UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-Q

☒ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the Quarterly Period Ended June 30, 2004

Commission File No.: 0-50231

Federal National Mortgage Association
(Exact name of registrant as specified in its charter)

Fannie Mae

Federally chartered corporation (State or other jurisdiction of incorporation or organization)	**52-0883107** (I.R.S. Employer Identification No.)
3900 Wisconsin Avenue, NW **Washington, DC** (Address of principal executive offices)	**20016** (Zip Code)

Registrant's telephone number, including area code: (202) 752-7000

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

☒ Yes ☐ No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act).

☐ Yes ☒ No

As of the close of business on July 31, 2004, there were 967,903,726 shares of common stock outstanding.

CROSS-REFERENCE INDEX TO FORM 10-Q

TABLE REFERENCE

The interim financial information provided in this report reflects all adjustments that, in the opinion of management, are necessary for a fair presentation of the results for such periods. Such adjustments are of a normal recurring nature, unless otherwise disclosed in this Form 10-Q. The results of operations in our interim financial statements are not necessarily indicative of the results that may be expected for the full year. The interim financial information should be read in conjunction with Fannie Mae's 2003 Annual Report on Form 10-K, filed with the Securities and Exchange Commission ("SEC") and available on our Web site at www.fanniemae.com/ir and the SEC's Web site at www.sec.gov under "Federal National Mortgage Association" or CIK number 0000310522. We do not intend these internet addresses to be active links. Therefore, other than the portions of our 2003 Annual Report on Form 10-K explicitly stated to be incorporated herein, the information that appears on these Web sites is not incorporated into this Form 10-Q.

This report on Form 10-Q highlights significant factors influencing Fannie Mae's results of operations and financial condition. Management's Discussion and Analysis and other sections of our Form 10-Q contain forward-looking statements based on management's estimates of trends and economic factors in the markets in which Fannie Mae is active as well as the company's business plans. Such estimates and plans may change without notice and future results may vary from expected results if there are significant changes in economic, regulatory, or legislative conditions affecting Fannie Mae or its competitors. For a discussion of these factors, investors should review our Annual Report on Form 10-K for the year ended December 31, 2003. We undertake no duty to update these forward-looking statements.

PART I—FINANCIAL INFORMATION

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

SELECTED FINANCIAL DATA

The following selected financial data includes performance measures and ratios based on our reported results and core business earnings, a supplemental non-GAAP (generally accepted accounting principles) measure used by management in operating our business. Our core business earnings measures are not defined terms within GAAP and may not be comparable to similarly titled measures presented by other companies. See "Management's Discussion and Analysis ('MD&A')—Reported Results and Core Business Earnings" for a discussion of how we use core business earnings measures and why we believe they are helpful to investors. Our results for the three and six-month periods ended June 30, 2004 and 2003 are unaudited and, in the opinion of management, include all adjustments of a normal recurring nature necessary for a fair presentation. We have reclassified certain prior period amounts to conform to our current year presentation. Results for the reported period are not necessarily indicative of the results that may be expected for the full year.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	**2004**	2003
	(Dollars and shares in millions, except per share amounts)			
Reported Earnings Data:				
Net income	**$ 1,112**	$ 1,102	**$ 3,012**	$ 3,042
Preferred stock dividends and issuance costs on redemptions	**(40)**	(34)	**(84)**	(64)
Net income available to common stockholders	**$ 1,072**	$ 1,068	**$ 2,928**	$ 2,978
Basic earnings per common share	**$ 1.11**	$ 1.09	**$ 3.02**	$ 3.03
Diluted earnings per common share	**1.10**	1.09	**3.01**	3.02
Weighted-average diluted common shares outstanding	**970**	982	**973**	987
Cash dividends per common share	**$ .52**	$ .39	**$ 1.04**	$ .78
Net interest yield, taxable-equivalent basis	**1.37%**	1.63%	**1.38%**	1.61%
Return on average assets	**.43**	.47	**.59**	.66
Return on common equity	**21.2**	31.3	**30.6**	43.1
Average equity to average assets	**2.5**	1.9	**2.3**	1.9
Dividend payout ratio	**47.0**	35.8	**34.5**	25.8
Ratio of earnings to combined fixed charges and preferred stock dividends[1]	**1.14:1**	1.15:1	**1.21:1**	1.21:1
Core Business Earnings Data:[2]				
Core business earnings[3]	**$ 1,896**	$ 1,860	**$ 3,916**	$ 3,710
Core business earnings per diluted common share	**1.91**	1.86	**3.94**	3.70
Core taxable-equivalent revenues[4]	**3,259**	3,980	**6,786**	7,583
Net interest margin, taxable-equivalent basis[5]	**1.04%**	1.30%	**1.05%**	1.28%
Core return on average assets[6]	**.75**	.80	**.77**	.80
Core return on average realized common equity[7]	**23.4**	27.7	**24.5**	27.9

	June 30, 2004	December 31, 2003
Balance Sheet Data:		
Mortgage portfolio, net	**$ 891,386**	$ 901,802
Liquid assets[8]	**51,664**	65,148
Total assets	**989,341**	1,009,569
Borrowings:		
Due within one year	**424,372**	483,193
Due after one year	**515,296**	478,539
Total liabilities	**963,220**	987,196
Preferred stock	**4,108**	4,108
Stockholders' equity	**26,121**	22,373
Core capital[9]	**36,115**	34,405
Total capital[10]	**36,862**	35,182

