase a designated dollar amount of single-family mortgage loans from the lenders if they convert their standby commitments to mandatory delivery portfolio commitments. Optional commitments do not obligate the lenders to sell the loans to Fannie Mae; they are obligated to do so only after such commitments are converted to mandatory delivery portfolio commitments. The yield on the mortgage loans is established at the time of conversion of the optional commitments. See ''MD&A—Balance Sheet Analysis—Liquidity and Capital Resources.''

Underwriting Guidelines

Fannie Mae has established certain underwriting guidelines for purchases of conventional mortgage loans to help reduce the risk of loss from borrower defaults. These guidelines are designed to assess the creditworthiness of the borrower, as well as the value of the mortgaged property relative to the amount of the mortgage loan. Fannie Mae, in its discretion, accepts waivers from the guidelines. Fannie Mae also reviews and changes its guidelines from time to time. As part of its affordable housing initiatives, Fannie Mae continues to introduce new underwriting criteria that could make the mortgage finance system more accessible to minorities, low-and moderate-income families, under-served and rural residents and people with special housing needs. In addition, Fannie Mae is

continuing its underwriting initiatives involving alternative methods of assessing the creditworthiness of potential borrowers, among other factors. See "Affordable Housing Initiatives."

Fannie Mae generally relies on lender representations to ensure that the mortgage loans it purchases conform to its applicable underwriting guidelines. Fannie Mae also performs quality control reviews of selected loans to monitor compliance with the guidelines. In the event that a lender is found to have breached its representations with respect to a loan's compliance with the guidelines, Fannie Mae can demand that the lender repurchase the loan or indemnify Fannie Mae against any loss.

Over the last several years, Fannie Mae has enhanced Desktop Underwriter®, its automated underwriting system, to assist lenders in meeting its underwriting standards. Desktop Underwriter is designed to help lenders process mortgage applications in a more efficient and accurate manner and to apply Fannie Mae's underwriting criteria consistently, objectively, and in a more customized manner to all prospective borrowers. If Desktop Underwriter provides an "approve" recommendation to a loan application, Fannie Mae waives certain representations as long as the loan is originated in accordance with the information that was submitted to Desktop Underwriter.

Credit Risk Sharing

Risk sharing through various types of credit enhancement is an integral part of Fannie Mae's credit risk management strategy. In addition, Fannie Mae's charter requires that conventional single-family mortgage loans with an unpaid principal balance (" UPB") in excess of 80 percent of the value of the mortgaged property be subject to one of three credit enhancement structures in order to be eligible for purchase by Fannie Mae. Fannie Mae uses all three structures. The most commonly used credit enhancement is primary mortgage insurance in at least the amount of the loan over the 80 percent level, provided by an insurance company acceptable to Fannie Mae. In addition, Fannie Mae contracts for and manages credit enhancements at, or subsequent to, acquisition of loans to optimize credit risk management. Fannie Mae also has obtained credit enhancement for a majority of the mortgage loans in its multifamily loan portfolio. Fannie Mae bears the risk that in some cases parties assuming credit enhancement obligations may be unable to meet their contractual obligations. Fannie Mae regularly monitors this risk and follows specific criteria in evaluating and accepting credit enhancement arrangements in order to minimize its exposure to credit loss. See "MD&A—Risk Management—Credit Risk Management—Non-Derivative Counterparty Risk."

Servicing

Fannie Mae generally does not service mortgage loans, except for some government-insured multifamily loans or loans that are serviced under a subservicing arrangement with a major servicing entity, such as after termination of a servicer. Mortgage loans held in portfolio or backing MBS can be serviced only by a servicer approved by Fannie Mae, and they must be serviced subject to Fannie Mae's guidelines. Lenders who sell single-family mortgage loans and conventional multifamily loans to Fannie Mae typically are approved servicers and typically service the mortgage loans they sell to Fannie Mae. Servicing includes the collection and remittance of principal and interest payments, administration of escrow accounts, evaluation of transfers of ownership interests, responding to requests for partial releases of security, handling proceeds from casualty losses, negotiating problem loan workouts and, if necessary, processing foreclosures. In the case of multifamily loans, servicing also may include performing property inspections, evaluating the financial condition of owners, and administering various types of agreements (including agreements regarding replacement reserves, completion or repair, and operations and maintenance). Fannie Mae compensates servicers primarily by permitting them to retain a specified portion of each interest payment on a serviced mortgage loan. Fannie Mae reserves the right to remove servicing responsibility from a lender.

Mortgage-Backed Securities

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

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

MBS are not assets of Fannie Mae, except when acquired for portfolio investment purposes, nor are MBS recorded as liabilities. Fannie Mae is liable under its guarantee, however, to make timely payments to investors of principal and interest on the MBS, even if Fannie Mae has not received payments of principal or interest on the mortgage loans in the underlying pools. MBS enable Fannie Mae to further its statutory purpose of increasing the liquidity of residential mortgage loans and create a source of guaranty fee income. Fannie Mae assumes the ultimate credit risk of borrowers' defaults on mortgage loans underlying MBS as a result of its guarantee of the timely payment of principal and interest on the MBS. See ''MD&A—Mortgage-Backed Securities.''

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

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

Fannie Mae also issues and guarantees other mortgage-backed securities that involve more than one class of certificates and, therefore, require special allocations of cash flows. SMBS are issued in series with one or more classes, each of which is entitled to different cash flows and may represent (1) an undivided interest solely in the principal payments, (2) an undivided interest solely in the interest payments, or (3) different percentage interests in principal and interest payments to be made on a pool of mortgage loans, MBS, REMICs, other SMBS and/or Ginnie Mae certificates. REMICs represent beneficial interests in a trust having multiple classes of certificates entitled to different cash flows from the underlying mortgage loans, MBS, SMBS, Megas, Ginnie Mae certificates and/or other REMICs. Pursuant to the guaranty provided to REMICs and SMBS certificate holders, Fannie Mae is obligated to make timely distribution of required installments of principal and/or interest and, in the case of REMICs, to distribute the principal balance in full by a specified date, whether or not

sufficient funds are available in the related REMIC trust. Fannie Mae has issued a limited amount of subordinated REMIC classes that are not guaranteed by Fannie Mae.

