

Prospectus

Federal National Mortgage Association



Guaranteed Mortgage Pass-Through Certificates

(Residential Mortgage Loans)

Principal and Interest payable on the 25th day of each month

THE OBLIGATIONS OF THE FEDERAL NATIONAL MORTGAGE ASSOCIATION UNDER ITS GUARANTY ARE OBLIGATIONS SOLELY OF THE CORPORATION AND ARE NOT BACKED BY THE FULL FAITH AND CREDIT OF THE UNITED STATES. THE CERTIFICATES ARE EXEMPT FROM THE REGISTRATION REQUIREMENTS OF THE SECURITIES ACT OF 1933 AND ARE "EXEMPTED SECURITIES" WITHIN THE MEANING OF THE SECURITIES EXCHANGE ACT OF 1934.

The Guaranteed Mortgage Pass-Through Certificates ("Certificates") are issued and guaranteed by the Federal National Mortgage Association (the "Corporation" or "Fannie Mae"), a corporation organized and existing under the laws of the United States, under the authority contained in Section 304(d) of the Federal National Mortgage Association Charter Act (12 U.S.C. 1716 *et seq.*).

Each Certificate offered hereby and by the Supplement related hereto will represent an undivided interest in a pool of mortgage loans (a "Pool") to be formed by the Corporation. Each Pool will consist of residential mortgage loans ("Mortgage Loans") either previously owned by the Corporation or purchased by it in connection with the formation of the Pool. Each Pool will consist entirely of one of the following: (i) fixed-rate level installment Mortgage Loans, (ii) fixed-rate growing equity Mortgage Loans that provide for scheduled annual increased payments, with the full amount of the increase applied to principal, (iii) fixed-rate graduated payment Mortgage Loans having deferred interest features, (iv) conventional variable-rate California Mortgage Loans, (v) other adjustable-rate Mortgage Loans, and (vi) fixed-rate Mortgage Loans secured by multifamily projects consisting of five or more dwelling units, some of which multifamily Mortgage Loans may have balloon payments or other irregular features or characteristics.

Interests in each Pool will be evidenced by a separate issue of Certificates. Information regarding the aggregate principal amount and characteristics of the related Pool (including the type of Mortgage Loans in the Pool) will be furnished in a Supplement to this Prospectus at the time of the identification of the Pool.

Unless the related Supplement to this Prospectus provides otherwise, Certificates evidencing undivided interests in Pools formed on or after May 1, 1985, and containing Mortgage Loans of the type described in (i), (ii), (iv), or (v) above, will be available in book-entry form only.

The Corporation will have certain contractual servicing responsibilities with respect to each Pool. In addition, the Corporation will be obligated to distribute scheduled monthly installments of principal and interest (adjusted to reflect the Corporation's servicing and guaranty fee) to Certificateholders, whether or not received. The Corporation also will be obligated to distribute to Certificateholders the full principal balance of any foreclosed Mortgage Loan, whether or not such principal balance is actually recovered.

The date of this Prospectus is September 4, 1986

Retain this Prospectus for future reference. This Prospectus may not be used to consummate sales of Certificates unless accompanied by a Prospectus Supplement.

No salesman, dealer, bank or other person has been authorized to give any information or to make any representation other than those contained in this Prospectus and, if given or made, such information or representation must not be relied upon as having been authorized by the Corporation. This Prospectus does not constitute an offer to sell or a solicitation of an offer to buy any securities other than the Certificates offered hereby and by the related Supplement nor an offer of the Certificates to any person in any state or other jurisdiction in which such offer would be unlawful.

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SUMMARY OF PROSPECTUS

The following summary of certain pertinent information is qualified in its entirety by reference to the detailed information appearing elsewhere in this Prospectus and by reference to the information with respect to each pool of residential mortgage loans ("Mortgage Loans") contained in the supplement to this Prospectus (a "Prospectus Supplement") to be prepared in connection with the issue of Guaranteed Mortgage Pass-Through Certificates (the "Certificates") evidencing undivided interests in such pool of Mortgage Loans ("Pool").

Title of Security	Guaranteed Mortgage Pass-Through Certificates.
Issuer and Guarantor	Federal National Mortgage Association (the "Corporation"), a corporation organized and existing under the laws of the United States. See "Federal National Mortgage Association" and the remainder of the Prospectus following that section. The obligations of the Corporation under its guaranty are obligations solely of the Corporation and are not backed by, nor entitled to, the full faith and credit of the United States.
Description of Security	Each Certificate will represent a fractional undivided interest in a Pool of Mortgage Loans to be formed by the Corporation. A Certificate will initially represent at least \$25,000 unpaid principal amount of Mortgage Loans. Unless the related Supplement to this Prospectus provides otherwise, Certificates evidencing undivided interests in Pools formed on or after May 1, 1985, and containing Mortgage Loans of the type described in (i), (ii), (iv) or (v) under "The Mortgage Pools" below, will be available in book-entry form only and will not be convertible to definitive form.
Interest	Interest on each Mortgage Loan will be passed through monthly to Certificateholders, commencing on the 25th day of the month following the month of initial issuance of the related Certificates. For all Pools containing fixed-rate Mortgage Loans ("Fixed-Rate Pools"), interest will be passed through at a uniform Pass-Through Rate (or Accrual Rate in the case of Fixed-Rate Pools containing graduated payment mortgage loans), which will be specified in the Prospectus Supplement and will not be greater than the lowest annual interest rate borne by any Mortgage Loan in the related Pool, less a specified minimum annual percentage representing compensation for servicing and the Corporation's guaranty and less, in the case of Fixed-Rate Pools containing graduated payment Mortgage Loans, deferred interest, which is added to the principal balances of the underlying Mortgage Loans. For Pools containing variable-rate Mortgage Loans ("VRM Pools"), interest will be passed through on the basis of a Weighted Average Pass-Through Rate, which is equal at any time to the then-current weighted average of the Mortgage Interest Rates of all Mortgage Loans in the related VRM Pool, less a specified fixed annual percentage representing compensation for servicing and the Corporation's guaranty. For Pools containing adjustable-rate Mortgage Loans ("ARM Pools"), interest will be passed through on each Mortgage Loan at the interest rate at the time applicable thereto less (i) the Corporation's fixed servicing and guaranty fee applicable to such Mortgage Loan and (ii) any deferred interest that is added to the principal balance of such Mortgage Loan pursuant to its terms. See "Yield Considerations."
Principal (including prepayments)	Passed through monthly, commencing on the 25th day of the month following the month of initial issuance of the related Certificates. See "Maturity and Prepayment Assumptions" and "Description of Certificates."

Guaranty .

The Corporation is obligated to distribute scheduled monthly installments of principal and interest (adjusted to reflect the Corporation's servicing and guaranty fee) on the Mortgage Loans in a Pool, whether or not received. The Corporation is also obligated to distribute to Certificateholders the full principal balance of any foreclosed Mortgage Loan, whether or not such principal balance is actually recovered. If the Corporation were unable to perform these guaranty obligations, distributions to Certificateholders would consist solely of payments and other recoveries on Mortgage Loans and, accordingly, delinquencies and defaults would affect monthly distributions to Certificateholders. See "Description of Certificates—The Corporation's Guaranty."

Servicing

The Corporation will be responsible for servicing the Mortgage Loans and will, in most cases, contract with mortgage lenders to perform certain servicing functions on its behalf. See "Description of Certificates—Servicing Through Lenders."

The Mortgage Pools

Each Pool will consist entirely of Mortgage Loans of only one of the following types: (i) fixed-rate level installment Mortgage Loans, (ii) fixed-rate growing equity Mortgage Loans that provide for scheduled annual increased payments, with the full amount of the increase applied to principal, (iii) fixed-rate graduated payment Mortgage Loans with deferred interest features, (iv) conventional variable-rate California Mortgage Loans, (v) other adjustable-rate Mortgage Loans, and (vi) fixed-rate Mortgage Loans secured by multifamily projects consisting of five or more dwelling units, some of which multifamily Mortgage Loans may have balloon payments or other irregular features or characteristics. The Mortgage Loans in each Pool will have unpaid principal balances aggregating not less than \$1,000,000. Each Mortgage Loan will be secured by a first lien on a residential property and each Mortgage Loan will meet the applicable standards set forth under "Purchase Program." Pool information as to the type of Mortgage Loans (including whether such Mortgage Loans are conventional Mortgage Loans or are insured by the Federal Housing Administration or guaranteed by the Veterans Administration), the aggregate principal balance of the Mortgage Loans as of the Issue Date, the Pass-Through Rate for Certificates evidencing interests in level installment Fixed-Rate Pools, the then-current Weighted Average Pass-Through Rate for Certificates evidencing interests in VRM Pools, the Accrual Rate for Certificates evidencing interests in graduated payment Fixed-Rate Pools, and the latest maturity date of any Mortgage Loan will be contained in the related Prospectus Supplement. For a VRM Pool or an ARM Pool, the related Prospectus Supplement will also contain information respecting the index upon which adjustments are based, the frequency of interest rate and payment adjustments and any maximum or minimum limitations thereon, the Corporation's fixed guaranty and servicing fee, and, in the case of an ARM Pool, whether the underlying Mortgage Loans contain provisions for the deferral of interest.

Financial Results

The Corporation was profitable during 1985 and the first six months of 1986 after experiencing a loss for the year 1984. The Corporation operated profitably in 1983. The primary reason for the loss in 1984 was the excess in the cost of the Corporation's outstanding debt over the yield on its mortgage portfolio (or "negative spread"). During 1985 and in 1983, the Corporation's negative spread was substantially less than in 1984 and its impact was more than offset by income from other sources. The Corporation had a positive spread on its portfolio during the first six months of 1986. See "Selected Financial Data," "Management's Discussion and Analysis of Financial Results," and "Mortgage Portfolio Spread."

THE MORTGAGE POOLS

The Federal National Mortgage Association (the "Corporation") has implemented a program for (a) the setting aside of residential mortgage loans (the "Mortgage Loans") into separate pools (the "Pools") bearing distinctive identification and (b) the issuance and sale of trust certificates of beneficial interest evidencing pro rata undivided ownership interests in the Mortgage Loans comprising each separate Pool (the "Guaranteed Pass-Through Certificates" or "Certificates"). The Mortgage Loans may be purchased by the Corporation expressly for the Pools or may be Mortgage Loans that have been held by the Corporation in its own portfolio. Each Pool will consist of Mortgage Loans evidenced by promissory notes (the "Mortgage Notes") secured by first mortgages or deeds of trust (the "Mortgages") on either one- to four-family residential properties or multifamily projects consisting of five or more dwelling units (the "Mortgaged Properties"). A Pool will contain Mortgage Loans of only one of the following types: (i) fixed-rate level payment Mortgage Loans ("Level Payment Mortgage Loans"), (ii) fixed-rate growing equity Mortgage Loans that provide for scheduled annual increased payments, with the full amount of the increase applied to principal ("GEMs"), (iii) fixed-rate graduated payment Mortgage Loans with deferred interest features ("GPMs"), (iv) conventional variable-rate California Mortgage Loans ("VRMs"), (v) other adjustable-rate Mortgage Loans ("ARMs"), and (vi) fixed-rate Mortgage Loans secured by multifamily projects consisting of five or more dwelling units ("Multifamily Mortgage Loans"), some of which Multifamily Mortgage Loans may have balloon payments or other irregular features or characteristics. The Mortgage Loans may be either conventional Mortgage Loans (i.e., not insured or guaranteed by any United States government agency) or Mortgage Loans that are either insured by the Federal Housing Administration or guaranteed by the Veterans Administration ("Conventional Mortgage Loans" and "FHA/VA Mortgage Loans," respectively). The Mortgage Loans purchased expressly for the Pools will be sold to the Corporation by eligible institutions that meet certain requirements set forth under "Purchase Program" and are referred to herein as "Lenders." No Pool will consist of Mortgage Loans having an aggregate unpaid principal balance of less than \$1,000,000 on the first day of the month of issuance of the related Certificates. See "Purchase Program—Mortgage Loan Eligibility" for a description of certain criteria applicable to the eligibility of Mortgage Loans for inclusion in Pools.

Interests in each Pool will be evidenced by a separate series of Certificates (an "Issue"). The Corporation will acquire the Mortgage Loans that it has purchased expressly for Pools under purchase contracts. By entering into such contracts, the Corporation will obligate itself to issue Certificates to, or to the order of, the Lenders named in the contracts, upon delivery to the Corporation of the required Mortgage Loans conforming to the Corporation's standards. The Corporation will not insure or guarantee the performance by any Lender of its obligation to deliver Mortgage Loans and, correspondingly, does not insure or guarantee the performance by any person of any obligation to deliver Certificates.

The Mortgage Loans in each Pool of fixed-rate Mortgage Loans other than GPMs will be held for the benefit of the holders of Certificates ("Certificateholders" or "Holders") pursuant to the combined terms of a trust indenture, as amended, executed by the Corporation in its corporate capacity and in its capacity as Trustee (the Trust Indenture dated as of November 1, 1981, as modified and amended by a First Supplemental Indenture dated as of February 15, 1982, a Second Supplemental Indenture dated as of October 1, 1982, a Third Supplemental Indenture dated as of August 1, 1983, a Fourth Supplemental Indenture dated as of May 1, 1984, a Fifth Supplemental Indenture dated as of July 1, 1984, a Sixth Supplemental Indenture dated as of May 1, 1985, and a Seventh Supplemental Indenture dated as of August 1, 1986, being herein called the "Fixed-Rate Trust Indenture"), and a supplement thereto for the related Issue (the "Issue Supplement"). The Mortgage Loans in each Pool of VRMs will be held for the benefit of Certificateholders pursuant to the combined terms of an Issue Supplement and a Trust Indenture dated as of July 1, 1982, as modified and amended by a First Supplemental Indenture dated as of December 1, 1983, a Second

Supplemental Indenture dated as of September 1, 1984, a Third Supplemental Indenture dated as of February 1, 1985, and a Fourth Supplemental Indenture dated as of August 1, 1985, each executed by the Corporation in its corporate capacity and in its capacity as Trustee (such Trust Indenture, as amended, being hereinafter called the "VRM Trust Indenture"). The Mortgage Loans in each Pool of GPMs and ARMs will be held for the benefit of the Certificateholders pursuant to the combined terms of an Issue Supplement and a Trust Indenture dated as of July 1, 1984 (the "GPM Trust Indenture") and a Trust Indenture dated as of July 1, 1984, as modified and amended by a First Supplemental Indenture dated as of May 1, 1985 (the "ARM Trust Indenture"), respectively, each executed by the Corporation in its corporate capacity and in its capacity as Trustee. The Fixed-Rate Trust Indenture, the VRM Trust Indenture, the GPM Trust Indenture, and the ARM Trust Indenture are herein, collectively, referred to as the "Trust Indenture" or "TI" where common terms and provisions are being referred to or described. Certain capitalized words or series of words in this Prospectus refer to and are further defined in the Trust Indenture. The Corporation will be responsible for the administration and servicing of the Mortgage Loans in the Pool, including the supervision of the servicing activities of Lenders, if appropriate, the collection and receipt of payments from Lenders, and the remittance of distributions and certain reports to Certificateholders. The Corporation will be entitled to receive a fee for its guaranty obligations and its services pursuant to the Trust Indenture. The fee to the Corporation for any Mortgage Loan (out of which it will compensate Lenders for servicing the Mortgage Loans) will, as to any Pool containing fixed-rate Mortgage Loans (a "Fixed-Rate Pool"), be equal to the difference between the annual interest rate borne by the Mortgage Loan and the annual rate of interest paid to Certificateholders at the Pass-Through Rate for the related Fixed-Rate Pool or the Accrual Rate for Fixed-Rate Pools containing GPMs (a "GPM Pool"). For any Pool containing ARMs or VRMs (an "ARM Pool" or "VRM Pool"), the Corporation will similarly compensate itself from interest payments on the underlying ARMs or VRMs in an amount, as to each ARM or VRM Pool, determinable from information in the related Prospectus Supplement. The Corporation will reserve 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 Certificateholders. In such event, the Corporation will meet its obligation to provide servicing either by directly servicing the Mortgage Loans itself or by finding a replacement Lender that meets the eligibility standards.

The Corporation's obligations with respect to the Mortgage Loans will be limited to the servicing responsibilities under the Trust Indenture, and, in the event of any delinquency in payment or loss on any Mortgage Loan, its obligation to make supplemental payments in amounts described herein under "Description of Certificates—The Corporation's Guaranty."

Because the principal amount of the Mortgage Loans in a Pool will decline (with the exception of Fixed-Rate Pools containing GPMs and certain ARM Pools that contain ARMs providing for deferred interest) monthly as principal payments, including prepayments, are received, each Certificate Principal Balance (defined as to any Certificate to be the principal amount of Mortgage Loans in the related Pool evidenced thereby) will also decline over time. See "Maturity and Prepayment Assumptions."

YIELD CONSIDERATIONS

Effect of Delay

The effective yield to Certificateholders in all Pools will be reduced slightly below the yield otherwise produced by the applicable Pass-Through Rate, Accrual Rate or Weighted Average Pass-Through Rate because the distribution of interest that accrues from the first day of each month will not be made until the 25th day of the month following the month of accrual.

Fixed-Rate Pools Not Containing GPMs

Each Fixed-Rate Pool not containing GPMs will consist of Mortgage Loans that bear simple interest at fixed annual rates ("Mortgage Interest Rates"). Such a Fixed-Rate Pool may include

Mortgage Loans that bear different Mortgage Interest Rates. The Pass-Through Rate of interest payable to Certificateholders of each such Issue will be equal to the lowest Mortgage Interest Rate borne by any Mortgage Loan in the related Pool, less a specified minimum annual percentage representing compensation for servicing and the Corporation's guaranty. Because the Pass-Through Rate for an Issue will not be greater than the lowest Mortgage Interest Rate for the related Pool, any disproportionate principal prepayments among Mortgage Loans bearing different Mortgage Interest Rates will not affect the return to Certificateholders.

When a Mortgage Loan is prepaid or otherwise liquidated, the proceeds of such prepayment or liquidation will, unless the Corporation elects in its discretion to make any distribution thereof in the following month, be passed through to Certificateholders in the second month following the month of such prepayment or other liquidation. Because the Corporation agrees to distribute on each Distribution Date to each Certificateholder an amount as to interest representing one month's interest at the Pass-Through Rate on the Certificate Principal Balance, any prepayment or other liquidation of a Mortgage Loan and the timing of the distribution of the proceeds thereof will have no effect on the interest return to Certificateholders.

Assuming performance by the Corporation of its obligations under its guaranty, the net effect of each distribution respecting interest will be the pass-through to each Certificateholder of an amount that is equal to one month's interest at the Pass-Through Rate on the Certificate Principal Balance of such Holder's Certificate. See "Description of Certificates—Payments on Mortgage Loans; Distributions on Certificates."

GPM Pools

A GPM Pool will consist of fixed-rate fully amortizing Mortgage Loans providing for monthly payments that increase annually for a period of years (generally between three to seven) and are level thereafter. During all or part of the period in which monthly payments are increasing, those payments will not be sufficient to cover the full amount of interest on the GPM at the Mortgage Interest Rate borne thereby. The amount of each such interest insufficiency will be added to the principal balance of the GPM, which will accrue interest thereafter on this new increased amount.

GPM Pools will have characteristics similar to Fixed-Rate Pools described above commencing with the time at which payments are sufficient to cover interest on the principal balances of the underlying GPMs. Prior to that time, the Certificates evidencing interests in GPM Pools will provide for the monthly distribution of the scheduled interest payment on each Mortgage Loan in the Pool less the Corporation's servicing and guaranty fee attributable thereto, the amount of any such fee being equal to the difference between the fixed Mortgage Interest Rate at which interest accrues on the GPM and the Accrual Rate borne by the related Certificates.

The Prospectus Supplement relating to a GPM Pool will set forth the period over which payments on the GPMs increase.

The Corporation's guaranty of Certificates evidencing interests in GPM Pools will cover the principal amount of each underlying GPM, including any portion thereof representing deferred interest. The Corporation will, following the period (the "Deferred Interest Period") during which such payments are insufficient to cover interest at the Mortgage Interest Rate on their then-outstanding principal balances, including deferred interest that has been added thereto, also be obligated to distribute on each Distribution Date one month's interest at the Accrual Rate on the then-outstanding principal balances of the underlying GPMs. During the Deferred Interest Period, the Corporation's guaranty will cover, as to each underlying GPM, the amount of each scheduled payment less the Corporation's servicing and guaranty fee applicable thereto.

VRM Pools

A VRM Pool will be composed of California home Mortgage Loans which bear interest at rates that will vary in response to a cost of funds index published by the Federal Home Loan Bank of San Francisco, as described in the Prospectus Supplement. The interest rates will be adjusted periodically at uniform specified intervals. The Prospectus Supplement to be prepared with respect to each Issue will specify the fixed annual percentage servicing fee or "Spread" (out of which the Corporation will compensate Lenders), which the Corporation will retain from interest payments on Mortgage Loans in the related Pool. The resultant interest rate, equal as to each Mortgage Loan to the related Mortgage Interest Rate less this fixed percentage servicing fee, is the "Pass-Through Rate" for that Mortgage Loan. The Corporation has agreed in the VRM Trust Indenture to pass through payments of interest on the Mortgage Loans in a Pool, whether or not received, in an amount equal to one month's interest at the then-current weighted average of the Pass-Through Rates of all Mortgage Loans in that Pool (the "Weighted Average Pass-Through Rate") multiplied by the Certificate Principal Balance as of the preceding Distribution Date (or, respecting the initial distribution, as of the Issue Date). The Weighted Average Pass-Through Rate as of the Issue Date as well as information regarding the original indexes, the initial Mortgage Interest Rates and the then-current Mortgage Interest Rates of all Mortgage Loans in a VRM Pool will also be set forth in the Prospectus Supplement. This Weighted Average Pass-Through Rate will change with any changes in the underlying Mortgage Interest Rates and as disproportionate payments of principal are made on Mortgage Loans bearing different Mortgage Interest Rates.

When a Mortgage Loan is prepaid or otherwise liquidated, the proceeds of such prepayment or liquidation will, unless the Corporation elects in its discretion to make any distribution thereof in the following month, be passed through to Certificateholders in the second month of such prepayment or other liquidation. Since the Corporation will agree in each Certificate to distribute on each Distribution Date to the Holder thereof an amount as to interest representing one month's interest at the then-current Weighted Average Pass-Through Rate on the related Certificate Principal Balance, any prepayment or other liquidation of a Mortgage Loan and the timing of the distribution of the proceeds thereof will have no effect on the interest return to Certificateholders.

Assuming performance by the Corporation of its obligations under its guaranty, the net effect of each distribution respecting interest will be the pass-through to each Certificateholder of an amount which is equal to one month's interest at the then-current Weighted Average Pass-Through Rate on the Certificate Principal Balance of such Holder's Certificate. See "Description of Certificates—Payments on Mortgage Loans; Distributions on Certificates."

ARM Pools

An ARM Pool will contain Mortgage Loans that bear interest at rates that will vary in response to a single specified index (such as then-prevailing yields on five-year Treasury obligations) and will adjust periodically at uniform specified intervals. The actual Mortgage Interest Rate at any time borne by an ARM will be equal to a specified percentage, or Margin, over the index rate then applicable thereto. ARMs may or may not contain provisions limiting the amount by which rates may be adjusted upward or downward and may or may not limit the amount by which monthly payments may be increased or decreased to accommodate upward or downward adjustments in interest. Certain ARMs may provide for periodic adjustments of scheduled payments in order to fully amortize the Mortgage Loan by its stated maturity while other ARMs may permit that maturity to be extended or shortened in accordance with the portion of each payment that is applied to interest in accordance with the periodic interest rate adjustments.

Where an ARM provides for limitations on the amount by which monthly payments may be increased or changes to the Mortgage Interest Rate of the ARM are made more frequently than payment changes, it is possible that an increase in the rate of interest cannot be covered by the amount of the scheduled payment. In that case, the uncollected portion of interest will be deferred and added to the principal balance of the Mortgage Loan.

Since the interest rates borne by Mortgage Loans in an ARM Pool will vary and since a portion of the interest accrued thereon may be deferred and payable at a future time, Certificates evidencing interests in such Pools will not provide for the distribution of interest at a fixed Pass-Through Rate. Rather, each Certificate issued with respect to an ARM Pool will provide for the monthly pass-through of all interest payable on each Mortgage Loan in the Pool less the Corporation's servicing and guaranty fee. In some ARM Pools, the Corporation's servicing and guaranty fee may not be the same amount as to each ARM in the ARM Pool, but will rather be a percentage amount as to each such ARM that, when subtracted from the related Margin, will cause each ARM in the ARM Pool to float above the applicable index at a single uniform "security spread" (the "Security Spread"). As a result, for such an ARM Pool, the rate at which interest accrues to Certificateholders (the "Accrual Rate") at any time (other than the period immediately following origination during which an initial rate having no relationship to the index may apply or during a period when a Mortgage Interest Rate minimum or maximum is applicable) on each Mortgage Loan included therein will be equal to the then-applicable index plus the Security Spread.

The Prospectus Supplement relating to an ARM Pool will contain information respecting the index upon which adjustments are based, the Security Spread, if any, the frequency of interest rate and payment adjustments and any maximum and minimum limitations thereon. The Prospectus Supplement will also describe any provisions for deferred interest and will, to the extent applicable, set forth the original rates of interest borne by the underlying Mortgage Loans.

The Corporation's guaranty of Certificates evidencing interests in ARM Pools will cover the principal of each underlying Mortgage Loan, including any portion thereof representing deferred interest. Its guaranty of interest will cover all interest due and payable by the mortgagor (net of the Corporation's servicing and guaranty fee). The Corporation will also agree to add to the amount of interest accompanying the prepayment of an underlying Mortgage Loan any amount by which such interest is less than one month's interest at the Accrual Rate on the prepaid principal balance thereof. As a consequence, the timing of the prepayment of a Mortgage Loan will have no effect on the interest return to Certificateholders.