Other Performance Measures:	Three Months Ended June 30, 2004	Three Months Ended June 30, 2003	Six Months Ended June 30, 2004	Six Months Ended June 30, 2003
Average effective guaranty fee rate[11]	**.194%**	.212%	**.207%**	.208%
Credit loss ratio[12]	**.003**	.005	**.002**	.004
Administrative expense ratio[13]	**.069**	.071	**.069**	.072
Efficiency ratio[14]	**11.8**	8.9	**11.3**	9.2
Mortgage purchases[15]	**$ 91,299**	$ 127,960	**$132,303**	$259,965
MBS issues acquired by others[16]	**134,595**	282,502	**256,603**	486,435
Business volume[17]	**225,894**	410,462	**388,906**	746,400

	June 30, 2004	December 31, 2003
Gross mortgage portfolio[18]	**$ 891,210**	$ 898,445
Outstanding MBS[19]	**1,360,045**	1,300,166
Book of business[20]	**2,251,255**	2,198,611

(1) For purposes of this ratio, "earnings" includes reported net income plus (a) provision for federal income taxes and (b) fixed charges. Fixed charges include interest expense. "Combined fixed charges and preferred stock dividends" include (a) fixed charges, (b) preferred stock dividends, and (c) issuance costs on redemptions of preferred stock.

(2) See "Management's Discussion and Analysis of Financial Condition and Results of Operations—Core Business Earnings and Business Segment Results" for additional discussion of our supplemental non-GAAP (generally accepted accounting principles) core business earnings measures and for a reconciliation to comparable GAAP measures.

(3) Core business earnings is a non-GAAP measure developed by management in conjunction with the adoption of FAS 133 to evaluate and assess the quality of Fannie Mae's earnings from its principal business activities on a consistent basis. Core business earnings is presented on a net of tax basis and excludes changes in the time value of purchased options recorded under FAS 133 and includes purchased options premiums amortized over the original estimated life of the option and any acceleration of expense related to options extinguished prior to exercise.

(4) A non-GAAP measure that includes revenues net of operating losses, primarily on low-income housing tax credit limited partnerships, and purchased options premiums amortization expense, adjusted to include taxable-equivalent amounts of tax-exempt income using the applicable federal income tax rate of 35 percent.

(5) A non-GAAP measure calculated based on annualized core net interest income on a tax-equivalent basis divided by the weighted average net investment balance.

(6) A non-GAAP measure calculated based on annualized core business earnings less preferred stock dividends and issuance costs on redemptions divided by average assets.

(7) A non-GAAP measure calculated based on annualized core business earnings less preferred stock dividends and issuance costs on redemptions divided by average realized common stockholders' equity (common stockholders' equity excluding accumulated other comprehensive income).

(8) Liquid assets include (a) cash and cash equivalents less any pledged collateral, (b) nonmortgage investments, and (c) mortgage assets designated for securitization.

(9) Core capital represents a regulatory measure of capital that includes the sum of (a) the stated value of common stock, (b) the stated value of outstanding noncumulative perpetual preferred stock, (c) paid-in capital, and (d) retained earnings, less treasury stock.

(10) Total capital represents a regulatory measure of capital. Total capital includes the sum of (a) core capital and (b) the total allowance for loan losses and guaranty liability for MBS, less (c) the specific loss allowance. Specific loss allowances totaled $10 million and $20 million at June 30, 2004 and December 31, 2003, respectively.

(11) Annualized guaranty fee income as a percentage of average outstanding MBS.

(12) Annualized charge-offs and foreclosed property expense (income), net of recoveries, as a percentage of average mortgage credit book of business.

(13) Annualized administrative expenses as a percentage of average gross mortgage portfolio and average outstanding MBS.

(14) Administrative expenses as a percentage of core taxable-equivalent revenues.

(15) Unpaid principal balance of loans, MBS, and other mortgage-related securities purchased by Fannie Mae during the reporting period.

(16) Unpaid principal balance of MBS issued and guaranteed by Fannie Mae and acquired by investors other than Fannie Mae during the reporting period.

(17) Business volume for the period includes the sum of (a) mortgage purchases and (b) MBS issues acquired by others.

(18) Unpaid principal balance of mortgages held in portfolio, excluding the effect of unrealized gains or losses on available-for-sale securities, unrealized losses on held-for-sale loans, deferred balances, and the allowance for loan losses.

(19) Unpaid principal balance of MBS guaranteed by Fannie Mae and held by investors other than Fannie Mae.

(20) Book of business includes the sum of (a) gross mortgage portfolio and (b) outstanding MBS.

Reported Results and Core Business Earnings

Our reported results, which are based on GAAP, may fluctuate significantly from period to period because of the accounting for purchased options under Financial Accounting Standard No. 133, *Accounting for Derivative Instruments and Hedging Activities* ("FAS 133"). FAS 133 requires that we record in earnings changes in the time value of purchased options that we use to manage interest rate risk; however, we do not record in earnings changes in the intrinsic value of some of those options or similar changes in the fair value of options in all of our callable debt or mortgage assets. We expect changes in the time value of purchased options to create temporary unrealized gains and losses that will often vary substantially from period to period with changes in interest rates, expected interest rate volatility, and derivatives activity.

Management also tracks and analyzes Fannie Mae's financial results based on "core business earnings." We developed core business earnings as a supplemental non-GAAP measure in conjunction with our January 1, 2001 adoption of FAS 133 to adjust for accounting differences between alternative transactions we use to hedge interest rate risk that produce similar economic results but require different accounting treatment under FAS 133. For example, our core business earnings measure allows management and investors to evaluate the quality of earnings from Fannie Mae's principal business activities in a way that accounts for comparable hedging transactions in a similar manner. While the core business earnings measure is not a substitute for GAAP net income, we rely on core business earnings in operating our business because we believe core business earnings provides our management and investors with a better measure of our financial results and better reflects our risk management strategies than our GAAP net income. We provide additional information on our core business earnings results in "MD&A—Core Business Earnings and Business Segment Results."

