

**Supplement dated August 9, 2002 to
Information Statement dated April 1, 2002**



This Supplement describes the financial condition of the Federal National Mortgage Association (“Fannie Mae”) as of June 30, 2002, and contains unaudited financial information with respect to Fannie Mae for the three months and six months ended June 30, 2002. This Supplement is a supplement to, and should be read in conjunction with, Fannie Mae’s Information Statement dated April 1, 2002 (the “Information Statement”) and the Supplement dated May 15, 2002 thereto. The Information Statement describes the business and operations of Fannie Mae and contains financial data as of December 31, 2001. The Supplement dated May 15, 2002 describes the financial condition of Fannie Mae as of March 31, 2002, and contains unaudited financial information with respect to Fannie Mae for the three months ended March 31, 2002. Fannie Mae also periodically makes available statistical information on its mortgage purchase and mortgage-backed securities volumes as well as other relevant information about Fannie Mae. You may obtain copies of the Information Statement, any supplements thereto, and other available information regarding Fannie Mae, including Fannie Mae’s Proxy Statement dated April 2, 2002, without charge from Fannie Mae’s Office of Investor Relations, 3900 Wisconsin Avenue, NW, Washington, D.C. 20016 (202-752-7115) or by accessing Fannie Mae’s web site at <http://www.fanniemae.com/ir>.

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. Fannie Mae may incorporate this Supplement by reference in one or more other offering documents. This Supplement does not offer any securities for sale.

Fannie Mae is a federally chartered corporation. Its principal office is located at 3900 Wisconsin Avenue, NW, Washington, D.C. 20016 (202-752-7000). Fannie Mae’s 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, and Fannie Mae is not currently required to file periodic reports under the Securities Exchange Act of 1934. At the close of business on July 31, 2002, approximately 989 million shares of Fannie Mae’s common stock (without par value) were outstanding.

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

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SELECTED FINANCIAL DATA

The following selected financial data for the three-month and six-month periods ended June 30, 2002 and 2001 are unaudited and include, in the opinion of management, all adjustments (consisting of normal recurring accruals) necessary for a fair presentation. Financial data for the periods ended June 30, 2002 are not necessarily indicative of the results expected for the entire year.

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

	Three months ended June 30,		Six months ended June 30,	
	2002	2001	2002	2001
Income Statement Data:				
Interest income	\$ 12,746	\$ 12,218	\$ 25,323	\$ 24,213
Interest expense	10,214	10,319	20,360	20,606
Net interest income	2,532	1,899	4,963	3,607
Guaranty fee income	423	357	831	700
Fee and other income, net	42	25	45	52
Credit-related expenses	(24)	(17)	(46)	(47)
Administrative expenses	(301)	(254)	(591)	(494)
Purchased options income (expense) (1)	(498)	35	(1,286)	(202)
Debt extinguishments	(225)	(142)	(396)	(226)
Income before federal income taxes and cumulative effect of change in accounting principle	1,949	1,903	3,520	3,390
Provision for federal income taxes	(485)	(500)	(848)	(862)
Income before cumulative effect of change in accounting principle	1,464	1,403	2,672	2,528
Cumulative effect of change in accounting principle, net of tax effect (2)	—	—	—	168
Net income	\$ 1,464	\$ 1,403	\$ 2,672	\$ 2,696
Preferred stock dividends	(24)	(35)	(57)	(68)
Net income available to common shareholders	\$ 1,440	\$ 1,368	\$ 2,615	\$ 2,628
Basic earnings per diluted common share	\$ 1.45	\$ 1.37	\$ 2.63	\$ 2.63
Diluted earnings per common share	1.44	1.36	2.61	2.61
Cash dividends per common share .....	.33	.30	.66	.60
Balance Sheet Data at June 30:				
	2002	2001		
Mortgage portfolio, net	\$740,590	\$662,998		
Liquid assets	64,863	59,083		
Total assets	826,677	737,151		
Borrowings:				
Due within one year	358,814	329,159		
Due after one year	430,095	373,175		
Total liabilities	808,947	717,720		
Stockholders' equity	17,730	19,431		
Core capital(3)	26,382	22,978		
	2002	2001	2002	2001
Operating Earnings Data:				
Operating net income (4)	\$ 1,573	\$ 1,314	\$ 3,091	\$ 2,553
Operating earnings per diluted common share	1.55	1.27	3.03	2.47
Total taxable-equivalent revenue (5)	2,971	2,448	5,811	4,724
Average net interest margin	1.16%	1.09%	1.16%	1.06%
Operating return on average realized common equity (6)	25.8	25.5	25.8	25.5
Other Data:				
Average effective guaranty fee rate .....	.183%	.189%	.184%	.190%
Credit loss ratio (7) .....	.004	.005	.005	.007
Dividend payout ratio	22.8	21.9	25.1	22.8
Ratio of earnings to combined fixed charges and preferred stock dividends (8)	1.19:1	1.19:1	1.17:1	1.17:1
Mortgage purchases	\$ 56,917	\$ 65,270	\$ 147,863	\$ 123,997
MBS issues acquired by others	102,909	100,439	209,713	147,289
Outstanding MBS at period-end (9)	945,100	773,836	945,100	773,836
Weighted-average diluted common shares outstanding	1,000	1,007	1,001	1,007

(1) Represents the change in the fair value of the time value of purchased options under FAS 133, *Accounting for Derivative Instruments and Hedging Activities*, which includes amortization expense related to purchased option premiums of \$330 million and \$641 million in the second quarter and first half of 2002, respectively, and \$100 million and \$164 million in the second quarter and first half of 2001, respectively.

(2) Represents the after-tax effect of the adoption of FAS 133 on January 1, 2001.

(3) The sum of (a) the stated value of outstanding common stock, (b) the stated value of non-cumulative perpetual preferred stock, (c) paid in capital, and (d) retained earnings.

(4) Operating net income is a non-GAAP (generally accepted accounting principles) measure developed by management, in conjunction with the adoption of FAS 133, to evaluate and assess the quality of Fannie Mae's earnings from its principal business activities on a consistent basis. For further detail, see second and third paragraphs under "Results of Operations" on the following page.

(5) Includes revenues net of operating losses and amortization expense of purchased option premiums, plus taxable-equivalent adjustments for tax-exempt income and investment tax credits using the applicable federal income tax rate.

(6) Annualized operating net income less preferred stock dividends divided by average realized common stockholders' equity (common stockholders' equity excluding accumulated other comprehensive income).

(7) Annualized charge-offs, net of recoveries, and foreclosed property expenses as a percentage of average net portfolio and average outstanding MBS.

(8) "Earnings" consists of (a) income before federal income taxes and cumulative effect of accounting changes and (b) fixed charges. "Fixed charges" represent interest expense.

(9) MBS held by investors other than Fannie Mae.

**MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND
RESULTS OF OPERATIONS
FOR THE THREE-MONTH AND SIX-MONTH PERIODS ENDED JUNE 30, 2002**

Results of Operations

Fannie Mae's net income for the second quarter of 2002 was \$1.464 billion, an increase of 4 percent over the second quarter of 2001. Second quarter earnings per diluted share (EPS) was \$1.44, 6 percent above the same period last year. Net income and EPS for the six months ended June 30, 2002, were \$2.672 billion and \$2.61, respectively. The increase in second quarter net income was driven by growth in net interest income and guaranty fee income. Net income for the first half of 2002 was flat, compared with the first half of 2001. Fannie Mae's net interest income in the second quarter increased to \$2.532 billion from \$1.899 billion in the corresponding prior year period primarily because of a 14 percent increase in the average net investment balance and a 7 basis point increase in the average net interest margin. In the first half of 2002, net interest income grew 38 percent to \$4.963 billion as a result of a 14 percent increase in the average net investment balance and a 10 basis point increase in the average net interest margin. Guaranty fee income increased in both periods due to strong growth in average outstanding mortgage-backed securities (MBS), which more than offset a decline in the average guaranty fee rate (see discussion of guaranty fee income on page 7 for more details).

In conjunction with the January 1, 2001 adoption of Financial Accounting Standard No. 133, (FAS 133) *Accounting for Derivative Instruments and Hedging Activities*, Fannie Mae's management also began tracking performance based on "operating net income," which is a non-GAAP (generally accepted accounting principles) measure developed by management to evaluate and assess the quality of Fannie Mae's earnings from its principal business activities on a consistent basis. Fannie Mae's operating net income measure provides consistent accounting treatment for purchased options and the embedded option in callable debt — funding transactions that are economically equivalent — by allocating the cost of purchased options over the period the options are held. Furthermore, operating net income reflects the strategy to hold options to maturity and not realize the period-to-period fluctuations in option values.

Operating net income excludes the transition adjustment from the adoption of FAS 133 and unrealized gains and losses on purchased options recorded under FAS 133, and includes purchased option premiums amortized on a straight-line basis over the life of the option. Operating net income does not exclude any other accounting effects related to the application of FAS 133. Management believes operating net income is a meaningful measure of Fannie Mae's performance and a valuable assessment tool because it reflects the underlying economics of our use of purchased options that are a substitute for callable debt.

Operating net income and operating EPS in the second quarter of 2002 grew 20 percent and 22 percent, respectively, over second quarter 2001 to \$1.573 billion and \$1.55. The increase in operating net income was driven by portfolio, guaranty fee income, and net interest margin growth. Operating net income and operating EPS in the first half of 2002 grew 21 percent and 23 percent, respectively, over the first half of 2001 to \$3.091 billion and \$3.03. The following table reconciles net income to operating net income.