MATURITY AND PREPAYMENT ASSUMPTIONS

The original maturities of substantially all of the Conventional Level Payment Mortgage Loans are expected to be between either eight to 15 years or 20 to 30 years. The maturities of substantially all of the FHA/VA Level Payment Mortgage Loans at origination are expected to be 30 years. Each Level Payment Mortgage Loan with an original maturity of 30 years will provide for amortization of principal according to a schedule that, in the absence of prepayments, would result in repayment of one-half of the original principal amount of such Mortgage Loan by approximately the 23rd to 27th year, with higher Mortgage Interest Rates resulting in slower amortization of principal. A 15-year fully amortizing Level Payment Mortgage Loan would, in the absence of prepayments, result in repayment of one-half of the original principal amount by approximately the 10th to 12th year, with higher Mortgage Interest Rates resulting in slower amortization of principal.

A significant number of the Conventional Mortgage Loans may provide by their terms that in the event of the sale of all or some of the underlying property the full unpaid principal balance of the Mortgage Loan is due and payable at the option of the holder. FHA/VA Mortgage Loans contain no such "due-on-sale" provisions. As set forth under "Description of Certificates—Collection and Other Servicing Procedures," the Trust Indenture requires the Corporation to exercise its right to accelerate the maturity of a Conventional Mortgage Loan other than a VRM in such an event so long as acceleration is permitted under applicable law unless it elects to repurchase such Mortgage Loan.

The ability of mortgage lenders and their assignees and transferees to enforce "due-on-sale" clauses was addressed by the "Garn-St Germain Depository Institutions Act of 1982," which was passed by Congress and signed into law on October 15, 1982. This legislation, subject to certain exceptions, pre-empts state statutory and case law that prohibits the enforcement of "due-on-sale" clauses. Exempted from this pre-emption are mortgage loans (originated other than by federally chartered lenders) that were made or assumed during the period beginning on the date a state, by statute or statewide court decision, prohibited the exercise of "due-on-sale" clauses and ending on October 15, 1982 (the "window period"). Mortgage lenders, however, may require any successor or transferee of the borrower to meet customary credit standards. The exemption for such loans ended on October 15, 1985 unless the state acted to otherwise regulate these loans by that date. Several states passed legislation extending the assumability of the mortgage loans that were made or assumed during the window period. In the case of those states, the enforceability of "due-on-sale" clauses in loans made or assumed during the window period is limited by the provisions of the applicable state legislation. The federal legislation also enumerates nine circumstances under which a lender may not enforce "due-on-sale" clauses, *e.g.*, the creation of a subordinate encumbrance that does not relate to a transfer of rights of occupancy in the property, a transfer by devise, descent, or operation of law on the death of a joint tenant or tenant by the entirety, and the granting of a leasehold interest of three years or less not containing an option to purchase.

Conventional Mortgage Loans purchased by the Corporation from November 10, 1980, to October 15, 1982, in jurisdictions where, on the date of origination, the law substantially restricted lenders from enforcing "due-on-sale" provisions may provide that they are due and payable at the holder's option at the end of seven years. As described in "Description of Certificates—Collection and Other Servicing Procedures," the Trust Indenture provides that the Corporation will exercise or refrain from exercising any such "call option rider" in a manner that is consistent with then-current policies or practices employed by the Corporation respecting comparable mortgage loans held in its own portfolio.

Past experience of the Federal Housing Administration ("FHA") relating to government-insured single-family mortgage loans at various interest rates with original maturities of 26 to 30 years indicates that, while some of such mortgage loans remain outstanding until the scheduled maturity, a pool of 30-year FHA-insured single-family mortgage loans will produce an average loan life of 12 years. A 12-year prepayment assumption is the industry norm for quoting yields on 30-year single-family mortgage loans and is used in generally accepted yield tables. FHA data also indicate that for a pool of 15-year single-family mortgage loans a 7-year average loan life is produced.

There can be no assurance that the rate of prepayment will conform to past FHA experience. Based upon published information and the Corporation's own experience, the rate of prepayments on 30-year single-family loans has fluctuated significantly in recent years. For example, the table under "Business—Mortgage Loan Portfolio Statistics" shows that the level of principal repayments as a percentage of the Corporation's mortgage loan portfolio in 1983, 1984 and 1985 increased substantially from the unusually low levels of 1981 and 1982. The table also shows that this increase accelerated in the first quarter of 1986, with the recent substantial decline in interest rates when the \$2.9 billion in mortgage repayments the Corporation received included approximately \$2.1 billion for mortgages that were prepaid.

In an environment of declining interest rates, lenders servicing mortgage loans often are asked by mortgagors to refinance the mortgage loans through issuance of new loans secured by mortgages on the same properties. The resultant prepayments, if they involve Mortgage Loans in Pools, result in the distribution to Certificateholders of the principal balances of the prepaid Mortgage Loans and their removal from the Pools. Under current Fannie Mae policy, Lenders servicing Mortgage Loans are permitted to advertise in a general manner their availability to

handle refinancings, although they may not specifically target mortgagors whose Mortgage Loans are in MBS Pools. Fannie Mae does not, however, permit Lenders to remove Mortgage Loans from Pools for the purpose of Mortgage Loan modifications.

In general, when the level of interest rates declines significantly below the interest rates on mortgage loans, the rate of prepayment is likely to increase, although the prepayment rate is influenced by a number of other factors, including general economic conditions and homeowner mobility. Accordingly, the Corporation cannot estimate what the prepayment experience of the Mortgage Loans in Pools will be or how it might compare with the FHA 12-year prepayment assumption respecting insured mortgage loans. See also "Description of Certificates—Termination" for a description of the Corporation's option to repurchase the Mortgage Loans in any Pool when the aggregate principal balance thereof becomes less than 10 percent of the aggregate principal balance of the Mortgage Loans in the Pool on the Issue Date.

A GEM provides for scheduled annual increases in the mortgagor's monthly payments. Because the additional scheduled portion of the monthly payments is applied to reduce the unpaid principal balance of a GEM, the scheduled maturity of a GEM will be significantly shorter than the 25- or 30-year term used as the basis for calculating the initial level installment of principal and interest applicable until the first adjustment. No GEM that matures by its terms more than 15 years subsequent to the Issue Date of the related Certificates will be eligible for inclusion in a Pool. Because GEMs have not, until recently, been originated in any appreciable volume, there are no reliable data available regarding their prepayment experience.

As set forth above under "Yield Considerations," GPMs provide for payments that increase annually for a period of years (generally between three and seven) and then amortize on a level payment basis to their stated maturity. Because the principal amount of a GPM will increase during its Deferred Interest Period, the time at which one-half of the principal amount of a GPM will be paid in accordance with its amortization schedule will be longer than for a Level Payment Mortgage Loan bearing a similar Mortgage Interest Rate. The maturities of substantially all VRMs at origination are expected to be thirty years, but the maturity of each Mortgage Loan may at the option of the mortgagor be increased to a term not in excess of forty years in the event of certain increases in the Mortgage Interest Rate. ARMs vary substantially as to their terms and it is impossible to generalize other than that, because of their adjustable feature, ARMs may be less subject to prepayment than fixed-rate Mortgage Loans should interest rates decline below levels prevailing at origination. Because both GPMs and ARMs have not been originated in quantity until recent periods, there are, like GEMs, no reliable data available regarding their prepayment experience.

PURCHASE PROGRAM

Set forth below is a description of certain aspects of the Corporation's purchase program for mortgage loans eligible for inclusion in a Pool (the "Program"). The Prospectus Supplement to be prepared with respect to each Issue will contain information on the Mortgage Loans in the Pool, including information as to the type of Mortgage Loans, the aggregate principal balance of the Mortgage Loans as of the Issue Date, for Fixed-Rate Pools the Pass-Through Rate or Accrual Rate, whichever is applicable, for VRM Pools the initial Weighted Average Pass-Through Rate, and the latest maturity date of any Mortgage Loan.

Lender Eligibility

The Corporation will purchase Mortgage Loans from eligible federally and state-chartered savings and loan associations, mutual savings banks, commercial banks, credit unions, and similar financial institutions, the deposits or accounts of which are insured by the Federal Savings and Loan Insurance Corporation ("FSLIC"), the Federal Deposit Insurance Corporation ("FDIC"), or the National Credit Union Administration ("NCUA"), from certain other state-insured financial institutions and from certain institutions, principally mortgage bankers, that are mortgage sellers approved by the Corporation. The Corporation, on an individual institution basis, will

determine whether such institutions will be approved as eligible Lenders for the Program by applying certain criteria, which may include depth of mortgage origination experience, servicing experience, and financial capacity. Approved Lenders will be party with the Corporation to a Mortgage Selling and Servicing Contract.

Mortgage Loan Eligibility

General

The Mortgage Loans to be included in each Pool will be Mortgage Loans on residential properties. Each Mortgage Loan purchased for inclusion in a Pool will be subject to and must comply with the terms of the current Selling and Servicing Guide applicable to the Program. These Mortgage Loans are permanent loans (as opposed to construction and land development loans) secured by Mortgages on properties comprised of (i) one- to four-family dwelling units, including units in condominium projects, planned unit developments, and *de minimis* planned unit developments or (ii) multifamily projects consisting of five or more dwelling units. The Prospectus Supplement to be prepared with respect to each Issue backed by Multifamily Mortgage Loans will describe the eligibility criteria for such loans, which will differ in certain respects from the criteria described below. Each Mortgage Loan will be documented by the appropriate FNMA/FHLMC Uniform Instrument in effect at the time of origination, FHA or VA mortgage instrument or other instrument acceptable to the Corporation, and will comply with all applicable federal and local laws, including laws relating to usury, equal credit opportunity, and disclosure.

There is no requirement that Mortgage Loans be payable on the first day of the month in order to be eligible for inclusion in a Pool. The Mortgage Loans must have had maturities of not more than 30 years from their date of origination, although VRMs can be extended to 40 years at the option of the mortgagor in the event of certain increases in the Mortgage Interest Rates.

Conventional Mortgage Loans

Pursuant to the requirements of the MBS Selling and Servicing Guide, Conventional Mortgage Loans must be real estate loans secured by first Mortgages on residential properties, with original principal balances that (when combined with the original principal balance of any second mortgage in which the Corporation has an interest) did not exceed certain federally imposed maximum principal balance limitations applicable to the Corporation. In 1986, the maximum dollar purchase limitations for Conventional Mortgage Loans are as follows: \$133,250 for mortgages secured by single-family residences (\$199,875 in Alaska and Hawaii); \$170,450 for mortgages secured by two-family residences (\$255,675 in Alaska and Hawaii); \$205,950 for mortgages secured by three-family residences (\$308,925 in Alaska and Hawaii); and \$256,000 for mortgages secured by four-family residences (\$384,000 in Alaska and Hawaii).

No Conventional Mortgage Loan with a loan-to-value ratio in excess of 95 percent will be included in any Pool. Conventional Mortgage Loans with loan-to-value ratios exceeding 80 percent must have the principal amount of the indebtedness in excess of 75 percent of the appraised value of the Mortgaged Property insured by a policy of primary mortgage guaranty insurance. Each mortgage insurer must be licensed to transact a mortgage guaranty insurance business in the state where the Mortgaged Property is located and be acceptable to the Corporation as a mortgage insurer. As an alternative to the requirement to obtain mortgage insurance for Conventional Mortgage Loans with loan-to-value ratios in excess of 80 percent, Lenders may contract with the Corporation to repurchase such Conventional Mortgage Loans at a price equal to the unpaid principal balance thereof in the event of default before the loan-to-value ratio has been reduced to 80 percent of the original value.

The maximum loan-to-value ratio at the time of purchase for a Conventional Mortgage Loan secured by a first Mortgage on an owner-occupied property including the unpaid principal balances of all subordinate financing is 95 percent. In the case of a Conventional Mortgage Loan secured by a first Mortgage on a non-owner occupied property, the maximum loan-to-value ratio including the unpaid principal balances of all subordinate financing is 90 percent. The maximum

loan-to-value ratio for Mortgage Loans secured by non-owner occupied properties is generally 80 percent but may vary based on the Corporation's evaluation of the age of a Mortgage Loan and its experience with the Lender from whom it purchases such Mortgage Loan.

Pursuant to the requirements of the MBS Selling and Servicing Guide, each eligible Lender that sells a Conventional Mortgage Loan to the Corporation for the purposes of the Program must assume responsibility for underwriting such Conventional Mortgage Loan using the same underwriting criteria, as from time to time in effect, that must be met by mortgage loans eligible for Fannie Mae portfolio purchases. After delivery of the Conventional Mortgage Loans, the Corporation will conduct reviews of the quality of credit and property underwriting used in the origination of certain randomly selected Conventional Mortgage Loans.

FHA/VA Mortgage Loans

Pursuant to the requirements of the MBS Selling and Servicing Guide, FHA/VA Mortgage Loans must be real estate loans with stated constant annual rates of interest, secured by first Mortgages on residential properties. The principal balance and loan-to-value ratio of each FHA Mortgage Loan must comply with the standards established by the FHA. In the case of VA Mortgage Loans, the Corporation has imposed a maximum principal balance limitation of \$135,000. In addition, the unguaranteed portion of the VA Mortgage Loan amount cannot be greater than 75 percent of the lesser of (i) the purchase price of the property or (ii) the VA's estimate of reasonable value. For two- to four-family properties, such unguaranteed portion cannot be greater than 75 percent of the least of (i) above, (ii) above, or the appraiser's estimate of market value. Each FHA/VA Mortgage Loan must be insured or guaranteed by a valid and subsisting policy or guaranty in full force and effect. On April 15, 1986, Fannie Mae announced that it would allow newly originated and seasoned FHA/VA Mortgage Loans to be included in MBS Pools. Prior to that date, each FHA/VA Mortgage Loan had to be originated at least 12 months preceding the Corporation's purchase of the Mortgage Loan for inclusion in a Pool.

DESCRIPTION OF CERTIFICATES

Each Issue of Certificates will be issued pursuant to the applicable Trust Indenture described above. The applicable Trust Indenture will, as to each Issue, be supplemented by an Issue Supplement, which will be prepared at the time of the creation of such Issue. The Issue Supplement will set forth the specific terms of the Issue, such as the Pass-Through Rate applicable thereto in the case of Fixed-Rate Pools (other than those containing GPMs) and the Issue Date. The Issue Supplement will also contain any variation from the basic Trust Indenture applicable to a particular Issue, any such variation also being described in the Prospectus Supplement relating to such Issue. As set forth under "Legal Opinion," the validity of each Issue of Certificates, the Trust Indenture, and the applicable Issue Supplement will be passed upon by the General Counsel of the Corporation upon the request of any Holder of Certificates of such Issue.

Mortgage Loans not previously held in the Corporation's portfolio will be purchased pursuant to a Pool Purchase Contract for cash or in exchange for Certificates in the related Pool. Such Mortgage Loans will be serviced by one of the Corporation-approved Lenders, normally the same entity as the loan originator, pursuant to the terms of the Pool Purchase Contract, as supplemented by the MBS Selling and Servicing Guide, which is incorporated therein by reference. Copies of the Trust Indenture and the Pool Purchase Contract, together with the Selling and Servicing Guide, may be obtained from the Corporation's Washington, D.C. office, or from any of the Corporation's regional offices in Philadelphia, Atlanta, Chicago, Dallas, and Los Angeles.

The following summaries describe certain provisions of the Trust Indenture. These summaries do not purport to be complete and are subject to, and qualified in their entirety by reference to, the more complete provisions of the Trust Indenture.

General

The Certificates will represent Fractional Undivided Interests in the Trust Fund created pursuant to the Trust Indenture and Issue Supplement for each Issue. The Fractional Undivided Interest represented by a particular Certificate will be equal to the initial principal denomination of such Certificate set forth on the face thereof (or, if in book-entry form, entered on the books of a Federal Reserve Bank) divided by the aggregate Stated Principal Balance⁽¹⁾ of the Mortgage Loans in the Pool (the "Pool Principal Balance") as of the Issue Date. The Trust Fund for an Issue consists of (i) such Mortgage Loans as from time to time are subject to the Trust Indenture and Issue Supplement, (ii) such payments or other recoveries on Mortgage Loans as from time to time may be considered to be held by the Corporation for Certificateholders, (iii) property acquired by foreclosure of Mortgage Loans or by deed in lieu of foreclosure, and (iv) the interest of Certificateholders in the obligation of the Corporation to supplement payments and other recoveries on Mortgage Loans to the extent necessary to make required distributions to Certificateholders.

Unless the related Supplement to this Prospectus provides otherwise, Certificates evidencing undivided interests in Pools formed on or after May 1, 1985, (other than Pools containing GPMs or Mortgage Loans secured by multifamily projects) will be available in book-entry form only and will not be convertible to definitive form. A Fiscal Agency Agreement between the Corporation and the Federal Reserve Bank of New York makes generally applicable to Certificates in book-entry form (i) regulations governing the Corporation's use of the book-entry system, contained in 24 C.F.R. Part 81, Subpart E, (ii) such procedures, insofar as applicable, as may from time to time be established by regulations of the United States Department of the Treasury governing United States securities, as now set forth in Treasury Department Circular Number 300, 31 C.F.R. Part 306 (other than Subpart O), and (iii) the Federal Reserve Bank's operating circulars and letters. Certificates in book-entry form are available in a minimum denomination of \$1,000 and in additional increments of one dollar and will be freely transferable on the records of a Federal Reserve Bank.

Certificates will be maintained on the book-entry system of a Federal Reserve Bank in a manner that permits separate trading and ownership. The Federal Reserve Bank of New York will make payments on the Certificates on behalf of Fannie Mae on the applicable Distribution Dates by crediting accounts on its records or on the records of other Federal Reserve Banks. Certificates in book-entry form may be held of record only by entities eligible to maintain book-entry accounts with a Federal Reserve Bank. Such entities are not necessarily the beneficial owners of the Certificates. Beneficial owners will ordinarily hold Certificates through one or more financial intermediaries, such as banks, brokerage firms and securities clearing organizations. A Certificateholder that is not the beneficial owner of a Certificate, and each other financial intermediary in the chain to the beneficial owner, will have the responsibility of establishing and maintaining accounts for its respective customers. The rights of the beneficial owner of a Certificate with respect to Fannie Mae and the Federal Reserve Bank may be exercised only through the financial intermediaries thereof. Fannie Mae and the Federal Reserve Bank will have no direct obligation to a beneficial owner of a Certificate that is not also the owner of record according to the account maintained by the Federal Reserve Bank. The Federal Reserve Bank will act only upon the instructions of the record owner in recording transfers of a Certificate.

(1) All references herein to the Stated Principal Balance of a Mortgage Loan or to the aggregate Stated Principal Balance of all Mortgage Loans in a Pool are to the principal balance or aggregate principal balance, as the case may be, utilized by the Corporation in calculating the then-outstanding principal balances of Certificates. Such Stated Principal Balances may differ from actual principal balances for a number of reasons, including supplemental payments by the Corporation on delinquent Mortgage Loans pursuant to its guaranty obligations and delays in the distribution of certain Mortgage Loan receipts.

In the event Certificates are issued in fully registered form, such Certificates may only be issued in initial principal denominations of not less than \$25,000 and integral multiples of \$5,000 in excess of \$25,000, with the exception of one odd denomination that may be issued for each Pool. (TI Section 7.01) Certificates issued in fully registered form will be freely transferable and exchangeable at the corporate trust office of Chemical Bank, New York, New York. A service charge may be imposed for any exchange or registration of transfer of Certificates issued in fully registered form, and the Corporation may require payment of a sum sufficient to cover any tax or other governmental charge. (TI Section 7.02)

Distributions of principal and interest on each Issue of Certificates will be made by the Corporation on the 25th day of each month (the "Distribution Date") to the persons in whose names the Certificates are entered on the books of a Federal Reserve Bank (or registered in the Certificate Register in the case of fully registered Certificates) as of the close of business on the last day of the preceding month (the "Record Date"). The first distribution for each Issue of Certificates will be in the month following the month in which the Issue Date occurs. Distributions for each Issue will be made by wire (or by check in the case of fully registered Certificates) to the person entitled thereto as it appears on the Certificate not later than the 25th day of each month; provided, however, that the final distribution in retirement of fully registered Certificates of any Issue will be made only upon presentation and surrender of the Certificates at the office or agency of the Corporation specified in the notice to Certificateholders of such final distribution.

As described under "Rights Upon Event of Default," Holders of Certificates will have the right under certain circumstances to appoint a successor Trustee.

Transfer of Mortgage Loans to Pools

Each Mortgage Loan transferred to a Pool will be identified in a Mortgage Loan Schedule appearing as an exhibit to the Issue Supplement for the related Issue of Certificates. In addition, the Corporation, as Trustee of the Mortgage Loans, will retain on behalf of Certificateholders the original Mortgage Note, endorsed in blank, and a completed and executed assignment to the Corporation of the mortgage instrument in suitable form for recording but not recorded. At its option, the Corporation may choose to maintain such documents either with a custodian institution (the Lender or another institution) whose deposits or accounts are insured by the FDIC, FSLIC, or a state agency or with a subsidiary of the Lender. The Corporation will review the Mortgage Loan Schedule prior to the issuance of the Certificates and will conduct random spot checks to confirm the sufficiency of the documents after issuance of the Certificates.

Although the above procedures are intended to protect the interests of the Holders of Certificates in the Mortgage Loans in the related Pool, the law applicable to a liquidation, reorganization, or similar proceeding involving the assets of a Lender or of the Corporation is unclear and as a result no opinion can be rendered as to the status of Certificateholders' interests in the event of any such proceeding. The Corporation's guaranty would, however, by its terms be available in the event of any such proceeding involving the assets of a Lender.

Servicing Through Lenders

Pursuant to the Trust Indenture, the Corporation is responsible for servicing and administering the Mortgage Loans but, in its discretion, is permitted to contract with the originator of each Mortgage Loan, or another eligible servicing institution, to perform such functions under the supervision of the Corporation as more fully described herein. Any servicing contract or arrangement by the Corporation with a Lender for the direct servicing of Mortgage Loans is a contract solely between the Corporation and that Lender, and the Certificateholders are not deemed to be parties thereto and have no claims, rights, obligations, duties, or liabilities with respect to such Lender. (TI Section 5.01)

Lenders will be obligated pursuant to the MBS Selling and Servicing Guide to perform diligently all services and duties customary to the servicing of mortgages, as well as those

specifically prescribed by the MBS Selling and Servicing Guide. The Corporation will monitor the Lender's performance and has the right to remove any Lender for cause at any time it considers such removal to be in the best interest of Certificateholders. The duties performed by Lenders include general loan servicing responsibilities, collection and remittance of principal and interest payments, administration of mortgage escrow accounts, collection of insurance claims, and, if necessary, foreclosure.

The Corporation retains as to each Fixed-Rate Mortgage Loan the difference in interest between the annual Mortgage Interest Rate borne by the Mortgage Loan and the Pass-Through Rate or Accrual Rate on the Certificates. For example, if a Mortgage Loan with a 12.25 percent Mortgage Interest Rate is included in a Pool against which a Certificate with an 11.25 percent Pass-Through Rate is issued, the Corporation would be entitled to receive total compensation of one percent per annum on the Mortgage Loan. For VRMs, the Corporation will retain from interest payments a fixed annual servicing fee, or "Spread," as described under "VRM Pools" above. For ARMs, the Corporation will retain an amount equal to the percentage Spread applicable thereto applied to the outstanding principal balance as increased by any deferred interest that has been included therein. See "Yield Considerations." The Corporation is also entitled to retain prepayment fees, late charges, assumption fees, and similar charges to the extent they are collected from borrowers. The Corporation will compensate Lenders in an amount up to, but never exceeding, the amount of interest retention described above, less a prescribed minimum amount to be retained by the Corporation for itself in consideration of its guaranty obligations and servicing responsibilities.

Payments on Mortgage Loans; Distributions on Certificates

On the twenty-fifth day of each month (beginning with the month following the month of the Issue Date), the Corporation will, respecting each Issue, distribute to Certificateholders an amount equal to the total of (i) the principal due on the Mortgage Loans in the related Pool during the period beginning on the second day of the month prior to the month of such distribution and ending on the first day of such month of distribution (the "Due Period"), (ii) the Stated Principal Balance of any such Mortgage Loan that was prepaid in full during the second month next preceding the month of such distribution (including as prepaid for this purpose any Mortgage Loan repurchased by the Corporation as described herein because of the Corporation's election to repurchase the Mortgage Loan after it is delinquent, in whole or in part, with respect to four consecutive installments of principal and interest, or because of the Corporation's election to repurchase such Mortgage Loan under the circumstances described in the last paragraph under "Collection and Other Servicing Procedures" below), (iii) the amount of any partial prepayment of a Mortgage Loan received in the second month next preceding the month of distribution, and (iv) in respect of all Fixed-Rate Mortgage Loans other than GPMs during their Deferred Interest Period, one month's interest at the Pass-Through Rate (or Accrual Rate in the case of GPMs) on the Certificate Principal Balance as reported to Certificateholders in connection with the previous distribution (or, respecting the first distribution, the Certificate Principal Balance on the Issue Date). For purposes of distributions, a Mortgage Loan will be considered to have been prepaid in full if, in the Corporation's reasonable judgment, the full amount finally recoverable on account of such Mortgage Loan has been received, whether or not such full amount is equal to the Stated Principal Balance of the Mortgage Loan. The Corporation may, in its discretion, include with any distribution principal prepayments, both full and partial, received during the month prior to the month of distribution but is under no obligation to do so.

For each GPM during its Deferred Interest Period and each ARM, the Corporation will, on each monthly Distribution Date, distribute an amount as to interest equal to the amount of interest payable on such Mortgage Loan during the applicable Due Period (which will, in the case of GPMs during their Deferred Interest Period, and may, in the case of ARMs having deferred interest features, be less than one month's interest at the Mortgage Interest Rate) less the amount retained by the Corporation as described under "Servicing Through Lenders" above. For each VRM Pool, the Corporation will, on each Distribution Date, distribute an amount as to

interest equal to one month's interest at the then-current Weighted Average Pass-Through Rate on the Certificate Principal Balance of each Certificate.

Distributions on any Distribution Date will be made to Certificateholders of record on the prior Record Date (the close of business on the last day of the immediately preceding month). Each Certificateholder will be entitled to receive an amount equal to the total amount distributed multiplied by the Fractional Undivided Interest evidenced by such Holder's Certificate.