EXECUTIVE SUMMARY

About Fannie Mae

Fannie Mae is the nation's largest source of financing for home mortgages. We are a shareholder-owned corporation, chartered by the U.S. Congress to provide liquidity in the secondary mortgage market to increase the availability and affordability of homeownership for low-, moderate-, and middle-income Americans. Our business activities are aligned with national policies that support the expansion of homeownership in America, and serve to increase the total amount of funds available to finance housing. Though chartered by Congress, our business is self-sustaining and funded exclusively with private capital. The U.S. government does not guarantee, directly or indirectly, Fannie Mae's securities or other obligations. We compete in the secondary market for residential mortgage debt outstanding ("MDO").

We generate revenues by investing in and managing one primary asset class—residential mortgage assets (in the form of mortgage loans and mortgage-related securities) through two complementary business lines: our *Portfolio Investment* business and our *Credit Guaranty* business.

Market Dynamics

In the second quarter of 2004, our market began to fully reflect the impact of a transition we had anticipated for some time—from an environment of extremely low interest rates and record mortgage refinance volume to one of higher rates with very low levels of refinance-driven volume. We expect this transition to reduce mortgage originations by as much as $1 trillion in 2004, from the unprecedented refinance-driven origination level of $3.7 trillion in 2003. We anticipate this year's volume of mortgages for home purchases to slightly exceed last year's record levels, helping to support still robust growth in total mortgage debt outstanding in a range of 9-10 percent for the full year.

The second quarter included a complete reversal of the decline in interest rates at the end of the first quarter of the year, reflecting the impact of actual and anticipated tightening actions by the Board of Governors of the Federal Reserve System (the "Federal Reserve"). The relative increases in short- and long-term interest rates led to a notable flattening of the yield curve. Interest rates on thirty-year fixed rate mortgages rose from an average of 5.52 percent at the end of March 2004 to 6.21 percent by the end of

June. The changing interest rate environment had a pronounced effect on our competitive market—affecting mortgage product mix, competition for mortgage assets, and the level of issuances of mortgage-related securities by entities other than Fannie Mae, Freddie Mac, or Ginnie Mae (known as "private label securities")—all of which have had a notable impact on our financial results.

Rising mortgage rates and home price appreciation that remained generally strong resulted in a significant shift in the product mix of mortgage originations, with an increasing proportion of borrowers choosing alternative mortgage products, such as adjustable-rate mortgages ("ARMs") and hybrid mortgages, to maintain affordability. Although we expect purchases of these products for our portfolio to provide economic profits over their lives similar to a fixed-rate mortgage, they typically have lower initial purchase spreads. In addition to the shift in product mix, competition for mortgage assets remained intense by historical standards, with depositories continuing to add to their mortgage holdings during the second quarter of 2004, although at a more moderate pace. Finally, since the beginning of 2004 the market share of private label mortgage-related securities has increased dramatically. This increase reflects modest contraction in the spreads between private label securities and Fannie Mae MBS in general, and considerable contraction of spreads on subordinated tranches of private label issuance representing higher credit risk product.

These factors directly affected growth in our mortgage portfolio and MBS during the second quarter of 2004. Despite the changed product mix and continued heightened competition for mortgage assets, our mortgage portfolio returned to positive growth in the second quarter of 2004 following two consecutive quarters of negative growth, reflecting modest improvements in mortgage-to-debt spreads and a substantial decline in mortgage liquidations in the latter part of the quarter. Our combined book of business, which includes our gross mortgage portfolio and outstanding MBS, grew 4 percent on an annualized basis during the second quarter of 2004. For the first six months of 2004, our combined book of business expanded at a 5 percent annualized rate, reflecting annualized growth of 9 percent in outstanding MBS that offset a 2 percent annualized decline in our mortgage portfolio.

The changing mix of mortgage assets made available in the secondary market and the sustained level of competition for mortgage assets affected earnings growth for both our Portfolio Investment and Credit Guaranty businesses, which we discuss in more detail in "MD&A—Core Business Earnings and Business Segment Results."

Performance Overview

Despite significant challenges in our competitive environment, we delivered solid business results that reflected our continued focus on disciplined risk management. We reported net income and diluted earnings per common share ("EPS") of $1.112 billion and $1.10, respectively, for the second quarter of 2004, substantially unchanged from the same period last year. Our results for the second quarter reflect the benefits from a $764 million reduction in losses on the call and repurchase of debt, guaranty fee income growth of $25 million or 4 percent, and lower than expected credit losses, which were offset by a $402 million decrease in fee and other income, a $388 million or 11 percent decline in reported net interest income, and a $97 million increase in expense related to the time value of our purchased options that was due primarily to fluctuations in interest rates and interest rate volatility. The decrease in fee and other income resulted largely from recognizing $278 million of other-than-temporary impairment expense in the second quarter of 2004. The substantial majority—$265 million—of this amount related to recognizing additional impairment on our investment in non-agency securities, including manufactured housing securities, which resulted from a change in our estimation process for identifying and recognizing when other-than-temporary impairment, as defined by our regulator, has occurred. Non-agency securities include any debt security issued by an entity other than the government-sponsored enterprises Fannie Mae, Freddie Mac, or Ginnie Mae. We provide additional detail on the change to our other-than-temporary impairment estimation process and its effect in "MD&A—Critical Accounting Policies and Estimates—Other-Than-Temporary Impairment."

We reported net income of $3.012 billion and diluted EPS of $3.01 for the first six months of 2004, a decrease of less than 1 percent from the same period last year. A $1.129 billion reduction in losses on the call and repurchase of debt, growth in guaranty fee income of $215 million or 18 percent, and lower than expected credit losses had a favorable impact on our results. A $560 million or 8 percent decline in reported net interest income, a $513 million decrease in fee and other income that was due in part to the increase in other-than-temporary impairment expense during the second quarter of 2004, and a $431 million increase in purchased options expense reduced reported net income for the first six months of 2004.