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

Fannie Mae typically does not service the loans in an MBS pool. Fannie Mae, however, reserves the right to remove the servicing responsibility from a lender at any time if it considers such removal to be in the best interest of MBS certificate holders. In such event, Fannie Mae finds a replacement lender or subservicer to service the loans. Fannie Mae is responsible to MBS holders for the administration and servicing of mortgage loans underlying MBS, including the collection and receipt of payments from lenders and the remittance of distributions and certain reports to holders of MBS certificates.

Affordable Housing Initiatives

In March 2000, Fannie Mae announced its "American Dream Commitment℠"—a pledge to invest $2 trillion during the following ten years to help finance housing for 18 million home buyers and renters and join with housing partners to reverse decay in inner cities and older suburbs and expand the availability of livable, affordable rental housing. The new plan will focus on: (1) promoting mortgage consumer rights, including broader, more equal access to low-cost mortgage credit; (2) fighting mortgage discrimination and leading the housing market in serving minority families, including a pledge to provide $420 billion in financing for 3 million minority households; (3) addressing the unique housing needs of women-headed households, young families, new immigrants, seniors, and urban and rural dwellers; (4) strengthening inner city and older suburban areas through new capital investments and expanded Partnership Offices; (5) providing new technologies to mortgage lenders and consumers in order to lower the costs of mortgage financing; and (6) increasing the supply of affordable rental housing. In 2000, Fannie Mae met its "Trillion Dollar Commitment" to help finance over 10 million homes for families and communities most in need during the seven years from 1994 through 2000.

Housing Goals

Under the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (the "1992 Act"), Fannie Mae has certain goals to promote affordable housing for moderate-, low- and very low-income families and to serve the housing needs of those in underserved areas. In 2001, Fannie Mae exceeded the applicable goals. See "MD&A—Housing Goals."

Delinquencies and REO

When a mortgage loan for which Fannie Mae bears the default risk is liquidated through foreclosure or transferred by deed in lieu of foreclosure, Fannie Mae generally acquires the underlying property (such real estate owned is called "REO") and holds it for sale. The level of delinquencies

and number of REO are affected by economic conditions, loss mitigation efforts (which include contacting delinquent borrowers to offer a repayment plan, loan modification, preforeclosure sale, or other options), contractual provisions in credit enhancements, and a variety of other factors. Fannie Mae manages the risk of delinquencies and REO as described in "MD&A—Risk Management—Credit Risk Management."

Fee-Based Services

Fannie Mae offers certain services to lenders and other customers in return for a fee. These include issuing REMICs, SMBS, Fannie Megas and grantor trust securities, providing technology services for originating and underwriting loans, and the facilitation of securities transactions. Fannie Mae receives fee income from dealers in exchange for creating and issuing REMICs, SMBS, grantor trust securities, and Megas. In addition to issuing these securities, Fannie Mae is responsible for all tax reporting and administration costs associated with these securities.

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

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

Competition

Fannie Mae competes, within the limits prescribed by its Charter Act, for the purchase of mortgage loans for portfolio and the issuance of mortgage-backed securities in the secondary mortgage market. For single-family products, Fannie Mae competes primarily with the Federal Home Loan Mortgage Corporation ("Freddie Mac"), another government-sponsored enterprise with a mission, authority, and regulatory oversight that are virtually identical to those of Fannie Mae, and with the Federal Home Loan Banks, which also finance and service single-family mortgage loans through the Mortgage Partnership Finance Programs that were initiated in 1997. Fannie Mae competes to a lesser extent with savings and loan associations, savings banks, commercial banks and other companies that purchase single-family mortgage loans for their own portfolio or pool single-family mortgage loans for sale to investors as whole loans or mortgage-backed securities.

Fannie Mae competes with the FHA insurance program, a program of the U.S. Department of Housing and Urban Development ("HUD"), for the business of guaranteeing the credit performance of mortgage loans and, due to the eligibility of such FHA-insured loans for securitization by Ginnie Mae, with Ginnie Mae as well. The base maximum principal balance for loans eligible for the FHA insurance program is 48 percent of Fannie Mae's loan limits. The loan limit for FHA-insured loans in high cost areas is as much as 87 percent of Fannie Mae's limits. The higher FHA limits may result in increased competition for Fannie Mae's guaranty business. For additional information on the maximum principal balances for loans purchased by Fannie Mae, see "Mortgage Loan Portfolio—Mortgage Loans Purchased—Principal Balance Limits."

In the case of multifamily products, Fannie Mae generally competes with government housing programs, Freddie Mac, insurance companies, and the same kinds of entities it competes with in the single-family market. In addition, there is competition for multifamily mortgage loans from certain entities typically sponsored by investment banks and commercial banks that purchase such loans and pool them for sale to investors in the commercial mortgage-backed securities market. Such entities

are referred to as ''conduits,'' and their role in the multifamily mortgage market has increased significantly over the last five years. Conduits continue to be a strong source of competition.

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

Fannie Mae competes primarily on the basis of price, products, structures, and services offered. Competition based on advances in technology-related and other fee-based services continues to increase, as do the types and nature of the products offered by Fannie Mae, Freddie Mac, and other market participants. Fannie Mae's market share of loans purchased for cash or swapped for MBS is affected by the volume of mortgage loans offered for sale in the secondary market by loan originators and other market participants and the amount purchased by other market participants that compete with Fannie Mae.