The Corporation's Guaranty

The Corporation's obligation described above to distribute amounts representing scheduled principal and interest, whether or not received, and its obligation to distribute the full principal amount of any foreclosed or otherwise finally liquidated Mortgage Loan, whether or not such principal amount is actually recovered, constitute the Corporation's guaranty obligations in respect of the Certificates. If the Corporation were unable to perform such obligations, distributions to Certificateholders would consist solely of payments and other recoveries on Mortgage Loans and, accordingly, delinquencies and defaults would affect monthly distributions to Certificateholders.

Reports to Certificateholders

With respect to each distribution, the Corporation will cause to be forwarded to each Certificateholder with respect to all Certificates held by such Certificateholder in each Pool, a statement setting forth, to the extent applicable, the following information:

- (i) the amount, if any, due on such Certificates on the related Distribution Date on account of total scheduled and unscheduled principal (including any Deferred Interest);
- (ii) the amount due on such Certificates on the related Distribution Date on account of interest;
- (iii) the total of the cash distribution on such Certificates on the related Distribution Date;
- (iv) the Certificate Principal Balances of such Certificates on the related Distribution Date after giving effect to any distribution of principal made on such date and to any Deferred Interest added to the principal balances of the underlying Mortgage Loans during the preceding Due Period;
- (v) the total amount of any Deferred Interest that was added to the principal balances of the underlying Mortgage Loans during the preceding Due Period;
- (vi) the amount, if any, of (i) above that is allocable to Deferred Interest;
- (vii) the amount, if any, of (iv) above that is allocable to Deferred Interest;
- (viii) for VRM Pools, the Weighted Average Pass-Through Rate applicable to such Distribution Date; and
- (ix) for ARM Pools, the Accrual Rate applicable to such Distribution Date (or, in the event the underlying Mortgage Loans have different Accrual Rates, the approximate weighted average Accrual Rate).

Within a reasonable period of time after the end of each calendar year, the Corporation will furnish to each Person who at any time during the calendar year was a Certificateholder a statement containing the information set forth in items (i), (ii), (v), and (vi) above, in summary form for such calendar year, or for any portion thereof during which such Person was a Certificateholder.

Servicing Compensation and Payment of Certain Expenses by the Corporation

As compensation for its activities and obligations under the Trust Indenture, the Corporation will be entitled to retain the amounts applicable to interest that are not required to be distributed

to Certificateholders as described above. In addition, the Corporation is entitled to retain any amounts by which the proceeds of the liquidation of a Mortgage Loan exceed (i) the Stated Principal Balance of that Mortgage Loan and (ii) interest thereon at the Pass-Through Rate in the case of a Fixed-Rate Mortgage Loan (other than a GPM) or a VRM or interest thereon at the Accrual rate in the case of a GPM or an ARM. The Corporation will pay all expenses incurred by it in connection with its servicing activities, including, without limitation, the fees to Lenders, and is not entitled to reimbursement therefor out of the Trust Fund.

Additional servicing compensation in the form of prepayment charges, assumption fees, late payment charges, or otherwise will be retained by the Corporation.

Collection and Other Servicing Procedures

The Corporation is responsible for servicing the Mortgage Loans in each Pool and may, as set forth above, conduct such servicing through Lenders or through other Corporation-approved mortgage servicers. In connection with its servicing activities, the Corporation has full power and authority to do or cause to be done any and all things as it may deem necessary or appropriate in its sole discretion, including the foreclosure or comparable conversion of a defaulted Mortgage Loan. In lieu of undertaking any such foreclosure, the Corporation may, in its discretion and without obligation, repurchase from the Trust Fund any Mortgage Loan that is delinquent, in whole or in part, as to four consecutive installments of principal and interest. The purchase price will be equal to the Stated Principal Balance of the delinquent Mortgage Loan together with accrued interest at the Pass-Through Rate (or the Accrual Rate in the case of a GPM or an ARM) and will be distributed to Certificateholders in the same manner as full prepayments of Mortgage Loans. See "Description of Certificates—Payments on Mortgage Loans; Distributions on Certificates." (TI Sections 5.01 and 5.03)

With respect to each Mortgage Loan in a Pool, the Lender makes certain warranties to the Corporation concerning such matters as the recordation of the original Mortgage, the validity of the Mortgage Loan as a first lien on the Mortgaged Property, and compliance by such Mortgage Loan with applicable state and federal laws. In the event of a material breach of any such warranty or a material defect in the Mortgage Loan documentation, the Corporation may withdraw such Mortgage Loan from the Trust Fund at a price equal to its Stated Principal Balance together with interest thereon at the Pass-Through Rate (or the Accrual Rate in the case of a GPM or an ARM). Alternatively, the Corporation may, at its option, for all Pools other than Pools containing Multifamily Mortgage Loans, substitute a new Mortgage Loan for a defective Mortgage Loan; provided, however, that no such substitution may take place more than two years subsequent to the date of the original issue of the related Certificates, and any such substitute Mortgage Loan must satisfy certain eligibility criteria designed to assure that the nature of the Pool will not be altered by any such substitution. Any amount by which the Stated Principal Balance of the defective Mortgage Loan exceeds the principal balance of the substitute Mortgage Loan (the substitute Mortgage Loan may not be larger than the Mortgage Loan it is replacing) will be passed through to Certificateholders.

Subject to the following paragraph and to the extent consistent with then-current policies of the Corporation respecting mortgage loans held in its own portfolio, the Corporation in its discretion may enforce or waive enforcement of any of the terms of any Mortgage Loan or enter into an agreement for the modification of any of the terms of any Mortgage Loan, or take any action or refrain from taking any action in servicing any Mortgage Loan. In such connection, the Corporation may waive any prepayment charge, assumption fee, or late payment charge or may exercise or refrain from exercising any "call option rider"; provided, however, that any decision to exercise or refrain from exercising any "call option rider" must be consistent with then-current policies or practices employed by the Corporation respecting comparable mortgage loans held in its own portfolio and must be without consideration of the ownership status of the related Mortgage Loan.

In the VRM Trust Indenture, the Corporation agrees that any decision as to whether or not (i) to increase a Mortgage Interest Rate (where any such increase is permitted by the terms of such Mortgage Loan and by applicable law) or (ii) to shorten the maturity of any Mortgage Note, will be made in accordance with the then-current practice of the related Lender respecting similar Mortgage Notes and without consideration of the ownership status of the related Mortgage Note. If the Corporation is then directly servicing a VRM, it will increase the related Mortgage Interest Rate and shorten the maturity whenever any such change is permitted by the terms of such Mortgage Loan and by applicable law. Any adjustment downward by reason of a decrease in the applicable index is mandatory. See the Prospectus Supplement for criteria and procedures governing changes in Mortgage Interest Rates.

In connection with the transfer or prospective transfer of title to a Mortgaged Property (other than a Mortgaged Property securing a VRM), the Corporation is obligated to accelerate the maturity of the related Mortgage Loan where that Mortgage Loan contains a "due-on-sale" clause permitting acceleration under those conditions unless the Corporation is restricted by law from enforcing the "due-on-sale" clause or the Corporation elects to withdraw such Mortgage Loan from the Pool. In the case of a VRM, the Corporation will enforce or refrain from enforcing any "due-on-sale" clause in the related Mortgage Note in accordance with the then-current practice of the related Lender without consideration of the ownership status of the Mortgage Note. If the Corporation is then directly servicing the Mortgage Loan, it will enforce the "due-on-sale" clause unless such enforcement is prohibited by law or the Corporation elects to withdraw such Mortgage Loan from the Pool. See "Maturity and Prepayment Assumptions."

In the event that, for any reason, the Corporation is not obligated to accelerate the maturity of a Conventional Mortgage Loan upon the transfer, or prospective transfer, of title to the underlying Mortgaged Property, the Corporation may enter into a transaction by which the obligor is released from liability on the related Mortgage Loan and the transferee assumes such liability; provided, however, that no such transaction shall (i) be entered into which would not have been entered into had the Mortgage Loan been held in the Corporation's own portfolio, (ii) provide for reduction of the Mortgage Interest Rate or, in the case of any ARM, provide for any change in any interest rate adjustment provision or provision governing the calculation of scheduled payments if any such change would be adverse to the interests of Certificateholders, or (iii) in the case of any VRM, provide for any change in the original index applicable thereto.

The Trust Indenture provides that the Corporation may repurchase from the related Pool, at a price equal to the Stated Principal Balance thereof plus accrued interest thereon at the applicable Pass-Through Rate (or the applicable Accrual Rate in the case of a GPM or an ARM), any Mortgage Loan respecting which the underlying Mortgaged Property is transferred, or proposed to be transferred, under circumstances permitting the Corporation to accelerate the maturity of such Mortgage Loan pursuant to the terms of any "due-on-sale" clause contained therein.

Certain Matters Regarding the Corporation

The Trust Indenture provides that the Corporation may not resign from its obligations and duties thereunder, except upon determination that those duties are no longer permissible under applicable law. No such resignation will become effective until a successor has assumed the Corporation's obligations and duties under the Trust Indenture; provided, however, that no successor will succeed to the Corporation's guaranty obligations described above, the Corporation continuing to be responsible thereunder notwithstanding any termination of its other duties and responsibilities under the Trust Indenture. In the event that the Corporation is unable to fulfill its continuing guaranty obligations, the Trust Indenture may be modified to provide for monthly distributions to be made from then-available Mortgage Loan payments and other recoveries in a manner similar to practices and procedures followed in the servicing of whole loans for institutional investors. (TI Section 9.01)

The Trust Indenture also provides that neither the Corporation nor any director, officer, employee, or agent of the Corporation will be under any liability to the Trust Fund or to Certificateholders for any action taken, or for refraining from the taking of any action, in good faith pursuant to such Trust Indenture or for errors in judgment; provided, however, that neither the Corporation nor any such person will be protected against any liability that would otherwise be imposed by reason of willful misfeasance, bad faith, or gross negligence or by reason of willful disregard of obligations and duties.

In addition, the Trust Indenture provides that the Corporation is not under any obligation to appear in, prosecute, or defend any legal action that is not incidental to its responsibilities under the Trust Indenture and that in its opinion may involve it in any expense or liability. The Corporation may, however, in its discretion undertake any such legal action that it may deem necessary or desirable in the interests of the Certificateholders. In such event, the legal expenses and costs of such action and any liability resulting therefrom will be expenses, costs, and liabilities of the Corporation that will not be reimbursable to the Corporation out of the Trust Fund. (TI Section 8.02)

Any corporation into which the Corporation may be merged or consolidated, or any corporation resulting from any merger, conversion, or consolidation to which the Corporation is a party, or any corporation succeeding to the business of the Corporation, will be the successor of the Corporation under the terms of the Trust Indenture. (TI Section 9.02)

Events of Default

Events of Default under the Trust Indenture will consist of (i) any failure by the Corporation to distribute to Certificateholders any required payment that continues unremedied for 15 days after the giving of written notice of such failure to the Corporation by the Holders of Certificates evidencing Fractional Undivided Interests aggregating not less than five percent of the related Trust Fund; (ii) any failure by the Corporation duly to observe or perform in any material respect any other of its covenants or agreements in the Trust Indenture which failure continues unremedied for 60 days after the giving of written notice of such failure to the Corporation by the Holders of Certificates evidencing Fractional Undivided Interests aggregating not less than 25 percent of the related Trust Fund; and (iii) certain events of insolvency, readjustment of debt, marshalling of assets and liabilities, or similar proceedings and certain actions by or against the Corporation indicating its insolvency, reorganization, or inability to pay its obligations. (TI Section 9.03)

Rights Upon Event of Default

As long as an Event of Default under the Trust Indenture for any Issue remains unremedied, the Holders of Certificates evidencing Fractional Undivided Interests aggregating not less than 25 percent of the related Trust Fund may, in writing, terminate all of the obligations and duties of the Corporation as Trustee and in its corporate capacity under the Trust Indenture in respect of such Issue (other than its guaranty obligations described above which continue notwithstanding any such termination) and name and appoint, in writing, a successor to succeed to all such responsibilities, duties, and obligations of the Corporation thereunder (other than the Corporation's guaranty obligations) and to the legal title to the Mortgage Loans held in such Trust Fund. (TI Section 9.03)

Amendment

The Trust Indenture as it relates to any Issue may be amended by the Corporation without the consent of or notice to any of the Certificateholders, for one or more of the following purposes: (i) to add to the covenants of the Corporation; (ii) to evidence the succession of another party or parties to the Corporation and the assumption by such successor or successors of the obligations of the Corporation thereunder in its corporate capacity or in its capacity as Trustee or in both such capacities; (iii) to eliminate any right reserved to or conferred upon the Corporation in its

corporate capacity; (iv) to make provisions for the purpose of curing any ambiguity or correcting or supplementing any provision in the Trust Indenture or any Issue Supplement, provided such provisions do not adversely affect the interests of any Certificateholder; or (v) to modify the Trust Indenture under the circumstances and for the purposes set forth in the final sentence of the first paragraph under "Certain Matters Regarding the Corporation" above. (TI Section 11.01)

The Trust Indenture as it relates to any Issue may also be amended by the Corporation with the consent of the Holders of Certificates evidencing Fractional Undivided Interests aggregating not less than 66 percent of the related Trust Fund so as to waive compliance by the Corporation with any terms of the Trust Indenture or related Issue Supplement, or to allow the Corporation to eliminate, change, add to, or modify the terms of the Trust Indenture or Issue Supplement. However, no such waiver or amendment may, without the consent of all Certificateholders, terminate or modify the guaranty obligations of the Corporation or reduce the percentages of Certificates the Holders of which are required to consent to any waiver or amendments. In addition, no waiver or amendment shall, without the consent of each Certificateholder affected thereby, reduce in any manner the amount of, or delay the timing of, payments received on Mortgage Loans that are required to be distributed on any Certificate. (TI Section 11.02)

Termination

The Trust Indenture as it relates to each Issue terminates upon the final payment or liquidation of the last Mortgage Loan remaining in the related Pool and distribution of all proceeds thereof. The Trust Indenture as it relates to each Issue will terminate also upon repurchase by the Corporation, at its option, of all remaining Mortgage Loans in the related Pool at a price equal to 100 percent of the Stated Principal Balance of each such Mortgage Loan together with one month's interest thereon at the Pass-Through Rate (or, in the case of a VRM Pool, one month's interest on the Stated Principal Balance at the Weighted Average Pass-Through Rate, or, in the case of a GPM Pool or an ARM Pool, one month's interest on the Stated Principal Balance of each GPM or ARM, as the case may be, at the applicable Accrual Rate). (TI Section 10.01) The exercise of such option will effect early retirement of the Certificates of that Issue, but the Corporation's right to repurchase is conditioned upon the Pool Principal Balance at the time of repurchase being less than ten percent of the Pool Principal Balance on the Issue Date. In addition, the Corporation has stated that it will be its policy not to exercise any such option in respect of any Pool if (i) it has knowledge that any related Certificate has been pledged to secure an issue of cash flow obligations and (ii) the exercise of such option would take place prior to the earliest date upon which the issuer of such cash flow obligations can exercise an option to redeem such obligations without premium. In no event, however, will the trust relating to each Pool as created by the Trust Indenture continue beyond the expiration of 21 years from the death of the last survivor of the persons named in the Trust Indenture. For each Issue, the Corporation will give written notice of termination of the Trust Indenture as it relates to such Issue to each affected Certificateholder, and the final distribution will be made to the person entitled thereto; provided, however, that the final distribution for fully registered Certificates will be made only upon surrender and cancellation of the Certificates at an office of the Corporation specified in the notice of termination. (TI Section 10.01)

FEDERAL TAX ASPECTS

This is a discussion of certain federal income tax consequences to persons purchasing Certificates. The discussion does not purport to deal with all aspects of federal taxation that may be relevant to particular investors. Prospective investors are advised to consult their own tax advisors regarding the federal income tax consequences of holding and disposing of Certificates as well as any tax consequences arising under the laws of any state or other taxing jurisdiction.

Revenue Ruling 84-10, 1984-1 C.B. 155, sets forth certain federal income tax consequences relating to investments in the Certificates issued with respect to a Pool. Pursuant to Revenue Ruling 84-10, a Pool will not be classified as an association taxable as a corporation, but will be

classified as a trust of which the beneficial owners of the Certificates (the "Owners") are the owners under Subpart E of Part I of Subchapter J of the Internal Revenue Code of 1954, as amended (the "Code"). Each Owner will be treated as the owner of a pro rata undivided interest in the ordinary income and corpus of the trust attributable to that particular Pool and will be considered to be the equitable owner of a pro rata undivided interest in each of the Mortgage Loans included therein, subject to the discussion below concerning a possible recharacterization of a portion of the servicing fee.

Accordingly, Owners of a particular series will be required to report on their federal income tax returns, consistent with their methods of accounting, their pro rata share of the entire income from the Mortgage Loans in that particular Pool, including interest, prepayment penalties, assumption fees and late payment charges attributable to the Mortgage Loans in the Pool, plus any amount paid by the Corporation as interest under its guaranty. Owners will be entitled to deduct their pro rata share of the servicing fee paid to the Corporation, as provided in section 162 or section 212 of the Code, consistent with their methods of accounting and subject to the discussions below.

Owners must also report as ordinary income their pro rata share of any original issue discount on each of the Mortgage Loans in a manner consistent with their methods of accounting unless the special rules of section 1272 of the Code apply. If the special rules of section 1272 of the Code do apply, Owners may be required to include their share of any original issue discount in income before the receipt of cash attributable to that income regardless of their methods of accounting. The special rules of section 1272 of the Code will not apply with respect to Mortgage Loans originated before March 2, 1984 if the mortgagors of such Mortgage Loans were natural persons, but may apply with respect to Mortgage Loans to mortgagors who are natural persons if the Mortgage Loans are originated on or after March 2, 1984.

Under proposed regulations recently issued by the Treasury Department, certain arrangements in connection with the origination of the Mortgage Loans, such as the financing of points, may give rise to original issue discount subject to the special rules of section 1272 of the Code. In the case of mortgage loans originated after May 8, 1986, the proposed regulations provide that lenders that made the mortgage loans give notice of original issue discount on such mortgage loans at the time they sell them to the Corporation. The Corporation will report annually to holders of record their share of such original issue discount. However, the Owner's share of any original issue discount is income to the Owner regardless of whether it is reported to the Corporation by the Lender.

With respect to any undivided interest in a Mortgage Loan purchased at a premium, an Owner will not be entitled to a deduction for amortization under the present rules of section 171 of the Code unless the mortgagor is not an individual and the other conditions for the application of that section are met. If section 171 is inapplicable, such a premium may result in the inclusion by the Owner of a lesser amount of original issue discount under the special rules of section 1272 of the Code. However, under the tax reform proposals being considered by Congress, the special rules of section 171 of the Code may be amended so as to permit the amortization of premium under an economic accrual method on all obligations (including those issued by individuals) originated after a specified date.

Owners are advised to consult with their tax advisors as to whether premium or discount results from the acquisition of Certificates. Such premium might be deductible only upon sale or final distribution in respect of the Certificates, and then only as a short- or long-term capital loss, depending upon how long the Certificates have been held. The long-term holding period is six months with respect to a Certificate acquired by an Owner on or before December 31, 1987 and will be one year with respect to Certificates acquired thereafter.

The Internal Revenue Service also ruled in Revenue Ruling 84-10 as follows:

1 A Certificate owned by a domestic building and loan association is considered as representing "loans secured by an interest in real property" within the meaning of section

7701(a)(19)(C)(v) of the Code, provided the real property underlying the Mortgages is (or, from the proceeds of the Mortgage Loans, will become) the type of real property described in that section of the Code.

2. A Certificate is considered as representing "qualifying real property loans" within the meaning of section 593(d) of the Code, provided the real property underlying the Mortgages is (or, from the proceeds of the Mortgage Loans, will become) the type of real property described in that section of the Code. Thus, a Certificate owned by a domestic building and loan association or any other thrift institution described in section 593(a) of the Code will represent "qualifying real property loans" within the meaning of section 593(d) of the Code, provided the real property underlying the Mortgages is (or, from the proceeds of the Mortgage Loans, will become) the type of real property described in that section of the Code.

3. A Certificate owned by a real estate investment trust is considered as representing "real estate assets" within the meaning of section 856(c)(5)(A) of the Code, and the interest income is considered "interest on obligations secured by mortgages on real property" within the meaning of section 856(c)(3)(B) of the Code.

Although these rulings do not specifically refer to Mortgage Loans involving interest rate buydown accounts, the conclusions reflected in paragraphs 1 and 2 should be generally applicable to an Owner's investment in a Mortgage Loan secured by an interest rate buydown account that conforms with the requirements of the Corporation's MBS Selling and Servicing Guide ("Buydown Mortgage Loan"), and which does not represent an account with the Owner, since the fair market value of the real property securing each Buydown Mortgage Loan would have exceeded the amount of such Buydown Mortgage Loan at the time it was made. Owners and their tax advisors are advised to review section 1.593-11(d) of the Treasury Regulations and to compare Revenue Ruling 81-203, 1981-2 C.B. 137. In the case of the rulings referred to in paragraph 3, an investment in a Buydown Mortgage Loan by a real estate investment trust should also be treated in its entirety as a "real estate asset" within the meaning of section 856(c)(5)(A) of the Code if the fair market value of the real property securing the Buydown Mortgage Loan equals or exceeds the principal amount of such Buydown Mortgage Loan at the time the real estate investment trust makes a commitment to acquire a Certificate. This conclusion is supported by Treasury Regulation section 1.856-5(c)(1)(i), which specifies that if a mortgage loan is secured by both real property and by other property and the value of the real property alone equals or exceeds the amount of the loan, then all interest income will be treated as "interest on obligations secured by mortgages on real property" within the meaning of section 856(c)(3)(B) of the Code. Since there are no directly applicable precedents with respect to the federal income tax treatment of investments in Buydown Mortgage Loans, Owners should consult with their tax advisors concerning such tax treatment.

In general, for purposes of sections 1276 and 1277 of the Code, an Owner's interest in a Mortgage Loan will be considered to be acquired at a market discount if the face amount of such interest exceeds the Owner's basis in such interest. Pursuant to section 1276 of the Code, an Owner will be required to include as ordinary income (i) gain realized on the disposition of any Mortgage Loan (including repayment thereof) originated after July 18, 1984 that is attributable to accrued market discount (as defined in section 1276 of the Code) on such Mortgage Loan or (ii) gain realized on the disposition of a Certificate (including repayment thereof) representing an interest in such a Mortgage Loan. Pursuant to section 1277 of the Code, an Owner's deduction for interest paid or accrued to purchase or carry a Certificate that represents Mortgage Loans acquired (by virtue of the acquisition of the Certificate) at a market discount after July 18, 1984 may have to be deferred to the extent such interest is attributed under section 1277 of the Code to the portion of such market discount that accrued during the taxable year. A deduction for such deferred interest or a portion thereof will, in general, be allowed when such Mortgage Loans are disposed of (including repayment thereof) or when an Owner disposes of its Certificate. Any gain recognized upon such a disposition will have to be recognized as ordinary income to the extent of the deferred interest deduction. The Treasury Department has not yet issued

regulations implementing the market discount rules, and Owners should consult their tax advisors regarding the application of these rules as well as the advisability of making any elections relating to such rules

Owners are advised to consult with their tax advisors as to the possibility that the Mortgage Loans could be treated by the Internal Revenue Service as a collection of "stripped bonds" and "stripped coupons" within the meaning of section 1286 of the Code. A debt obligation becomes a "stripped bond" within the meaning of section 1286 of the Code when the ownership of the right to receive some or all of the interest payments thereon is separated from the ownership of the right to receive some or all of the principal. Interest payments with respect to a stripped bond are "stripped coupons" within the meaning of section 1286 of the Code. The Mortgage Loans could be treated as a collection of "stripped bonds" and "stripped coupons" if the Corporation's servicing fee applicable to a particular Pool were considered by the Internal Revenue Service to exceed reasonable compensation for the services performed and the "excess" portion of such fee were recharacterized as a separate, retained right to receive a portion of the interest payments to be made by mortgagors pursuant to the Mortgage Loans. If the Mortgage Loans were so treated, a major consequence may be, in effect, to require the current accrual of market discount and permit the current deduction of premium on the Mortgage Loans. However, absent Treasury regulations, it is not clear what the applicable rules would be. There are also other possible ways to characterize the "excess" portion of a servicing fee. For example, it is possible that the Internal Revenue Service would recharacterize such a portion as additional purchase price paid under a deferred payment obligation incurred by an Owner at the time such Owner purchased its Certificate representing its individual interest in the Mortgage Loans. In this event, the Owner's initial deductions could be less than the deductions that would have been allowed if the portion of the servicing fee had not been so recharacterized.

The Corporation will furnish to each holder of record with each distribution a statement setting forth the amount of such distribution allocable to principal and to interest. In addition, the Corporation will furnish or make available, within a reasonable time after the end of each calendar year, to each holder who at any time during such year received a distribution from the Corporation, a statement setting forth such holder's pro rata share of interest received and administrative expense for such calendar year.

Payments of interest and principal, as well as payments of proceeds from the sale of Certificates, may be subject to the "backup withholding" tax under section 3406 of the Code at a rate of 20 percent if the recipient of such a payment is not an "exempt recipient" and fails to furnish certain information, including its taxpayer identification number, to the Corporation or its agent, or otherwise fails to establish an exemption from such tax. Any amounts deducted and withheld from such a payment would be allowed as a credit against the Owner's federal income tax. Furthermore, certain penalties may be imposed by the Internal Revenue Service on a holder or Owner who is required to supply information but who does not do so in the proper manner.