Our core business earnings for the second quarter of 2004 increased 2 percent over the second quarter of 2003 to $1.896 billion, while core business diluted earnings per share increased 3 percent to $1.91. Growth in core business earnings was driven by the $764 million reduction in losses on the call and repurchase of debt and increase in guaranty fee income, which were partially offset by a $445 million or 16 percent decline in core net interest income resulting from the narrowing of our net interest margin and the decrease in fee and other income that was due in part to the increase in other-than-temporary impairment expense resulting from the change in our estimation process.

Core business earnings and core business diluted earnings per share for the first six months of 2004 increased 6 percent over the prior year period to $3.916 billion and $3.94, respectively, reflecting the benefit of reduced losses on the call and repurchase of debt and growth in guaranty fee income that were partially offset by a $627 million or 12 percent decline in core net interest income and decrease in fee and other income from the other-than-temporary impairment expense resulting from the revision to our estimation process.

Regulatory Developments

Our regulator, the Office of Federal Housing Enterprise Oversight ("OFHEO"), is conducting a special examination of the accounting policies and practices at Fannie Mae. The special examination is ongoing. We have provided OFHEO, at its request, a considerable amount of information and documentation and will continue to do so. We also are making available to OFHEO a number of our employees as part of the examination. We continue to meet with OFHEO staff frequently on a range of issues at their request.

OFHEO required us to change our estimation process for identifying and recognizing when other-than-temporary impairment has occurred on non-agency securities effective April 1, 2004. Consistent with OFHEO's directive, we continue to account for these securities in accordance with the provisions of Financial Accounting Standard No. 115, *Accounting for Certain Investments in Debt and Equity Securities* ("FAS 115"). We provide additional detail on the change to our other-than-temporary impairment estimation process and its effect in "MD&A—Critical Accounting Policies and Estimates—Other-Than-Temporary Impairment."

On April 12, 2004, OFHEO published a proposed regulation seeking to amend its corporate governance regulation that would change a number of the corporate governance standards applicable to Fannie Mae and Freddie Mac. Fannie Mae filed its comments on the proposal with OFHEO on June 11, 2004. The Nominating and Corporate Governance Committee of Fannie Mae's Board of Directors filed separate comments on the proposal.

On May 3, 2004, the U.S. Department of Housing and Urban Development ("HUD") published a proposal to amend its housing goals regulation. The regulation mandates goals for Fannie Mae's and Freddie Mac's overall mix of business—that is, the ratio of "goals business" to "non-goals business" that the companies must achieve each year. It imposes percent-of-business goals relating to the purchase or securitization of mortgages in three statutorily defined categories: loans to low- and moderate-income borrowers, loans to underserved areas, and special affordable housing. The proposed rule seeks to increase the housing goals in these three categories for Fannie Mae and Freddie Mac for calendar years 2005 through 2008; establish new subgoals for purchases of single-family, owner-occupied purchase money mortgages for the same period; and establish new data verification procedures, among other things. Fannie Mae filed comments on the proposal with HUD on July 16, 2004.

The proposed housing goals are designed to change the companies' current mix of business. If the goals are adopted as proposed, and the mandated business mix goes beyond the mix of business available to us in the market, we may be forced to over-invest in market categories that are more likely to generate goals-qualifying mortgages or to reduce our investment in non goals-qualifying mortgages. We expect that HUD will issue a final regulation prior to the end of 2004, and possibly early enough so that the new requirements will be effective beginning in 2005. However, we cannot predict whether the final rule will be the same as or similar to the proposed rule. Accordingly, we are uncertain as to the effect the final regulation may have on our business.

REPORTED RESULTS OF OPERATIONS

Net Interest Income

Table 1 presents Fannie Mae's net interest yield based on reported net interest income calculated on a taxable-equivalent basis. Our net interest yield calculation subsequent to the adoption of FAS 133 does not fully reflect the cost of our purchased options (see "MD&A—Core Business Earnings and Business Segment Results—Core Net Interest Income" for a discussion of our supplemental non-GAAP measures, core net interest income, and net interest margin).

Table 1: Net Interest Yield

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	**2003**	**2004**	**2003**
	(Dollars in millions)			
Taxable-equivalent net interest income:				
Interest income:				
Mortgage portfolio	**$ 11,794**	$ 12,256	**$ 23,909**	$ 24,846
Liquid investments	**261**	336	**490**	642
Total interest income	**12,055**	12,592	**24,399**	25,488
Interest expense:(1)				
Short-term debt(2)	**750**	697	**1,463**	1,447
Long-term debt(3)	**8,192**	8,394	**16,627**	17,172
Total interest expense	**8,942**	9,091	**18,090**	18,619
Net interest income	**3,113**	3,501	**6,309**	6,869
Taxable-equivalent adjustment on tax-exempt investments(4)	**119**	119	**238**	242
Taxable-equivalent net interest income	**$ 3,232**	$ 3,620	**$ 6,547**	$ 7,111
Average balances:(5)				
Interest-earning assets:(6)				
Mortgage portfolio, net	**$870,229**	$808,215	**$876,615**	$806,510
Liquid investments	**76,732**	81,966	**71,629**	74,550
Total interest-earning assets	**946,961**	890,181	**948,244**	881,060
Interest-free funds(7)	**(20,407)**	(32,431)	**(21,242)**	(30,432)
Total interest-earning assets funded by debt	**$926,554**	$857,750	**$927,002**	$850,628
Interest-bearing liabilities:(1)				
Short-term debt(2)	**$272,263**	$231,718	**$270,470**	$221,063
Long-term debt(3)	**654,291**	626,032	**656,532**	629,565
Total interest-bearing liabilities	**$926,554**	$857,750	**$927,002**	$850,628
Average interest rates:(4,5)				
Interest-earning assets:				
Mortgage portfolio, net	**5.43%**	6.07%	**5.47%**	6.17%
Liquid investments	**1.39**	1.66	**1.40**	1.74
Total interest-earning assets	**5.10**	5.66	**5.16**	5.80
Interest-free return(7)	**.13**	.21	**.12**	.18
Total interest-earning assets and interest-free return	**5.23**	5.87	**5.28**	5.98
Interest-bearing liabilities:(1)				
Short-term debt(2)	**1.09**	1.19	**1.07**	1.29
Long-term debt(3)	**5.02**	5.36	**5.07**	5.46
Total interest-bearing liabilities	**3.86**	4.24	**3.90**	4.37
Net interest yield, taxable-equivalent basis	**1.37%**	1.63%	**1.38%**	1.61%