	<u>Three Months</u> <u>Ended June 30,</u>		<u>Six Months</u> <u>Ended June 30,</u>	
	<u>2002</u>	<u>2001</u>	<u>2002</u>	<u>2001</u>
	(Dollars in millions)			
Net income	\$1,464	\$1,403	\$2,672	\$2,696
Cumulative after-tax gain upon adoption of FAS 133	—	—	—	(168)
After-tax expense (income) from the change in the fair value of the time value of purchased options	324	(24)	836	131
After-tax amortization expense of purchased option premiums	<u>(215)</u>	<u>(65)</u>	<u>(417)</u>	<u>(106)</u>
Operating net income	<u>\$1,573</u>	<u>\$1,314</u>	<u>\$3,091</u>	<u>\$2,553</u>

Highlights of Fannie Mae’s second quarter 2002 performance versus second quarter 2001 include:

- *Growth in taxable-equivalent revenues of 21 percent,*
- *Growth in adjusted net interest income of 22 percent,*
- *An average net interest margin of 116 basis points compared with 109 basis points,*
- *Growth in guaranty fee income of 18 percent,*
- *Credit-related losses of \$17 million compared with \$16 million, and*
- *Losses of \$225 million from the call and repurchase of debt compared with \$142 million.*

Taxable-equivalent revenue increased 21 percent and 23 percent over the second quarter and first half of 2001 to \$2.971 billion and \$5.811 billion, respectively, largely due to growth in adjusted net interest income. Taxable-equivalent revenue represents total revenue, less operating losses and amortization expense of purchased option premiums, adjusted to reflect the benefits of tax-exempt income and investment tax credits based on applicable federal income tax rates.

Following the adoption of FAS 133, Fannie Mae also began measuring net interest income and net interest margin on an adjusted basis. Management believes Fannie Mae’s adjusted net interest income and net interest margin provides a meaningful basis to measure Fannie Mae’s performance. Adjusted net interest income is net of the amortization expense related to purchased option premiums. Prior to the adoption of FAS 133, net interest income included the amortization expense of purchased option 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 category “purchased options income (expense).”

Adjusted net interest income for the second quarter of 2002 increased 22 percent to \$2.202 billion and increased 26 percent to \$4.322 billion for the first half of 2002 over the prior year periods. Fannie Mae grew the average net mortgage portfolio 13 percent and the average net interest margin by 7 basis points during the second quarter of 2002. The average mortgage portfolio increased by 14 percent and the average net interest margin increased by 10 basis points in the first half of 2002. Fannie Mae’s net interest margin for the first six months of 2002 continued to benefit from an unusually steep yield curve and low short-term interest rates. Portfolio growth subsided in the second quarter of 2002 from 2001 levels as mortgage-to-debt spreads narrowed and liquidation rates remained relatively high. Management expects the average net interest margin to move lower over the remainder of 2002 and into 2003 if the yield curve flattens somewhat from its current steep slope or if mortgage liquidations increase. The results of Fannie Mae’s *portfolio investment business*, which manages the interest rate risk of the company’s mortgage portfolio and other investments, is largely reflected in adjusted net interest income.

The following table presents an analysis of GAAP net interest income, adjusted net interest income, net interest margin, and average balances for the three-month and six-month periods ended June 30, 2002 and 2001.

Net Interest Income and Average Balances

(Dollars in millions)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2002	2001	2002	2001
Interest income:				
Mortgage portfolio	\$ 12,326	\$ 11,498	\$ 24,497	\$ 22,630
Investments and cash equivalents	420	720	826	1,583
Total interest income	<u>12,746</u>	<u>12,218</u>	<u>25,323</u>	<u>24,213</u>
Interest expense:				
Short-term debt	719	1,764	1,461	3,578
Long-term debt	9,495	8,555	18,899	17,028
Total interest expense	<u>10,214</u>	<u>10,319</u>	<u>20,360</u>	<u>20,606</u>
GAAP net interest income	2,532	1,899	4,963	3,607
Amortization of purchased option premiums	(330)	(100)	(641)	(164)
Adjusted net interest income	2,202	1,799	4,322	3,443
Taxable-equivalent adjustment(1)	126	114	249	225
Adjusted net interest income taxable-equivalent basis	<u>\$ 2,328</u>	<u>\$ 1,913</u>	<u>\$ 4,571</u>	<u>\$ 3,668</u>
Average balances:				
Interest-earning assets(2):				
Mortgage portfolio, net	\$732,796	\$647,493	\$724,200	\$635,128
Investments and cash equivalents	69,187	56,764	67,176	56,243
Total interest-earning assets	<u>\$801,983</u>	<u>\$704,257</u>	<u>\$791,376</u>	<u>\$691,371</u>
Interest-bearing liabilities(3):				
Short-term debt	\$128,885	\$145,857	\$130,153	\$137,907
Long-term debt	648,902	535,161	637,140	529,797
Total interest-bearing liabilities	777,787	681,018	767,293	667,704
Interest-free funds	24,196	23,239	24,083	23,667
Total interest-bearing liabilities and interest-free funds	<u>\$801,983</u>	<u>\$704,257</u>	<u>\$791,376</u>	<u>\$691,371</u>
Average interest rates(1):				
Interest-earning assets:				
Mortgage portfolio, net	6.77%	7.14%	6.81%	7.18%
Investments and cash equivalents	2.45	5.13	2.49	5.69
Total interest-earning assets	<u>6.40</u>	<u>6.98</u>	<u>6.44</u>	<u>7.06</u>
Interest-bearing liabilities(3):				
Short-term debt	2.21	4.82	2.39	5.16
Long-term debt	6.06	6.47	6.10	6.49
Total interest-bearing liabilities	<u>5.42</u>	<u>6.12</u>	<u>5.47</u>	<u>6.22</u>
Investment spread(4) .....	.98	.86	.97	.84
Interest-free return(5) .....	.18	.23	.19	.22
Net interest margin(6)	<u>1.16%</u>	<u>1.09%</u>	<u>1.16%</u>	<u>1.06%</u>

- (1) Reflects pro forma adjustments to permit comparison of yields on tax-advantaged and taxable assets.
- (2) Includes average balance of nonperforming loans of \$4.5 billion and \$4.3 billion for the three- and six-month periods ended June 30, 2002, respectively, compared with \$2.3 billion for both the three- and six-month periods ended June 30, 2001.
- (3) 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 option premiums.
- (4) Consists primarily of the difference between the yield on interest-earning assets, adjusted for tax benefits of nontaxable income, and the effective cost of funds on interest-bearing liabilities.
- (5) Consists primarily of the return on that portion of the investment portfolio funded by equity and non-interest-bearing liabilities.
- (6) Based on adjusted net interest income, on a taxable equivalent basis, as a percentage of the average investment portfolios.

The following rate/volume analysis shows the relative contribution of asset and debt growth and interest rate changes to changes in GAAP net interest income for the three- and six-month periods ended June 30, 2002 and 2001.

Rate / Volume Analysis

(Dollars in millions)

<u>Second Quarter 2002 vs. Second Quarter 2001</u>	<u>Increase (Decrease)</u>	<u>Attributable to Changes in (1)</u>	
		<u>Volume</u>	<u>Rate</u>
Interest income:			
Mortgage portfolio	\$ 828	\$1,458	\$ (630)
Investments and cash equivalents.....	(300)	133	(433)
Total interest income.....	<u>528</u>	<u>1,591</u>	<u>(1,063)</u>
Interest expense(2):			
Short-term debt	(1,045)	(186)	(859)
Long-term debt	940	1,708	(768)
Total interest expense	<u>(105)</u>	<u>1,522</u>	<u>(1,627)</u>
Net interest income	<u>\$ 633</u>	<u>\$ 69</u>	<u>\$ 564</u>
<u>First Six Months 2002 vs. First Six Months 2001</u>	<u>Increase (Decrease)</u>	<u>Attributable to Changes in (1)</u>	
		<u>Volume</u>	<u>Rate</u>
Interest income:			
Mortgage portfolio	\$ 1,867	\$3,056	\$(1,189)
Investments and cash equivalents.....	(757)	263	(1,020)
Total interest income.....	<u>1,110</u>	<u>3,319</u>	<u>(2,209)</u>
Interest expense(2):			
Short-term debt	(2,117)	(191)	(1,926)
Long-term debt	1,871	3,257	(1,386)
Total interest expense	<u>(246)</u>	<u>3,066</u>	<u>(3,312)</u>
Net interest income	<u>\$ 1,356</u>	<u>\$ 253</u>	<u>\$ 1,103</u>

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

(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.

Guaranty fee income increased by \$66 million, or 18 percent, to \$423 million in the second quarter of 2002, compared with \$357 million in the second quarter of 2001. This increase resulted from a 22 percent growth in average outstanding MBS, partially offset by a decline in the effective guaranty fee rate to 18.3 basis points in the second quarter of 2002 from 18.9 basis points in the second quarter of 2001. For the first half of 2002, guaranty fee income increased by \$131 million, or 19 percent, to \$831 million compared with the first half of 2001. This increase was the result of a 22 percent increase in average outstanding MBS, partially offset by a .6 basis point decrease in the average effective guaranty fee rate to 18.4 basis points. The average effective guaranty fee rate declined primarily due to the liquidation of higher-fee rate MBS. Fannie Mae's *credit guaranty business* manages the Company's credit risk. Results of this business segment are primarily reflected in guaranty fee income and

credit-related expenses. For the credit guaranty business, GAAP net income and operating net income are the same.