Payments made to, or on behalf of, an Owner who is not a U.S. Person (a "Non-U.S. Person") on a Certificate that represents an undivided interest in a Pool of Mortgage Loans all of which were issued after July 18, 1984 generally will be exempt from U.S. federal income and withholding taxes, provided the following conditions are satisfied (a) such Owner does not hold the Certificate in connection with the conduct by such person of a trade or business in the United States, (b) the Owner is not, with respect to the United States, a personal holding company or a corporation that accumulates earnings in order to avoid U.S. federal income tax, (c) the Owner is not a U.S. expatriate or former U.S. resident who is taxable in the manner provided in section 877(b) of the Code, (d) the Owner does not own, either directly or through attribution, 10 percent or more of the total combined voting power of all classes of voting stock of the Corporation, (e) the Owner signs a statement under penalties of perjury that certifies that it is a Non-U.S. Person or, in the case of an individual, that the Owner is neither a citizen nor resident of the United

States, and provides the name and address of the Owner and (f) the last U.S. Person in the chain of payment to the Owner (the "Withholding Agent") receives such non-U.S. beneficial ownership statement from the Owner or a financial institution holding on behalf of the Owner and does not have actual knowledge that such statement is false. That portion of interest income of an Owner who is a Non-U.S. Person on a Certificate that represents an interest in one or more Mortgage Loans issued before July 19, 1984 will be subject to a U.S. withholding tax at the rate of 30 percent or lower treaty rate, if applicable. Regardless of the date of issuance of the Mortgage Loans, backup withholding will not apply to payments made to an Owner that is such a Non-U.S. Person if the Owner or a financial institution holding on behalf of the Owner provides the non-U.S. beneficial ownership statement to the Withholding Agent. The applicable prospectus supplement will indicate the year or years of the origination of the Mortgage Loans.

The non-U.S. beneficial ownership statement referred to in the preceding paragraph may be made on an Internal Revenue Service Form W-8 or substantially similar substitute form. The Owner or financial institution holding on behalf of the Owner must inform the Withholding Agent of any change in the information on the statement within 30 days of such change. In all cases, the Form W-8 or substitute form must be filed by the Withholding Agent with the Internal Revenue Service. "U.S. Person" means a citizen or resident of the United States, a corporation, partnership or other entity created or organized in or under the laws of the United States or any political subdivision thereof, or an estate or trust that is subject to U.S. federal income tax regardless of the source of its income.

The proposals for tax reform under consideration by Congress may, if enacted, adversely affect certain Owners' holding of the Certificates. For example, the proposals for tax reform, as summarized by the Joint Committee on Taxation on August 16, 1986, would restrict the ability of certain thrift institutions to claim deductions for additions to a reserve for bad debts under section 593. In addition, the deduction of Owners who are individuals for their pro rata share of the Corporation's servicing fee under section 212 of the Code may be restricted under such proposals. Owners are advised to consult their own tax advisors concerning the impact of such proposals on their holding of Certificates.

LEGAL OPINION

Any purchaser of Certificates will be furnished upon request an opinion by Caryl S. Bernstein, Esq., Executive Vice President, General Counsel, and Secretary of the Corporation, as to the validity of the Certificates, the applicable Trust Indenture, and the relevant Issue Supplement.

ERISA CONSIDERATIONS

On May 13, 1982, the Department of Labor issued a final regulation (29 C.F.R. § 2550.401b-1), effective June 17, 1982, which provides that in the case where an employee benefit plan ("plan") subject to the Employee Retirement Income Security Act of 1974 ("ERISA") acquires a "guaranteed governmental mortgage pool certificate" then, for purposes of the fiduciary responsibility provisions of ERISA and the prohibited transaction provisions of the Code, the plan's assets include the certificate and all of its rights with respect to such certificate under applicable law, but do not, solely by reason of the plan's holding of such certificate, include any of the mortgages underlying such certificate. Under the regulation, the term "guaranteed governmental mortgage pool certificate" is specifically defined to include a mortgage pool certificate with respect to which interest and principal payable pursuant to the certificate are guaranteed by the Corporation. The effect of such regulation is to make clear that the sponsor (that is, the entity that organizes and services the pool, in this case the Corporation), the trustee, and other persons, in providing services with respect to the mortgages in the pool, would not be subject to the fiduciary responsibility provisions of Title I of ERISA, nor be subject to the

prohibited transaction provisions of Section 4975 of the Code, merely by reason of the plan's investment in a certificate. The Corporation has been advised by its counsel, Brown & Wood, that, on the basis of the final regulation and class exemptions previously issued by the Department of Labor, the acquisition from the Corporation and holding of the Certificates by plans are not prohibited either by ERISA or related provisions of the Code.

FEDERAL NATIONAL MORTGAGE ASSOCIATION

The Corporation is a federally chartered and stockholder-owned corporation organized and existing under the Federal National Mortgage Association Charter Act, 12 U.S.C. 1716 *et seq.* (the "Charter Act"). See "Government Regulation and Charter Act." It is the largest investor in home mortgage loans in the United States, with a net portfolio of \$93.9 billion of mortgage loans as of June 30, 1986. The Corporation was originally established in 1938 as a United States government agency to provide supplemental liquidity to the mortgage market and was transformed into a stockholder-owned and privately managed corporation by legislation enacted in 1968.

The Corporation provides funds to the mortgage market primarily by purchasing mortgage loans from lenders, thereby replenishing their funds for additional lending. The Corporation acquires funds to purchase loans from many capital market investors that may not ordinarily invest in mortgage loans, thereby expanding the total amount of funds available for housing. Operating nationwide, the Corporation helps to redistribute mortgage funds from capital-surplus to capital-short areas. In addition, the Corporation issues mortgage-backed securities ("MBS"), primarily in exchange for pools of mortgage loans from lenders.

The Corporation was profitable in 1985 and in the first six months of 1986 after experiencing a loss in 1984. The Corporation operated profitably in 1983. The primary reason for the loss in 1984 was the excess in the cost of the Corporation's outstanding debt over the yield on its mortgage portfolio (or "negative spread"). During 1985 and 1983, the Corporation's negative spread was substantially less than in 1984 and its impact was more than offset by income from other sources. The Corporation had a positive spread on its mortgage loan portfolio in the last quarter of 1985 and in the first six months of 1986, although the spread was zero during June 1986. See "Selected Financial Data," "Management's Discussion and Analysis of Financial Results," and "Business—Mortgage Loan Portfolio Spread."

The principal office of the Corporation is located at 3900 Wisconsin Avenue, NW, Washington, DC 20016 (telephone: 202-537-7000). The Corporation has five regional offices located in Atlanta, Georgia; Chicago, Illinois; Dallas, Texas; Los Angeles, California; and Philadelphia, Pennsylvania.

Copies of the Corporation's most recent annual and quarterly reports and proxy statement are available without charge from Paul Paquin, Vice President for Investor Relations, Federal National Mortgage Association, 3900 Wisconsin Avenue, NW, Washington, DC 20016 (telephone: 202-537-7115).

CAPITALIZATION

The following table sets forth the capitalization of the Corporation as of June 30, 1986

	<u>Average Maturity</u>	<u>Average Cost (3)</u>	<u>Outstanding</u> (Dollars in millions)
Bonds, notes, and debentures (1):			
Due within one year			
Short-term notes, net of unamor- tized discount	3 mos	7.23%	\$ 6,993
Master notes	11 mos	6.43	1,762
Investment agreements (2)		8.15	4,518
Mortgage-backed bonds	4 mos.	9.01	13
Debentures	6 mos.	11.15	<u>18,240</u>
Total due within one year			<u>31,526</u>
Due after one year			
Mortgage-backed bonds	4 yrs. 9 mos.	8.95	286
Investment agreements (2)	3 yrs. 1 mos.	9.27	866
Debentures, net of unamortized discount	4 yrs 5 mos	10.75	57,360
Exchangeable debentures	4 yrs. 8 mos.	12.66	450
Zero coupon debentures, net of unamortized discount	28 yrs.	11.50	262
Zero coupon capital debentures, net of unamortized discount	33 yrs. 3 mos	10.22	245
Capital debentures, net of unamortized discount	7 yrs. 1 mos.	10.45	1,548
Convertible capital debentures	10 yrs. 3 mos.	4.43	<u>19</u>
Total due after one year			<u>61,036</u>
Total bonds, notes, and debentures			<u>\$92,562</u>
Stockholders' equity			<u>\$ 1,495</u>

(1) See "Business—Corporate Indebtedness" for a description of certain limitations applicable to debt issued by the Corporation.

(2) Investment agreements are individually negotiated agreements providing for the investment of a variable principal amount at a fixed or floating rate of interest. The average term as of June 30, 1986, of the outstanding agreements was 3 years, 2 months. Generally, average maturities of the amounts issued and outstanding vary and are indeterminate.

(3) The average cost includes the amortization of discounts, issuance costs, and hedging results.

The Corporation issues debentures, notes and other debt obligations frequently. The amount of bonds, notes, and debentures on any date subsequent to June 30, 1986 will differ from that shown on the table above

SELECTED FINANCIAL DATA

The following selected financial data for the years 1981 through 1985 (which data are not covered by the report of independent certified public accountants) have been summarized or derived from the audited financial statements. The financial data for the six months ended June 30, 1985 and 1986, are unaudited and include, in the opinion of management, all adjustments (consisting of normal recurring accruals) necessary for a fair presentation. The results of operations for the six months ended June 30, 1986 are not necessarily indicative of the results expected for the entire year. These data should be read in conjunction with the audited financial statements and notes to financial statements that are presented elsewhere herein.

Condensed Statements of Operations (Dollars in millions, except per share amounts)

	Year Ended December 31,					Six Months Ended June 30,	
	1981	1982	1983	1984	1985	1985	1986
Total interest income	\$5,534	\$6,821	\$7,927	\$8,844	\$9,997	\$4,865	\$5,105
Interest on borrowings and related costs	5,997	7,327	7,989	8,996	9,926	4,911	4,947
Interest margin	(463)	(506)	(62)	(152)	71	(46)	158
Commitment, guaranty, and other fees	125	301	238	228	345	162	218
Gain on sales of mortgages	—	44	91	12	—	—	—
Administrative expenses	(50)	(60)	(81)	(112)	(142)	(63)	(79)
Provision for losses (1)	28	(36)	(48)	(86)	(206)	(65)	(147)
Income (loss) before federal income taxes and extraordinary item	(360)	(257)	138	(110)	68	(12)	150
Provision for federal income taxes	170	123	(63)	53	(31)	6	(68)
Income (loss) before extraordinary item	(190)	(134)	75	(57)	37	(6)	82
Extraordinary item, gain on early retirement of debt(2)	—	29	—	—	—	—	—
Net income (loss)	<u>\$ (190)</u>	<u>\$ (105)</u>	<u>\$ 75</u>	<u>\$ (57)</u>	<u>\$ 37</u>	<u>\$ (6)</u>	<u>\$ 82</u>
Earnings (loss) per share:							
Before extraordinary item:							
Primary	\$(3.22)	\$(2.20)	\$ 1.15	\$ (.87)	\$.52	\$ (.09)	\$ 1.12
Fully diluted	(3.22)	(2.20)	1.13	(.87)	.52	(.09)	1.10
Net							
Primary	(3.22)	(1.72)	1.15	(.87)	.52	(.09)	1.12
Fully diluted	(3.22)	(1.72)	1.13	(.87)	.52	(.09)	1.10
Cash dividends per share	.40	.16	.16	.16	.16	.08	.08

(1) Results for the year ended December 31, 1981, include a \$42.0 million reduction in the allowance for loan losses effected in the second quarter. The effect of this action decreased after-tax loss for the year 1981 by \$22.2 million (\$.38 per share).

(2) In September 1982, the Corporation entered into a nontaxable transaction that resulted in the issuance of 6.3 million shares of its common stock in exchange for \$101 million of its long-term debentures, which were retired.

Condensed Balance Sheets
(Dollars in millions)

	December 31,					June 30,	
	1981	1982	1983	1984	1985	1985	1986
Assets							
Mortgage portfolio, net	\$59,846	\$69,714	\$75,665	\$84,599	\$95,038	\$91,416	\$93,941
Other assets	2,052	3,753	3,253	3,760	4,049	3,110	4,581
Total assets	\$61,898	\$73,467	\$78,918	\$88,359	\$99,087	\$94,526	\$98,522
Liabilities							
Bonds, notes, and debentures, net:							
Due within one year	\$17,365	\$25,781	\$26,860	\$31,261	\$31,939	\$31,019	\$31,526
Due after one year	41,186	43,833	47,734	52,458	61,957	58,499	61,036
Other liabilities	2,104	2,650	3,048	3,432	3,849	3,704	4,465
Total liabilities	60,655	72,264	77,642	87,151	97,745	93,222	97,027
Stockholders' equity	1,243	1,203	1,276	1,208	1,342	1,304	1,495
Total liabilities and stockholders' equity	\$61,898	\$73,467	\$78,918	\$88,359	\$99,087	\$94,526	\$98,522

Condensed Statements of Changes in Financial Position
(Dollars in millions)

	Six Months Ended June 30,	
	1985	1986
Funds Provided		
Operations	\$ 25	\$ 227
Proceeds from issuance of debentures and bonds	14,018	8,921
Increase (decrease) in notes and investment agreements	1,325	(2,392)
Mortgage repayments, less discount amortized	3,569	8,158
Sales of mortgages, excluding gains and losses	100	3,150
Other items	167	211
Total funds provided	19,204	18,275
Funds Applied		
Debentures and bonds retired	9,568	7,920
Mortgage purchases, less discount	10,540	10,317
Dividends paid	5	6
Total funds applied	20,113	18,243
Decrease in cash and marketable securities	(909)	32
Beginning balance, cash and marketable securities	1,889	1,929
Ending balance, cash and marketable securities	\$ 980	\$1,961

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL RESULTS

Annual Periods

General

Nineteen eighty-five was both a profitable year for Fannie Mae and a year in which the Corporation made major progress in restructuring its debt and mortgage portfolios to better match their maturities. In addition, the Corporation achieved significant growth in its mortgage-backed securities ("MBS") program, further building this stable earnings base. Performance was adversely affected, however, by an increased level of foreclosure losses that caused a substantial increase in the provision for loan losses.

The Corporation's performance continues to be affected by the movement of interest rates, because a large portion of its mortgage portfolio consists of long term fixed-rate mortgages financed with debt of shorter maturities. Since 1981, the Corporation has adopted strategies to reduce its sensitivity to interest rate changes. They include emphasizing the purchase of adjustable-rate mortgages ("ARMs") and other shorter term mortgages, extending the maturity of debt outstanding when rates are favorable, and developing sources of income that are less susceptible to changes in interest rates, such as guaranty fees from MBS. In 1985, the Corporation implemented a strategy of matching within six months' tolerance the estimated duration of new mortgage purchases and the duration of the debt used to finance these purchases.

This discussion reports on the Corporation's operating activities and financial results for the three years ended December 31, 1985.

Results of Operations

Fannie Mae earned net income of \$37 million in 1985, compared with a loss of \$57 million in 1984 and earnings of \$75 million in 1983. Lower interest rates and increased earnings from commitment fees contributed significantly to the improved results for 1985; however, loan losses were at a higher level than in 1984 and 1983 and reduced overall performance for the year.

For 1985, Fannie Mae reported fully diluted earnings per share of \$0.52, compared with a loss of \$0.87 per share in 1984 and earnings of \$1.13 per share in 1983. Cash dividends were \$0.16 per share in each of the years 1985, 1984, and 1983.

Interest margin—the return on the mortgage portfolio and marketable securities, less the cost of debt—was \$71 million in 1985, the first positive margin reported since 1980. During 1984 and 1983, interest margins were a negative \$152 million and a negative \$62 million, respectively.

The most important factor affecting interest margin is the spread or difference between the average net yield on the mortgage portfolio and the average cost of outstanding debt. This spread showed improvement throughout 1985. In September, the Corporation began earning a positive spread on its portfolio for the first time since December 1979. For the full year of 1985, however, the average portfolio yield was 10.92 percent and the average cost of outstanding debt was 11.14 percent, resulting in an average negative spread of .22 percent. In 1984, the average portfolio yield was 10.81 percent and the average cost of outstanding debt was 11.39 percent, producing an average negative spread of .58 percent. In 1983, the average portfolio yield was 10.67 percent and the average cost of outstanding debt was 11.12 percent, for an average negative spread of .45 percent.

The other factor affecting interest margin is the interest earned on marketable securities. Fannie Mae earned \$124 million of such interest in 1985, compared with \$197 million in 1984 and \$222 million in 1983. The reduced earnings on marketable securities reflect the lower interest rate environment, as well as the Corporation's decision to maintain a smaller average liquidity position in 1985 than in the previous two years.

Commitment fees were \$196 million in 1985, compared with \$114 million in 1984 and \$151 million in 1983. Because of a change in the product mix of commitments, fee income was higher in 1985 than in 1984, even though total commitment volume was slightly less. In 1985, the Corporation issued a greater volume of commitments for 30-year fixed-rate mortgages, which carry higher fee rates than ARMs and other shorter term mortgage products that were more popular in 1984. The decline in commitment fees in 1984 compared to 1983 was attributable to a change in product mix toward shorter term mortgages.

In December 1985, the Financial Accounting Standards Board issued an exposure draft proposing a change in accounting for commitment fees. Currently, the Corporation recognizes most fee income in the period in which the committing service is rendered; however, the exposure draft proposes that such fees be deferred and amortized over the contract life of the related mortgage as a yield adjustment. If adopted, the proposed accounting standard, which may require retroactive application, would likely have a significant adverse impact on Fannie Mae's financial statements in the future. The proposed standard would not be implemented until 1987 or later.

MBS guaranty fees increased to \$112 million in 1985 from \$78 million in 1984 and \$54 million in 1983. These fees grow in relation to the securities outstanding. At December 31, 1985, there were \$55.0 billion in securities outstanding, compared with \$36.2 billion and \$25.1 billion at December 31, 1984 and 1983, respectively.

There were no significant gains or losses on sales of mortgages in 1985, while gains of \$12 million and \$91 million were reported in 1984 and 1983, respectively. Mortgage sales are discussed under the section entitled "Mortgage-Backed Securities."

The provision for loan losses increased to \$206 million in 1985 from \$86 million in 1984 and \$48 million in 1983, reflecting the Corporation's increased foreclosure loss experience, primarily with conventional home loans. The increase in the provision in 1985 resulted from the increase in mortgage purchases, the issuance of a higher volume of MBS without recourse to the lender, the full-year effect of higher provision rates adopted in late 1984, and other additions made in response to the higher level of foreclosure losses.

During 1985, charge-offs of conventional home mortgages in the Corporation's loan portfolio totaled \$143 million, compared with \$87 million in 1984 and \$39 million in 1983. Higher foreclosure losses are an industry-wide problem and are due, in part, to a substantially reduced level of housing inflation and adverse economic conditions in certain geographical areas. In October 1985, Fannie Mae tightened its underwriting standards and credit requirements for certain of its mortgage products. These changes should contribute to improved foreclosure experience after several years.

Administrative expenses increased to \$142 million in 1985 from \$112 million in 1984 and \$81 million in 1983. The increases were due primarily to increases in the number of employees required because of the growth and restructuring of the business, the need to develop automated business systems, and an increased emphasis on quality control and management of acquired properties.

The Mortgage Portfolio

The Corporation's net mortgage portfolio totaled \$95.0 billion at December 31, 1985, compared with \$84.6 billion and \$75.7 billion at December 31, 1984 and 1983, respectively. ARMs and second mortgages represented 21 percent of the portfolio balance at December 31, 1985, up from 17 percent at December 31, 1984 and 12 percent at December 31, 1983.

Fannie Mae issues commitments to purchase standard mortgage products through its "open window," for which required mortgage yields are posted daily. The Corporation also purchases non-standard products, issuing such commitments on a negotiated basis.

Most of the commitments that the Corporation issues are for mandatory delivery, with the yield set upon issuance of the commitment. Fannie Mae also issues market-rate standby

commitments in which the Corporation commits only to purchase a designated amount of mortgages. To deliver mortgages, the lender must convert the standby commitment to a mandatory delivery commitment, at which time the yield is established at Fannie Mae's current posted window rate.

During 1985, the Corporation issued \$20.2 billion in mortgage purchase commitments, compared with \$21.0 billion in 1984 and \$18.6 billion in 1983. Negotiated transactions represented 68 percent of the total commitments issued in 1985, compared with 83 percent in 1984 and 58 percent in 1983. The lower level of negotiated transactions in 1985 reflects the popularity of the standard fixed-rate mortgage when mortgage rates are relatively low.

The Corporation purchased a record volume of mortgages in 1985, totaling \$21.5 billion at an average yield of 11.59 percent, compared with \$16.7 billion at 12.79 percent in 1984 and \$17.6 billion at 12.65 percent in 1983. ARMs were 33 percent of mortgage purchases in both 1985 and 1984, while second mortgages were 4 percent of 1985 purchases, down from 6 percent in 1984. In 1983, ARMs and second mortgages were 24 percent and 8 percent of total purchases, respectively.

Mortgage repayments totaled \$9.0 billion in 1985, compared with \$5.4 billion in 1984 and \$6.2 billion in 1983. The increase in repayments in 1985 reflects the large number of refinancings that occurred in response to the declining level of mortgage rates, as well as higher prepayments, reflecting the general increase in home sales.

Financing Activities

During 1985, with interest rates on average at the lowest levels since 1979, Fannie Mae made substantial progress toward reducing its sensitivity to interest rate fluctuations by matching within two months the estimated duration of new mortgage purchases and that of the debt used to finance the mortgages and by lengthening the average maturity of outstanding debt. As a result of these actions, the Corporation reduced the duration gap between assets and liabilities from 2.4 years at December 31, 1984 to 1.6 years at December 31, 1985.

Fannie Mae raised a total of \$48.2 billion of debt at an average cost of 9.62 percent and an average maturity of 46 months in 1985, including \$10.0 billion in debt with effective maturities of 7 years or more. During 1984, the Corporation issued \$48.0 billion in debt at an average cost of 11.47 percent and an average maturity of 29 months; while in 1983, the Corporation issued \$40.0 billion in debt at an average cost of 10.07 percent and an average maturity of 29 months.

As a result of these activities, the average cost of debt outstanding at December 31, 1985 was reduced to 10.79 percent from 11.56 percent at December 31, 1984, while the average maturity was extended to 40 months from 31 months. At December 31, 1983, the average cost of debt was 11.12 percent and the average maturity was 29 months.

In recent years, Fannie Mae has expanded its investor base both domestically and abroad. The Corporation has become active with innovative financings, obtaining rates lower than those that could generally be achieved through traditional sources. The Corporation raised over \$1 billion directly in the European and Japanese markets in 1985, in addition to the funds raised from foreign investors through regular debt offerings in the United States. The Corporation also issued the first yen-denominated debentures sold in the domestic market by a U.S. corporation. On all borrowings denominated in a foreign currency, the Corporation has negated the foreign exchange risk by concurrently entering into swap arrangements for U.S. dollars.

During 1985, Fannie Mae further expanded its investment agreement and master note programs, both of which provide funds at costs lower than those of traditional forms of borrowing. In addition, the Corporation continues to enter into interest rate swaps to reduce its overall debt costs and to extend the maturity of its debt.

The Corporation added \$107 million to stockholders' equity in 1985 by issuing 7 million shares of common stock, raising the total number of shares outstanding to 73 million.

Mortgage-Backed Securities

The Corporation's MBS continue to grow. Over \$65 billion in securities have been issued since the program was introduced in 1981, with securities outstanding of \$55.0 billion at December 31, 1985.

The Corporation began issuing MBS as part of its overall effort to reduce its sensitivity to interest rate fluctuations. The amount of guaranty fee income, which is earned by the Corporation for guaranteeing the timely payment of principal and interest on the mortgage securities, is related to the total amount of securities outstanding.

In 1985, the Corporation issued \$23.6 billion in MBS, compared with \$13.5 billion in 1984 and \$13.3 billion in 1983. Most of the MBS are issued through swap transactions, where participating lenders place pools of mortgages in trust in exchange for securities. Fannie Mae also issues MBS by pooling mortgages from its portfolio and selling securities for cash through public offerings or private placements. These mortgage sales both enhance the liquidity of the MBS market and advance the Corporation's portfolio restructuring efforts. Sales from portfolio totaled \$1.3 billion in 1985, compared with \$1.0 billion in 1984 and \$4.4 billion in 1983.

Interim Periods

Operations of the Corporation for the first half of 1986 resulted in net income of \$81.8 million or \$1.10 per share, compared with net income of \$43.1 million or \$0.59 per share for the second half of 1985 and a net loss of \$6.2 million or \$0.09 per share for the first half of 1985. The increase in net income primarily reflects a substantial improvement in interest margin and higher commitment fees and guaranty fees. These improvements were offset somewhat by an increase in the provision for losses and, to a lesser extent, increased administrative expenses in the first half of 1986.

Mortgage purchases totaled \$10.4 billion at a net yield of 9.79 percent during the first half of 1986, compared with \$10.6 billion at 11.13 percent for the second half of 1985 and \$10.9 billion at 12.04 percent for the first half of 1985. ARMs and second mortgages comprised 11 percent of total mortgage purchases in the first half of 1986, compared with 35 percent and 39 percent of mortgages purchased in the second half and first half of 1985, respectively. The decrease primarily reflects the lower demand for ARMs in the current low interest rate environment. However, the impact of the decrease in adjustable-rate and second mortgage purchases on average asset life during 1986 has been mitigated by a significant increase in 15-year mortgage purchases during the period. Average portfolio yield was 10.67 percent during the first half of 1986, compared with 10.89 percent and 10.96 percent for the second half and first half of 1985, respectively. Purchases of mortgages at rates less than the average portfolio yield combined with an increase in prepayments of high yielding mortgages primarily were responsible for the decrease in the average portfolio yield.

Interest margin was a positive \$158.2 million for the first half of 1986, an increase over the positive margin of \$116.0 million for the second half of 1985 and the negative margin of \$45.5 million for the first half of 1985. The substantial improvement in interest margin in the first half of 1986 and the second half of 1985, as compared with the first half of 1985, reflects primarily the decreased average cost of debt outstanding, which resulted from refinancing maturing debt at lower rates in a declining interest rate environment.

Debt issued in the first half of 1986 of \$17.4 billion had an average cost of 7.67 percent, a significant decline from an average cost of 9.06 percent for the \$23.0 billion of debt issued in the second half of 1985 and 10.15 percent for the \$25.2 billion of debt issued in the first half of 1985. The average cost of debt outstanding was 10.65 percent for the first half of 1986, compared with 10.90 percent and 11.37 percent for the second half and first half of 1985, respectively.

Mortgage purchase commitments issued during the first half of 1986 totaled \$16.2 billion, compared with \$9.8 billion issued during the second half of 1985 and \$10.4 billion issued during the first half of 1985. Commitment fee income was \$125.5 million for the first half of 1986, compared with \$102.3 million and \$93.4 million for the second half and first half of 1985, respectively. The increase in commitment fee income in the first half of 1986 primarily reflects the increased commitment volume in that period. Commitment fee income, however, does not vary directly with the total volume of commitments issued because commitment fee rates depend on the type of commitment issued, the type of mortgage product, and market conditions.