(1) Classification of interest expense and interest-bearing liabilities as short-term or long-term is based on effective maturity or repricing date of outstanding debt, taking into consideration the effect of derivative financial instruments.

(2) Short-term debt includes debt scheduled to reprice in one year or less, taking into consideration the effect of derivative instruments.

(3) Long-term debt includes debt scheduled to reprice after one year, taking into consideration the effect of derivative instruments.

(4) Reflects non-GAAP adjustments to permit comparison of yields on tax-exempt and taxable assets based on a 35 percent marginal tax rate.

(5) Averages have been calculated on a monthly basis based on amortized cost.

(6) Includes average balance of nonaccrual loans of $6.6 billion and $5.9 billion for the three months ended June 30, 2004 and 2003, respectively, and $6.6 billion and $5.8 billion for the six months ended June 30, 2004 and 2003, respectively.

(7) Interest-free funds represent the portion of our investment portfolio funded by equity and non-interest bearing liabilities.

Reported net interest income for the second quarter of 2004 decreased 11 percent from the second quarter of 2003 to $3.113 billion, driven by a 16 percent (26 basis points) decline in our reported net interest yield to 1.37 percent that was partially offset by a 6 percent increase in our average net investment balance. Our average net investment balance (also referred to as total interest-earning assets) consists of our mortgage portfolio (net of unrealized gains and losses on available-for-sale securities and deferred balances) and liquid investments, excluding cash. Reported net interest income for the first six months of 2004 decreased 8 percent from the same prior year period to $6.309 billion, driven by a 14 percent (23 basis points) decline in our reported net interest yield to 1.38 percent that was partially offset by an 8 percent increase in our average net investment balance.

The decline in our net interest yield was primarily due to high levels of liquidations of higher yielding mortgages during the second half of 2003 and the purchase of lower yielding, current coupon mortgages. In addition, we extended the duration of our liabilities to offset the extended duration of our mortgage assets that resulted from the rise in interest rates.

Table 2 shows a rate/volume analysis of the changes in our reported net interest income between the three and six-month periods ended June 30, 2004 and 2003.

Table 2: Rate/Volume Analysis of Reported Net Interest Income

	Increase (Decrease)	Attributable to Changes in[1] Volume	Attributable to Changes in[1] Rate
	(Dollars in millions)		
Second Quarter 2004 vs. Second Quarter 2003			
Interest income:			
Mortgage portfolio	**$ (462)**	$ 899	$(1,361)
Liquid investments	**(75)**	(21)	(54)
Total interest income	**(537)**	878	(1,415)
Interest expense:[2]			
Short-term debt	**53**	115	(62)
Long-term debt	**(202)**	369	(571)
Total interest expense	**(149)**	484	(633)
Change in net interest income	**$ (388)**	$ 394	$ (782)
Change in taxable-equivalent adjustment on tax-exempt investments[3]	**—**		
Change in taxable-equivalent net interest income	**$ (388)**		
First Six Months of 2004 vs. First Six Months of 2003			
Interest income:			
Mortgage portfolio	**$ (937)**	$2,053	$(2,990)
Liquid investments	**(152)**	(24)	(128)
Total interest income	**(1,089)**	2,029	(3,118)
Interest expense:[2]			
Short-term debt	**16**	292	(276)
Long-term debt	**(545)**	717	(1,262)
Total interest expense	**(529)**	1,009	(1,538)
Change in net interest income	**$ (560)**	$1,020	$(1,580)
Change in taxable-equivalent adjustment on tax-exempt investments[3]	**(4)**		
Change in taxable-equivalent net interest income	**$ (564)**		

(1) Combined rate/volume variances, a third element of the calculation, are allocated to the rate and volume variances based on their relative size.
(2) Classification of interest expense and interest-bearing liabilities as short-term or long-term is based on effective maturity or repricing date, taking into consideration the effect of derivative financial instruments.
(3) Reflects non-GAAP adjustments to permit comparison of yields on tax-exempt and taxable assets based on a 35 percent marginal tax rate.

Guaranty Fee Income

Table 3 compares guaranty fee income and our average effective guaranty fee rate for the three and six-month periods ended June 30, 2004 and 2003.

Table 3: Guaranty Fee Data

	Three Months Ended June 30,			Six Months Ended June 30,		
	2004	2003	% Change	**2004**	2003	% Change
	(Dollars in millions)					
Guaranty fee income	**$ 657**	$ 632	4%	**$ 1,394**	$ 1,179	18%
Average balance of outstanding MBS[1]	**1,355,868**	1,193,264	14	**1,344,654**	1,134,797	18
Average effective guaranty fee rate (basis points)	**19.4**	21.2	(8)	**20.7**	20.8	—

(1) "Outstanding MBS" refers to mortgage-related securities guaranteed by Fannie Mae and held by investors other than Fannie Mae. If an MBS has been resecuritized into another MBS, we only include the principal amount once in the outstanding balance.