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

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

Facilities

Fannie Mae owns its principal office, which is located at 3900 Wisconsin Avenue, NW, Washington, DC, offices at 3939 Wisconsin Avenue, NW and 4250 Connecticut Avenue, NW, in Washington, DC, and two facilities in Herndon, Virginia. These owned facilities total 776,000 square feet of office space. In addition, Fannie Mae leases 386,000 square feet of office space at 4000 Wisconsin Avenue, NW, which is adjacent to Fannie Mae's principal office, 62,000 square feet of office space at 2115 Wisconsin Avenue, NW, in Washington, DC, 230,000 square feet of office space at 12900 Worldgate Drive in Herndon, Virginia and 80,000 square feet of office space at 11600 Sallie Mae Drive, in Reston, Virginia. The present lease for 4000 Wisconsin Avenue expires in 2003, and Fannie Mae has options to extend the lease for up to 15 additional years, in 5-year increments. The lease for 2115 Wisconsin Avenue expires in 2002 and Fannie Mae is currently in negotiations to extend the lease. The lease for 12900 Worldgate Drive expires in 2012 with a 5 year renewal option, and the lease for 11600 Sallie Mae Drive expires in 2008 with two 3-year renewal options. Fannie Mae also maintains offices in leased premises in Pasadena, California; Atlanta, Georgia; Chicago, Illinois; Philadelphia, Pennsylvania; and Dallas, Texas. These regional offices negotiate mortgage loan and MBS business with lenders, assist in supervising the servicing of Fannie Mae's mortgage loan portfolio by lenders, assist in supervising or managing the handling and disposition of REO, and provide training to the staffs of lenders. In addition to the regional offices, Fannie Mae has 50 ''Fannie Mae Partnership Offices'' in leased premises around the country which work with cities, rural areas and other underserved communities. Fannie Mae also plans to establish four additional Partnership

Offices in 2002. There currently are Fannie Mae Partnership Offices in Birmingham, Alabama; Phoenix, Arizona; Los Angeles, California; San Francisco, California; Denver, Colorado; Hartford, Connecticut; Washington, D.C.; Miami, Florida; Orlando, Florida; Atlanta, Georgia; Chicago, Illinois; Indianapolis, Indiana; Des Moines, Iowa; Lexington, Kentucky; New Orleans, Louisiana; Baltimore, Maryland; Boston, Massachusetts; Detroit, Michigan; St. Paul, Minnesota; Jackson, Mississippi; Kansas City, Missouri; St. Louis, Missouri; Helena, Montana; Lincoln, Nebraska; Las Vegas, Nevada; Manchester, New Hampshire; Newark, New Jersey; Albuquerque, New Mexico; Buffalo, New York; New York, New York; Charlotte, North Carolina; Bismarck, North Dakota; Oklahoma City, Oklahoma; Cleveland, Ohio; Columbus, Ohio; Portland, Oregon; Pittsburgh, Pennsylvania; Wilkes-Barre, Pennsylvania; Providence, Rhode Island; Columbia, South Carolina; Sioux Falls, South Dakota; Nashville, Tennessee; Houston, Texas; San Antonio, Texas (two offices, one of which is responsible for border region issues); Salt Lake City, Utah; Arlington, Virginia; Seattle, Washington; Milwaukee, Wisconsin; and Cheyenne, Wyoming.

Employees

At December 31, 2001, Fannie Mae employed approximately 4,500 full-time personnel.

GOVERNMENT REGULATION AND CHARTER ACT

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

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

Although the 1968 Act eliminated all federal ownership interest in Fannie Mae, it did not terminate government regulation of Fannie Mae. Under the Charter Act, approval of the Secretary of the Treasury is required for Fannie Mae's issuance of its debt obligations and MBS. In addition, the 1992 Act established the Office of Federal Housing Enterprise Oversight ("OFHEO"), an independent office within HUD under the management of a Director (the "Director") who is responsible for ensuring that Fannie Mae is adequately capitalized and operating safely in accordance with the 1992 Act. The Director is authorized to levy, pursuant to annual Congressional appropriations, annual assessments on Fannie Mae and Freddie Mac to cover reasonable expenses of OFHEO. The 1992 Act established minimum capital, risk-based capital, and critical capital requirements for Fannie Mae and required the Director to establish, by regulation, a risk-based capital test to be used to determine the amount of total capital Fannie Mae must hold to meet the risk-based capital standard. OFHEO issued

a final rule (the "Rule") in 1996 that sets forth the minimum capital requirements for Fannie Mae and Freddie Mac, which are to be calculated, reported, and classified on a quarterly basis. Fannie Mae is in compliance with the Rule. See also "MD&A—Regulatory Environment."

OFHEO published regulations in September 2001 to establish the risk-based capital test, followed by amendments published in February 2002. Under the 1992 Act, Fannie Mae and Freddie Mac are required to hold enough capital to withstand a stringent 10-year stress period, characterized by unprecedented interest-rate movements and credit losses occurring simultaneously. The risk-based capital test evaluates combined interest-rate and credit stress for both rising and declining interest-rate scenarios. The more stringent of these two scenarios determines the required risk-based capital. The test assumes that (i) interest rates increase or decrease by up to 600 basis points over the first year, and remain constant at this new level for the remaining 9 years of the test; (ii) severe credit conditions apply nationwide; and (iii) no new business is acquired by Fannie Mae during this period except to meet outstanding mortgage commitments. The regulations specify that "benchmark loss experience" will be combined with other assumptions and applied each quarter to Fannie Mae's book of business to establish credit losses under the risk-based capital standard. The regulations also specify the housing price index that OFHEO will use in connection with the standard and how the test will be used to determine Fannie Mae's risk-based capital requirements. The 1992 Act provides that the final regulations will be enforceable one year after issuance.

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

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

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

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

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

The Secretary of the Treasury of the United States has discretionary authority to purchase obligations of Fannie Mae up to a maximum of $2.25 billion outstanding at any one time. This facility has not been used since Fannie Mae's transition from government ownership in 1968. Neither the United States nor any agency thereof is obligated to finance Fannie Mae's operations or to assist Fannie Mae in any other manner. The Federal Reserve Banks are authorized to act as depositories, custodians, and fiscal agents for Fannie Mae, for its own account, or as fiduciary.

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

LEGAL PROCEEDINGS

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

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

Fannie Mae also is a party to legal proceedings from time to time arising from other aspects of its business and administrative policies. Claims and proceedings of all types are subject to many uncertain factors that generally cannot be predicted with assurance. However, in the case of the legal proceedings and claims that are currently pending against Fannie Mae, management believes that their outcome will not have a material adverse effect on Fannie Mae's financial condition or results of operations.