The provision for portfolio loan and MBS losses during the first half of 1986 was \$147.0 million, compared with \$140.9 million for the second half of 1985 and \$64.6 million for the first half of 1985. Total foreclosure losses charged off for portfolio loans and MBS were \$87.9 million in the first half of 1986, compared with \$112.2 million and \$56.8 million in the second half and first half of 1985, respectively. The higher provision for losses in the first half of 1986 and the second half of 1985, as compared with the first half of 1985, reflects actions taken by management to maintain the allowance for losses at an appropriate level, in consideration of the increased levels of current and anticipated charge-offs. See "Business—Mortgage Loan Portfolio—Single-Family Conventional Mortgage Loan Portfolio Loss Charge-Off, Delinquency, and REO Experience."

MBS guaranty fees were \$75.3 million in the first half of 1986, \$60.8 million in the second half of 1985, and \$50.7 million in the first half of 1985. The increase in guaranty fees is primarily due to the increase in the amount of MBS outstanding. MBS issued in the first half of 1986 totaled \$23.4 billion, compared with \$15.4 billion in the second half of 1985 and \$8.2 billion in the first half of 1985. MBS outstanding at June 30, 1986 totaled \$72.4 billion, compared with \$55.0 billion at December 31, 1985 and \$42.8 billion at June 30, 1985.

Sales of mortgages in the first half of 1986 totaled \$3.2 billion, which resulted in a loss of \$0.6 million. Mortgage sales in the second half and first half of 1985 totaled \$1.2 billion and \$0.1 billion, respectively. The 1985 sales resulted in no significant gain or loss to the Corporation. The increase in sales activity during the first six months of 1986 results from the Corporation's intention, announced on April 30, 1986, to sell \$10 billion of mortgage loans from its portfolio during 1986, assuming favorable market conditions, to help reduce the Corporation's sensitivity to future changes in the level of interest rates. The sales have been largely of assumable FHA-insured or VA-guaranteed mortgage loans purchased prior to 1981 with an average yield below the average yield on the Corporation's portfolio. It is expected that the sales will be effected largely through the Corporation's MBS program at no significant net aggregate gain or loss. Proceeds from the sale may be used to reduce outstanding debt, increase investments, buy mortgage loans, or for other corporate purposes.

The Corporation added \$67.6 million to stockholders' equity in the first half of 1986 by issuing 11,500,000 detachable stock purchase warrants as part of units with debentures.

HISTORY

The Federal National Mortgage Association was incorporated in 1938 pursuant to Title III of the National Housing Act. It was then a wholly owned government corporation that borrowed operating funds almost entirely from the United States Treasury. Its business primarily consisted of the purchase and resale of mortgage loans insured by the Federal Housing Administration ("FHA") and, since 1948, mortgage loans guaranteed by the Veterans Administration ("VA") for the purpose of establishing and maintaining a secondary market for such mortgage loans. Title III was revised in 1954 and called the Federal National Mortgage Association Charter Act. Under the new Charter Act, the Federal National Mortgage Association became a mixed-ownership corporate instrumentality of the United States. In connection with its secondary market operations, it issued nonvoting preferred stock, par value \$100 per share, to the Secretary of the Treasury and nonvoting common stock, par value \$100 per share, to the institutions from which it purchased mortgages.

From 1950 to 1965, the Federal National Mortgage Association was a constituent agency of the Housing and Home Finance Agency and from November 9, 1965 to September 1, 1968 it operated in the Department of Housing and Urban Development ("HUD"). The Charter Act, as in effect prior to September 1, 1968, empowered the Federal National Mortgage Association to (1) conduct secondary market operations in FHA-insured and VA-guaranteed home mortgage loans consisting of purchases and sales of such loans ("Secondary Market Operations"), (2) perform special assistance functions in the purchase of mortgage loans as authorized by the President of the United States or by the Congress to assist in financing home loans in instances where established home financing facilities were inadequate ("Special Assistance Functions"), and (3) manage and liquidate certain mortgage loans ("Management and Liquidating Functions").

Pursuant to amendments to the Charter Act enacted in the Housing and Urban Development Act of 1968 (the "1968 Act"), the Federal National Mortgage Association in 1968 was partitioned into two separate and distinct corporations. One, the Government National Mortgage Association ("GNMA"), is a wholly owned corporate instrumentality of the United States within HUD. GNMA retained all of the assets and liabilities acquired and incurred under the Special Assistance Functions and Management and Liquidating Functions carried on by the predecessor corporation prior to the effective date of the 1968 Act.

The second, the Corporation, now constituted as a federally chartered corporation, retained the assets and liabilities related to the Secondary Market Operations prior to the effective date of the 1968 Act. The 1968 Act changed each share of outstanding nonvoting common stock of the Federal National Mortgage Association, par value \$100 per share, into one share of voting common stock, without par value, and authorized the Corporation to issue its common stock to the public. The 1968 Act also provided for a transitional period for the Corporation's stockholders to assume control of the Corporation, and all preferred stock theretofore held by the Secretary of the Treasury was retired in 1968. Accordingly, the entire equity interest in the Corporation became, and is now, stockholder-owned.

GOVERNMENT REGULATION AND CHARTER ACT

The Corporation is a federally chartered and stockholder-owned corporation organized and existing under the Charter Act (12 U.S.C. 1716 *et seq.*) whose purpose is to provide supplementary assistance to the secondary market for home mortgages by providing a degree of liquidity for mortgage investments, thereby improving the distribution of investment capital available for home mortgage financing. Although the 1968 Act eliminated all federal ownership interest in the Corporation, it did not terminate the significant government regulation of the Corporation. Under the Charter Act, approval of the Secretary of the Treasury is required for the Corporation's issuance of its debt obligations. Under the Charter Act, issuance of stock by the Corporation is required to be approved by the Secretary of HUD, who must also approve stock holding requirements imposed upon mortgage servicers for the Corporation.

Obligations of the Corporation issued under Section 304(b) of the Charter Act are subject to limitations imposed by the Charter Act and regulations adopted by HUD. See "Business—Corporate Indebtedness"

In addition to specific enumerated powers, including those described above, the Secretary of HUD is granted general regulatory power over the Corporation under the Charter Act with authority to promulgate rules and regulations to carry out the purposes of the Charter Act. Also, the Secretary may require, pursuant to the Charter Act, that a reasonable portion of the Corporation's mortgage loan purchases be related to the national goal of providing adequate housing for low- and moderate-income families, but with a reasonable economic return to the Corporation.

The Charter Act also gives the Secretary of HUD the authority to audit and examine the books and financial transactions of the Corporation, but this authority has never been exercised.

Although thirteen members of the Corporation's eighteen-member Board of Directors are elected by the holders of the Corporation's common stock, the remaining five members are appointed by the President of the United States. One such appointed director is required to be from each of the home building, mortgage lending, and real estate industries. Any member of the Board of Directors, including a member elected by stockholders, may be removed by the President of the United States for good cause.

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

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

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

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

BUSINESS

General

The principal activity of the Corporation consists of the purchase of mortgage loans on residential properties, and participation interests in such loans, meeting certain eligibility requirements established by statute and by the Corporation. Both whole loans and participations are referred to herein as "loans" or "mortgage loans." Substantially all of such purchases are made by the Corporation pursuant to forward purchase commitments issued by the Corporation. Under such commitments, the Corporation agrees in advance to purchase a specified dollar amount of mortgage loans at an agreed price. (The term "mortgage" as used herein includes deed of trust.) See "Mortgage Loan Portfolio—Mortgage Loan Purchase Activity" and "Mortgage Loan Portfolio—Commitments." The Corporation obtains funds to purchase mortgage loans from various capital markets. See "Corporate Indebtedness." In addition, the Corporation issues guaranteed mortgage pass-through certificates evidencing beneficial interests in pools of mortgage loans. See "Mortgage-Backed Securities Program."

While the Corporation has implemented changes that are reducing its sensitivity to increases in interest rates, the operations and earnings of the Corporation are still heavily influenced by the level of interest rates and the availability of alternative sources of mortgage credit.

At June 30, 1986, the Corporation employed approximately 2,200 full-time personnel.

Mortgage Loan Portfolio Spread

The performance of the portfolio is measured by the difference, or "spread," between the return that the Corporation receives on its mortgage loan portfolio and the cost of money it borrows to finance that portfolio. The following table sets forth the spread on the portfolio during the periods indicated.

<u>For the Month</u>	<u>Average Net Portfolio During Month</u>	<u>Average Cost of Outstanding Indebtedness (1)</u>					<u>Spread</u>
		<u>Average Yield (1)</u>	<u>Short-term Notes (2)</u>	<u>Bonds and Debentures</u>	<u>Aggregate</u>		
	(In millions)						
December 1981	\$59,628	9.82%	16.10%	10.63%	11.42%	(1.60%)	
December 1982	68,733	10.69	10.85	11.55	11.39	(.70)	
December 1983	75,144	10.70	9.64	11.35	11.07	(.37)	
December 1984	83,540	10.93	11.23	11.64	11.56	(.63)	
<u>1985</u>							
July	91,158	10.97	9.01	11.42	11.10	(.13)	
August	91,866	10.93	8.84	11.35	10.99	(.06)	
September	92,430	10.90	8.70	11.28	10.89	.01	
October	92,995	10.88	8.58	11.25	10.85	.03	
November	93,596	10.84	8.51	11.22	10.82	.02	
December	94,192	10.81	8.47	11.16	10.77	.04	
<u>1986</u>							
January	94,516	10.78	8.46	11.10	10.74	.04	
February	94,605	10.76	8.45	11.06	10.73	.03	
March	94,522	10.71	8.18	11.02	10.70	.01	
April	94,260	10.67	7.91	10.98	10.65	.02	
May	94,019	10.60	7.73	10.94	10.59	.01	
June	93,213	10.52	7.60	10.87	10.52	—	

(footnotes to table on following page)

(1) Average yield on portfolio is calculated for the month shown and converted to an annual interest rate using, as the numerator, the interest income plus the amortized discount less servicing fees and, as the denominator, the average outstanding unpaid principal balance of the mortgage loan portfolio less unamortized discount. Similarly, the average cost of bonds and debentures and aggregate indebtedness is calculated using net interest expense and the average outstanding applicable indebtedness during the month. The average cost of short-term indebtedness is the average original issue cost computed on an actual/360-day basis for short-term notes and master notes and on an actual/actual day basis for investment agreements.

(2) Includes master notes and investment agreements.

An improvement in the spread will depend upon the Corporation's ability to increase the yield on its mortgage loan portfolio or to refinance maturing borrowings at lower rates. Approximately \$17.7 billion principal amount at maturity of bonds and debentures (original term of one year or longer) will mature during the twelve months following June 30, 1986, as shown below. Such bonds and debentures have a weighted average cost of 11.27 percent at June 30, 1986.

<u>Maturity Date</u>	<u>Principal Amount at Maturity</u>	<u>Average Cost</u>	<u>Maturity Date</u>	<u>Principal Amount at Maturity</u>	<u>Average Cost</u>
	(In millions)			(In millions)	
<u>1986</u>			<u>1987</u>		
July 10	\$ 860	11.90%	January 12	\$1,300	10.93%
August 11	1,300	13.96	February 10	1,800	10.55
September 10	975	10.72	March 10	1,350	10.38
October 10	1,500	12.15	April 10	2,348	12.72
November 10	1,800	12.17	May 11	750	11.21
December 10	1,460	9.31	June 10	1,350	10.53
Other Dates	471	8.23	Other Dates	400	7.26

Mortgage Loan Portfolio

Mortgage Loan Purchase Activity

Prior to 1972, all mortgage loans purchased by the Corporation were insured or guaranteed by the federal government, but, since 1972, under authority granted by the Emergency Home Finance Act of 1970, the Corporation also has purchased mortgage loans that are not federally insured or guaranteed (so-called "conventional" mortgage loans). In the first six months of 1986 and in 1985, approximately 98 percent of the Corporation's purchases for portfolio were conventional mortgage loans. The remainder were insured by the FHA or guaranteed by the VA.

Substantially all loans currently in the Corporation's portfolio are secured by first liens, but the Corporation also purchases second lien loans. The Corporation purchases both whole mortgage loans and participations in mortgage loans. With the exception of \$6.8 billion of multifamily project loans held by the Corporation at June 30, 1986, all of the mortgage loans purchased by the Corporation and held in its portfolio are secured by one- to four-family ("single-family" or "home") properties. The Corporation has purchased ARMs since 1981.

Because FHA-insured and VA-guaranteed mortgage loans, as a result of their government backing, involve minimal risk from a credit standpoint, the Corporation's basic eligibility criterion for their purchase is simply the FHA insurance or the VA guaranty.

Because conventional mortgage loans have no federal government backing, the Corporation has established certain underwriting guidelines for their purchase in an effort to reduce the risk of loss from mortgagor defaults. These guidelines are designed to assess the creditworthiness of the mortgagor as well as the value of the mortgaged home relative to the amount of the mortgage

loan. These guidelines are changed from time to time by the Corporation, and the Corporation may deviate from them as to particular mortgage loans. The Corporation no longer requires that the appraisal of the property securing the mortgage loan it purchases be performed by a Corporation-approved appraiser and generally relies on lender representations to ensure that the mortgage loan conforms to the Corporation's underwriting guidelines. In light of the continuing high volume of foreclosure losses, in 1985 the Corporation revised certain of its underwriting and borrower eligibility guidelines. The new underwriting guidelines increased the amount of income a borrower needs to qualify for mortgage loans with low down payments; required additional borrower cash down payment for certain types of loans; eliminated the purchase of graduated-payment ARMs and payment-capped ARMs without interest-rate caps; and limited contributions paid by any interested party to the transaction other than the homebuyer. These new underwriting guidelines became effective with commitments to purchase loans issued by the Corporation on and after October 15, 1985, except for certain loans over one year old. For information on the Corporation's loss and delinquency experience on conventional mortgage loans, see "Single-Family Conventional Mortgage Loan Portfolio Loss Charge-off, Delinquency and REO Experience."

Generally, the Corporation requires that the unpaid principal amount of each conventional first mortgage loan purchased by it (i) not be greater than 80 percent of the value of the mortgaged property or (ii) if it is greater than 80 percent, that the excess over 75 percent be insured by an acceptable mortgage insurance company for so long as the principal balance of the mortgage loan is greater than 80 percent of such original value (or of the appraised value as determined by a subsequent appraisal). Although under the Charter Act mortgage insurance is not required on mortgage loans with loan-to-value ratios greater than 80 percent if the mortgage seller retains a participation in the loan of not less than 10 percent or, in certain instances, agrees to repurchase the loan in the event of default, the Corporation is requiring mortgage insurance in such cases, except where mortgage insurance is not available and the lender agrees to repurchase the loan in the event of default. Mortgage insurance is generally required for second mortgages if the combined loan-to-value ratios of the first and second mortgages on the property exceed 70 percent. -

Conventional mortgage loans on one-family dwellings may not be purchased by the Corporation if their original principal balance exceeds \$133,250, except for loans secured by properties in Alaska and Hawaii. Higher maximum mortgage amounts also apply to loans secured by two or more family dwelling units. Maximum principal balances applicable to the Corporation's conventional mortgage loan purchases are increased annually if there have been increases in the average cost of certain homes. Loans eligible for insurance by the FHA are subject to statutory maximum amount limitations, and the Corporation imposes maximum amount limitations on loans guaranteed by the VA.

In addition to conventional fixed-rate loans, the Corporation purchases ARMs, which are mortgage loans with interest rates that are automatically adjusted, both up and down, in accordance with changes in a specified index. The Corporation specifies the types of ARMs that are eligible for purchase under its standard plans. In addition, the Corporation purchases through negotiated transactions ARMs that do not conform to its standard plans. In 1985, the Corporation purchased \$7.1 billion of ARMs, which constituted 33 percent of the loans it purchased. For the first six months of 1986, the Corporation purchased only \$0.9 billion in ARMs, which represented 8 percent of the loans purchased during that period, as a result of the lower number of ARMs originated and available for purchase in the current low interest rate environment. As of June 30, 1986, the Corporation had \$1.2 billion of ARMs in its portfolio and had outstanding commitments to purchase ARMs totaling \$0.8 billion. In 1984, the Corporation began limiting its purchase of ARMs to those with adjustments limited by caps on the amounts by which monthly payments or the interest rate on the mortgage loans may increase or decrease. Effective October 15, 1985, the Corporation only issues commitments to purchase ARMs with caps on the amount the interest rate may change.

In addition to mortgage loans secured by first liens, the Corporation purchases conventional loans secured by second mortgages. Second mortgages generally bear higher interest rates than contemporaneous first mortgages of comparable maturities and have shorter maturities. For the first six months of 1986, the Corporation purchased \$0.3 billion in second mortgages, which represented 3 percent of mortgage loans purchased during that period. In 1985, the Corporation purchased \$0.9 billion of second mortgages, which constituted 4 percent of the loans it purchased. At June 30, 1986, the Corporation owned \$2.6 billion of loans secured by second mortgages and had outstanding commitments to purchase \$0.1 billion of such loans.

In the last 2 years the Corporation has been purchasing 15-year loans and such purchases increased significantly in the first six months of 1986. In the first half of 1986 the Corporation purchased \$1.4 billion of conventional 15-year fixed rate mortgages as compared to the \$1.7 billion it purchased in 1985.

The Corporation's purchases of ARMs, 15-year loans, and loans secured by second mortgages, as well as the growth of the Corporation's MBS program (see "Mortgage-Backed Securities Program"), are designed to assist in mitigating the risks associated with rising interest rates and to better match the generally shorter maturities of its borrowings.

Since 1981, to upgrade the yield on its portfolio, the Corporation has offered financing for persons purchasing or refinancing homes that secure its existing portfolio loans. These new mortgage loans are offered at interest rates that result from combining the existing balance at its original rate with an additional amount at a market rate. The resulting rate tends to be less than prevailing market rates but significantly greater than that applicable to the refinanced loan. Refinanced mortgage loans facilitate the complete financing of the sale and discourage the assumption of the existing mortgage loan as part of a financing package. As of June 30, 1986, \$2.5 billion of resale/refinance mortgage loans had been made by the Corporation since the inception of the program and, of that amount, \$1.1 billion, or 44 percent, represented newly loaned money.

The Corporation has begun purchasing conventional multifamily mortgage loans for its portfolio. These mortgage loans typically have a shorter term than first mortgage loans secured by single-family dwellings. This aids the Corporation's goal of reducing the difference between the average life of its debt and that of its assets. The multifamily mortgage loans that the Corporation purchases generally do not have an effective term exceeding 15 years. In 1985 the Corporation purchased \$0.7 billion of conventional multifamily mortgage loans. For the first six months of 1986, the Corporation purchased \$0.6 billion of conventional multifamily mortgage loans. Conventional multifamily loans purchased by the Corporation are subject to certain maximum principal amounts, as set forth in the Charter Act, based on the number of units in the property being financed and its location.

Of the single-family mortgages purchased in the first six months of 1986, approximately 47 percent were from mortgage banking companies, 34 percent were from savings and loan associations, 17 percent were from commercial and mutual savings banks, and 2 percent were from other companies.

The Corporation purchases mortgages in two ways: through standard, posted program commitments and through negotiated commitments for bulk purchases. The Corporation's standard, posted mortgage products currently include 15-year and 30-year fixed-rate mortgages, several types of ARM mortgages, and second mortgages. Mortgages delivered pursuant to the Corporation's standard, posted programs are sold to the Corporation and serviced in accordance with the Corporation's published guidelines. Negotiated purchases are used whenever the mortgages do not conform in some manner to one of the Corporation's standard, posted mortgage products or program requirements.

Commitments

The Corporation's mortgage loan purchases are based on its issuance of commitments by which the Corporation agrees in advance to purchase a specified dollar amount of loans. Lenders often pay fees, typically from one-half of 1 percent to 2 percent of the amount of the

commitment, for these commitments depending on market conditions, the type of mortgage loan, and the length and characteristics of the commitment. See "Management's Discussion and Analysis of Financial Results" for a discussion of the Corporation's current accounting treatment for such fees and an exposure draft issued by the Financial Accounting Standards Board proposing a change in accounting for commitment fees.

The Corporation purchases most of its mortgage loans pursuant to mandatory delivery commitments. Under such commitments, lenders are obligated to sell loans to the Corporation at the commitment yield.

The Corporation also issues standby commitments. Under these commitments, the Corporation commits to purchase a designated amount of mortgage loans. A yield on the mortgages is not established at the time the standby commitment is issued. To deliver the mortgage loans, the lender must convert the standby commitment to a mandatory delivery commitment. In such event, the lender generally pays an additional fee to the Corporation. The yield on the mortgage loans is established at the time of conversion.

In 1985, the Corporation began issuing commitments that enable lenders to lock in an interest rate at the time they receive a standby commitment. The rate remains in effect for the term of the commitment; however, the lender must convert its commitment to a mandatory delivery commitment before the Corporation will purchase the mortgage loans. The commitments are structured so that the Corporation can hedge its interest rate risk. The combined term of the standby and mandatory commitments can be up to five months. The Corporation also issued such commitments in 1984 as part of a pilot program.

The following table sets forth the Corporation's mortgage loan portfolio commitment activity

Mortgage Loan Portfolio Commitments
(Dollars in millions)

		Year Ended December 31,					Six Months Ended June 30,	
		1981	1982	1983	1984	1985	1985	1986
Commitments Issued								
Home.	Government insured or guaranteed	\$2,971	\$ 923	\$ 141	\$ 68	\$ 197	\$ 99	\$ 124
	Conventional Fixed-rate	4,927	13,405	10,562	11,838	11,902	5,476	14,194
	Adjustable-rate	1,360	6,024	6,573	7,072	6,525	4,048	771
	Second mortgage	213	1,745	1,325	1,240	808	490	265
	Total home mortgage loans	<u>9,471</u>	<u>22,097</u>	<u>18,601</u>	<u>20,218</u>	<u>19,432</u>	<u>10,053</u>	<u>15,354</u>
Multifamily	Government insured	—	9	—	—	—	—	—
	Conventional Fixed-rate	—	—	6	703	793	365	817
	Adjustable-rate	—	—	—	86	—	—	—
	Total multifamily mortgage loans	<u>—</u>	<u>9</u>	<u>6</u>	<u>789</u>	<u>793</u>	<u>365</u>	<u>817</u>
Total		<u>\$9,471</u>	<u>\$22,106</u>	<u>\$18,607</u>	<u>\$21,007</u>	<u>\$20,225</u>	<u>\$10,418</u>	<u>\$16,171</u>
		December 31,					June 30,	
Commitments Outstanding		1981	1982	1983	1984	1985	1985	1986
Home	Government insured or guaranteed	\$ 920	\$ 44	\$ 8	\$ 12	\$ 17	\$ 43	\$ 18
	Conventional Fixed-rate	1,468	4,016	1,554	3,015	1,697	2,007	6,538
	Adjustable-rate	1,279	3,331	3,828	2,913	1,276	2,568	807
	Second mortgage	31	206	66	331	205	242	87
	Total home mortgage loans	<u>3,698</u>	<u>7,597</u>	<u>5,456</u>	<u>6,271</u>	<u>3,195</u>	<u>4,860</u>	<u>7,450</u>
Multifamily	Government insured	19	9	—	—	—	—	—
	Conventional Fixed-rate	—	—	4	113	207	202	412
	Total multifamily mortgage loans	<u>19</u>	<u>9</u>	<u>4</u>	<u>113</u>	<u>207</u>	<u>202</u>	<u>412</u>
Total		<u>\$3,717</u>	<u>\$ 7,606</u>	<u>\$ 5,460</u>	<u>\$ 6,384</u>	<u>\$ 3,402</u>	<u>\$ 5,062</u>	<u>\$ 7,862</u>

Servicing

Those who sell single-family mortgage loans and conventional multifamily loans to the Corporation generally retain, subject to the Corporation's supervision, the responsibility for servicing the mortgage loans sold. Servicers are compensated through the retention of a specified portion of each interest payment on a serviced mortgage loan. Servicing includes the collection and remittance of principal and interest payments, administration of escrow accounts, collection of insurance claims, and, if necessary, processing of foreclosures. The Corporation services the government-insured multifamily loans in its portfolio.

Mortgage Loan Portfolio Statistics

At June 30, 1986, the majority of the Corporation's mortgage loan portfolio consisted of fixed-rate mortgage loans. Substantially all such loans provide for level monthly installments of principal and interest, such installments consisting primarily of interest during the early and middle years, with the major portion of the original principal balance being payable during the years immediately preceding maturity.

In 1981, the Corporation began purchasing both ARMs and second mortgage loans. At June 30, 1986, such loans totaled 17 percent and 3 percent, respectively, of the Corporation's portfolio. In addition to 30-year fully amortized conventional fixed-rate loans, the Corporation purchases growing equity mortgages ("GEMs") and conventional fixed-rate loans with 15-year terms. For the first six months of 1986, the Corporation purchased \$1.4 billion of conventional 15-year fixed-rate mortgages and \$0.3 billion in GEMs for portfolio. During 1985, the Corporation purchased over \$1.7 billion in conventional 15-year fixed-rate mortgages and \$0.7 billion in GEMs for portfolio.

The majority of loans in the Corporation's portfolio had original maturities of not less than 25 years (generally 30 years for single-family loans and 40 years for FHA-insured project loans). At June 30, 1986, the weighted average life (based on the underlying amortization schedules, balloon provisions, and assuming no prepayments) of the mortgage loans in the Corporation's mortgage portfolio was approximately 23 years, and the weighted average yield was 10.51 percent.

The following table sets forth the composition of the Corporation's mortgage loan portfolio, purchase activity, principal repayments, mortgage loan sales, the weighted average yield (net of servicing) on the mortgage loan portfolio, and the average net yield on mortgage loans purchased.