Guaranty fee income for the second quarter of 2004 grew 4 percent over the second quarter of 2003 to $657 million, driven by 14 percent growth in average outstanding MBS that was partially offset by an

8 percent decline in the average effective guaranty fee rate on outstanding MBS to 19.4 basis points. Guaranty fee income for the first six months of 2004 increased 18 percent to $1.394 billion, primarily due to 18 percent growth in average outstanding MBS combined with a slight decline in the average effective guaranty fee rate to 20.7 basis points.

Our issuance of single-family MBS was relatively low in the second quarter of 2004, resulting in an annualized growth in outstanding MBS of only 4 percent for the quarter and 9 percent for the first six months of 2004. MBS issues acquired by other investors fell by more than 50 percent to $135 billion in the second quarter of 2004, from $283 billion in the same prior year period. MBS issues acquired by other investors fell by 47 percent to $257 billion for the first six months of 2004, compared with $486 billion for the first six months of 2003.

The substantial decline in our MBS growth rate from the elevated levels of the past three years was due to a combination of factors, including the drop in mortgage origination volumes, the sustained high retention of mortgages by depository institutions supported by a continued rise in adjustable-rate mortgages, and a record level of issuances of private label securities backed largely by loans with higher credit risk. The decrease in our average effective guaranty fee rate reflects the effect of the rise in interest rates in the second quarter of 2004 and the resulting decrease in projected prepayments, which slowed our recognition of deferred fee income.

Fee and Other Income (Expense), Net

We recorded net expense of $170 million and $168 million in fee and other income for the second quarter and first six months of 2004, respectively, compared with income of $232 million and $345 million for the second quarter and first six months of 2003, respectively. Fee and other income includes transaction fees, technology fees, multifamily fees and other miscellaneous items and is net of credit enhancement expense and operating losses from tax-advantaged investments in affordable housing projects. We also include gains and losses on the sale of securities and any other-than-temporary impairment expense in fee and other income.

The decreases in fee and other income in the second quarter and first six months of 2004 were primarily due to the change in our process for estimating when other-than-temporary impairment has occurred and a reduction in transaction and technology fees. In the second quarter of 2004, we changed our estimation process for identifying and recognizing other-than-temporary impairment on our investment in non-agency securities that resulted in a $265 million pre-tax increase in other-than-temporary impairment expense and an $.18 per share decrease in diluted EPS for the three and six-month periods ended June 30, 2004. We provide additional detail on our revised estimation process in "MD&A—Critical Accounting Policies and Estimates—Other-Than-Temporary Impairment." Other-than-temporary impairment expense, including the amount attributable to our revised estimation process, totaled $278 million for the second quarter of 2004 and $341 million for the first six months of 2004 and related primarily to the change in the process we now use to estimate when other-than-temporary impairment has occurred. Other-than-temporary impairment expense totaled $102 million and $197 million for the second quarter and first six months of 2003, primarily attributable to our investments in certain nonmortgage investments and manufactured housing securities.

Transaction and technology fees are largely driven by business volumes, which have fallen significantly in 2004, in part due to the decline in mortgage originations. Market-related transaction and technology fees for the second quarter and first six months of 2004 were substantially reduced relative to the same prior year periods. Transaction and technology fees in the second quarter and first six months of 2004 totaled $110 million and $218 million, respectively, down by more than 50 percent from the same prior year periods. Our business volume, which includes portfolio purchases and MBS issues acquired by other investors, fell to $226 billion and $389 billion in the second quarter and first six months of 2004, respectively, from $410 billion and $746 billion in the second quarter and first six months of 2003. We expect markedly lower total business volumes for full year 2004, which is likely to result in a considerable reduction in transaction and technology fees from the prior year.

Credit-Related Expense

Credit-related expense, which includes foreclosed property expense (income) and the provision for losses, totaled $21 million of income in the second quarter of 2004, compared with $23 million of expense in the second quarter of 2003. Credit-related expense for the first six months of 2004 totaled $13 million of income, compared with $43 million of expense for the first six months of 2003.

The decrease in credit-related expense was due primarily to incorporating the continued lower-than-projected level of credit losses into the assessment of our allowance for loan losses and guaranty liability for MBS. Based on recent credit performance, we reduced the allowance for loan losses and guaranty liability for MBS to $757 million at June 30, 2004, from $795 million at March 31, 2004 and $797 million at December 31, 2003, and recorded a negative loss provision of $12 million for the second quarter of 2004 and an expense of $20 million for the first six months of 2004. In comparison, we recorded a provision for losses of $26 million and $49 million for the second quarter and first six months of 2003, respectively. We provide additional detail on the update to the assumptions used in estimating our allowance for loan losses and guaranty liability for MBS in "MD&A—Critical Accounting Policies and Estimates—Allowance for Loan Losses and Guaranty Liability for MBS."

We recorded foreclosed property income of $9 million in the second quarter of 2004, up from $3 million of income in the second quarter of 2003. Foreclosed property income increased to $33 million for the first six months of 2004 from $6 million for the first six months of 2003. At the same time, acquisitions of single-family foreclosed properties increased to 8,146 and 16,259 for the second quarter and first six months of 2004, respectively, from 6,569 and 12,487 for the second quarter and first six months of 2003. The strong housing market, combined with our management of problem loans and protection through credit enhancements and other risk sharing agreements, has mitigated the impact of recent increases in foreclosure activity.