Fee and other income, net increased \$17 million to \$42 million of income in the second quarter of 2002, compared with \$25 million of income in the second quarter of 2001. Fee and other income increased in the second quarter of 2002 primarily due to gains on the sale of MBS classified as available-for-sale. Fee and other income, net for the first six months of 2002 decreased \$7 million to \$45 million of income, compared with \$52 million of income for the first half of 2001. Fee and other income includes 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.

Administrative expenses in the second quarter of 2002 totaled \$301 million, up 19 percent from the second quarter of 2001 primarily due to increased costs associated with reengineering the technology underlying Fannie Mae's core operating infrastructure and systems. Fannie Mae's efficiency ratio (ratio of administrative expenses to taxable-equivalent revenue) improved to 10.1 percent for the second quarter of 2002 from 10.4 percent for the second quarter of 2001. For the first half of 2002, administrative expenses grew 20 percent to \$591 million, compared with the same period in 2001. Fannie Mae's efficiency ratio improved to 10.2 percent for the first half of 2002 from 10.5 percent for the first half of 2001. Fannie Mae's ratio of annualized administrative expenses to the average net mortgage portfolio plus average outstanding MBS (average combined book of business) remained stable at .073 percent for the three-month period ended June 30, 2002, compared with the corresponding prior year period. This ratio increased slightly to .073 percent for the six-month period ended June 30, 2002 from .072 percent in the corresponding prior year period.

Purchased options income (expense) totaled \$498 million and \$1,286 million of expense, respectively, during the three- and six-month periods ended June 30, 2002, and totaled \$35 million of income and \$202 million of expense, respectively, during the three- and six-month periods ended June 30, 2001. Purchased options income (expense) represents the change in the fair value of the time value of purchased options during the reporting period. Purchased options expense for the three- and six-month periods ended June 30, 2002 and June 30, 2001 includes \$330 million and \$641 million, and \$100 million and \$164 million, respectively, in amortization expense that would have been reported in net interest income prior to the adoption of FAS 133. 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. The increase in purchased options expense was caused by an increase in the notional balance of caps and swaptions along with a sharp decline in interest rates. 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 net expense included in earnings from the purchase date until the exercise date of an option will equal the option premium paid.

Debt extinguishments created losses of \$225 million from the call or repurchase of debt in the second quarter of 2002, compared with losses of \$142 million from the call or repurchase of debt in the second quarter of 2001. Fannie Mae regularly calls or repurchases debt as part of its interest rate risk management program. Debt called or repurchased in the second quarter of 2002 totaled \$30 billion, compared with \$36 billion in the second quarter of 2001. Fannie Mae incurred debt extinguishment losses of \$396 million from the call or repurchase of debt in the first half of 2002, compared with debt extinguishment losses of \$226 million from the call or repurchase of debt in the first half of 2001. Fannie Mae called or repurchased \$60 billion of debt in the first half of 2002, compared with \$115 billion in the first half of 2001. Fannie Mae continued to call or repurchase debt in the first half of 2002 as a result of the sharp decline in interest rates that began in 2001. During the second quarter of 2002, Fannie Mae adopted Financial Accounting Standard No. 145 (FAS 145), *Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections*, which eliminates extraordinary treatment of the gains and losses on Fannie Mae's debt repurchases. For comparative purposes, all prior periods, which were presented net of tax, have been reclassified to reflect this revised reporting.

Federal income tax expense decreased \$15 million to \$485 million in the second quarter of 2002 from \$500 million in the second quarter of 2001. Federal income tax expense, including the tax impact from the cumulative effect of the change in accounting principle from the adoption of FAS 133, decreased \$104 million to \$848 million in the first half of 2002 from \$952 million in the first half of 2001. The effective federal income tax rate for the second quarter and first half of 2002 decreased to 25 percent and 24 percent, respectively, from 26 percent for the second quarter and first half of 2001 primarily due to the marginal increase in tax benefits from low-income housing tax credits and tax-exempt investments in the second quarter and first half of 2002. Fannie Mae's effective federal income tax rate on operating income remained stable at 26 percent for the second quarter and first half of 2002 over the prior year periods.

Fannie Mae's results for the first half of 2001 include pre-tax income of \$258 million (\$168 million after-tax) in the first quarter of 2001 from the change in accounting principle recorded upon adoption of FAS 133 on January 1, 2001. The cumulative effect on earnings from the change in accounting principle is attributable to recording the fair value of the time value of purchased options that the company used as a substitute for callable debt at adoption of FAS 133 on January 1, 2001.

Risk Management

Fannie Mae is exposed to several major areas of risk, including interest rate risk and credit risk, that are described and discussed in the Information Statement under "Recent Developments" and "MD&A—Risk Management."

Interest Rate Risk Management

Two primary measures of interest rate risk used by Fannie Mae to manage its mortgage portfolio business are net interest income at risk and portfolio duration gap.

Fannie Mae's net interest income at risk measures the sensitivity of Fannie Mae's projected net interest income to an immediate 50 basis point increase or decrease in interest rates and an immediate 25 basis point increase or decrease in the slope of the yield curve. Yield curve slope sensitivity is calculated assuming a 25 basis point flattening or steepening between one and ten-year maturities, with the five-year yield held constant. Over the company's monthly reporting period, a 50 basis point change in interest rates and a 25 basis point change in the slope of the yield curve encompass approximately 95 percent of the actual changes that are likely to occur.

Net interest income at risk expresses the percentage change in projected net interest income under the more adverse interest rate and yield curve scenarios. Fannie Mae's net interest income at risk over a one-year and four-year period under each of the interest rate scenarios was as follows at June 30, 2002:

	<u>Assuming a 50 basis point change in interest rates</u>		<u>Assuming a 25 basis point change in slope of yield curve</u>	
	<u>One-year</u>	<u>Four-year</u>	<u>One-year</u>	<u>Four-year</u>
June 2002	1.2%	2.4%	3.0%	5.7%

A positive number indicates the percent by which projected net interest income could be reduced by the rate shock. Actual portfolio net interest income may differ from these estimates because of specific interest rate movements, changing business conditions, changing prepayments, and management actions.

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. In computing duration gap, Fannie Mae uses a modified option-

adjusted duration calculation. Fannie Mae's effective duration gap was negative four months at June 30, 2002, compared to positive five months at both December 31, 2001 and June 30, 2001. Fannie Mae's duration gap target range is plus or minus six months.

Credit Risk Management

Fannie Mae's credit performance improved in the second quarter and first half of 2002 versus the prior year periods. Fannie Mae's credit loss ratio—annualized credit-related losses as a percentage of the average combined book of business—decreased to .4 basis points in the second quarter of 2002 from .5 basis points in the second quarter of 2001, and decreased to .5 basis points in the first six months of 2002 from .7 basis points in the first six months of 2001.

Total credit-related losses, which include loan charge-offs, net of recoveries, and foreclosed property expenses, grew only \$1 million to \$17 million in the second quarter of 2002 from the second quarter of 2001 due to an increase in foreclosed property expenses associated with a rise in foreclosed property acquisitions. Fannie Mae's credit loss per case in the second quarter of 2002 was \$2,700, down from \$3,000 in the second quarter of 2001. Credit-related losses decreased \$6 million to \$39 million in the first six months of 2002 from the first six months of 2001 as an increase in recoveries on charge-offs offset a rise in foreclosed property expenses resulting from an increase in the number of properties acquired.

The following table shows Fannie Mae's serious delinquencies for conventional loans in portfolio and underlying MBS, the number of conventional properties acquired, and total net charge-offs (recoveries) for the three- and six-month periods ended June 30, 2002 and 2001.

	Delinquency Rate (1)		Number of Properties Acquired				Net Charge-offs / (Recoveries) (Dollars in millions)			
			Three Months Ended June 30,		Six Months Ended June 30,		Three Months Ended June 30,		Six Months Ended June 30,	
	2002	2001	2002	2001	2002	2001	2002	2001	2002	2001
Single-family .....	.42%	.43%	4,688	3,566	9,025	7,159	\$(38)	\$(31)	\$(69)	\$(57)
Multifamily .....	.10%	.07	—	—	—	1	1	—	2	—
Total							<u>\$(37)</u>	<u>\$(31)</u>	<u>\$(67)</u>	<u>\$(57)</u>

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

The inventory of single-family properties held by Fannie Mae increased to 8,039 as of June 30, 2002 from 6,458 as of June 30, 2001, resulting primarily from the economic slowdown. Fannie Mae had no multifamily properties in its inventory at June 30, 2002, compared with 2 properties at June 30, 2001.

Total credit-related expenses, which include foreclosed property expenses and the provision for losses, increased \$7 million to \$24 million in the second quarter of 2002 from the second quarter of 2001 due to an increase in foreclosed property expenses. Total credit-related expenses decreased \$1 million to \$46 million in the first six months of 2002 from the first six months of 2001 due to an increase in the negative provision for losses.