Mortgage Loan Portfolio
(Dollars in millions)

	Year Ended December 31,					Six Months Ended June 30,	
	1981	1982	1983	1984	1985	1985	1986
Unpaid Principal Balances at End of Period							
Home: Government-insured or -guaranteed	\$34,550.7	\$33,742.3	\$30,999.9	\$29,016.3	\$27,414.1	\$28,380.9	\$24,440.8
Conventional: Fixed-rate	21,153.2	27,789.6	32,533.3	38,780.9	45,034.5	42,912.9	47,207.9
Adjustable-rate	106.8	3,331.9	7,126.3	11,729.2	16,895.4	14,784.5	16,188.2
Second mortgage	175.3	1,635.5	2,385.4	2,816.8	2,889.4	2,976.8	2,623.6
Multifamily: Government-insured	5,425.9	5,283.3	5,148.3	5,060.0	4,950.7	5,014.6	4,910.8
Conventional: Fixed-rate	—	31.1	63.0	634.4	1,819.1	911.8	1,889.1
Adjustable-rate	—	—	—	71.2	45.8	62.6	34.9
Total unpaid balance	<u>\$61,411.9</u>	<u>\$71,813.7</u>	<u>\$78,256.2</u>	<u>\$88,108.8</u>	<u>\$98,549.0</u>	<u>\$95,044.1</u>	<u>\$97,295.3</u>
Average yield net of servicing	9.85%	10.73%	10.70%	10.98%	10.81%	10.97%	10.51%
Purchases During Period							
Home: Government-insured or -guaranteed	\$ 2,284.0	\$ 901.1	\$ 186.1	\$ 189.7	\$ 465.5	\$ 297.9	\$ 217.1
Conventional: Fixed-rate	3,544.3	9,442.9	11,702.4	9,544.0	12,397.9	6,048.3	8,413.4
Adjustable-rate	106.8	3,210.0	4,246.3	5,403.2	7,082.6	3,768.7	870.5
Second mortgage	175.9	1,552.3	1,407.9	936.7	870.9	489.6	278.2
Multifamily: Government-insured	1.9	9.5	12.0	—	—	—	—
Conventional: Fixed-rate	—	—	2.3	567.0	693.3	275.1	586.7
Adjustable-rate	—	—	—	80.2	—	—	—
Total mortgage loans purchased (1)	<u>\$ 6,112.9</u>	<u>\$15,115.8</u>	<u>\$17,557.0</u>	<u>\$16,720.8</u>	<u>\$21,510.2</u>	<u>\$10,879.6</u>	<u>\$10,365.9</u>
Average net yield on mortgage loans purchased	15.38%	15.00%	12.65%	12.79%	11.59%	12.04%	9.79%
Repayments During Period							
Home: Government-insured or -guaranteed	\$ 1,252.1	\$ 1,263.6	\$ 2,045.5	\$ 1,650.6	\$ 2,073.6	\$ 937.1	\$ 1,350.5
Conventional: Fixed-rate	740.5	909.6	3,474.0	2,846.2	4,825.6	1,816.3	4,897.0
Adjustable-rate	—	23.9	451.9	934.2	2,038.8	787.7	1,601.6
Second mortgage	.6	92.1	658.0	505.3	798.3	329.6	544.0
Multifamily: Government-insured	127.1	121.0	110.5	81.4	109.3	45.4	39.9
Conventional: Fixed-rate	—	—	7.0	4.6	20.3	2.7	24.2
Adjustable-rate	—	—	—	9.0	25.4	8.6	10.9
Total mortgage loan repayments (1)	<u>\$ 2,120.3</u>	<u>\$ 2,415.2</u>	<u>\$ 6,746.9</u>	<u>\$ 6,031.3</u>	<u>\$ 9,891.3</u>	<u>\$ 3,927.4</u>	<u>\$ 8,468.1</u>
Sales During Period							
Home: Government-insured or -guaranteed	\$ —	\$ 518.2	\$ 907.2	\$ 528.8	\$ —	\$ —	\$ 1,841.1
Conventional: Fixed-rate	8.6	1,896.9	3,560.3	450.2	1,318.7	100.0	1,343.0
Multifamily: Government-insured	.8	—	—	—	—	—	—
Total sales	<u>\$ 9.4</u>	<u>\$ 2,415.1</u>	<u>\$ 4,467.5</u>	<u>\$ 979.0</u>	<u>\$ 1,318.7</u>	<u>\$ 100.0</u>	<u>\$ 3,184.1</u>

(1) Includes \$630 million, \$617 million, \$126 million, \$54 million, and \$10 million principal amount of mortgage loans that were refinanced under the Corporation's resale/refinance program in 1981, 1982, 1983, 1984, and 1985, respectively. In the first six months of 1986, there was no refinancing of mortgage loans under the resale/refinance program, compared with \$7 million principal amount of mortgage loans that were refinanced under this program in the first six months of 1985. Repayments also include \$243 million, \$357 million, \$537 million, \$648 million, and \$935 million in these years, respectively, of loans removed from portfolio as a result of foreclosures. Foreclosures included in repayments for the first six months of 1986 were \$535 million.

Prepayments and Assumptions

As shown by the table under "Mortgage Loan Portfolio Statistics," the level of principal repayments as a percentage of the Corporation's mortgage loan portfolio in 1983, 1984, 1985, and the first six months of 1986 reflects a substantial increase from the unusually low levels of 1981 and 1982. In the first six months of 1986, the \$7.9 billion in mortgage repayments the Corporation received included approximately \$6.8 billion for mortgages that were prepaid. Because all of the mortgage loans in the Corporation's portfolio are prepayable by the borrower (in some cases with a small penalty), the moderation in interest rates experienced since 1982 resulted in a significant increase in prepayments of the higher interest rate mortgage loans in the Corporation's loan portfolio. This phenomenon accelerated in the first six months of 1986 with the recent, substantial decline in mortgage interest rates and was the major cause of the decline in mortgage yields. In general, when the level of interest rates declines significantly below the interest rates on portfolio mortgage loans, the rate of prepayment is likely to increase, although the rate of principal payments is influenced by a variety of economic, geographic, social, and other factors.

The low level of principal prepayments experienced in 1981 and 1982 contributed to the Corporation's operating losses in 1981 and 1982. As a result, the Corporation was forced to rely more heavily on high-cost borrowings to finance new mortgage purchases and to refund maturing indebtedness. The Corporation believes that the significant reduction in principal paydowns during 1981 and 1982 was due primarily to the high interest rate environment. The high cost of new financing resulted in both a decline in the number of home sales and a major portion of home sales being financed through so-called "creative" financing wherein the existing mortgage was assumed by the purchaser of the home (and generally coupled with second mortgage or purchase money financing) or "wrapped" by another loan from another lender.

The Corporation currently enforces "due-on-sale" clauses in conventional fixed-rate mortgages purchased by the Corporation pursuant to commitments issued on and after November 10, 1980 and in conventional mortgages covering properties whose sale has been facilitated by "wraparound" or second mortgages made by institutional lenders. Because approximately 50 percent of the Corporation's portfolio loans (including all FHA and VA loans) do not contain any such clause and several states have limited the enforcement of such clauses in loans originated or assumed during certain periods prior to October 15, 1982, the Corporation has been unable to prevent assumptions on a major portion of its portfolio.

Single-Family Conventional Mortgage Loan Portfolio Loss Charge-off, Delinquency, and REO Experience

The portfolio of single-family conventional mortgage loans consists predominantly of loans made to owner-occupants and secured by first liens on residential real property. The losses charged off and the delinquencies experienced on the single-family conventional loan portfolio are summarized in the following tables. These tables exclude loans purchased as participation interests and loans purchased in summary format by the Corporation.

Single-Family Conventional Loan Loss Charge-off Experience

(Dollars in millions)

	Year Ended December 31,					Six Months Ended June 30,	
	1981	1982	1983	1984	1985	1985	1986
Net losses charged off during period (1)	\$.8	\$ 1.6	\$ 38.4	\$ 79.2	\$ 107.2	\$ 37.9	\$ 55.6
Principal balance at end of period	\$19,561.3	\$23,982.9	\$24,457.3	\$24,633.9	\$26,031.8	\$25,740.9	\$25,605.4
Net loss charge-off ratio	0.0041%	0.0067%	0.1570%	0.3215%	0.4118%	0.2945%	0.4343%
Number of foreclosures during period	606	1,270	2,963	4,664	6,220	3,349	3,608
Number of loans at end of period	472,414	539,465	538,470	540,188	553,826	555,216	537,633
Percent foreclosed	0.1283%	0.2354%	0.5503%	0.8634%	1.1231%	1.2064%	1.3422%

(1) For 1981 and 1982, net losses charged off were determined upon disposition of foreclosed properties by subtracting from the proceeds realized the sum of the book value of the foreclosed asset and related foreclosure costs, expenses, interest accrued but uncollected to the date of foreclosure, and other carrying costs. Beginning in September 1983, estimated losses on acquired properties are charged to the allowance for losses when properties are acquired rather than at disposition, and such estimated losses are adjusted, from time to time as appropriate, to reflect current estimates of net realizable value. Write-downs to market for properties on hand produced a charge to the allowance for losses of \$20.1 million in September 1983. Also charged to the allowance in September 1983 was \$6.2 million related to below-market financing on sales of acquired properties in all prior periods. The items had no effect on reported net income in 1983 because losses had been provided for previously.

Loan losses charged off relating to the remainder of the Corporation's total conventional mortgage loan portfolio totaled \$21.4 million for the first six months of 1986, \$35.6 million for the calendar year 1985 and \$8.1 million for 1984. The principal balance of such portion of the Corporation's portfolio at June 30, 1986 and at the end of 1985 and 1984 was \$40.4 billion, \$38.8 billion and \$28.7 billion, respectively. For periods prior to 1984, loan losses charged off on this part of the portfolio were insignificant.

The substantial increase in losses charged off on conventional mortgage loans, as indicated above, resulted both from an increase in the number of mortgage loans foreclosed and from a higher average loss per foreclosure. In response to the increase in charge-offs, effective October 1, 1984, the Corporation raised the rates at which it adds to the allowance when conventional mortgage loans are purchased. Effective in July 1985, the Corporation increased the minimum level at which it maintains the allowance for conventional loan losses from 0.10 percent to 0.15 percent of the conventional home mortgage loan portfolio. To maintain the allowance at this new level, the Corporation increased the provision for loan losses by an additional \$68 million in 1985. The allowance is also adjusted at other times to maintain it at a level management believes is appropriate.

The total allowance for losses on single-family conventional mortgage loans (including the allowance for losses on participations and loans in summary format) was \$132 million at June 30, 1986, \$107 million at December 31, 1985, \$92 million at December 31, 1984, and \$112 million at December 31, 1983.

Single-Family Conventional Loan Delinquency Experience

(Percent of Portfolio By Number of Loans)

Period of Delinquency	December 31.					June 30.	
	1981	1982	1983	1984	1985	1985	1986
One month	2.9%	3.3%	3.5%	3.7%	3.4%	3.2%	3.1%
Two months	.5	.7	.8	.9	.9	.7	.8
Three or more months	.2	.3	.5	.5	.6	.4	.5
Total(1)	3.6%	4.3%	4.8%	5.1%	4.9%	4.3%	4.4%
Under special lender forbearance	.2%	4%	5%	.6%	.7%	.6%	.8%
In foreclosure	.6	6	9	.8	.9	.8	1.0

(1) Delinquency percentages exclude loans under special lender forbearance or in foreclosure.

The number of properties owned by the Corporation as a result of foreclosures ("REOs") has increased significantly. As of June 30, 1986, the number of properties managed by the

Corporation totaled approximately 8,200 with an aggregate carrying value of approximately \$308 million. This compares with approximately 7,700 properties with an aggregate carrying value of approximately \$298 million at December 31, 1985, and approximately 7,800 properties with an aggregate carrying value of approximately \$344 million at June 30, 1985. As of March 31, 1984, the first date for which the Corporation compiled comparable data, the Corporation managed approximately 3,000 properties with an aggregate carrying value of approximately \$140 million. Properties managed by the Corporation exclude those acquired upon foreclosure of loans where the Corporation had a participation interest of less than 100 percent. Such properties are acquired and managed by the participating lenders. The Corporation expects that the addition of such properties would not increase the inventory by more than 10 percent.

The carrying value of a property is the lower of the Corporation's net investment (after deducting proceeds from any mortgage insurance company) or current estimated net realizable value. In recent years, due to the decrease in the rate of appreciation of property values, mortgage insurance companies generally have paid the insurance claims rather than take title to the foreclosed properties. This practice, in combination with an increased number of foreclosures and a longer average holding period of the properties, has caused the substantial increase in the Corporation's REO inventory.

The Corporation's loan portfolio also includes approximately \$102 million of mortgage loans of limited partnerships of which a successor to Equity Programs Investment Corp. ("EPIC") or a related company is the general partner under the reorganization plan discussed below. The EPIC limited partnerships stopped making payments on their mortgage loans after July 1985. Later in 1985, EPIC limited partnerships that are the mortgagors on most of such loans filed for protection from creditors under Chapter 11 of the federal bankruptcy code. On April 25, 1986, the Bankruptcy Court confirmed a reorganization plan under which the interest rate on EPIC mortgage loans is reduced from an average of 13.8 percent to a payment rate of 8.5 percent, and an accrual rate (for purposes of claims against sales proceeds and mortgage insurance) of 11 percent. Under the plan, the approximately 20,000 homes are to be sold over a five- to seven-year period, and are to be rented in the interim. The reduced interest payments will be funded by net rents and any other funds available from the EPIC partnerships and, for mortgages insured by participating mortgage insurers, by advances from the mortgage insurers to the extent that other funds are insufficient. Virtually all of the Corporation's EPIC mortgages are insured by mortgage insurers participating in the reorganization plan. It is not possible at this time to determine the extent of any loss that the Corporation may incur on mortgage loans purchased from EPIC. The Corporation expects that the orderly property management and disposition process provided under the EPIC reorganization plan will mitigate potential losses. The Corporation stopped accruing income on its EPIC assets when the first defaults occurred in the third quarter of 1985.

TMIC Insurance Company, Inc. ("TMIC"), formerly Ticor Mortgage Insurance Company, a major national private mortgage insurer and a participating insurer in the EPIC plan, was placed into conservatorship by the California Insurance Department in April, in part because it has insured a significant amount, relative to its total capital and reserves, of EPIC mortgage loans. On April 28, 1986, the Los Angeles Superior Court approved a Rehabilitation Plan for TMIC that enables TMIC to participate in the EPIC reorganization plan with respect to the EPIC mortgages that TMIC insures. As part of the reorganization plan, TMIC's parent, TICOR, has agreed to provide TMIC with \$30 million in new capital over four years.

TMIC also insures individual mortgage loans owned by the Corporation that, in the aggregate, constitute approximately 15 percent (approximately \$2.3 billion) of its insured, conventional whole-loan portfolio, as of June 30, 1986. This estimate excludes loans purchased as participation interests, loans purchased in summary format, and loans in MBS pools, for which data are not readily available. Effective September 5, 1985, the Corporation ceased to issue commitments to purchase, or issue MBS with respect to, individual loans covered by mortgage insurance issued by TMIC. TMIC's Rehabilitation Plan provides that non-EPIC claims will be

paid in three equal annual installments, with simple interest at 8 percent per year on the unpaid installments payable one year after payment of the third installment.

Corporate Indebtedness

Although the Corporation is stockholder-owned and its obligations (other than its outstanding mortgage-backed bonds guaranteed by GNMA) are not backed by the United States or any agency or instrumentality thereof other than the Corporation, the Corporation's debt has traditionally been treated as "U.S. Agency" debt in the U.S. marketplace. The Corporation, as a result, has historically enjoyed ready access to funds in the U.S. credit markets at rates that are slightly higher than the yields on U.S. Treasury obligations of comparable maturities.

The following table sets forth at June 30, 1986, the maturity profile of the Corporation's debentures and bonds that were originally issued with a maturity of one year or longer.

<u>Maturing Within</u>	<u>Book Value</u> (In millions)	<u>Average Cost</u>
One year	\$17,664	11.27%
One to two years	15,577	11.41
Two to three years	12,131	11.01
Three to four years	9,362	10.57
Four to five years	5,658	9.96
Over five years	17,587	10.34

The outstanding indebtedness of the Corporation consists of general unsecured obligations issued under Section 304(b) of the Charter Act, subordinated capital debentures (including convertible capital debentures), which are unsecured subordinated general obligations issued under Section 304(e) of the Charter Act, and mortgage-backed bonds issued under Section 304(d) of the Charter Act.

Section 304(b) of the Charter Act provides that the aggregate amount of obligations outstanding under such subsection shall not exceed, at any one time, fifteen times the sum of the capital (including, for this purpose, capital debentures), capital surplus, general surplus, reserves, and undistributed earnings of the Corporation unless a greater ratio is fixed by the Secretary of HUD. In 1982, the Secretary of HUD increased this ratio to 30:1. Regulations adopted by HUD provide that this increased ratio is, in the event of a reduction in the Corporation's capital, automatically increased to such ratio as shall be necessary to include all obligations outstanding pursuant to Section 304(b). At June 30, 1986 and December 31, 1985, this debt-to-capital ratio was 25.7:1, compared with a ratio of 28.2:1 at June 30, 1985. At June 30, 1986, the Corporation could have issued approximately \$14.9 billion additional obligations under Section 304(b) of the Charter Act.

Prior to October 15, 1982, the Charter Act provided that the total principal amount of obligations issued under Section 304(e) that may be outstanding at any one time shall not exceed two times the sum of (i) the capital of the Corporation represented by its outstanding common stock and (ii) its surplus and undistributed earnings at such time. Although this restriction was removed by Congress in 1982, the Corporation is obligated to holders of certain outstanding issues of subordinated capital debentures to maintain such ratio until such outstanding debentures mature or are redeemed. At June 30, 1986, this subordinated debt-to-equity ratio was 1.2:1, compared with 1.6:1 at December 31, 1985 and 1.3:1 at June 30, 1985. At June 30, 1986, the Corporation could have issued approximately \$1.177 billion additional subordinated obligations under Section 304(e) of the Charter Act. The latest maturity date of a series of subordinated debentures containing the subordinated debt-to-equity restriction is September 30, 2002, although that series is callable at the Corporation's option beginning in 1988. Other noncallable

subordinated obligations containing the subordinated debt-to-equity restriction are scheduled to be outstanding until May 1989. Regulations adopted by HUD provide that, at the maturity or other event requiring the payment or redemption of obligations issued under Section 304(e) of the Charter Act, the permitted debt-to-capital ratio is automatically increased as necessary to permit the issuance of obligations under Section 304(b) of the Charter Act in an amount sufficient to provide the proceeds required to pay the principal of and interest on the outstanding subordinated obligations and so required to be paid at such time.

Issuances of indebtedness pursuant to Section 304(b) are also subject to the condition that, at the time of any such issuance, the aggregate amount of such indebtedness then outstanding under such Section 304(b), after giving effect to the indebtedness being issued, is not greater than the Corporation's ownership, free from any liens or encumbrances, of cash, mortgages or other security holdings and obligations, participations or other investments. Unlike the debt-to-capital ratio limitation described above, this Section 304(b) limitation is statutory and may not be waived or varied by the Secretary of HUD. For purposes of each of the foregoing calculations, the Corporation accounts for debt obligations issued at a discount at their book value (face amount less unamortized discount).

Section 304(d) of the Charter Act, pursuant to which MBS and mortgage-backed bonds are outstanding, imposes a requirement with respect to securities issued thereunder that the mortgages pledged or set aside must be sufficient at all times to make timely debt service payments on the securities. There is no other limitation on the amount of MBS and mortgage-backed bonds that may be outstanding. At June 30, 1986, the Corporation had \$299 million in mortgage-backed bonds outstanding, of which \$290 million were guaranteed by GNMA pursuant to Section 306(g) of the National Housing Act and thus are backed by the full faith and credit of the United States.

Section 304(c) of the Charter Act authorizes the Secretary of the Treasury, in his discretion, as a public debt transaction, to purchase obligations of the Corporation up to a maximum of \$2.25 billion outstanding at any one time. This authority has not been used since the Corporation's transition from government control. Although the Secretary of the Treasury is authorized to purchase the obligations of the Corporation, the Secretary is under no requirement to do so. Any such obligations purchased by the Secretary of the Treasury must be issued pursuant to Section 304(b) of the Charter Act and, accordingly, would be subject to the applicable limitations and restrictions described above.

The following table sets forth the Corporation's borrowing activity and outstanding borrowings, the respective costs of borrowings, and average maturities. The amounts given are book value (face amount less unamortized discount) except for short-term notes, which, because they have a maturity of less than one year, are reported at their face amount.

Debt
(Dollars in millions)

	Year Ended December 31,					Six Months Ended June 30,	
	1981	1982	1983	1984	1985	1985	1986
Short-Term Notes, Master Notes, and Investment Agreements							
Issued during period:							
Amount	\$30,185	\$34,196	\$20,262	\$23,135	\$22,482	\$11,198	\$ 8,368
Average cost	16.56%	12.31%	9.47%	10.87%	8.50%	8.90%	7.01%
Average Maturity—Days(1)	98	129	161	211	236	227	224
Outstanding at end of period:							
Amount	\$ 9,189	\$11,752	\$11,841	\$13,080	\$16,741	\$14,325	\$14,255
Average cost	15.47%	10.48%	9.67%	11.00%	8.31%	9.04%	7.55%
Average Maturity—Days(1)	57	141	106	129	121	161	136
Bonds and Debentures							
Issued during period:							
Amount	\$10,221	\$20,764	\$19,756	\$24,836	\$25,704	\$14,018	\$ 8,946
Average cost	15.26%	13.62%	10.66%	11.90%	10.35%	10.88%	8.27%
Average Maturity—Months..	43	36	53	46	64	63	80
Outstanding at end of period:							
Amount	\$49,560	\$58,279	\$63,046	\$71,059	\$77,365	\$75,533	\$78,423
Average cost	10.71%	11.55%	11.38%	11.61%	11.13%	11.47%	10.84%
Average Maturity—Months..	36	32	34	35	41	39	44
Total Debt							
Issued during period:							
Amount	\$40,406	\$54,960	\$40,018	\$47,971	\$48,186	\$25,216	\$17,314
Average cost(2)	16.22%	12.82%	10.07%	11.47%	9.62%	10.15%	7.67%
Average Maturity— Months(1)(2)	13	16	29	29	46	44	50
Outstanding at end of period:							
Amount	\$58,749	\$70,031	\$74,887	\$84,089	\$94,106	\$89,858	\$92,678
Average cost(2)	11.42%	11.38%	11.12%	11.56%	10.79%	11.21%	10.53%
Average Maturity— Months(1)(2)	31	27	29	31	40	36	43

(1) The average maturity is calculated exclusive of investment agreements, because the balance associated with each investment agreement fluctuates over the life of the agreement.

(2) Average cost and maturity of total debt issued and outstanding include effects of interest rate swaps.

Mortgage-Backed Securities Program

In 1981, the Corporation began issuing mortgage-backed securities ("MBS"). These are guaranteed mortgage pass-through certificates evidencing beneficial interests in pools of mortgage loans. The pools of mortgage loans are not assets of the Corporation, nor are the related outstanding securities liabilities of the Corporation. The Corporation, however, is liable under its guaranty.

Initially, the Corporation issued MBS only for conventional fixed-rate mortgages secured by single-family dwellings. However, in 1982, the Corporation expanded the program to include pools of California variable-rate, FHA-insured, VA-guaranteed, and growing equity mortgages. In 1984, the program was further expanded to include ARMs, graduated-payment mortgage

loans, and conventional multifamily loans. The majority of the Corporation's MBS outstanding represents beneficial interests in conventional fixed-rate mortgage loans on single-family dwellings.

Most MBS are issued in "swap" transactions, in which lenders approved by the Corporation exchange pools of mortgage loans directly for MBS. Lenders then either hold the certificates, sell them to other investors, or use them as loan collateral in repurchase agreements. In 1984, the Corporation began a program to swap MBS representing beneficial interests in conventional single-family or multifamily mortgage loans financed by bond issues of state or local governments or authorities. In addition to "swap" transactions, the Corporation pools mortgage loans from its own portfolio or purchases mortgage loans from lenders in exchange for cash, and assembles the mortgage loans in a pool, and sells the related certificates.

The MBS carry the Corporation's guaranty of timely payment of scheduled principal and interest on the underlying pooled mortgage loans, whether or not such payments are received from the mortgagor. Because of the Corporation's guaranty of timely payment on the MBS, these instruments attract investors that would not ordinarily invest in mortgage loans. The program enables the Corporation to further its statutory purpose of increasing the liquidity of residential mortgage loans without requiring that the Corporation take the financing or "spread" risk on the pooled mortgage loans. In addition, MBS create a stable source of guaranty fee income to the Corporation that is not as interest-rate-sensitive as the Corporation's portfolio investing activities.

The Corporation receives guaranty and commitment fees for its MBS. For the six months ended June 30, 1986, MBS guaranty fees and commitment fees totaled \$75 and \$6 million, respectively. During 1985, fees from MBS included \$112 million of guaranty fees and \$25 million of commitment fees. Commitment fees are paid at the time a commitment is issued. Guaranty fees are generally paid monthly. Commitments for MBS provide for optional or mandatory delivery.

Because the Corporation guarantees timely payment of scheduled principal and interest on the MBS, it absorbs the ultimate credit risk of a borrower's default on all conventional mortgage loans in MBS pools. The Corporation protects against this risk in the same manner as for portfolio mortgage loans. Specifically, the guidelines for mortgage loans purchased for MBS pools are the same as those for mortgage loans purchased for portfolio as described under "Mortgage Loan Portfolio—Mortgage Loan Purchase Activity." In addition, the Corporation's risk may be offset somewhat to the extent sellers of pools of mortgage loans elect to remain at risk on the loans sold to the Corporation. Lenders are provided an option to assume the credit risk in exchange for paying a lower guaranty fee. At June 30, 1986, \$41 billion of the conventional mortgage loans that are part of MBS pools were purchased with recourse to the sellers in the event of default by the borrowers on the underlying mortgage loans. If the loss rate on conventional mortgage loans in pools should appreciably increase, the Corporation's losses could, to the extent not offset by recourse to sellers, become significant. For those mortgages on which the Corporation does not have recourse to sellers, the Corporation provides for loan losses at the time of the issuance of the pools. At June 30, 1986, the estimated liability for foreclosure losses on MBS was \$58 million.