Credit-related losses, which include charge-offs plus foreclosed property expense (income), were significantly lower than expected during the second quarter of 2004, driven by the continuation of a very low average loss per case on foreclosed properties. Average severities on the sale of foreclosed properties have remained low by historical standards due to overall strong home prices and greater benefits from our credit loss sharing strategies than we had anticipated. Credit-related losses totaled $16 million in the second quarter of 2004, down from $23 million in the second quarter of 2003. Credit-related losses for the first six months of 2004 decreased $17 million from the same prior year period to $26 million. As our mortgage credit book of business becomes more seasoned, we continue to expect an upward trend in serious delinquency rates and foreclosures. As a result, we anticipate a moderate upward trend in credit losses during the remainder of the year. However, because of the extremely low levels of losses in the first six months of 2004, we believe that total losses for the year—on a larger mortgage credit book of business—may be no higher than losses recorded in 2003.

Administrative Expenses

Administrative expenses totaled $384 million and $767 million in the second quarter and first six months of 2004, respectively, up 8 percent and 10 percent over the second quarter and first six months of 2003, primarily due to the combined effect of annual salary increases, a 5 percent increase in the number of employees, and a higher level of stock compensation expense recognized under the fair value recognition provisions of Financial Accounting Standard No. 123, *Accounting for Stock-Based Compensation* ("FAS 123"), which we adopted on January 1, 2003.

We evaluate growth in administrative expenses in relation to growth in core taxable-equivalent revenues and our average book of business. Core taxable-equivalent revenues is a supplemental non-GAAP measure discussed further in "MD&A—Core Business Earnings and Business Segment Results." The increase in administrative expenses and decrease in core taxable-equivalent revenues during the second quarter and first six months of 2004 resulted in a higher efficiency ratio—the ratio of administrative expenses to core taxable-equivalent revenues—for each period. Our efficiency ratio increased to 11.8 percent for the second quarter of 2004 from 8.9 percent for the same prior year period, and 11.3 percent for the first six months of 2004 from 9.2 percent for the same prior year period. The ratio of administrative expenses as a percentage of our average book of business improved to .069 percent for both the second quarter and first six months of 2004, compared with .071 percent for the second quarter of 2003 and .072 percent for the first six months of 2003. We continue to expect the growth rate in administrative expenses to slow to single-digits in 2004 from double-digit growth in 2003, primarily due to reduced costs related to the multi-year project initiated in 2001 to re-engineer our core infrastructure systems.

Purchased Options Expense

We recorded purchased options expense of $1.980 billion in the second quarter of 2004, up from expense of $1.883 billion in the second quarter of 2003. Purchased options expense for the first six months of 2004 and 2003 totaled $2.939 billion and $2.508 billion, respectively. The expense recorded during each period was due primarily to changes in the time value of purchased options that resulted from fluctuations in interest rates, volatility, and the notional amount of options held during each quarter. The estimated fair value of the time value portion of our outstanding purchased options, which is included on our balance sheet under "Derivatives in gain positions," decreased to $6.287 billion at June 30, 2004 from $8.139 billion at December 31, 2003. The fair value changes in the time value of our purchased options will vary from period to period with changes in interest rates, expected interest rate volatility, and derivative activity.

Debt Extinguishments, Net

We recognized gains of $24 million in the second quarter of 2004 on the call of $75 billion and repurchase of $2 billion of debt and losses of $3 million during the first six months of 2004 on the call of $189 billion and repurchase of $2 billion of debt. In comparison, we recognized losses of $740 million in the second quarter of 2003 on the call of $66 billion and repurchase of $7 billion of debt and losses of $1.132 billion during the first six months of 2003 on the call of $110 billion and repurchase of $11 billion of debt. The significant decrease in losses resulted from the reduced level of debt repurchases in 2004, combined with opportunities to repurchase debt at a discount during the second quarter of 2004. The level of debt repurchases typically has a greater impact on gains and losses recognized on debt extinguishments than the level of debt calls. We repurchase or call debt securities and related interest rate swaps on a regular basis as part of our interest rate risk management efforts and to reduce future debt costs. Because debt repurchases, unlike debt calls, may require the payment of a premium and therefore result in higher extinguishment costs, we generally repurchase high interest rate debt at times (and in amounts) when we believe Fannie Mae has sufficient income available to absorb or offset those higher costs.

We called or repurchased a significant amount of debt during 2003 as a result of the historically low interest rate environment, steep yield curve, and debt spreads relative to the swap market which created opportunities to replace longer-term, higher-cost debt with shorter-term, lower-cost debt. This environment also contributed to a temporary elevation of our net interest margin and provided Fannie Mae with substantial income that we chose to reinvest in the repurchase of above-market debt to reduce our future debt costs. We began to curb our debt repurchase activity in 2004 as interest rates rose and our net interest margin began to narrow, which reduced the level of earnings available to invest in significant debt repurchases.

Income Taxes

We recorded a provision for federal income taxes of $169 million based on our reported results in the second quarter of 2004 that resulted in an effective tax rate of 13 percent, compared with a provision of $263 million and effective tax rate of 19 percent in the same prior year quarter. We recorded a provision for federal income taxes of $827 million and effective tax rate of 22 percent for the first six months of 2004, compared with a provision of $970 million and effective tax rate of 24 percent for the first six months of 2003. The decrease in the effective tax rate in 2004 was primarily due to the combined effect of a decline in our reported income, which produces a higher relative tax benefit for tax-exempt income and tax credits, and an increase in the actual dollar amount of tax credits. Investment tax credits increased by

$66 million during the second quarter of 2004 over the prior year quarter, most of which resulted from our affordable housing investments.