COMMON AND PREFERRED STOCK

Section 303(a) of the Charter Act provides that Fannie Mae shall have common stock, without par value. Each share of common stock is entitled to one vote at all elections of directors and on all other matters presented for common shareholder vote. The common stock has no conversion or preemptive rights or redemption or sinking fund provisions. The outstanding shares of common stock are fully paid and nonassessable. There is no prohibition against the purchase by Fannie Mae of its own common stock, holding such common stock in its treasury, and reselling such stock. In the event of liquidation of Fannie Mae, holders of common stock are entitled to share ratably, in accordance with their holdings, in the remaining assets of Fannie Mae after payment of all liabilities and amounts payable to the holders of preferred stock. The holders of the common stock elect thirteen directors, and the President of the United States appoints the remaining five directors. The Charter Act, Fannie Mae's governing instrument, cannot be amended by the stockholders, but only by an Act of Congress.

Fannie Mae also is authorized by the Charter Act to have preferred stock on such terms and conditions as the Board of Directors of Fannie Mae may prescribe. No common stockholder approval is required to issue preferred stock. As of February 28, 2002, Fannie Mae had outstanding $250 million of non-cumulative preferred stock issued in 1996, $150 million in 1998, $150 million in 1999, $978 million in 2000, and $400 million in 2001 that is redeemable at Fannie Mae's option beginning in 2001, 1999, 2004, 2002 and 2006, respectively. Holders of these preferred stock issues 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. See "Notes to Financial Statements—Note 12" for additional information on preferred stock.

The Charter Act contains no limitation on the amount of stock that may be issued except that, if Fannie Mae fails to meet certain minimum capital standards, the Director of OFHEO could require the right to approve Fannie Mae's issuance of stock or securities convertible into stock. At February 28, 2002, there were outstanding approximately 995.8 million shares of common stock. As of December 31, 2001, there were approximately 26,000 stockholders of record. Based on the number of requests for proxies and quarterly reports, Fannie Mae estimates that there are approximately 380,000 additional stockholders who held shares through banks, brokers and nominees.

Holders of common and preferred stock are entitled to receive cash dividends if, as, and when declared by the Board of Directors. However, certain provisions of the 1992 Act may operate to restrict the ability of the Board of Directors to declare dividends in certain circumstances. The 1992 Act established risk-based capital, minimum capital and critical capital requirements for Fannie Mae. OFHEO has released proposed risk-based capital regulations for public review and comment. Until one year after the final regulations establishing the risk-based capital test are in effect, a dividend may be paid without the prior approval of the Director of OFHEO if Fannie Mae meets the minimum capital level and the dividend payment would not decrease Fannie Mae's base capital below such level. See "Government Regulation and Charter Act." One year after final regulations establishing the risk-based capital test take effect, a dividend may be paid without the prior approval of the Director if Fannie Mae meets both the risk-based capital and minimum capital levels and the dividend payment would not decrease Fannie Mae's total capital below the risk-based capital level or its core capital below the minimum capital level. If Fannie Mae meets either the risk-based capital standard or the minimum capital standard, it may make a dividend payment without obtaining the approval of the

Director only if the dividend payment would not cause Fannie Mae to fail to meet another capital standard. At any time when Fannie Mae does not meet the risk-based capital standard but meets the minimum capital standard, Fannie Mae is prohibited from making a dividend payment that would cause Fannie Mae to fail to meet the minimum capital standard. If Fannie Mae meets neither the risk-based capital standard nor the minimum capital standard but does meet the critical capital standard established under the 1992 Act, it may make a dividend payment only if Fannie Mae would not fail to meet the critical capital standard as a result of such payment and the Director approves the payment after finding that it satisfies certain statutory conditions. The Director has the authority to require Fannie Mae to submit a report to the Director regarding any capital distribution (including any dividend) declared by Fannie Mae before Fannie Mae makes the distribution. See ''Government Regulation and Charter Act'' and ''MD&A—Balance Sheet Analysis—Regulatory Environment'' regarding the capital standards applicable to Fannie Mae.

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

Dividends on common stock have been declared and paid for each quarter during Fannie Mae's two most recent fiscal years. See ''Quarterly Results of Operations'' for quarterly dividends paid on common stock during 2001 and 2000.

This description is summarized from the Charter Act, the 1992 Act, the bylaws and certain resolutions of the Board of Directors and stockholders of Fannie Mae. This description does not purport to be complete, and is qualified in its entirety by reference to the Charter Act, the 1992 Act, the bylaws of Fannie Mae, and the resolutions.

Fannie Mae's common stock is publicly traded on the New York, Pacific, and Chicago stock exchanges and is identified by the ticker symbol ''FNM.'' The transfer agent and registrar for the common stock is First Chicago Trust Company of New York, a division of EquiServe, P.O. Box 2598, Jersey City, New Jersey 07303. The following table shows, for the periods indicated, the high and low prices per share of Fannie Mae's common stock on the New York Stock Exchange Composite Transactions as reported in the Bloomberg Financial Markets service.

Quarterly Common Stock Data

	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

The closing price of Fannie Mae's common stock on March 26, 2002, as so reported, was $79.73.

FORWARD-LOOKING INFORMATION

From time to time, Fannie Mae may make forward-looking statements relating to matters such as Fannie Mae's anticipated financial performance, business prospects, future business plans, financial condition, or other matters. For example, "MD&A" includes forward-looking statements that are not historical facts or explanations of historical data. The words "believes," "anticipates," "expects," "should" and similar expressions generally identify forward-looking statements.