The Corporation's activity in MBS is shown in the following table

MBS
(Dollars in Millions)

	Year Ended December 31,					Six Months Ended June 30,	
	1981	1982	1983	1984	1985	1985	1986
Commitments							
Issued during period	\$3,259	\$15,517	\$15,722	\$42,235 (1)	\$32,957	\$14,637	\$29,041
Outstanding at period end	2,555	2,331	1,627	4,505	10,093	10,213	14,551 (2)
MBS Certificates							
Issued during period	\$ 717	\$13,970	\$13,340	\$13,546	\$23,649	8,200	23,359
Outstanding at period end	717	14,450	25,121	36,215	54,987	42,755	72,377

(1) The substantial increase in the commitment volume for mortgage-backed securities in 1984 resulted from a marketing effort that included the elimination of commitment fees for a limited period on optional delivery MBS commitments. Because these optional delivery commitments were issued without charging any commitment fee, the delivery rate on these commitments was lower than normal.

(2) The \$14.6 billion in commitments consists of approximately \$7.3 billion in mandatory delivery commitments and approximately \$7.3 billion in optional delivery commitments.

Competition

The Corporation competes, within the limits prescribed by its Charter Act, in the purchase of mortgage loans for portfolio and the issuance of mortgage-backed securities in the secondary mortgage market. The Corporation competes primarily with savings and loan associations, savings banks, commercial banks, mortgage bankers, government-sponsored corporations, and companies that pool mortgage loans ("conduits") for sale to investors as whole loans or mortgage-backed securities. The number and types of institutions that compete with the Corporation have increased significantly in recent years, with the substantial increase in the amount of mortgage loans sold in the secondary mortgage market and the growth of mortgage-backed securities.

The Corporation's market share of loans purchased for portfolio is affected by the volume of mortgage loans offered for sale in the secondary market by loan originators and other market participants, the amount purchased by other market participants that compete with the Corporation, and the adequacy of funds to meet the demands of the housing industry. In its purchase of mortgage loans for portfolio, the Corporation competes primarily on the basis of yield, fees, and products offered. Competition has been particularly intense for ARMs because many savings and loan associations and other market participants have purchased or retained such loans to better match the terms of their assets and liabilities.

The Corporation's MBS program competes primarily with other companies that issue mortgage-backed securities, including conduits, savings and loan associations, and commercial banks. Based on available information, the Corporation estimates that approximately \$66 billion of conventional mortgage pass-through securities were issued in 1985. The Corporation's primary competitor for MBS is the Federal Home Loan Mortgage Corporation, whose primary business consists of the issuance of mortgage-backed securities. The Corporation and the Federal Home Loan Mortgage Corporation compete primarily on the basis of the amount of the guaranty fee charged, the products offered, and differences in their programs. Since 1985, the Corporation has responded to increased competition by more frequently negotiating the guaranty fee, which has resulted in a decrease in the average level of the guaranty fee charged by the Corporation. The "Guarantor" program is the Federal Home Loan Mortgage Corporation's program that is comparable to the Corporation's "swap" program. In 1985, the Corporation issued approximately \$22.1 billion in connection with its "swap" program, and the Federal Home Loan Mortgage Corporation issued approximately \$25.0 billion in connection with its "Guarantor" program.

RECENT LEGISLATIVE DEVELOPMENTS

The Administration's proposed 1987 fiscal year budget package included a recommendation to require the Corporation and other government-sponsored enterprises to pay user fees to the United States Treasury. The amounts proposed for the fees vary among the enterprises, with those proposed for the Corporation at the highest levels. The proposal would impose on the Corporation's debt, as described below, a 10 basis point fee in the government's fiscal year 1987, which begins October 1, 1986; a 30 basis point fee in fiscal year 1988; and a 50 basis point fee in fiscal year 1989 and beyond. The debt-related fee would be imposed on (1) new borrowings over September 30, 1986 levels plus (2) the lesser of (a) any pre-October 1, 1986 debt rolled over during the year or (b) the sum of any repayments and prepayments from pre-October 1, 1986 mortgages. In addition, the proposal would impose for one year a 5 basis point fee on MBS issued in the fiscal year beginning October 1, 1986 and thereafter a 10 basis point annual fee on all MBS issued after September 30, 1987. The Corporation currently estimates that under the user fee proposal it would pay the Treasury over \$1 billion over the first five years. Imposition of such user fees would require legislation. The Corporation has strongly opposed the user fee proposal.

The Administration appears to remain committed to a goal of eliminating the current government-related enterprise status of the Corporation and the Federal Home Loan Mortgage Corporation and suggests that the imposition of user fees would be a first step toward altering their current government ties. However, some believe the proposed user fees would make the government ties more explicit. Any alteration of the relationship of the Corporation to the federal government would require legislation. No such legislation has been introduced to date. Alteration or elimination of the Corporation's current relationship with the federal government could require the Corporation to change the manner in which it currently conducts business and could have a material adverse effect on its results of operations.

Neither the budget resolution passed by the Senate on May 1, nor that passed by the House of Representatives on May 15, contains a provision for the imposition of user fees on the Corporation.

On January 31, 1986, the Subcommittee on Taxation and Debt Management of the Senate Finance Committee held hearings regarding two bills that would create a proposed new type of multiple-class mortgage-backed security. The Treasury Department witness testified that the Administration supports the proposed legislation provided that the Corporation, the Federal Home Loan Mortgage Corporation and GNMA not be permitted to issue multiple-class mortgage-backed securities. However, the Administration's witness testified that the securities of these entities could be eligible collateral for such multiclass securities. A provision of the Senate-passed, tax overhaul legislation (H.R. 3838) would amend the federal tax laws to permit the issuance of multiple-class mortgage-backed securities. A similar provision was included in the recent Conference Agreement on the proposed Tax Reform Act.

The Department of Housing and Urban Development is preparing a report to the Congress on the activities of the Corporation, as required by 1984 legislation.

MANAGEMENT

Directors

The age and background, as of August 15, 1986, of each of the members of the Board of Directors of the Corporation are as follows:

<u>Name and Age</u>	<u>Principal Occupation, Business Experience, and Residence</u>	<u>First Became Director</u>	<u>Other Directorships(1)</u>
James A. Aliber, 61	Chairman of the Board and Chief Executive Officer, First Federal of Michigan, a savings and loan association, 1978 to present; Birmingham, Michigan	1985	
Samuel W Bartholomew, Jr(2), 42	Partner, Donelson, Stokes & Bartholomew, P.A, a law firm practicing in Nashville, Tennessee, 1977 to present; Nashville, Tennessee	1985	
Felix M. Beck, 60	Chairman of the Board and Chief Executive Officer, Margaretten & Co., Inc., a mortgage banking company, 1969 to present; Livingston, New Jersey	1985	
Roger E Birk, 56	Chairman Emeritus, Merrill Lynch & Co., Inc, a financial services company, April 1985 to present; Chairman of the Board, 1981 to April 1985, Chief Executive Officer, 1981 to 1984, and President, 1976 to 1982, Merrill Lynch & Co., Inc.; Redbank, New Jersey	1985	Mutual of America
Eli Broad, 53	Chairman of the Board and Chief Executive Officer, Kaufman and Broad, Inc., a housing and financial services corporation, 1976 to present; President and Chief Executive Officer, Sun Life Insurance Company of America, 1983 to present; Chairman of the Board, Sun Life Group of America, Inc., a life insurance company, 1978 to present; Los Angeles, California	1984	
Alberto R. Cardenas(2), 38	Partner, Broad and Cassel, a law firm practicing in Florida and Georgia, 1983 to present; Partner, Barrow, Lehman, Cardenas & Picken, a law firm, 1981 to 1983; Miami, Florida	1985	
Henry C Cashen II(2), 47	Partner, Dickstein, Shapiro & Morin, a law firm practicing in Washington, D.C and New York, 1973 to present; Washington, D C.	1985	
George L. Clark (2), 45	Vice President, George L. Clark, Inc., a real estate company, 1962 to present; Brooklyn, New York	1986	
Joseph P. Hayden, 56	Chairman of the Board and Chief Executive Officer, 1980 to present, and President and Chief Executive Officer, 1961 to 1980, The Midland Company and its subsidiaries, a company engaged in financing and insuring of manufactured housing; Cincinnati, Ohio	1969	First National Cincinnati Corporation; First National Bank of Cincinnati

<u>Name and Age</u>	<u>Principal Occupation, Business Experience, and Residence</u>	<u>First Became Director</u>	<u>Other Directorships (1)</u>
Carla A. Hills, 52	Partner, Latham, Watkins & Hills, a law firm practicing in Washington, D.C., Illinois, and California, 1978 to present, Washington, D.C	1982	AMR Corporation, Corning Glass Works, International Business Machines Corporation; The Signal Companies, Inc., Chevron Corporation
David O Maxwell, 56	Chairman of the Board of Directors and Chief Executive Officer of the Corporation, 1981 to present; President and Chief Operating Officer of the Corporation 1981; Chairman of the Board and Chief Executive Officer, Ticor Mortgage Insurance Company (now known as TMIC Insurance Company), a private mortgage insurance company, 1973 to 1981, Washington, D.C	1981	Kaufman and Broad, Inc
Vance C. Miller (2), 52	Chairman, Executive Committee, Henry S Miller Co., a real estate development company, 1980 to present, Dallas, Texas	1986	BancTexas Group, Inc.
John M. O'Mara, 59	Managing Director, Chase Manhattan Capital Markets Corporation, a financial services corporation, September 1985 to present; Senior Vice President, Wertheim & Co., investment bankers, 1981 to September 1985; Vice President, Merrill Lynch White Weld Capital Markets Group, a securities business, 1978 to 1981; Greenwich, Connecticut	1970	Baldwin & Lyons, Inc., The Midland Company
Samuel J. Simmons, 59	President, National Caucus and Center on Black Aged, Inc., a non-profit organization, 1982 to present; housing and real estate consultant, 1981 to present; President, National Center for Housing Management, a non-profit research and training organization, 1972 to 1981; Washington, D.C.	1978	
Christopher J Sumner, 40	President, Chief Executive Officer and Director, Western Savings and Loan Company, a financial institution, 1980 to present; Salt Lake City, Utah	1985	Financial American Network
Richard C. Van Dusen, 61	Chairman, Dickinson, Wright, Moon, Van Dusen & Freeman, a Detroit law firm, 1977 to present; Birmingham, Michigan	1981	Pennwalt Corporation; Primark Corporation
Mallory Walker, 47	President, Walker & Dunlop, Inc. a mortgage banking and real estate company, 1976 to present, Washington, D.C	1981	

(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 are also noted in the occupation column.

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

Executive Officers

The executive officers of the Corporation, their ages, and their business experience as of August 15, 1986, are as follows:

David O. Maxwell, 56, has been Chairman of the Board of Directors and Chief Executive Officer since 1981. He also served briefly as the Corporation's President and Chief Operating Officer in 1981 until his election to his present position.

Caryl S. Bernstein, 52, has been Executive Vice President since 1982 and General Counsel and Secretary since 1981. Mrs. Bernstein was Senior Vice President from 1981 until her election as Executive Vice President.

William A. Dawson, 56, has been Executive Vice President—Technology since February 1985. Prior to his employment with the Corporation, Mr. Dawson was Executive Vice President in charge of bank operations and information systems for Girard Bank, a commercial bank.

Bruce C. McMillen, 43, has been Executive Vice President and Chief Financial Officer since September 1985. Prior to his employment with the Corporation, Mr. McMillen was Executive Vice President and Chief Financial Officer of Barclays American Corporation, a diversified financial services company.

Dale P. Riordan, 38, has been Executive Vice President—Administration and Corporate Relations since February 1986. Mr. Riordan was Senior Vice President—Government Relations from 1983 until his election as Executive Vice President. He joined the Corporation in June 1981. Prior to his employment with the Corporation, Mr. Riordan was Chief Economist at the Federal Home Loan Bank Board.

Michael A. Smilow, 48, has been Executive Vice President—Operations since July 1984. Prior to his employment with the Corporation, Mr. Smilow was Executive Vice President of Mortgage Guaranty Insurance Corporation, a mortgage insurance company. He was also an officer and director of MGIC Investment Corporation and related companies.

Glenn T. Austin, Jr., 38, has been Senior Vice President—Southeastern Regional Office since May 1985. Mr. Austin was Regional Vice President from April 1982 until his election as Senior Vice President. Prior to his employment with the Corporation, Mr. Austin was Senior Vice President in charge of field operations at PMI Mortgage Insurance Company.

Douglas M. Bibby, 39, has been Senior Vice President—Corporate Affairs since October 1983. Prior to his employment with the Corporation, Mr. Bibby was Vice President of Russell Reynolds Associates, Inc., an executive recruiting firm, from September 1982 to October 1983 and was employed for 12 years by J. Walter Thompson Company, where his most recent title was Senior Vice President.

Richard H. Daniel, 40, has been Senior Vice President—Mortgage-Backed Securities since June, 1986. Mr. Daniel was Senior Vice President—Regional Activities from June 1984 to June 1986; Vice President for Regional Activities from April 1984 to June 1984 and Vice President for Marketing from March 1983 to April 1984. Prior to his employment with the Corporation, Mr. Daniel was employed by Wells Fargo and Company in San Francisco where his most recent position was vice president and manager of the real estate division of the retail banking group.

John H. Fulford, III, 37, has been Senior Vice President—Western Regional Office since November 1985. Mr. Fulford was Regional Vice President—Western Regional Office from May 1985 to November 1985 and Senior Assistant Regional Vice President—Marketing from February 1983 to May 1985. Prior to his employment with the Corporation, Mr. Fulford was employed by Tigor Mortgage Insurance Company (now known as TMIC Insurance Company) where his most recent title was Vice President—Director of Marketing Services.

Deane W. Hall, 36, has been Senior Vice President—Southwestern Regional Office since November 1985. Mr. Hall was Regional Vice President—Southwestern Regional Office from

October 1984 to November 1985 and Senior Assistant Regional Vice President—Marketing in the Southeastern Regional Office from October 1982 to October 1984. Prior to his employment with the Corporation, he was with PMI Mortgage Insurance Company where his most recent title was Secondary Marketing Zone Director.

Thomas R. Harter, 43, has been Senior Vice President—Customer and Management Information Services since July 1985. Prior to his employment with the Corporation, Mr. Harter was Senior Staff Vice President and Chief Economist for the Mortgage Bankers Association of America, a trade association.

Charles W. Harvey, Jr., 54, has been Senior Vice President—Northeastern Regional Office since May 1985. Mr. Harvey was Regional Vice President—Northeastern Regional Office from 1973 to May 1985.

John R. Hayes, 47, has been Senior Vice President—Midwestern Regional Office since November 1985. Mr. Hayes was Regional Vice President—Midwestern Regional Office from 1972 to November 1985.

J. Timothy Howard, 37, has been Senior Vice President—Economics and Corporate Planning since November 1985. Mr. Howard was Senior Vice President and Chief Economist from October 1983 to November 1985 and Vice President and Chief Economist from March 1982 to October 1983. Prior to his employment with the Corporation, Mr. Howard was Vice President and Senior Financial Economist for Wells Fargo Bank from April 1978 to March 1982.

Richard M. Leegant, 41, has been Senior Vice President—Mortgage Administration since June 1986. Mr. Leegant was Vice President—Mortgage Administration from April 1985 to June 1986 and Special Assistant to the Senior Vice President—Mortgage Operations from January 1984 to April 1985. Prior to his employment with the Corporation, he was with the Student Loan Marketing Association as Director of Systems Development.

Robert J. Levin, 30, has been Senior Vice President and Assistant to the Chairman of the Board since May 1986. Mr. Levin was Senior Vice President—Corporate Finance from November 1985 to May 1986, Vice President for Corporate Finance from July 1984 to November 1985, Director of Corporate Finance from November 1983 to July 1984, Senior Financial Analyst from March 1982 to November 1983, and Financial Analyst from May 1981 to March 1982.

Robert J. Mahn, 58, has been Senior Vice President and Controller since June 1985. Mr. Mahn was Senior Vice President—Mortgage Operations from February 1982 to June 1985, Vice President—Mortgage Operations from June 1981 to February 1982, and Vice President and Controller from April 1969 to June 1981.

Gary L. Perlin, 35, has been Senior Vice President—Finance and Treasurer since November 1985. Mr. Perlin was Vice President for Risk Management from October 1983 to November 1985 and Director of Hedge Management from February 1982 to October 1983. Prior to his employment with the Corporation, he was with Hadley Lockwood, Inc., a management consulting firm.

Edward J. Pinto, 37, has been Senior Vice President—Marketing and Product Management since April 1985. Mr. Pinto was Vice President for Negotiated Transactions from September 1984 to April 1985. Prior to his employment with the Corporation, Mr. Pinto was with Mortgage Guaranty Investment Corporation where he was Capital Markets Program Manager and Senior Legal Counsel and with the Michigan State Housing and Development Authority as Deputy Executive Director of Legal Affairs.

David E. Roberts, 45, has been Senior Vice President—Corporate Information Services since November 1985. Prior to his employment with the Corporation, Mr. Roberts was Vice President, Information Management Systems, at Acacia Mutual Life Insurance Company from January 1983 to September 1985 and Vice President, Information Services Department, at Great Southern Life Insurance Company from September 1981 to December 1982.

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REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

The Board of Directors and Stockholders
Federal National Mortgage Association:

We have examined the balance sheets of Federal National Mortgage Association as of December 31, 1985 and 1984, and the related statements of operations and changes in financial position for each of the years in the three-year period ended December 31, 1985. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the aforementioned financial statements present fairly the financial position of Federal National Mortgage Association at December 31, 1985 and 1984 and the results of its operations and the changes in its financial position for each of the years in the three-year period ended December 31, 1985, in conformity with generally accepted accounting principles applied on a consistent basis.

PEAT, MARWICK, MITCHELL & Co.

Washington, D.C.
January 24, 1986

FEDERAL NATIONAL MORTGAGE ASSOCIATION
STATEMENTS OF OPERATIONS

	Year Ended December 31,		
	1985	1984	1983
	(Dollars in millions, except per share amounts)		
Interest income:			
Mortgage portfolio, net of servicing fees	\$9,873	\$8,647	\$7,705
Marketable securities	124	197	222
Total interest income	9,997	8,844	7,927
Interest on borrowings and related costs	9,926	8,996	7,989
Interest margin	71	(152)	(62)
Other income:			
Commitment fees	196	114	151
Gain on sales of mortgages	—	12	91
Guaranty fees	112	78	54
Other	37	36	33
Total other income	345	240	329
Other expenses:			
Administrative	142	112	81
Provision for losses	206	86	48
Total other expenses	348	198	129
Income (loss) before federal income taxes	68	(110)	138
Provision for federal income taxes:			
Current	(14)	(112)	(15)
Deferred	45	59	78
	31	(53)	63
Net income (loss)	\$ 37	\$ (57)	\$ 75
Per share:			
Earnings (loss):			
Primary	\$.52	\$ (.87)	\$ 1.15
Fully diluted	.52	(.87)	1.13
Cash dividends	.16	.16	.16

See Notes to Financial Statements

**FEDERAL NATIONAL MORTGAGE ASSOCIATION
BALANCE SHEETS**

Assets

	December 31,	
	1985	1984
	(Dollars in millions)	
Mortgage portfolio, net	\$95,038	\$84,599
Cash	63	49
U.S. Government and Federal Agency securities—at cost, which approximates market	475	265
Federal funds	1,391	1,575
Accrued interest receivable	949	871
Federal income taxes refundable	153	265
Accounts receivable and other assets	441	259
Acquired property and foreclosure claims, less allowance for losses on claims of \$21 million in 1985 (\$14 million in 1984)	474	400
Unamortized debenture issue costs	103	76
Total Assets	\$99,087	\$88,359

Liabilities and Stockholders' Equity

Liabilities:

Bonds, notes and debentures, net:		
Due within one year	\$31,939	\$31,261
Due after one year	61,957	52,458
	93,896	83,719
Accrued interest payable	2,288	2,153
Mortgagors' escrow deposits, exclusive of approximately \$574 million held by servicers in 1985 (\$575 million in 1984)	328	309
Deferred federal income taxes	672	627
Other liabilities	561	343
Total liabilities	97,745	87,151

Stockholders' Equity:

Preferred stock, adjustable rate, series A, \$100 stated value, 4,500,000 shares authorized, no shares issued	—	—
Common stock, \$6.25 stated value, no maximum author- ization—73,078,937 shares issued in 1985 (66,045,677 shares in 1984)	457	413
Additional paid-in capital	375	311
Retained earnings	512	486
	1,344	1,210
Less treasury stock, at cost—179,906 shares in 1985 (208,926 in 1984)	2	2
Total stockholders' equity	1,342	1,208
Total Liabilities and Stockholders' Equity	\$99,087	\$88,359

See Notes to Financial Statements

FEDERAL NATIONAL MORTGAGE ASSOCIATION
STATEMENTS OF CHANGES IN FINANCIAL POSITION

	Year Ended December 31,		
	1985	1984	1983
	(Dollars in millions)		
Funds Provided:			
Net income (loss)	\$ 37	\$ (57)	\$ 75
Items not (providing) using funds:			
Interest capitalized on graduated pay- ment mortgages, net	(112)	(136)	(99)
Provision for deferred federal income taxes	45	59	78
Provision for losses	206	86	48
Funds provided by (applied to) operations	176	(48)	102
Proceeds from issuance of debentures and bonds	25,688	24,822	19,734
Net increase in notes and investment agreements	3,870	1,113	214
Mortgage repayments, less discount amortized	8,491	4,961	5,735
Claim collections and proceeds from disposition of properties	764	595	425
Sale of mortgages, excluding gains and losses	1,303	942	4,370
Net increase in stockholders' equity resulting from stock issuances and debenture conversions	108	—	8
Increase (decrease) in accrued interest pay- able/receivable, net	(13)	26	22
Other items, net	185	(62)	196
Total funds provided	40,572	32,349	30,806
Funds Applied:			
Debentures and bonds retired	19,449	16,840	14,991
Mortgage purchases, less discount	21,072	15,329	16,537
Dividends paid	11	11	11
Total funds applied	40,532	32,180	31,539
Increase (decrease) in cash and marketable securities	40	169	(733)
Cash and marketable securities, beginning of year	1,889	1,720	2,453
Cash and marketable securities, end of year	\$ 1,929	\$ 1,889	\$ 1,720

See Notes to Financial Statements

FEDERAL NATIONAL MORTGAGE ASSOCIATION
NOTES TO FINANCIAL STATEMENTS

STATEMENT OF SIGNIFICANT ACCOUNTING POLICIES

The Corporation operates in the residential mortgage finance industry. Its accounting policies conform to generally accepted accounting principles. The following is a description of significant accounting policies and practices:

Mortgage Portfolio and Purchase Discount

Mortgages acquired for investment are carried at their unpaid principal balances less unamortized discount. Discount is recognized as income using an amortization method that, in the aggregate, approximates a level yield over the estimated life of the related mortgages. The Corporation discontinues the accrual of interest on conventional mortgages when they become 90 days delinquent.

Guaranteed Mortgage-Backed Securities

The Corporation guarantees the payment of principal and interest on mortgage-backed securities. These securities represent interests in pools of mortgages held in trust by the Corporation. These mortgages are not assets of the Corporation, nor are the outstanding securities liabilities of the Corporation; accordingly, neither is reflected in the accompanying balance sheets.

Foreclosure Losses

On conventional home mortgages acquired for portfolio, the Corporation maintains an allowance for losses that may be incurred as a result of defaults. The allowance is established by charges to income when mortgages are purchased and adjusted at other times to maintain the allowance at an appropriate level. The Corporation reduces the allowance to recognize net losses on foreclosures.

On U.S. Government insured or guaranteed loans, the Corporation establishes an allowance for losses when specific loans are determined to be in default. At that time, an allowance is recorded to provide for estimated unreimbursable foreclosure costs.

On mortgage-backed securities where the Corporation assumes the foreclosure loss risk related to the mortgages, a liability for estimated losses is maintained. The Corporation records the liability by making charges to income at the time mortgage-backed securities are issued or transfers the related allowance when it sells mortgages from portfolio into mortgage-backed securities.

Real estate acquired as a result of foreclosure is carried at the lower of the investment in the property or its estimated net realizable value.

Risk Management

From time to time, the Corporation takes positions in financial markets to hedge against fluctuations in interest rates that may affect the cost of certain planned borrowings or the yield on certain mortgage purchases. Results of hedging activities are deferred and amortized over the lives of the related borrowings or assets.

FEDERAL NATIONAL MORTGAGE ASSOCIATION
NOTES TO FINANCIAL STATEMENTS—Continued

Commitment Fees

Commitment fees generally are recognized as income upon the execution of the commitment contract. Commitment fees that are considered to be an adjustment to the yield on the related mortgages purchased, however, are deferred and recognized as income using an amortization method that, in the aggregate, approximates a level yield over the estimated life of the related mortgages.

Income Taxes

Certain income and expense items are recognized in different periods for financial reporting and income tax purposes. The Corporation provides deferred income taxes for such timing differences. Investment tax credits are recognized as reductions from income tax expense in the year the related assets are purchased (flow-through method).

Earnings Per Share

Earnings per share are computed using the weighted average number of shares outstanding, including dilutive common stock equivalents. Fully diluted earnings per share are computed on the assumption that all outstanding subordinated convertible capital debentures were converted at the beginning of the year, after increasing earnings for the related interest expense, net of federal income taxes.

MORTGAGE PORTFOLIO, NET

The mortgage portfolio balances consist of the following investments at December 31:

	<u>1985</u>	<u>1984</u>
	(Dollars in millions)	
Home mortgages:		
First mortgages:		
Government insured or guaranteed	\$27,414	\$29,016
Conventional fixed-rate	45,035	38,781
Conventional adjustable-rate	16,895	11,729
Second mortgages	<u>2,889</u>	<u>2,817</u>
	<u>92,233</u>	<u>82,343</u>
Multifamily mortgages:		
Government insured	4,951	5,060
Conventional fixed-rate	1,319	635
Conventional adjustable-rate	46	71
	<u>6,316</u>	<u>5,766</u>
Total unpaid principal balance	98,549	88,109
Less:		
Unamortized discount	3,399	3,414
Allowance for losses	<u>112</u>	<u>96</u>
	<u>\$95,038</u>	<u>\$84,599</u>

The total unpaid principal balance of conventional home loans in non-accrual status (those 90 days or more delinquent or in the process of foreclosure) was \$1.0 billion at December 31, 1985 and \$0.7 billion at December 31, 1984.