The allowance for losses increased to \$813 million at June 30, 2002 from \$806 million at December 31, 2001. The allowance for losses declined as a percentage of Fannie Mae's total book of business to .048 percent at June 30, 2002 from .052 percent at December 31, 2001. Nonperforming

loans outstanding totaled \$4.3 billion at June 30, 2002, compared with \$3.7 billion at December 31, 2001.

The use of credit enhancement contracts is an important tool to provide protection against credit losses, and they covered a larger amount of single-family credit losses in both the second quarter and first half of 2002 versus the prior year periods. Credit enhancement contracts include primary loan-level mortgage insurance, pool mortgage insurance, recourse arrangements with lenders, and other customized contracts, which together absorbed \$134 million, or 89 percent, of \$150 million in gross single-family losses on loans in portfolio and underlying outstanding MBS in the second quarter of 2002. In comparison, credit enhancements absorbed \$110 million, or 87 percent, of \$126 million in gross single-family credit losses during the second quarter of 2001. Credit enhancement contracts absorbed \$270 million, or 88 percent, of \$307 million in gross single-family losses on loans in portfolio and underlying outstanding MBS in the first half of 2002. In comparison, credit enhancements absorbed \$214 million, or 83 percent, of \$258 million in gross single-family credit losses during the first half of 2001.

Fannie Mae's primary credit risk on credit enhancements is that counterparties will not fulfill their contractual obligations to make payments due to Fannie Mae. At June 30, 2002, Fannie Mae was the beneficiary on primary mortgage insurance coverage of \$324 billion for single-family loans in portfolio or underlying MBS. Seven mortgage insurance companies, all rated AA or higher by Standard & Poor's, provided 99 percent of this coverage. At June 30, 2002, the unpaid balance of single-family loans where Fannie Mae has recourse to lenders for losses totaled an estimated \$44 billion. Fifty-five percent of the \$44 billion was covered by recourse agreements with investment grade counterparties with a rating of BBB- /Baa3 or higher by Standards & Poor's and Moody's Investor Service, respectively. Fannie Mae held \$252 million in collateral directly or through custodians on single-family recourse transactions at June 30, 2002. Fannie Mae also retains the right to terminate a lender's contractual status as a Fannie Mae seller/servicer as a result of a lender's nonperformance, to sell the rights to service Fannie Mae loans, and to retain sale proceeds. Lenders with recourse obligations had servicing rights on \$1.411 trillion of mortgages at June 30, 2002.

Fannie Mae also has counterparty performance risk in its derivatives and liquidity investments. Credit risk information related to derivatives and liquidity investments is provided under "Balance Sheet Analysis—Derivative Instruments" and "Balance Sheet Analysis—Investments," respectively.

Fannie Mae discloses on a quarterly basis the sensitivity of its future single-family credit losses to an immediate 5 percent decline in home prices as part of its voluntary safety and soundness initiatives. At March 31, 2002, the present value of Fannie Mae's sensitivity of net future credit losses to an immediate 5 percent decline in home prices was \$425 million, taking into account the beneficial effect of third-party credit enhancements. This amount reflects a gross credit loss sensitivity of \$1,285 million before the effect of credit enhancements and is net of projected credit risk-sharing proceeds of \$860 million. Comparative amounts at December 31, 2001 were \$487 million, \$1,332 million, and \$845 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.

Balance Sheet Analysis

Mortgage Portfolio

As of June 30, 2002, the net mortgage portfolio totaled \$741 billion with an average yield (before deducting the allowance for losses) of 6.76 percent, compared with \$705 billion with an average yield of 6.95 percent as of December 31, 2001 and \$663 billion with an average yield of 7.12 percent as of June 30, 2001. The decline in the net mortgage portfolio yield was primarily due to a decrease in

interest rates as conventional mortgage purchase yields fell and prepayments on mortgages with higher yields remained relatively high.

Fannie Mae purchased \$57 billion of mortgages at an average yield of 6.37 percent in the second quarter of 2002, compared with \$65 billion of mortgage purchases at an average yield of 6.76 percent in the second quarter of 2001. The decrease in mortgage purchases between the second quarter of 2002 and 2001 primarily resulted from decreased availability of mortgages in the secondary market, which contributed to tighter mortgage-to-debt spreads. During the first six months of 2002, mortgage purchases were \$148 billion at an average yield of 6.34 percent, compared with purchases of \$124 billion at an average yield of 6.81 percent for the first six months of 2001. Portfolio growth in June fell to an annual rate of 0.8 percent, as mortgage purchases slowed in response to tighter mortgage-to-debt spreads and liquidation rates remained relatively high. Management expects portfolio growth in the low-to-mid teens for all of 2002.

Mortgage loan repayments increased during the second quarter of 2002 to \$46 billion from \$41 billion in the second quarter of 2001. During the first half of 2002, mortgage loan repayments increased to \$106 billion from \$64 billion in the first half of 2001. The increase in loan repayments was primarily due to an increased level of refinance activity in a lower interest rate environment.

Mandatory commitments issued to purchase mortgages net of commitments to sell mortgages decreased to \$60 billion during the second quarter of 2002 from \$66 billion during the second quarter of 2001. At June 30, 2002, Fannie Mae's outstanding mandatory delivery commitments to purchase mortgages decreased to \$27 billion versus \$55 billion of such commitments at December 31, 2001 and \$38 billion at June 30, 2001.

Investments

Presented below are the amortized cost and fair value of the Liquid Investment Portfolio and other investments classified as held-to-maturity at June 30, 2002 and December 31, 2001.

Dollars in millions	June 30, 2002						December 31, 2001					
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value	Average Maturity in Months	% Rated A or Better	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value	Average Maturity in Months	% Rated A or Better
Held-to-maturity investments:												
Eurodollar time deposits	\$ 7,978	\$ —	\$—	\$ 7,978	2.9	100.0%	\$11,185	\$ —	\$—	\$11,185	.3	100.0%
Asset-backed securities(1) ..	6,121	51	—	6,172	17.7	100.0	6,065	88	—	6,153	10.6	100.0
Repurchase agreements	3,176	—	—	3,176	0.5	100.0	9,380	—	—	9,380	.5	100.0
Auction rate preferred stock	1,909	—	—	1,909	1.9	95.5	2,127	—	—	2,127	1.7	100.0
Federal funds	1,850	—	—	1,850	2.8	100.0	4,904	—	—	4,904	.4	100.0
Commercial paper	100	—	—	100	6.8	100.0	2,844	1	—	2,845	.6	100.0
Other	5,311	52	—	5,363	7.0	83.2	2,166	73	—	2,239	16.7	56.4
Total	<u>\$26,445</u>	<u>\$103</u>	<u>\$—</u>	<u>\$26,548</u>	<u>6.8</u>	<u>96.3%</u>	<u>\$38,671</u>	<u>\$162</u>	<u>\$—</u>	<u>\$38,833</u>	<u>3.0</u>	<u>97.5%</u>

(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 June 30, 2002 and December 31, 2001.

Dollars in millions	June 30, 2002						December 31, 2001					
	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
Available-for-sale investments:												
Asset-backed securities(1) ..	\$17,285	\$10	\$—	\$17,295	30.1	100.0%	\$14,876	\$—	\$ 4	\$14,872	26.2	99.9%
Floating rate notes(1)	12,559	—	35	12,524	15.6	85.7	12,114	—	33	12,081	18.2	84.3
Commercial paper	7,277	—	—	7,277	0.9	100.0	8,879	1	—	8,880	.9	100.0
Other	450	—	—	450	4.9	100.0	50	—	—	50	9.5	100.0
Total	<u>\$37,571</u>	<u>\$10</u>	<u>\$35</u>	<u>\$37,546</u>	<u>19.3</u>	<u>95.2%</u>	<u>\$35,919</u>	<u>\$ 1</u>	<u>\$37</u>	<u>\$35,883</u>	<u>17.2</u>	<u>94.7%</u>

(1) As of June 30, 2002, 100 percent of asset-backed securities and floating rate notes reprice at intervals of 90 days or less.

Gross realized gains of \$.3 million and \$1.3 million were recorded in the second quarter and first half of 2002, respectively, and \$2.9 million and \$6.2 million were recorded in the second quarter and first half of 2001, respectively, on investments that were classified as available-for-sale. Gross realized losses of \$1.6 million were recorded in the first half of 2002 on investments that were classified as available-for-sale. Gross realized losses of \$.4 million and \$2.2 million were recorded in the second quarter and first half of 2001, respectively, on investments that were classified as available-for-sale.

The following table shows the amortized cost, fair value, and yield of the Liquid Investment Portfolio and other investments at June 30, 2002 and December 31, 2001 by remaining maturity.

Dollars in millions	June 30, 2002			December 31, 2001		
	Amortized Cost	Fair Value	Yield	Amortized Cost	Fair Value	Yield
Due within one year	\$30,884	\$30,987	2.25%	\$42,190	\$42,210	2.41%
Due after one year through five years	9,692	9,707	2.87	11,459	11,481	3.01
Due after five years	34	34	4.86	—	—	—
	40,610	40,728	2.40	53,649	53,691	2.54
Asset-backed securities(1)	<u>23,406</u>	<u>23,366</u>	<u>2.66</u>	<u>20,941</u>	<u>21,025</u>	<u>3.07</u>
Total	<u>\$64,016</u>	<u>\$64,094</u>	<u>2.50%</u>	<u>\$74,590</u>	<u>\$74,716</u>	<u>2.69%</u>

(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.