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

- significant changes in borrower preferences for fixed- or adjustable-rate mortgages, originator preferences for selling mortgages in the secondary market, investor preferences for Fannie Mae's securities versus other investments, the availability of funding at attractive spreads in the financial markets (in particular from callable debt), and other factors affecting the overall mix of mortgage loans available for purchase, Fannie Mae's funding opportunities, or Fannie Mae's net interest margins;

- significant changes in employment rates, housing price appreciation, or other factors affecting delinquency or foreclosure levels and credit losses;

- significant changes in Fannie Mae's policies or strategies, such as its underwriting requirements or its interest rate risk management, credit loss mitigation, or investment strategies;

- regulatory or legislative changes affecting Fannie Mae, its competitors, or the markets in which Fannie Mae is active, including changes in taxes or capital requirements applicable to Fannie Mae or its activities (see "Government Regulation and Charter Act," and "MD&A—Balance Sheet Analysis—Regulatory Environment" regarding certain matters currently being considered by regulators, legislators, or the Administration);

- competitive developments in the markets for mortgage purchases and for the sale of mortgage-backed and debt securities, or significant changes in the rate of growth in conforming residential mortgage debt;

- significant changes in the amount and rate of growth of Fannie Mae's expenses, and the costs (and effects) of legal or administrative proceedings (see "Legal Proceedings") or changes in accounting policies or practices;

- significant changes in general economic conditions or the monetary or fiscal policy of the United States; and

- unanticipated, substantial changes in interest rates. It is possible that sudden, severe swings in interest rates could have at least a short-term significant effect on Fannie Mae's results.

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

SELECTED FINANCIAL INFORMATION: 1997-2001 (Unaudited)

The following selected financial information for the years 1997 through 2001 has been summarized or derived from the audited financial statements and other financial information. This information should be read in conjunction with the audited financial statements and notes to the financial statements.

Income Statement Data for the years ended:	**2001**	**2000**	**1999**	**1998**	**1997**
	(Dollars in millions, except per common share amounts)				
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
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
Credit-related expenses	(78)	(94)	(127)	(261)	(375)
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 shareholders	$ 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
Balance Sheet Data at December 31:					
Mortgage portfolio, net	$705,167	$607,399	$522,780	$415,223	$316,316
Investments	74,554	54,968	39,751	58,515	64,596
Total assets	799,791	675,072	575,167	485,014	391,673
Borrowings:					
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 liabilities	781,673	654,234	557,538	469,561	377,880
Stockholders' equity	18,118	20,838	17,629	15,453	13,793
Core capital(2)	25,182	20,827	17,876	15,465	13,793
Other Data for the year ended December 31:					
Total taxable-equivalent revenues(3)	$ 10,187	$ 7,825	$ 6,975	$ 6,272	$ 5,735
Average net interest margin	1.11%	1.01%	1.01%	1.03%	1.17%
Operating return on average realized common equity	25.4	25.2	25.0	25.2	24.6
Dividend payout ratio	20.9	26.0	28.8	29.5	29.4
Average effective guaranty fee rate	.190	.195	.193	.202	.227
Credit loss ratio	.006	.007	.011	.027	.041
Ratio of earnings to combined fixed charges and preferred stock dividends(4)	1.20:1	1.16:1	1.17:1	1.18:1	1.19:1
Mortgage purchases	$270,584	$154,231	$195,210	$188,448	$ 70,465
MBS issues acquired by others	344,739	105,407	174,850	220,723	108,120
Outstanding MBS(5)	858,867	706,684	679,169	637,143	579,138
Weighted-average diluted common shares outstanding, in millions	1,006	1,009	1,031	1,037	1,056

(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 on mortgages and mortgage-backed securities (MBS), and the amortization of upfront guaranty fee adjustments. Further discussion of these critical accounting 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 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

	Year Ended December 31, 2001
	(Dollars in millions)
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,	
	2001	2000
	(Dollars in millions)	
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 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 option 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.

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 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,		
	2001	2000	1999
	(Dollars in millions)		
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."

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.

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.

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

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.

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.

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%	14,822	72%

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.

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, 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 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 pursues early intervention in a delinquency 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 enhancements.

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 credit 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

Dollars in millions	Year Ended December 31, 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 Delinquency Rates (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	$100,813	$92,800	$134,718	$118,100	$115,700
(The maximum loan amount was $275,000 in 2001.)					

(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 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 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

Dollars in millions	Year Ended December 31, 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 at year-end 2001. 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.

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 due 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 percent in 2001. Although the economic downturn increased Fannie Mae's serious delinquency rates in 2001, 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, compared with 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.

Changes in the allowance for losses for the years 1997 – 2001 are summarized below.

Allowance for Losses

	Total (Dollars in millions)
Balance, December 31, 1996	$ 780
Provision	100
Net chargeoffs	(77)
Balance, December 31, 1997	803
Provision	(50)
Net recoveries	49
Balance, December 31, 1998	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

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 Service, respectively) with the exception of its recourse and mortgage servicing counterparties. Fannie Mae does not require an investment grade credit 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 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 transactions 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 credit 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.

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)		
	2001	2000	1999	2001	2000	1999	2001	2000	1999
	(Dollars in millions)								
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

	2001	2000	1999
	Dollars in millions		
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

	2001	2000	1999
	Dollars in billions		
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 modify 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)			Pay Variable/ Receive Fixed Swaps	Basis Swaps	Caps and Swaptions	Other(4)	Total
	Amount	Pay Rate(3)	Receive Rate(3)					
	Dollars in millions							
Notional Amounts:(1)								
Notional balance at								
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 at								
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 at								
December 31, 2001	$213,680	6.21%	2.47%	$39,069	$47,054	$219,943	$13,393	$533,139
Fair value at								
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 concentra-

tions. 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 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						
	Less than 1 year	1 to 5 years	Over 5 years	Maturity Distribution Netting (2)	Exposure	Collateral Held	Exposure Net of Collateral
	(Dollars in millions)						
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

Credit Rating		
S&P	Moody's	Exposure Threshold
		(Dollars in millions)
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, 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 programs.

Fannie Mae raised $400 million in additional equity in 2001 by issuing variable-rate 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 noncumulative 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,	
	2001	2000
	Dollars in millions	
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.

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)				Outstanding (1)			
	Fannie Mae Risk	Lender or Shared Risk	Total	MBS Issues Acquired by Others	Fannie Mae Risk	Lender of Shared Risk (2)	Total (3)	Outstanding MBS Held by Other Investors
	(Dollars in millions)							
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 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 been applied since acquisition of the loans. 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 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 is 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 developed 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.

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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

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.