FEDERAL NATIONAL MORTGAGE ASSOCIATION
NOTES TO FINANCIAL STATEMENTS—Continued

ALLOWANCE FOR FORECLOSURE LOSSES

Changes in the allowances for loan losses and the liability for estimated foreclosure losses on mortgage-backed securities for the years 1983-1985 are summarized below:

	<u>Mortgage Portfolio</u>			<u>Total</u>
	<u>Government Insured or Guaranteed</u>	<u>Conventional</u>	<u>Mortgage- Backed Securities</u>	
	(Dollars in millions)			
Balance, January 1, 1983	\$ 7	\$ 125	\$ 5	\$ 137
Provision	11	35	2	48
Net foreclosure losses charged-off	(4)	(39)	—	(43)
Transfers	—	(9)	9	—
Balance, December 31, 1983	14	112	16	142
Provision	13	68	5	86
Net foreclosure losses charged-off	(9)	(87)	(2)	(98)
Transfers	—	(1)	1	—
Balance, December 31, 1984	18	92	20	130
Provision	16	161	29	206
Net foreclosure losses charged-off	(8)	(143)	(19)	(170)
Transfers	—	(3)	3	—
Balance, December 31, 1985	<u>\$26</u>	<u>\$ 107</u>	<u>\$ 33</u>	<u>\$ 166</u>

The total allowance for foreclosure losses at December 31 is included in the following balance sheet accounts:

	<u>1985</u>	<u>1984</u>
	(Dollars in millions)	
Mortgage portfolio, net	\$112	\$ 96
Foreclosure claims, less allowance for losses	21	14
Other liabilities	<u>33</u>	<u>20</u>
	<u>\$166</u>	<u>\$130</u>

BONDS, NOTES, AND DEBENTURES, NET

The average cost of all debt outstanding at December 31, 1985 and 1984 (including the amortization of issuance costs and hedging results, and the effect of interest rate swaps) was 10.79 percent and 11.56 percent, respectively. The average effective maturity of all debt outstanding (including the effect of interest rate swaps but excluding investment agreements) was 40 months at December 31, 1985 and 31 months at December 31, 1984.

Pursuant to the Corporation's Charter Act and related regulations, no debt instrument may be issued without the approval of the Secretary of the Treasury. Under current regulatory authority, the maximum amount of the Corporation's general obligations outstanding (those neither subordinated nor secured) at any time generally may not exceed 30 times the sum of stockholders' equity, subordinated capital debentures, and reserves.

FEDERAL NATIONAL MORTGAGE ASSOCIATION
NOTES TO FINANCIAL STATEMENTS—Continued

In addition to debt restrictions under the Charter Act, the Corporation is subject to a restriction set forth in certain subordinated capital debenture agreements, which limits the amount of subordinated capital debentures outstanding to not more than two times the sum of the Corporation's common stock, additional paid-in capital, and retained earnings. At December 31, 1985, the Corporation could have issued an additional \$577 million in subordinated capital debentures and still have been in compliance with this restriction.

The Charter Act authorizes the Secretary of the Treasury to purchase obligations of the Corporation, as a public debt transaction, up to a maximum of \$2.25 billion outstanding at any one time. The interest rate on such obligations would be based upon the average rate on marketable obligations of the United States outstanding as of the last day of the month preceding the date of making such purchases. The Corporation has never utilized the Treasury borrowing authority.

Borrowings due within one year consist of the following at December 31:

	<u>1985</u>	<u>1984</u>
	(Dollars in millions)	
Short-term notes—net of \$209 million discount in 1985 (\$369 million in 1984)	\$ 8,946	\$10,165
Master notes	1,783	1,220
Investment agreements	4,863	1,275
Mortgage-backed bonds	76	34
Debentures	15,971	18,067
Capital debentures	<u>300</u>	<u>500</u>
Total due within one year	<u>\$31,939</u>	<u>\$31,261</u>

Short-term notes are general obligations of the Corporation with maturities that range up to 360 days. Master notes have varying maturities and carry a floating interest rate that is adjusted weekly and is tied to 91-day U.S. Treasury bill rates. Investors have the option of increasing or decreasing the principal amount outstanding on master notes on a daily basis, usually within a range of 80 to 120 percent of the original principal balance.

The Corporation had short-term and master notes outstanding of \$10.9 billion (face amount) at December 31, 1985 and \$11.8 billion at December 31, 1984. The largest aggregate amount of short-term and master notes outstanding at any month-end was \$14.2 billion in 1985 and \$13.4 billion in 1984. The average cost to the Corporation of notes outstanding at December 31, 1985 and 1984 was 8.21 percent and 11.16 percent, respectively. The average remaining terms were approximately 121 days and 129 days at December 31, 1985 and 1984, respectively. The average aggregate amount of notes outstanding during 1985 was \$12.1 billion at an average cost of 9.30 percent; during 1984, it was \$12.2 billion at an average cost of 10.70 percent.

Investment agreements are individually negotiated agreements that provide for the investment of a variable principal amount at a fixed or floating rate of interest. The agreements remain in effect for various periods of time. The average total outstanding during 1985 was \$2.5 billion at an average cost of 8.98 percent, compared with an average total outstanding of \$110 million during 1984 at an average cost of 10.89 percent. The average cost to the Corporation of investment agreements outstanding was 8.49 percent at December 31, 1985 and 9.65 percent at December 31, 1984.

FEDERAL NATIONAL MORTGAGE ASSOCIATION

NOTES TO FINANCIAL STATEMENTS—Continued

The Corporation has interest rate swap agreements with various parties to extend the effective maturity of its debt obligations. Under these agreements, the Corporation makes periodic payments based on fixed rates applied to a notional principal amount and in exchange receives periodic payments based on short-term variable rates. At December 31, 1985, the Corporation had interest rate swap agreements outstanding with an average remaining term of 6 years, 9 months on notional amounts totaling \$3.4 billion, compared with an average remaining term of 5 years, 4 months on notional amounts totaling \$1.3 billion for similar swap agreements outstanding at December 31, 1984. The effect of these agreements is not reflected in the maturities of the debt obligations reported in the summaries of borrowings.

Borrowings due after one year consist of the following at December 31:

(Dollars in millions)	1985		1984	
	Average Cost	Amount Outstanding	Average Cost	Amount Outstanding
Maturity				
Mortgage-backed bonds, 1986-2015	8.95%	\$ 292	8.42%	\$ 368
Investment agreements, 1987-1990	9.18	939	—	—
Debentures, net of \$57 million of discount in 1985 (none in 1984):				
1986	—	—	11.74	12,941
1987	11.53	17,464	11.58	16,948
1988	11.04	13,933	11.48	9,845
1989	11.31	8,000	11.97	4,650
1990	10.57	6,050	10.73	1,200
1991-1995	10.93	11,869	10.43	3,496
1996-2000	7.14	154	7.14	154
2001-2015	11.77	750	12.45	500
	11.15	58,220	11.53	49,734
Exchangeable debentures, 1991	12.66	450	12.66	450
Zero coupon debentures, net of \$5,752 million of discount in 1985 (\$5,779 million in 1984), 2014	11.50	248	11.50	221
Zero coupon subordinated capital debentures, net of \$6,517 million of discount in 1985 (\$6,539 million in 1984), 2019	10.22	233	10.22	211
Subordinated capital debentures, net of \$18 million of discount in 1985 (\$19 million in 1984):				
1986	—	—	8.19	300
1989	12.99	635	12.99	635
1990	9.15	400	—	—
1997	7.44	250	7.44	250
2002	9.21	263	9.21	261
	10.46	1,548	10.35	1,446
Subordinated convertible capital debentures, 1996	4.43	27	4.43	28
Total	11.10%	\$61,957	11.48%	\$52,458

FEDERAL NATIONAL MORTGAGE ASSOCIATION

NOTES TO FINANCIAL STATEMENTS—Continued

The average cost includes the amortization of discounts, issuance costs, and hedging results. Annual maturities of all debt for the years 1987-1991 are \$17.6, \$14.1, \$8.9, \$7.0, and \$1.8 billion, respectively.

The mortgage-backed bonds were issued pursuant to authority contained in the Charter Act to issue bonds secured by mortgages from the Corporation's portfolio. At December 31, 1985 and 1984, respectively, \$359 million and \$393 million of the mortgage-backed bonds outstanding were guaranteed as to principal and interest by the Government National Mortgage Association (GNMA). Assets of approximately \$542 million at December 31, 1985 and \$538 million at December 31, 1984 were restricted for the payment of principal and interest on mortgage-backed bonds.

In 1985, the Corporation issued debt securities in which principal, interest, or both were denominated in a foreign currency. Concurrently, the Corporation entered into foreign currency exchange agreements to offset the risk of any future exchange rate fluctuations. These foreign currency exchange agreements effectively establish an obligation of the Corporation at a cost that remains fixed in U.S. dollars throughout its term. The foreign currency denominated debt issuances are included in the above summary of borrowings due after one year and are reflected in the accompanying balance sheet at their equivalent U.S. dollar value as set forth by their respective foreign currency exchange agreements, net of any unamortized discount. At December 31, 1985, the U.S. dollar equivalent face amount of these foreign currency denominated borrowings was \$972 million.

The following debentures are redeemable at par, in whole or in part, at the option of the Corporation: \$154 million due in 1997; \$250 million due in 2013 (beginning in 1993); and \$250 million due in 2014 (beginning in 1994).

The subordinated capital debentures, due in 1997 and 2002, are redeemable at par, in whole or in part, at the option of the Corporation, on any interest payment date commencing October 1, 1982 and July 10, 1988, respectively.

The Corporation may call for the conversion of the exchangeable debentures at any time on or prior to March 15, 1991, in which case the debenture holders have two options. They may accept the conversion and receive 10 shares of adjustable-rate preferred stock, series A for each \$1,000 principal amount of exchangeable debentures. Alternatively, they may reject the call for conversion by extending the maturity date of those debentures to March 15, 1994. The Corporation may call for the conversion only once and only on the entire issue.

The subordinated convertible capital debentures are convertible into 1.4 million shares of common stock at a price of \$19.63 per share, subject to adjustment in certain events. These debentures are redeemable at par, at the option of the Corporation.

FEDERAL NATIONAL MORTGAGE ASSOCIATION
NOTES TO FINANCIAL STATEMENTS—Continued

STOCKHOLDERS' EQUITY

Transactions in common stock, additional paid-in capital, retained earnings, and treasury stock for the years 1983, 1984, and 1985 are summarized as follows:

	<u>Common Stock</u>	<u>Additional Paid-in Capital</u>	<u>Retained Earnings</u>	<u>Treasury Stock</u>	<u>Total Stockholders' Equity</u>
(Dollars in thousands)					
Balance, January 1, 1983	\$410,313	\$305,750	\$489,161	\$(1,895)	\$1,203,329
Conversions of convertible debentures	2,429	5,163	—	—	7,592
Net income	—	—	75,492	—	75,492
Dividends	—	—	(10,502)	—	(10,502)
Balance, December 31, 1983	412,742	310,913	554,151	(1,895)	1,275,911
Conversions of convertible debentures	43	93	—	—	136
Net loss	—	—	(57,374)	—	(57,374)
Dividends	—	—	(10,534)	—	(10,534)
Balance, December 31, 1984	412,785	311,006	486,243	(1,895)	1,208,139
New shares issued, May 8, 1985	43,750	63,465	—	—	107,215
Conversions of convertible debentures	208	450	—	—	658
Treasury stock issued for stock options and benefit plans	—	102	—	264	366
Accrual for stock appreciation rights	—	145	—	—	145
Net income	—	—	36,889	—	36,889
Dividends	—	—	(11,096)	—	(11,096)
Balance, December 31, 1985	<u>\$456,743</u>	<u>\$375,168</u>	<u>\$512,036</u>	<u>\$(1,631)</u>	<u>\$1,342,316</u>

Pursuant to the Corporation's Charter Act and related regulations, approval of the Secretary of Housing and Urban Development is required prior to the issuance of any stock of the Corporation or a change in the stockholding requirements for lenders. The Corporation is authorized by the Charter Act to have preferred stock on such terms and conditions as the Board of Directors of the Corporation may prescribe. To date, the Board of Directors has authorized a maximum of 4,500,000 shares of adjustable-rate preferred stock, series A, \$100 stated value. These shares may be issued only in exchange for the 12.50 percent exchangeable debentures due 1991. No shares have been issued.

In 1982, the Corporation adopted a performance share plan, under which awards were made to officers for three separate four-year periods starting in 1982, 1983, and 1984. Performance shares will be issued, generally half in cash and half in stock, provided certain financial goals are attained. No more than 200,000 shares of common stock can be distributed under the plan. As of December 31, 1985, 49,200 performance shares were outstanding for the 1983-86 period and 121,400 for the 1984-87 period. None of the 181,800 shares awarded for the 1982-85 period was issued.

In 1984, the Corporation adopted a stock option plan for key employees. Under the plan, the Corporation may grant options to purchase up to one million shares of common stock. The number of shares that can be granted under the plan may be increased by up to 200,000 shares, but only to the extent that shares are not issued under the previously described performance share plan. The options do not become exercisable until at least one year after the date granted and generally expire ten years from the date of grant. The purchase price of the common stock covered by each option is equal to the fair market value of the stock on the date that the options are granted.

FEDERAL NATIONAL MORTGAGE ASSOCIATION
NOTES TO FINANCIAL STATEMENTS—Continued

A summary of stock option activity follows:

	<u>Number of Shares</u>	<u>Option Price</u>
Balance, January 1, 1984.....	—	
Granted in 1984.....	323,100	\$16.12-\$23.75
Less: Terminated in 1984.....	18,500	\$16.12
Balance, December 31, 1984.....	304,600	\$16.12-\$23.75
Granted in 1985.....	94,800	\$14.81-\$23.94
Less: Exercised in 1985.....	400	\$16.12
Terminated in 1985.....	69,400	\$16.12-\$23.75
Balance, December 31, 1985.....	<u>329,600</u>	<u>\$14.81-\$23.94</u>

At December 31, 1985, stock options on 100,683 shares were exercisable. There were no stock options exercisable at December 31, 1984.

Subsequent to the adoption of the 1984 stock option plan for key employees, the Board of Directors granted stock appreciation rights ("SARs") on 42,049 shares relating to certain previously granted stock options. In 1985, the SARs were awarded to certain officers of the Corporation and permit them to exercise the SAR in place of the remaining related stock options, either in whole or in part. Upon exercise, they would receive an amount, half in cash and half in common stock, equivalent to the difference between the market price of the Corporation's stock on the date of exercise and the option price granted under the 1984 stock option plan. The exercise of the SAR cancels the related stock option and the exercise of the stock option cancels the SAR. The SARs may be exercised only during a limited period in 1986. After this period, unexercised SARs expire and the related stock options remain available to be exercised.

In 1984, the Board of Directors adopted the 1985 Employee Stock Purchase Plan. In 1985, the plan received the approval of the Corporation's stockholders and a favorable tax ruling from the Internal Revenue Service. Under the plan, the Corporation can issue up to 500,000 shares of common stock to qualified employees at a price equal to 85 percent of the fair market value of the stock on the first day of the period in which employees can elect to purchase the stock. The Corporation can grant each employee the right to purchase up to 200 shares of stock during a purchase period. At December 31, 1985, Fannie Mae employees had purchased 28,620 shares under the plan's 1985 offering. The Board of Directors has granted a similar offering in 1986 to Fannie Mae employees.

INCOME TAXES

Deferred federal income tax expense relating to timing differences consists of the following:

	<u>1985</u>	<u>1984</u>	<u>1983</u>
	(Dollars in millions)		
Amortization of purchase discount.....	\$(4)	\$32	\$53
Losses on dispositions of mortgages.....	5	(3)	44
Provision for losses—conventional mortgages.....	16	—	(8)
Risk management activities.....	39	27	(9)
Accrued interest expense not currently deductible.....	(7)	—	—
Systems development costs.....	2	6	1
Other items, net.....	<u>(6)</u>	<u>(3)</u>	<u>(3)</u>
Total deferred federal income tax expense.....	<u>\$45</u>	<u>\$59</u>	<u>\$78</u>

FEDERAL NATIONAL MORTGAGE ASSOCIATION
NOTES TO FINANCIAL STATEMENTS—Continued

The Internal Revenue Service has completed its examinations of the Corporation's federal income tax returns through the year 1982. All subsequent years are subject to examination. With respect to years examined, the Internal Revenue Service has proposed certain adjustments. The Corporation has filed a protest contesting the adjustments and has also filed amended tax returns or claims for refund of taxes paid in certain of these years. All of the proposed adjustments and claims relate to losses on sales or exchanges of mortgages or on amounts added to the allowance for loan losses. The applicable tax and related interest on all disputed amounts have either been substantially accrued or paid. It is management's opinion that any unfavorable determinations would have no material adverse impact on the results of operations.

At December 31, 1985, the Corporation had tax credit carryforwards of \$2.4 million (expiring at various dates from 1996 to 2000), which are available to reduce future federal income taxes. Certain tax losses totaling \$119 million are being carried forward and are available to reduce future taxable income through 1998.

The Corporation is exempt from state and local taxes, with the exception of real estate taxes.

RETIREMENT PLANS

All permanent, full-time employees of the Corporation are covered by the non-contributory Federal National Mortgage Association Retirement Plan or by the contributory Civil Service Retirement Law. Pension expenses for these plans were \$1.1 million and \$0.2 million, respectively, for the year ended December 31, 1985 (\$0.7 million and \$0.2 million in 1984, and \$0.6 million and \$0.2 million in 1983). For the Corporation's defined benefit pension plan, pension expense includes unfunded past service costs, which are being amortized over 10 years. Prior to 1984, the Corporation made annual contributions to the plans equal to the amounts accrued for pension expense. During 1984, the Corporation contributed \$0.2 million to the Corporation's pension plan and recorded a \$0.5 million liability to the plan at December 31, 1984. The Corporation made no payments to its pension plan in 1985 and had a \$1.6 million liability to the plan at December 31, 1985. Accumulated plan benefits, total actuarial liabilities and plan assets for the Corporation's defined benefit pension plan at January 1 are presented below:

	<u>1985</u>	<u>1984</u>
	(Dollars in Millions)	
Actuarial present value of accumulated plan benefits:		
Vested	\$ 9	\$ 8
Nonvested	2	1
Total accumulated benefits	<u>\$11</u>	<u>\$ 9</u>
Total actuarial liability	<u>\$25</u>	<u>\$22</u>
Net assets available for benefits	<u>\$39</u>	<u>\$34</u>

The rate of return for determining the present value of accumulated plan benefits is 7.5 percent.

The Corporation also has an Executive Pension Plan, which supplements for key senior officers the benefits payable to them under the Federal National Mortgage Association Retirement Plan. Participants are granted pension goals generally ranging from 30 to 60 percent of high-three total compensation as defined in the Plan, reduced by any benefits payable under the Federal National Mortgage Association Retirement Plan. Estimated benefits under the Plan are recorded as expenses over the period of employment.

In addition to providing pension benefits, the Corporation provides certain health care and life insurance benefits for retired employees. All employees who retire from the Corporation are

FEDERAL NATIONAL MORTGAGE ASSOCIATION
NOTES TO FINANCIAL STATEMENTS—Continued

eligible for these benefits. The cost of retiree health care and life insurance benefits is recognized as an expense as premiums are paid. In 1985 and 1984 these costs totaled \$0.5 million and \$0.6 million, respectively.

COMMITMENTS AND CONTINGENCIES

Portfolio

The Corporation had mandatory delivery commitments outstanding to purchase \$1.6 billion of mortgages at an average net yield of 10.62 percent at December 31, 1985, compared with \$3.5 billion at 12.32 percent at December 31, 1984.

The Corporation also issues standby commitments, which must be converted to mandatory delivery commitments in order for the seller to deliver mortgages. The yield is set on the date of conversion. The Corporation had \$1.8 billion of such commitments outstanding at December 31, 1985, compared with \$2.8 billion at December 31, 1984.

Mortgage-Backed Securities

As issuer and guarantor of mortgage-backed securities, the Corporation is obligated to disburse scheduled monthly installments of principal and interest (at the certificate rate), whether or not such amounts have actually been received, unscheduled principal payments when received, and the full principal balance upon liquidation of any foreclosed mortgage, whether or not such principal balance is recovered. Either the Corporation or the participating lender from whom the mortgages were acquired can assume the foreclosure loss risk on the mortgages in a pool.

The total outstanding principal balance of mortgage-backed securities guaranteed by the Corporation was \$55.0 billion at December 31, 1985, compared with \$36.2 billion at December 31, 1984. These amounts include \$16.7 billion at December 31, 1985 and \$9.5 billion at December 31, 1984 where the Corporation had assumed the foreclosure loss risk.

At December 31, 1985, the Corporation had commitments outstanding to issue and guarantee \$3.9 billion of mortgage-backed securities, upon delivery of the related mortgages by participating lenders (generally at their option), compared with \$2.9 billion at December 31, 1984. At December 31, 1985, the Corporation also had outstanding \$6.1 billion of mandatory delivery commitments to issue and guarantee mortgage-backed securities, compared with \$1.6 billion at December 31, 1984. The mandatory delivery commitments include \$2.0 billion at December 31, 1985 and \$0.4 billion at December 31, 1984 related to the credit enhancement of future tax-exempt bond issues.

FEDERAL NATIONAL MORTGAGE ASSOCIATION
NOTES TO FINANCIAL STATEMENTS—Continued

UNAUDITED INTERIM PERIOD RESULTS OF OPERATIONS

The following unaudited results of operations include, in the opinion of management, all adjustments (consisting of normal recurring accruals) necessary for a fair presentation of the results of operations for such periods.

	1985 Quarter Ended			
	December	September	June	March
	(Dollars in millions, except per share amounts)			
Interest margin	\$ 67	\$ 50	\$ 1	\$ (47)
Commitment fees	50	52	52	42
Guaranty fees	32	29	26	25
Other income	9	11	10	7
Administrative expenses	(40)	(39)	(33)	(30)
Provision for losses	(80)	(61)	(36)	(29)
Income (loss) before federal income taxes	38	42	20	(32)
Provision for federal income taxes	(17)	(20)	(9)	15
Net income (loss)	<u>\$ 21</u>	<u>\$ 22</u>	<u>\$ 11</u>	<u>\$ (17)</u>
Per share:				
Earnings (loss) (a)	\$.28	\$.31	\$.16	\$ (.26)
Cash dividends	.04	.04	.04	.04
	1984 Quarter Ended			
	December	September	June	March
	(Dollars in millions, except per share amounts)			
Interest margin (b)	\$ (79)	\$ (56)	\$ (22)	\$ 5
Commitment fees	45	17	28	24
Guaranty fees	23	20	19	16
Other income	10	9	12	17
Administrative expenses	(37)	(27)	(25)	(23)
Provision for losses	(22)	(44)	(8)	(12)
Income (loss) before federal income taxes	(60)	(81)	4	27
Provision for federal income taxes	29	38	(2)	(12)
Net income (loss) (b)	<u>\$ (31)</u>	<u>\$ (43)</u>	<u>\$ 2</u>	<u>\$ 15</u>
Per share:				
Earnings (loss)	\$ (.47)	\$ (.66)	\$.04	\$.22
Cash dividends	.04	.04	.04	.04

(a) The total of the four quarters does not equal the amount for the year, because the amount for each period is calculated independently based on the weighted average number of shares outstanding during that period.

(b) Effective October 1, 1984, the Corporation stopped accruing interest on all conventional loans that were 90 days or more delinquent. The effect of this change was to reduce interest income by approximately \$11.6 million in the fourth quarter of 1984, increasing the Corporation's after-tax loss by approximately \$6.0 million (\$.09 per share)

FEDERAL NATIONAL MORTGAGE ASSOCIATION
NOTES TO FINANCIAL STATEMENTS—Continued

Unaudited Financial Data Adjusted for Effects of Changing Prices

The Corporation is subject to a requirement, promulgated by the Financial Accounting Standards Board (FASB), that it provide supplementary financial information, which is intended to disclose the impact of changing prices (inflation) on its financial condition and the results of operations. As a financial institution, the Corporation does not maintain inventories or significant amounts of plant and equipment. Accordingly, the adjustments to income required by the statement for these items are not material and need not be reported.

The FASB statement also provides that the impact of inflation on the Corporation's financial condition be shown by reporting the loss from the decline in purchasing power of its net monetary assets. For the Corporation, the definition of net monetary assets is approximately equivalent to stockholders' equity. The loss from the decline in purchasing power is required to be measured by restating net monetary assets in constant dollars using the Consumer Price Index for All Urban Consumers.

In accordance with the FASB statement, an unaudited five-year comparison of the impact of changes in purchasing power on certain financial data is shown below:

FINANCIAL DATA ADJUSTED FOR EFFECTS OF CHANGING PRICES

	<u>1985</u>	<u>1984</u>	<u>1983</u>	<u>1982</u>	<u>1981</u>
	(Dollars in millions, except per share amounts)				
Interest margin:					
As reported	\$ 71	\$ (152)	\$ (62)	\$ (506)	\$ (463)
In constant dollars (a)	71	(157)	(66)	(564)	(547)
Net income (loss):					
As reported	37	(57)	75	(105)	(190)
In constant dollars (a)	37	(59)	81	(117)	(225)
Net monetary assets at end of year:					
As reported	1,288	1,159	1,233	1,164	1,204
In constant dollars (a)	1,266	1,181	1,306	1,278	1,372
Loss in purchasing power of average net monetary assets for the year	44	49	46	50	139
Per share:					
Fully diluted earnings (loss):					
As reported	.52	(.87)	1.13	(1.72)	(3.22)
In constant dollars (a)	.52	(.90)	1.22	(1.92)	(3.81)
Cash dividends:					
As reported	.16	.16	.16	.16	.40
In constant dollars (a)	.16	.17	.17	.18	.47
Year-end market price:					
As reported	25.88	15.38	23.00	24.50	8.50
In constant dollars (a)	25.43	15.67	24.37	26.90	9.69
Average consumer price index	322.0	311.1	298.4	289.1	272.4

(a) Constant dollars are computed by reference to the Consumer Price Index for All Urban Consumers and are expressed in average 1985 dollars