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. 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 both June 30, 2002 and December 31, 2001, 96 percent of the Liquid Investment Portfolio had a credit rating of A or higher.

Financing and Other Activities

Fannie Mae's total debt outstanding increased 12 percent to \$789 billion at June 30, 2002 from \$702 billion at June 30, 2001. The cost of debt outstanding at June 30, 2002 decreased to 5.36 percent

from 5.49 percent at December 31, 2001 and 6.03 percent at June 30, 2001. Fannie Mae's financing activities for the first half of 2002 and 2001 are summarized below.

<u>Dollars in billions</u>	<u>Three Months Ended June 30,</u>		<u>Six Months Ended June 30,</u>	
	<u>2002</u>	<u>2001</u>	<u>2002</u>	<u>2001</u>
Debt issued	\$ 389	\$ 462	\$ 913	\$ 904
Average cost	2.27%	4.56%	2.19%	4.99%
Debt redeemed	\$ 372	\$ 427	\$ 890	\$ 845
Average cost	2.31%	4.97%	2.28%	5.52%

Option-embedded debt instruments as a percentage of the total net mortgage portfolio increased to 58 percent at the end of the second quarter of 2002 from 45 percent at the end of the second quarter of 2001. The following table presents the amount of option-embedded debt instruments as a percentage of mortgage purchases and the net mortgage portfolio at June 30, 2002 and June 30, 2001. Option-embedded debt instruments include the effect of derivative financial instruments.

<u>Dollars in billions</u>	<u>Three Months Ended June 30,</u>		<u>Six Months Ended June 30,</u>	
	<u>2002</u>	<u>2001</u>	<u>2002</u>	<u>2001</u>
Issued during the period	\$ 52	\$ 76	\$117	\$133
Percentage of total mortgage purchases	92%	117%	79%	108%
Outstanding at end of period	\$430	\$296	\$430	\$296
Percentage of total net mortgage portfolio	58%	45%	58%	45%

The following table disaggregates option-embedded financial instruments at the end of the second quarter of 2002 between callable and noncallable instruments. The table summarizes the amounts and call periods of callable debt, callable swaps, and receive-fixed swaptions, excluding \$9 billion of callable debt that was swapped to variable-rate debt, and includes 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.

<u>Dollars in millions</u>	<u>Call Date</u>	<u>Year of Maturity</u>	<u>Amount Outstanding</u>	<u>Average Cost</u>
Callable debt, callable swaps, and receive-fixed swaptions:				
	Currently callable	2004-2016	\$ 1,773	5.46%
		2002	56,188	5.09
		2003	78,939	5.39
		2004	66,278	6.07
		2005	19,493	6.27
		2006	20,859	6.30
		2007	10,859	6.58
	2008 and later	2012-2030	<u>9,975</u>	<u>7.15</u>
			264,364	5.75%
Pay-fixed swaptions			75,700	
Interest-rate caps			<u>89,693</u>	
Total option-embedded financial instruments			<u>\$ 429,757</u>	

Derivative Instruments

Derivative instruments are important tools that Fannie Mae uses to manage interest rate risk. Fannie Mae primarily uses derivatives as a substitute for notes and bonds it issues. The ability to either issue debt or modify debt through the derivatives markets increases the funding flexibility of the company and reduces overall funding costs. The funding flexibility created by derivatives helps Fannie

Mae match the duration of its debt with the duration of its mortgage assets. This duration matching helps reduce the interest rate risk of prepayments in the mortgage portfolio. 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.

The following table summarizes by derivative type Fannie Mae's derivatives activity for the quarter and six months ended June 30, 2002 and year ended December 31, 2001, the fair values of its derivatives at June 30, 2002, and the expected maturities of the derivative instruments outstanding as of June 30, 2002.

Derivative Activity and Maturity Data

(Dollars in millions)

	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)					
Notional Amounts:(1)								
Notional balance at January 1, 2001 . . .	\$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
Additions	9,807	5.50	1.90	12,694	5,640	30,400	95	58,636
Maturities	1,200	5.97	2.83	9,017	2,834	12,250	213	25,514
Notional balance at March 31, 2002 . . .	222,287	6.18	1.96	42,746	49,860	238,093	13,275	566,261
Additions	16,145	5.53	1.96	13,274	400	18,925	314	49,058
Maturities	1,675	6.67	2.02	5,779	3,850	5,950	3,572	20,826
Notional balance at June 30, 2002	<u>\$236,757</u>	<u>6.12%</u>	<u>1.99%</u>	<u>\$50,241</u>	<u>\$ 46,410</u>	<u>\$251,068</u>	<u>\$10,017</u>	<u>\$594,493</u>
Fair value at June 30, 2002(5)	<u>\$(13,057)</u>			<u>\$ 1,892</u>	<u>\$ 9</u>	<u>\$ 7,081</u>	<u>\$(710)</u>	<u>\$(4,785)</u>
Future Maturities of Notional Amounts:(6)								
2002	\$ 25,370	5.50%	2.00%	\$14,549	\$ 27,170	\$ 38,650	\$ 1,309	\$107,048
2003	26,230	5.03	1.98	9,995	16,690	55,643	497	109,055
2004	20,615	5.89	1.97	2,830	2,100	12,300	1,200	39,045
2005	16,300	6.43	1.99	5,375	—	1,750	624	24,049
2006	22,225	6.15	1.97	2,980	100	4,750	—	30,055
Thereafter	126,017	6.46	2.00	14,512	350	137,975	6,387	285,241
Total	<u>\$236,757</u>	<u>6.12%</u>	<u>1.99%</u>	<u>\$50,241</u>	<u>\$ 46,410</u>	<u>\$251,068</u>	<u>\$10,017</u>	<u>\$594,493</u>

- (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 \$35 billion, \$33 billion, and \$31 billion with weighted-average pay rates of 6.75 percent, 6.73 percent, and 6.64 percent and weighted-average receive rates of 2.00 percent, 1.96 percent, and 4.63 percent at June 30, 2002, March 31, 2002, and June 30, 2001, 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 June 30, 2002, 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 June 30, 2002 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 June 30, 2002 (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 June 30, 2002. At June 30, 2002, 7 counterparties represented approximately 74 percent of the total notional amount of outstanding derivatives transactions, and each had a credit rating of A or better.

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. 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 fair value of derivatives in a gain position after offsetting arrangements, such as master netting agreements and the value of related collateral, is the appropriate measure of Fannie Mae's exposure to counterparty default and the actual credit risk of derivative contracts.

Fannie Mae's derivative credit loss exposure, net of collateral held, was \$278 million at June 30, 2002, compared with \$110 million at December 31, 2001. As further discussed below, at June 30, 2002, 54 percent of Fannie Mae's exposure, net of collateral held, was with counterparties rated AA by Standard & Poor's. At December 31, 2001, 83 percent of Fannie Mae's exposure, net of collateral held, was with counterparties rated AA by Standard & Poor's. 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 (after taking into account master settlement agreements that allow for netting of payments, but before consideration of collateral held) was \$958 million at June 30, 2002, compared with \$766 million at December 31, 2001. Fannie Mae expects the credit exposure on derivative contracts to fluctuate as interest rates change. Fannie Mae held \$680 million of collateral through custodians for derivative instruments at June 30, 2002 and \$656 million of collateral at December 31, 2001.

The following table provides a summary of counterparty credit ratings for the exposure on derivatives in a gain position at June 30, 2002.

Derivative Credit Loss Exposure (1)

(Dollars in millions)

Credit Rating	Years to Maturity			Maturity Distribution Netting (2)	Exposure	Collateral Held	Exposure Net of Collateral
	Less than 1 year	1 to 5 years	Over 5 years				
AAA.....	\$—	\$—	\$ 4	\$ (4)	\$ —	\$ —	\$ —
AA.....	26	9	639	(428)	246	97	149
A.....	—	1	1,054	(343)	712	583	129
Total.....	<u>\$26</u>	<u>\$10</u>	<u>\$1,697</u>	<u>\$(775)</u>	<u>\$958</u>	<u>\$680</u>	<u>\$278</u>

(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.

Part of Fannie Mae's credit exposure of \$1.733 billion based on these maturity categories was offset by \$775 million of exposure that counterparties had to Fannie Mae, resulting in net exposure before consideration of collateral held of \$958 million to counterparties. At June 30, 2002, 100 percent

of Fannie Mae's exposure on derivatives before and after consideration of collateral held was with counterparties rated A or better by Standard & Poor's. Twenty-six percent of Fannie Mae's exposure before consideration of collateral held was with counterparties rated AA by Standard & Poor's and 54 percent of Fannie Mae's exposure net of collateral held was with counterparties rated AA by Standard & Poor's. Four counterparties accounted for approximately 91 percent and 70 percent of exposure on derivatives before and after consideration of collateral held, respectively, at June 30, 2002, and each had a credit rating of A or better.

Fannie Mae minimizes derivative credit risk by dealing only with very high credit quality and experienced counterparties, maintaining a conservative collateral management policy, and regularly monitoring counterparties. Fannie Mae's 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 has never experienced a loss on a derivative transaction due to credit default by a counterparty. Derivative counterparties are obligated to post specific types of collateral when Fannie Mae is exposed to credit losses exceeding agreed-upon thresholds that are based on counterparty credit ratings. Fannie Mae further reduces its net exposure on derivatives by generally requiring overcollateralization from counterparties whose credit ratings have dropped below predetermined credit rating levels. 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. All of the collateral posted by Fannie Mae counterparties at June 30, 2002 was in the form of cash or U.S. Treasury securities and was 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 the Notes to Financial Statements.