Washington, DC
January 10, 2002

FANNIE MAE

FINANCIAL STATEMENTS AND REPORTS

STATEMENTS OF INCOME

	2001	2000	1999
	Year Ended December 31, (Dollars and shares in millions, except per common share amounts)		
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.

FANNIE MAE

BALANCE SHEETS

	December 31, 2001	December 31, 2000
	(Dollars in millions, except share stated values)	
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.

FANNIE MAE

STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

	Net Common Shares Outstanding	Preferred Stock	Common Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total Stockholders' Equity
	(Dollars and shares in millions)							
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.

FANNIE MAE

STATEMENTS OF CASH FLOWS

	Year Ended December 31,		
	2001	2000	1999
	(Dollars in millions)		
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.

FANNIE MAE

NOTES TO FINANCIAL STATEMENTS

1. Summary of Significant Accounting Policies

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

The accounting and reporting policies of 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 or more 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.

	2001	2000
	(Dollars in millions)	
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.

	Total
	(Dollars in millions)
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					
	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
	(Dollars in millions)											
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					
	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
	(Dollars in millions)											
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		
	Amortized Cost	Fair Value	Yield	Amortized Cost	Fair Value	Yield
	(Dollars in millions)					
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 Month-end	Outstanding at December 31		Average Outstanding During Year		Maximum Outstanding at Any Month-end
	Amount	Cost(1)	Amount	Cost(1)		Amount	Cost(1)	Amount	Cost(1)	
	(Dollars in millions)									
Short-term notes	$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	
	Maturity Date	Amount Outstanding	Average Cost(1)	Amount Outstanding	Average Cost(1)
		(Dollars in millions)			
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.

Call Date	Year of Maturity	Amount Outstanding	Average Cost
	(Dollars in millions)		
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:

	Total Debt by Year of Maturity (1)	Assuming Callable Debt Redeemed at Initial Call Date (1)
	(Dollars in millions)	
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:

	2001	2000	1999
	(Dollars in millions)		
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:

	2001	2000
	(Dollars in millions)	
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.

	Year Ended December 31,					
	2001		2000		1999	
	Basic	Diluted	Basic	Diluted	Basic	Diluted
	(Dollars and shares in millions, except per share amounts)					
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 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, so 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.

	2001		2000		1999	
	Options	Weighted-Average Exercise Price	Options	Weighted-Average Exercise Price	Options	Weighted-Average Exercise Price
			(Options in thousands)			
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		
	Portfolio Investment	Credit Guaranty	Total	Portfolio Investment	Credit Guaranty	Total	Portfolio Investment	Credit Guaranty	Total
	(Dollars in millions)								
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 option 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 U.S. 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		
	Fair Value Hedges	Cash Flow Hedges	Total
	(Dollars in millions)		
Interest rate swaps:			
Pay-fixed	$ 7,063	$206,617	$213,680
Receive-fixed and 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 the 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, compared with $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.

	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
	(Dollars in millions)						
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.

	2001	2000
	(Dollars in billions)	
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[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.

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	Gross UPB	Geographic Distribution					
		Northeast	Southeast	Midwest	Southwest	West	Total
	(Dollars in millions)						
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	Gross UPB	Geographic Distribution					
		Northeast	Southeast	Midwest	Southwest	West	Total
	(Dollars in millions)						
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	Gross UPB	LTV Ratio 60% or less	61-70%	71-75%	76-80%	81-90%	Over 90%	Total
	(Dollars in millions)							
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	Gross UPB	LTV Ratio 60% or less	61-70%	71-75%	76-80%	81-90%	Over 90%	Total
	(Dollars in millions)							
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,	Fixed-Rate Loans by Note Rate(1) Under 7.00%	7.00% to 7.99%	8.00% to 8.99%	9.00% to 9.99%	10.00% and over	Total
	(Dollars in billions)					
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

Assets

	December 31, 2001		December 31, 2000	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
	(Dollars in millions)			
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

	Carrying Amount 2001	Estimated Fair Value 2001	Carrying Amount 2000	Estimated Fair Value 2000
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 the expected cash flows or quoted market values of these instruments.

FANNIE MAE

QUARTERLY RESULTS OF OPERATIONS (Unaudited)

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

	2001 Quarter Ended			
	December	September	June	March
	(Dollars in millions, except per common share amounts)			
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, 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

(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.

FANNIE MAE

QUARTERLY RESULTS OF OPERATIONS (Unaudited) — (Continued)

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.

	2000 Quarter Ended			
	December	September	June	March
	(Dollars in millions, except per common share amounts)			
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(1):				
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(1):				
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) 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.

FANNIE MAE

NET INTEREST INCOME AND AVERAGE BALANCES (Unaudited)

	2001	2000	1999
	(Dollars in millions)		
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 portfolio.

FANNIE MAE

RATE / VOLUME ANALYSIS (Unaudited)

	Increase (Decrease)	Attributable to Changes in (1)	
		Volume	Rate
	(Dollars in millions)		
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				
	2001	2000	1999	1998	1997
	(Dollars in millions, except per common share amounts)				
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 assets	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) — (Continued)

	At December 31,				
	2001	2000	1999	1998	1997
	(Dollars in millions, except per common share amounts)				
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

MANAGEMENT

Directors

The age and background, as of March 26, 2002, of each of the members of the Board of Directors of Fannie Mae are as follows:

Name and Age	Principal Occupation and Business Experience	First Became Director	Other Directorships (1)
Victor H. Ashe (2), 57	Mayor of the City of Knoxville, Tennessee since 1987; Member, U.S. Conference of Mayors Executive Board; past President of the United States Conference of Mayors.	2001	
Stephen B. Ashley, 62	Chairman and Chief Executive Officer, The Ashley Group, a group of commercial and multifamily real estate, brokerage and investment companies, since January 1997.	1995	Exeter Fund, Inc.; The Genesee Corporation; Hahn Automotive Warehouse, Inc.; Manning & Napiers Insurance Fund, Inc.
Molly H. Bordonaro (2), 33	Associate, Norris, Beggs & Simpson, a commercial real estate service company, since 2001; owner and President of The Bordonaro Group, a Portland, Oregon strategic consulting firm specializing in economic and health care issues, from 1995 to 1999; Commissioner on the Commission on the Advancement of Women and Minorities in Science, Engineering and Technology from 1999 to 2000.	2001	
Kenneth M. Duberstein, 57	Chairman and Chief Executive Officer, The Duberstein Group, an independent strategic planning and consulting company, since July 1989; Chief of Staff to the President of the United States from 1988 to 1989.	1998	The Boeing Company; Conoco Inc.; Fleming Companies, Inc.; St. Paul Companies, Inc.
Stephen Friedman, 64	Senior Principal, Marsh McLennan Risk Capital Corp., an insurance brokerage, money management and consulting firm, since March 1998; Limited Partner since 1994, Senior Chairman from 1994 to 1998, and Co-Chairman or Chairman from 1990 to 1994, Goldman, Sachs & Co., an investment banking firm.	1996	Wal-Mart Stores, Inc.
Thomas P. Gerrity, 60	Professor of Management since 1990, Director since 1999 (Wharton Electronic Business Initiative), Dean from 1990 to 1999, The Wharton School of the University of Pennsylvania; President of CSC Consulting and Vice President of Computer Sciences Corporation from 1989 to 1990; Chairman and Chief Executive Officer, Index Group, a technology-oriented consulting company, from 1969 to 1989.	1991	CVS Corporation; Reliance Group Holdings, Inc.; Sunoco, Inc.; Knight-Ridder, Inc.; Internet Capital Group, Inc.; Morgan Stanley Institutional Funds (formerly MAS Fund)
Jamie S. Gorelick, 51	Vice Chair of Fannie Mae since May 1997; Deputy Attorney General of the United States from 1994 to 1997; General Counsel to the U.S. Department of Defense from 1993 to 1994; Partner, Miller, Cassidy, Larroca & Lewin, a law firm, from 1981 to 1993.	1997	United Technologies Corporation
William R. Harvey (2), 60	President of Hampton University since 1978; board member, First Union National Bank (Atlantic Division) and Trigon Blue Cross Blue Shield of Virginia.	2001	Wachovia Bank
Manuel J. Justiz (2), 53	Dean, College of Education at the University of Texas at Austin, since 1990.	2001	

Name and Age	Principal Occupation and Business Experience	First Became Director	Other Directorships (1)
Ann McLaughlin Korologos, 60	Senior Advisor, Benedetto, Gartland & Company, Inc., an investment banking firm; Vice Chairman of the RAND Board of Trustees, a non-profit institution; Chairman Emeritus since August 2000, Chairman from October 1996 to August 2000, Vice Chairman from 1993 to 1996, The Aspen Institute, a nonprofit organization; U.S. Secretary of Labor from 1987 to 1989.	1994	AMR Corporation (and its subsidiary, American Airlines); Harman International Industries, Inc.; Host Marriott Corporation; Kellogg Company; Microsoft Corporation; Vulcan Materials Company
Vincent A. Mai, 61	Chairman since 1999, Chairman and Chief Executive Officer from 1998 to 1999 and President and Chief Executive Officer from 1989 to 1998 of AEA Investors Inc., a private investment company; Managing Director, Shearson Lehman Brothers, Inc., an investment banking firm, from 1974 to 1989.	1991	
Donald B. Marron, 67	Managing General Partner, Lightyear Fund, an independent private equity fund, since November 2000; Chairman, UBS PaineWebber Inc., an investment services company, from 2000 to 2001; CEO of PaineWebber Incorporated from 1980 to 2000.	1999	
Daniel H. Mudd, 43	Vice Chairman and Chief Operating Officer of Fannie Mae since February 2000; President and Chief Executive Officer of GE Capital, Japan from 1999 to 2000. He was with GE Capital, a diversified financial services company and subsidiary of General Electric Company, since 1991 in a variety of positions including President and Chief Executive Officer of GE Capital, Asia Pacific from 1996 to 1999.	2000	
Anne M. Mulcahy, 49	Chairman and Chief Executive Officer since January 2002, President and Chief Operating Officer from May 2000 to December 2001, President, General Markets Operations from January 1998 to May 2000, of the Xerox Corporation, a global company serving document processing markets. She has been with Xerox since 1976 in a variety of positions including Senior Vice President and Chief Staff Officer.	2000	Target Corporation; Xerox Corporation
Joe K. Pickett, 56	Former Chairman HomeSide International, Inc. Chairman from February 1996 to June 2001 and Chief Executive Officer from February 1996 to February 2001 of Homeside International, Inc., and Chairman of its subsidiary, HomeSide Lending, Inc. (successor entity to BancBoston Mortgage Corporation), a mortgage banking company, from 1990 to February 2001.	1996	
Franklin D. Raines, 53	Chairman of the Board of Directors and Chief Executive Officer of Fannie Mae since January 1999; Chairman of the Board and Chief Executive Officer-Designate, from May 1998 to December 1998; Director, U.S. Office of Management and Budget, from 1996 to 1998; Vice Chairman of Fannie Mae, from 1991 to 1996.	1991	AOL Time Warner Inc.; Pfizer Inc.; Pepsico, Inc.

Name and Age	Principal Occupation and Business Experience	First Became Director	Other Directorships (1)
Taylor C. Segue, III (2), 47	Partner, Butzel Long, P.C., a Detroit, Michigan law firm since 1999; partner, Segue, Fair, Adams & Pope, P.L.C. from 1991 to 1999; board member, Michigan Education Trust and American Red Cross Southeastern Michigan Blood Services Region.	2001	
H. Patrick Swygert, 59	President of Howard University since 1995. President of the State University of New York at Albany from 1995 to 1999.	1999	The Hartford Financial Services Group, Inc.; United Technologies Corporation

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

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

The term of each director will end on the date of the May 2001 annual meeting of stockholders, except that the President of the United States may remove any director that the President appointed for good cause.