Capital Resources and Liquidity

Fannie Mae's core capital (defined as the stated value of outstanding common stock, the stated value of outstanding noncumulative perpetual preferred stock, paid-in capital, and retained earnings) increased to \$26.4 billion at June 30, 2002 from \$25.2 billion at December 31, 2001 and \$23.0 billion at June 30, 2001. Fannie Mae's core capital, which excludes accumulated other comprehensive income (AOCI), is a more accurate reflection of its capital resources than total stockholders' equity. AOCI is excluded from core capital because AOCI includes unrealized gains (losses) on derivatives and investment securities but does not include the related unrealized losses (gains) on items hedged by these derivatives nor the liabilities that fund the acquisition of investment securities.

Upon adoption of FAS 133 on January 1, 2001, Fannie Mae recorded a \$3.9 billion reduction in AOCI. The \$3.9 billion reduction in AOCI was attributable primarily 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 their fair values. FAS 133 requires that entities mark-to-market derivatives that qualify as cash flow hedges through AOCI to the extent they are effective hedges, but not the hedged items. Fannie Mae recorded a \$3.9 billion net decrease to AOCI during the second quarter of 2002 primarily related to a decrease in the fair value of derivatives used as cash flow hedges. During the second quarter of 2001, Fannie Mae recorded a \$1.8 billion increase to AOCI primarily related to an increase in the fair value of derivatives used as cash flow hedges.

Fannie Mae had approximately 993 million common shares outstanding as of June 30, 2002, compared with 997 million common shares outstanding as of December 31, 2001. Pursuant, in part, to the capital restructuring program described in the Information Statement under "MD&A—Balance Sheet Analysis—Liquidity and Capital Resources," Fannie Mae repurchased 3.3 million common shares at a weighted-average cost of \$78.06 and issued .5 million common shares for employee and other stock compensation plans during the second quarter of 2002. During the first half of 2002, Fannie Mae repurchased 10.8 million common shares at a weighted-average cost of \$78.20 and issued

6.3 million common shares for employee and other stock compensation plans and to fund its 2001 commitment of \$300 million to the Fannie Mae Foundation.

Also see “Subsequent Events—Capital Resources and Liquidity” on page 19.

As discussed in the Information Statement under “Government Regulation and Charter Act” and “MD&A—Balance Sheet Analysis—Regulatory Environment,” Fannie Mae is subject to capital standards. Fannie Mae met the applicable core capital standard as of June 30, 2002. On June 27, 2002, Fannie Mae’s regulator, Office of Federal Housing Enterprise Oversight (OFHEO), announced that had the company been subject to the risk-based capital standard as of March 31, 2002, Fannie Mae’s total capital exceeded the amount that would have been required by the risk-based capital standard by \$6.062 billion, or 23 percent. OFHEO has stated that it will not use its risk-based capital standard to classify Fannie Mae for regulatory purposes until the end of the third quarter of 2002. If the standard had been in effect at June 30, 2002, Fannie Mae believes it would have met the applicable OFHEO risk-based capital standard. Management expects to meet or exceed the applicable risk-based capital standard when effective.

As part of its voluntary adoption of measures to enhance disclosure, capital, and market discipline, Fannie Mae agreed to maintain more than three months worth of liquidity, assuming no access to the new issue debt markets, to reduce the possibility that the company’s operations could be disrupted during a significant financial crisis. Fannie Mae has a contingency plan in place to ensure funding needs are met for three months without access to the agency debt markets. Fannie Mae also committed to maintain at least five percent of on-balance-sheet assets in a liquid, marketable portfolio of nonmortgage securities and to maintain additional highly liquid securities in unencumbered form to facilitate liquidity. Fannie Mae’s liquid investments were 7.8 percent of Fannie Mae’s on-balance sheet assets at June 30, 2002.

Mortgage-Backed Securities

Fannie Mae issued \$135 billion of MBS during the second quarter of 2002, a decrease from \$143 billion issued in the second quarter of 2001. MBS issued for the first six months of 2002 totaled \$311 billion, up from \$227 billion in the first six months of 2001. The increase in MBS issued in the first half of 2002 was due to a decrease in interest rates and an increase in mortgage originations. REMIC issuances were \$22 billion in the second quarter of 2002 and \$58 billion in the first six months of 2002, compared with \$13 billion and \$22 billion, respectively, for the comparable periods of 2001.

The following table summarizes MBS activity for the three- and six-month periods ended June 30, 2002 and 2001.

Summary of MBS Activity

(Dollars in millions)

	MBS Issued			Outstanding (1)			Outstanding MBS Held by Other Investors
	Lender Originated Issues	MBS Purchased for Fannie Mae's Portfolio	MBS Issues Acquired by Others	Fannie Mae Risk	Lender or Shared Risk (2)	Total (3)	
Three Months Ended June 30,							
2002	\$132,042	\$29,133	\$102,909	\$1,181,044	\$223,550	\$1,404,594	\$945,100
2001	142,280	41,841	100,439	953,324	210,654	1,163,978	773,836
Six Months Ended June 30,							
2002	\$305,958	\$96,245	\$209,713				
2001	225,338	78,049	147,289				

(1) Based on primary default risk category. Includes MBS held by Fannie Mae and investors other than Fannie Mae. This table classifies lender originated issues and total MBS based on primary default risk category; however, Fannie Mae bears the ultimate risk of default on all MBS. Total MBS includes MBS that have been pooled to back Megas, SMBS, or REMICs.

(2) Included in lender or shared risk are \$174 billion and \$163 billion at June 30, 2002 and 2001, respectively, on which the lender or a third party agreed to bear default risk limited to a certain portion or percentage of the loans delivered and, in some cases, the lender has pledged collateral to secure that obligation.

(3) Includes \$459 billion and \$390 billion at June 30, 2002 and 2001, respectively, of MBS held by Fannie Mae.

Subsequent Events

Accounting for Stock-Based Compensation

On July 23, 2002, Fannie Mae announced its decision to recommend to its Board of Directors that Fannie Mae begin expensing all stock-based compensation with its next grant cycle pursuant to Financial Accounting Standard No. 123 (FAS 123), *Accounting for Stock-Based Compensation*. If Fannie Mae adopts this standard as of the beginning of 2002, the effect on EPS would be immaterial for the second quarter and the six months ended June 30, 2002.

Capital Resources and Liquidity

On July 31, 2002, Fannie Mae redeemed all of the outstanding shares of its 6.45 percent Series C preferred stock at \$50.27771 per share. The redemption price includes dividends of \$.27771 per share. At June 30, 2002, preferred stock made up 7.3 percent of Fannie Mae's core capital.

On July 16, 2002, the Board of Directors approved a dividend for the quarter ended June 30, 2002 of \$.33 per common share; and dividends of \$.65625 per Series D preferred share, \$.6375 per Series E preferred share, \$.4425 per Series F preferred share, \$.7529 per Series G preferred share, and \$.7263 per Series H preferred share for the period from and including June 30, 2002, to but excluding September 30, 2002.

On July 26, 2002, Fannie Mae issued \$1.5 billion of subordinated debt that received ratings of Aa2 from Moody's Investors Service, AA- from Standard & Poor's, and AA by Fitch Ratings. Fannie Mae's subordinated debt serves as an important supplement to Fannie Mae's equity capital, although it is not a component of core capital. 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. Subordinated debt totaled \$6.0 billion at June 30, 2002. Total capital and subordinated debt represented 3.5 percent of on-balance sheet assets at June 30, 2002 versus 3.4 percent at year-end 2001.

RECENT REGULATORY DEVELOPMENTS

The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (the “1992 Act”) established risk-based capital requirements for Fannie Mae. OFHEO published regulations under the 1992 Act in September 2001, as amended on March 15, 2002, establishing a risk-based capital test to determine the amount of total capital Fannie Mae must hold under the risk-based capital standard on a quarterly basis. (See the “Information Statement dated April 1, 2002—Government Regulation and Charter Act.”) Under the 1992 Act, the regulations will be enforceable one year after issuance. On June 27, 2002, OFHEO announced that Fannie Mae’s risk-based capital as of March 31, 2002 exceeded the risk-based capital that would be required by the risk-based capital rule.

On July 12, 2002, Fannie Mae announced that it will voluntarily register its common stock with the Securities and Exchange Commission (SEC) in 2003 under Section 12(g) of the Securities Exchange Act of 1934. As a result, Fannie Mae will file periodic reports with the SEC, including Annual Reports on Form 10-K, quarterly reports on Form 10-Q, and current reports on Form 8-K, together with any required exhibits. These filings will be available on the SEC’s EDGAR system. Registration of Fannie Mae’s common stock with the SEC will not impact the status of Fannie Mae’s securities as exempt securities within the meaning of the laws administered by the SEC.

MATTERS SUBMITTED TO STOCKHOLDERS

At the 2002 Annual Meeting of Stockholders of Fannie Mae held on May 21, 2002, the following matters were presented for a vote: (i) election of 13 members to the Board of Directors, each for a term ending on the date of the next Annual Meeting of Stockholders of Fannie Mae; (ii) ratification of the appointment of KPMG LLP as auditors of Fannie Mae for 2002; and (iii) a stockholder proposal to reinstate cumulative voting for directors. Under the stockholder proposal relating to cumulative voting, the Board of Directors would have been requested to take the necessary steps to provide for cumulative voting in the election of directors, which would mean that each stockholder would be entitled to as many votes as the number of common shares the stockholder owns, multiplied by the number of directors to be elected, and the stockholder could cast all such votes for a single candidate or distribute them among several nominees.

Of the 995,850,690 shares of common stock outstanding on the record date for the meeting, 840,212,326 shares were present in person or by proxy at the meeting.

The following persons were elected as directors of Fannie Mae by the respective votes indicated following their names: Stephen B. Ashley (828,062,523 votes for; 12,149,803 votes withheld); Kenneth M. Duberstein (823,392,617 votes for; 16,819,709 votes withheld); Stephen Friedman (827,985,827 votes for; 12,226,499 votes withheld); Thomas P. Gerrity (822,449,496 votes for; 17,762,830 votes withheld); Jamie S. Gorelick (823,932,265 votes for; 16,280,061 votes withheld); Ann McLaughlin Korologos (822,074,949 votes for; 18,137,377 votes withheld); Frederic V. Malek (822,220,535 votes for; 17,991,791 votes withheld); Donald B. Marron (827,992,182 votes for; 12,220,144 votes withheld); Daniel H. Mudd (823,648,520 votes for; 16,563,806 votes withheld); Anne M. Mulcahy (827,951,615 votes for; 12,260,711 votes withheld); Joe K. Pickett (828,054,356 votes for; 12,157,970 votes withheld); Franklin D. Raines (823,638,852 votes for; 16,573,474 votes withheld); H. Patrick Swygert (823,385,224 votes for; 16,827,102 votes withheld).

As noted under “Management,” the President of the United States has the authority to appoint five directors.

The ratification of KPMG LLP as auditors was approved by a vote of 806,714,140 for ratification and 28,790,420 against ratification. The stockholder proposal to reinstate cumulative voting was defeated by a vote of 162,908,583 for the proposal and 574,367,047 against the proposal.

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INDEPENDENT ACCOUNTANTS' REVIEW REPORT

To the Board of Directors and Stockholders of Fannie Mae:

We have reviewed the accompanying condensed balance sheet of Fannie Mae as of June 30, 2002 and the related condensed statements of income, changes in stockholders' equity, and cash flows for the three- and six-month periods ended June 30, 2002 and 2001. These condensed financial statements are the responsibility of Fannie Mae's management.

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

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

We have previously audited, in accordance with auditing standards generally accepted in the United States of America, the balance sheet of Fannie Mae as of December 31, 2001 (presented herein in condensed form) and the related statements of income, changes in stockholders' equity and cash flows for the year then ended (not presented herein); and in our report dated January 10, 2002, we expressed an unqualified opinion on those financial statements. In our opinion, the information set forth in the accompanying condensed balance sheet as of December 31, 2001, is fairly stated, in all material respects, in relation to the balance sheet from which it has been derived.

KPMG LLP

Washington, D.C.
July 11, 2002

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2002	2001	2002	2001
	(Dollars in millions, except per common share amounts)			
Interest income	\$12,746	\$12,218	\$25,323	\$24,213
Interest expense	10,214	10,319	20,360	20,606
Net interest income	2,532	1,899	4,963	3,607
Guaranty fee income	423	357	831	700
Fee and other income, net	42	25	45	52
Credit-related expenses	(24)	(17)	(46)	(47)
Administrative expenses	(301)	(254)	(591)	(494)
Purchased options income (expense)	(498)	35	(1,286)	(202)
Debt extinguishments	(225)	(142)	(396)	(226)
Income before federal income taxes and cumulative effect of change in accounting principle	1,949	1,903	3,520	3,390
Provision for federal income taxes	(485)	(500)	(848)	(862)
Income before cumulative effect of change in accounting principle	1,464	1,403	2,672	2,528
Cumulative effect of change in accounting principle, net of tax effect	—	—	—	168
Net income	<u>\$ 1,464</u>	<u>\$ 1,403</u>	<u>\$ 2,672</u>	<u>\$ 2,696</u>
Preferred stock dividends	(24)	(35)	(57)	(68)
Net income available to common stockholders	<u>\$ 1,440</u>	<u>\$ 1,368</u>	<u>\$ 2,615</u>	<u>\$ 2,628</u>
Basic earnings per common share:				
Earnings before cumulative effect of change in accounting principle	\$ 1.45	\$ 1.37	\$ 2.63	\$ 2.46
Cumulative effect of change in accounting principle	—	—	—	.17
Net earnings	<u>\$ 1.45</u>	<u>\$ 1.37</u>	<u>\$ 2.63</u>	<u>\$ 2.63</u>
Diluted earnings per common share:				
Earnings before cumulative effect of change in accounting principle	\$ 1.44	\$ 1.36	\$ 2.61	\$ 2.44
Cumulative effect of change in accounting principle	—	—	—	.17
Net earnings	<u>\$ 1.44</u>	<u>\$ 1.36</u>	<u>\$ 2.61</u>	<u>\$ 2.61</u>

CONDENSED BALANCE SHEETS
(Unaudited)

	June 30, 2002	December 31, 2001
	(Dollars in millions)	
Assets		
Mortgage portfolio, net	\$740,590	\$705,167
Investments	63,991	74,554
Derivatives in gain positions	1,198	954
Other assets	20,898	19,116
Total assets	<u>\$826,677</u>	<u>\$799,791</u>
Liabilities		
Debentures, notes, and bonds, net:		
Due within one year	\$358,814	\$343,492
Due after one year	430,095	419,975
Derivatives in loss positions	5,983	5,069
Other liabilities	14,055	13,137
Total liabilities	<u>808,947</u>	<u>781,673</u>
Stockholders' equity		
Accumulated other comprehensive income (loss)	(8,652)	(7,065)
Core capital	26,382	25,183
Total stockholders' equity	<u>17,730</u>	<u>18,118</u>
Total liabilities and stockholders' equity	<u>\$826,677</u>	<u>\$799,791</u>

See Notes to Interim Financial Statements

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

	<u>Three Months</u> <u>Ended June 30,</u>		<u>Six Months</u> <u>Ended June 30,</u>	
	<u>2002</u>	<u>2001</u>	<u>2002</u>	<u>2001</u>
	(Dollars in millions)			
Balance, beginning of period	\$20,753	\$16,086	\$18,118	\$20,838
Comprehensive income:				
Net income	1,464	1,403	2,672	2,696
Other comprehensive income, net of tax effect:				
Transition adjustment from the adoption of FAS 133	—	—	—	(3,973)
Unrealized gain on securities transferred to available-for-sale upon adoption of FAS 133	—	—	—	86
Cash flow hedging gains (losses), net	(4,680)	1,999	(2,154)	273
Unrealized gains (losses) on securities, net	775	(150)	567	57
Total comprehensive income (loss)	(2,441)	3,252	1,085	(861)
Dividends	(353)	(335)	(714)	(668)
Shares repurchased	(256)	—	(841)	(77)
Preferred stock issued	—	395	—	395
Preferred stock redeemed	—	—	(375)	(375)
Treasury stock issued for stock options, benefit plans, and special contribution	27	33	457	179
Balance, end of period	<u>\$17,730</u>	<u>\$19,431</u>	<u>\$17,730</u>	<u>\$19,431</u>

CONDENSED STATEMENTS OF CASH FLOWS
(Unaudited)

	<u>Three Months</u> <u>Ended June 30,</u>		<u>Six Months</u> <u>Ended June 30,</u>	
	<u>2002</u>	<u>2001</u>	<u>2002</u>	<u>2001</u>
	(Dollars in millions)			
Net cash provided by operating activities	\$ 2,757	\$ 4,293	\$ 6,858	\$ 7,150
Cash flows from investing activities:				
Purchases of mortgages	(58,138)	(65,068)	(148,999)	(123,773)
Proceeds from sales of mortgages	3,723	1,388	6,783	3,961
Mortgage principal repayments	45,605	41,638	106,972	65,672
Net (increase) decrease in investments	(7,639)	(14,156)	10,575	(3,276)
Net cash used in investing activities	(16,449)	(36,198)	(24,669)	(57,416)
Cash flows from financing activities:				
Proceeds from issuance of debt	387,798	459,479	910,269	897,899
Payments to redeem debt	(372,815)	(426,421)	(890,169)	(845,032)
Other	(1,357)	(1,138)	(2,934)	(2,394)
Net cash provided by financing activities	13,626	31,920	17,166	50,473
Net increase (decrease) in cash and cash equivalents	(66)	15	(645)	207
Cash and cash equivalents at beginning of period	939	809	1,518	617
Cash and cash equivalents at end of period	<u>\$ 873</u>	<u>\$ 824</u>	<u>\$ 873</u>	<u>\$ 824</u>

See Notes to Interim Financial Statements

NOTES TO INTERIM FINANCIAL STATEMENTS
(Unaudited)

Basis of Presentation

The accompanying unaudited condensed financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Certain amounts in 2001 have been reclassified to conform with the current presentation. Operating results for the three- and six-month periods ended June 30, 2002 are not necessarily indicative of the results that may be expected for the year ending December 31, 2002. The unaudited interim financial statements should be read in conjunction with the audited financial statements and notes to financial statements that are presented in the Information Statement dated April 1, 2002.