Executive Officers

The age and business experience, as of March 27, 2002, of each of the executive officers of Fannie Mae, are as follows:

Franklin D. Raines, 53, has been Chairman of the Board of Directors and Chief Executive Officer since January 1999. Mr. Raines was Chairman of the Board and Chief Executive Officer-Designate from May 1998 to December 1998. Mr. Raines was Director, Office of Management and Budget from September 1996 to May 1998, and Vice Chairman of Fannie Mae from September 1991 to August 1996.

Daniel H. Mudd, 43, has been Vice Chairman and Chief Operating Officer since February 2000. Mr. Mudd was with GE Capital from 1991 to 2000 in a variety of positions including, most recently, President and Chief Executive Officer of GE Capital, Japan, from 1999 to 2000 and of GE Capital, Asia Pacific, from 1996 to 1999.

Jamie S. Gorelick, 51, has been Vice Chair since May 1997. Ms. Gorelick was Deputy Attorney General of the United States from March 1994 to April 1997. Ms. Gorelick served as General Counsel to the United States Department of Defense from May 1993 to March 1994.

J. Timothy Howard, 53, has been Executive Vice President and Chief Financial Officer since February 1990.

Thomas E. Donilon, 46, has been Executive Vice President—Law and Policy since May 2000. He was Senior Vice President, General Counsel and Secretary from September 1999 to May 2000. Mr. Donilon was a partner with the law firm of O'Melveny & Myers from 1991 to 1993 and 1997 to 1999. He was Assistant Secretary of State for Public Affairs and Chief of Staff to the Secretary of State from 1993 to 1996.

Louis W. Hoyes, 53, has been Executive Vice President—Single Family Mortgage Business since May, 2000. Mr. Hoyes was Senior Vice President—Multifamily Lending and Investment from July 1995 to May 2000. Prior to his employment with Fannie Mae, Mr. Hoyes was with Citicorp Real Estate from 1982 until 1995, in various positions, including a managing director of the residential segment of Citicorp's real estate business in North America.

Robert J. Levin, 46, has been Executive Vice President—Housing and Community Development since June 1998. Mr. Levin was Executive Vice President—Marketing from June 1990 to June 1998.

Adolfo Marzol, 41, has been Executive Vice President and Chief Credit Officer since July 1998. Mr. Marzol was Senior Vice President—Single-Family Business Management from July 1996 to July 1998. Mr. Marzol was Senior Vice President—Capital Markets from February 1996 to July 1996.

Julie St. John, 50, has been Executive Vice President and Chief Technology Officer since July 2000. She was Senior Vice President—Mortgage Business Technology (previously Senior Vice President—Guaranty and Franchise Technologies and Senior Vice President of Transaction Processing and Management Systems) from June 1993 to July 2000.

Michael J. Williams, 44, has been President—Fannie Mae e-Business since January 2001. He was Senior Vice President—e-commerce from February 2000 to January 2001 and Senior Vice President—Customer Applications and Technology Integration from 1993 to 2000.

Kenneth J. Bacon, 47, has been Senior Vice President—Multifamily Lending and Investment since November 2000. He was Senior Vice President—American Communities Fund from September 1998 to November 2000 and Senior Vice President—Northeastern Regional Office from April 1993 to September 1998.

Arne L. Christenson, 40, has been Senior Vice President—Regulatory Policy since January 1999. Prior to his employment with Fannie Mae, Mr. Christenson was Chief of Staff for the former Speaker of the House, Congressman Newt Gingrich.

Kathy G. Gallo, 42, has been Senior Vice President—Human Resources since March 2002. Prior to her employment with Fannie Mae, Ms. Gallo was a partner at McKinsey and Company.

Vada Hill, 42, has been Senior Vice President and Chief Marketing Officer since November 2001. Mr. Hill was Chief Marketing Officer—Fannie Mae e-Business from January 2001 to November 2001 and Senior Vice President—Marketing from September 1999 to January 2001. Prior to his employment with Fannie Mae, Mr. Hill was a brand manager at Procter & Gamble.

Ann M. Kappler, 45, has been Senior Vice President and General Counsel since May 2000. Ms. Kappler was Senior Vice President and Deputy General Counsel from January 1999 to May 2000 and a partner in the law firm of Jenner & Block from 1994 to 1998.

Linda K. Knight, 52, has been Senior Vice President and Treasurer since February 1993.

Thomas A. Lawler, 49, has been Senior Vice President—Portfolio Management since November 1989.

Thomas A. Lund, 43, has been Senior Vice President—Investor Channel since August 2000. Mr. Lund was Senior Vice President—Southwestern Regional Office from July 1996 to August 2000 and Vice President—Marketing in the Southwestern Regional Office from January 1995 to July 1996.

William R. Maloni, 57, has been Senior Vice President—Government and Industry Relations since March 1989. Mr. Maloni was Vice President—Government and Industry Relations from 1984 to 1989 and director of Congressional Relations from 1983 to 1984.

Peter Niculescu, 42, has been Senior Vice President—Portfolio Strategy since March 1999. Prior to his employment with Fannie Mae, Mr. Niculescu was a Managing Director and Co-Head of Fixed Income Research for Goldman Sachs. He joined Goldman Sachs in 1990 and held a variety of positions including Managing Director—Mortgage Research, Vice President—Mortgage Research and Corporate Bond Strategist.

Michael A. Quinn, 47, has been Senior Vice President—Single Family Mortgage Business since June 1998. He was Senior Vice President—Credit Loss Management from April 1994 to June 1998. Mr. Quinn was Senior Vice President and Controller from March 1991 to April 1994.

Leanne G. Spencer, 46, has been Senior Vice President and Controller since November 1998. Ms. Spencer was Vice President of Financial Reporting from 1993 to 1998.

Additional Information

For information for 2001 concerning executive compensation, stock ownership of management and directors, certain transactions of executive officers, and any person or group owning more than five percent of the voting stock of Fannie Mae, reference is made to the proxy statement for Fannie Mae's 2002 annual meeting of stockholders and any later proxy statement published prior to Fannie Mae's publication of a new Information Statement, which are incorporated herein by this reference. The proxy statement for Fannie Mae's 2002 annual meeting of stockholders will be available in April 2002.

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

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