During the second quarter of 2002, Fannie Mae adopted Financial Accounting Standard No. 145 (FAS 145), *Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections*, which eliminates extraordinary treatment of the gains/losses on Fannie Mae's debt repurchases. For comparative purposes, all prior periods presented have been reclassified to reflect this revised reporting.

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, and interest rate caps, 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.

On 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*. The adoption of FAS 133 resulted in a cumulative after-tax increase to income of \$168 million and an after-tax reduction in accumulated other comprehensive income (AOCI) of \$3.9 billion. 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.

The following table reflects the hedge classification of the notional balances of derivatives by type that were held by Fannie Mae at June 30, 2002 and December 31, 2001.

	June 30, 2002			December 31, 2001		
	Cash Flow Hedges	Fair Value Hedges	Total	Cash Flow Hedges	Fair Value Hedges	Total
	(Dollars in millions)					
Interest rate swaps:						
Pay-fixed	\$223,414	\$ 13,343	\$236,757	\$206,617	\$ 7,063	\$213,680
Receive-fixed and basis	81,487	15,164	96,651	75,134	10,989	86,123
Interest rate caps	89,693	—	89,693	75,893	—	75,893
Swaptions:						
Pay-fixed	75,700	—	75,700	69,650	—	69,650
Receive-fixed	5,775	79,900	85,675	—	74,400	74,400
Other(1)	4,773	5,244	10,017	4,550	8,843	13,393
Total	<u>\$480,842</u>	<u>\$113,651</u>	<u>\$594,493</u>	<u>\$431,844</u>	<u>\$101,295</u>	<u>\$533,139</u>

(1) Includes foreign currency swaps, forward starting swaps, asset swaps, and other derivatives used to hedge anticipated debt issues.

The reconciliation below reflects the change in AOCI, net of taxes, associated with FAS 133 from December 31, 2001 through June 30, 2002:

Dollars in millions

Balance at December 31, 2001	\$(7,359)
Gains on cash flow hedges, net	1,193
Reclassifications to earnings, net	<u>1,333</u>
Balance at March 31, 2002	(4,833)
Losses on cash flow hedges, net	(6,076)
Reclassifications to earnings, net	<u>1,396</u>
Balance at June 30, 2002	<u><u>\$(9,513)</u></u>

At June 30, 2002, Fannie Mae was hedging an anticipatory issuance of \$250 million in debt that is expected to be issued in 18 days.

Line of Business Reporting

The following table sets forth Fannie Mae's operating net income, which excludes the effect of certain FAS 133 items, by line of business for the three- and six-month periods ended June 30, 2002 and 2001. Significant changes from period to period were due to the same factors discussed under "Results of Operations." Certain amounts for 2001 have been reclassified to conform with the allocation method used for 2002.

Three Months Ended June 30,	2002			2001		
	Portfolio Investment	Credit Guaranty	Total	Portfolio Investment	Credit Guaranty	Total
	(Dollars in millions)					
Net interest income	\$2,375	\$ 157	\$2,532	\$1,701	\$ 198	\$1,899
Guaranty fee income	(336)	759	423	(270)	627	357
Fee and other income (expense)	82	(40)	42	37	(12)	25
Credit-related expenses	—	(24)	(24)	—	(17)	(17)
Administrative expenses	(91)	(210)	(301)	(77)	(177)	(254)
Purchased options expense	(330)	—	(330)	(100)	—	(100)
Debt extinguishment	(225)	—	(225)	(142)	—	(142)
Federal income taxes	<u>(430)</u>	<u>(114)</u>	<u>(544)</u>	<u>(318)</u>	<u>(136)</u>	<u>(454)</u>
Operating net income(1)	<u>\$1,045</u>	<u>\$ 528</u>	<u>\$1,573</u>	<u>\$ 831</u>	<u>\$ 483</u>	<u>\$1,314</u>

<u>Six Months Ended June 30,</u>	<u>2002</u>			<u>2001</u>		
	<u>Portfolio Investment</u>	<u>Credit Guaranty</u>	<u>Total</u>	<u>Portfolio Investment</u>	<u>Credit Guaranty</u>	<u>Total</u>
	(Dollars in millions)					
Net interest income	\$4,647	\$ 316	\$ 4,963	\$3,236	\$ 371	\$3,607
Guaranty fee income	(654)	1,485	831	(533)	1,233	700
Fee and other income (expense)	142	(97)	45	71	(19)	52
Credit-related expenses	—	(46)	(46)	—	(47)	(47)
Administrative expenses	(176)	(415)	(591)	(149)	(345)	(494)
Purchased options expense	(641)	—	(641)	(164)	—	(164)
Debt extinguishment	(396)	—	(396)	(226)	—	(226)
Federal income taxes	(858)	(216)	(1,074)	(624)	(251)	(875)
Operating net income(1)	<u>\$2,064</u>	<u>\$1,027</u>	<u>\$ 3,091</u>	<u>\$1,611</u>	<u>\$ 942</u>	<u>\$2,553</u>

- (1) Operating net income excludes the cumulative after-tax gain of \$168 million from the change in accounting principle upon adoption of FAS 133 on January 1, 2001. Also excludes the after-tax expense of \$324 million and \$836 million recognized during the second quarter and first half of 2002 and after-tax income of \$24 million and after-tax expense of \$131 million recognized during the second quarter and first half of 2001 for the change in fair value of the time value of purchased options. Includes after-tax expense for the amortization expense of purchased option premiums of \$215 million and \$417 million for the second quarter and first half of 2002 and \$65 million and \$106 million for the second quarter and first half of 2001.

For the credit guaranty business, GAAP net income and operating net income are the same.

The Portfolio Investment line of business represented \$810 billion, or 98 percent of total assets, at June 30, 2002 and \$724 billion, or 98 percent of total assets, at June 30, 2001.

Commitments and Contingencies

Fannie Mae had outstanding commitments to purchase mortgages, to issue MBS, and to make other investments as shown below:

	<u>June 30, 2002</u>
	(Dollars in billions)
Commitments to purchase mortgages:	
Mandatory delivery	\$ 27
Lender option(1)	3
Average net yield on mandatory delivery	6.27%
Master commitments:	
Mandatory delivery(2)	\$ 27
Lender option	13
Other investments	2

- (1) Excludes commitments attached to master commitments, which are included in the total for master commitments.
- (2) Under a mandatory master commitment, a lender must either deliver under an MBS contract at a specified guaranty fee or enter into a mandatory portfolio commitment with the yield established upon executing the portfolio commitment.

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

	<u>June 30, 2002</u>
	(Dollars in billions)
Total MBS outstanding(1)	\$1,404
Amount for which Fannie Mae has primary foreclosure loss risk(2)	1,181
Credit enhancements	4
Other guarantees	7

(1) Includes \$459 billion of MBS held by Fannie Mae, net of \$596 million in allowance for losses.

(2) Fannie Mae, however, assumes the ultimate risk of loss on all MBS.

Computation of Earnings per Common Share

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

	<u>Three Months</u> <u>Ended June 30,</u>				<u>Six Months</u> <u>Ended June 30,</u>			
	<u>2002</u>		<u>2001</u>		<u>2002</u>		<u>2001</u>	
	<u>Basic</u>	<u>Diluted</u>	<u>Basic</u>	<u>Diluted</u>	<u>Basic</u>	<u>Diluted</u>	<u>Basic</u>	<u>Diluted</u>
	(Dollars and shares in millions, except per common share amounts)							
Net income before cumulative effect of change in accounting principle	\$1,464	\$1,464	\$1,403	\$1,403	\$2,672	\$2,672	\$2,528	\$2,528
Less:								
Cumulative effect of change in accounting principle	—	—	—	—	—	—	168	168
Preferred stock dividends	(24)	(24)	(35)	(35)	(57)	(57)	(68)	(68)
Net income available to common stockholders	<u>\$1,440</u>	<u>\$1,440</u>	<u>\$1,368</u>	<u>\$1,368</u>	<u>\$2,615</u>	<u>\$2,615</u>	<u>\$2,628</u>	<u>\$2,628</u>
Weighted average common shares	995	995	1,001	1,001	996	996	1,001	1,001
Dilutive potential common shares(1)	—	5	—	6	—	5	—	6
Average number of common shares outstanding used to calculate earnings per common share	<u>995</u>	<u>1,000</u>	<u>1,001</u>	<u>1,007</u>	<u>996</u>	<u>1,001</u>	<u>1,001</u>	<u>1,007</u>
Earnings per common share before cumulative effect of change in accounting principle	\$ 1.45	\$ 1.44	\$ 1.37	\$ 1.36	\$ 2.63	\$ 2.61	\$ 2.46	\$ 2.44
Net earnings per common share	1.45	1.44	1.37	1.36	2.63	2.61	2.63	2.61

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

MANAGEMENT

The President of the United States has the authority to appoint five members of Fannie Mae's eighteen-member Board of Directors. In May, the President reappointed Victor H. Ashe, Molly H. Bordonaro, William R. Harvey, Manual J. Justiz, and Taylor C. Segue, III to Fannie Mae's Board of Directors for a term expiring on the date of the May 2003 annual meeting of the stockholders.

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