Our effective tax rate calculated based on our core business earnings results, which is a non-GAAP measure that adjusts for the effect of FAS 133 on our purchased options, was 24 percent and 25 percent for the second quarter and first six months of 2004, respectively, compared with 27 percent and 26 percent for the same prior year periods. The decrease in our core business earnings effective tax rate during 2004 was primarily due to the increase in tax credits on affordable housing investments.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Fannie Mae's reported results and financial statements are based on GAAP, which in some cases requires us to make estimates and assumptions that affect our reported results and disclosures. For a complete discussion of Fannie Mae's significant accounting policies, see "Notes to the Financial Statements— Note 1, Summary of Significant Accounting Policies" in our 2003 Annual Report on Form 10-K. We have identified four accounting policies that we believe are critical in the preparation and understanding of our financial statements because they are highly dependent upon subjective or complex judgments, assumptions, and estimates. These policies relate to the following:

- determining the adequacy of the allowance for loan losses and guaranty liability for MBS;
- projecting mortgage prepayments to calculate the amortization of deferred price adjustments related to mortgage assets held in our mortgage portfolio and outstanding MBS;
- estimating the time value of purchased options; and
- assessing other-than-temporary impairment.

We detail the assumptions and judgment involved in applying these policies in Fannie Mae's 2003 Annual Report on Form 10-K under "Management's Discussion and Analysis of Financial Condition and Results of Operation—Critical Accounting Policies and Estimates." Following is an update of significant changes in the estimation process or assumptions used in applying our critical accounting policies since the end of 2003.

Allowance for Loan Losses and Guaranty Liability for MBS

Based on recent credit performance trends, the benefits we have received from credit enhancements and risk sharing arrangements have exceeded our expectations and reduced our average loss severity below historical levels. Accordingly, during the second quarter of 2004 we adjusted our allowance methodology for loan losses and guaranty liability for MBS to incorporate the lower than expected loss severity that we have continued to experience in accordance with the applicable accounting guidance provided in Financial Accounting Standard No. 5, *Accounting for Contingencies* ("FAS 5") and SEC Staff Accounting Bulletin No. 102, *Selected Loan Loss Allowance Methodology and Documentation Issues* ("SAB No. 102"). As a result of incorporating this trend into the risk factors we assess in estimating the allowance and guaranty liability, we reduced the allowance for loan losses and guaranty liability for MBS to $757 million at June 30, 2004, from $795 million at March 31, 2004 and $797 million at December 31, 2003, and recorded a negative loss provision of $12 million for the second quarter of 2004 and a positive provision for losses of $20 million for the first six months of 2004. In comparison, we recorded a positive provision for losses of $26 million and $49 million for the second quarter and first six months of 2003, respectively.

Deferred Price Adjustments

We continually update projected mortgage prepayment speeds in response to changes in interest rates and the effect on expected prepayments. In general, as interest rates decline expected prepayment speeds increase, which accelerates the amortization of deferred price adjustments. As mortgage interest rates rose during the second quarter of 2004 after falling sharply at the end of the first quarter, expected prepayment rates decreased. Accordingly, we slowed the amortization of deferred price adjustments in the second quarter of 2004, after accelerating amortization in the first quarter of 2004 in response to the sharp decline in interest rates and related increase in expected prepayments at the end of that quarter. The effect in the second quarter of 2004 was to reduce the amortization of deferred net premium expense related to our mortgage portfolio, which increased net interest income, and to reduce the accretion of deferred net discount income related to guaranty fee price adjustments, which reduced guaranty fee income.

Other-Than-Temporary Impairment

In the second quarter of 2004, OFHEO directed Fannie Mae to incorporate additional criteria into our process for estimating when other-than-temporary impairment has occurred on non-agency securities. After meeting with OFHEO staff to discuss the implementation of its directive and to refine the prescribed estimation process, we modified our process for identifying and recognizing other-than-temporary impairment on all of Fannie Mae's non-agency securities, including manufactured housing and certain asset-backed securities, effective April 1, 2004. In accordance with the provisions of Accounting Principles Board Opinion No. 20, *Accounting Changes* ("APB 20"), we accounted for this change prospectively as a change in accounting estimate, which resulted in the additional recognition of pre-tax other-than-temporary impairment expense of $265 million on certain manufactured housing and asset-backed securities in the second quarter of 2004 and reduced diluted EPS by $.18 per share for the three and six-month periods ended June 30, 2004.

We estimate other-than-temporary impairment in accordance with the guidance provided in FAS 115, SEC Staff Accounting Bulletin No. 59, *Noncurrent Marketable Equity Securities* ("SAB 59") and EITF 03-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments* ("EITF 03-1"). Prior to the April 1, 2004 modification of our estimation process, we generally recognized other-than-temporary impairment on our investments in debt securities when we determined that it was probable that we would be unable to collect all of the contractual principal and interest cash flows based on ongoing monitoring of our securities, extensive analysis, and consideration of the facts and circumstances related to each specific security, such as our ability and intent to hold the security to recover its value and the probability, extent, and timing of a valuation recovery.

In addition to the estimation process described above, we now apply a series of objective tests to recognize other-than-temporary impairment that include the current credit ratings of the security and the extent to which the fair value is below our current book value. We will continue to rigorously monitor all of our securities for potential other-than-temporary impairment. As we have previously done, at the end of each quarter we will perform a detailed analysis of both held-to-maturity and available-for-sale non-agency securities in our mortgage and nonmortgage investment portfolios that have unrealized losses to assess whether the losses are other than temporary. We will rely primarily on quoted market prices to estimate the fair value of our securities and determine the amount of unrealized losses.

When a held-to-maturity or available-for-sale security has an unrealized loss that is deemed to be other than temporary, we reduce the book value of the security to its current market value and recognize the decline as other-than-temporary impairment expense and include in our income statement as a component of fee and other income. Any unrealized gains or losses on available-for-sale securities are reflected in stockholders' equity as a component of accumulated other comprehensive income.

Other-than-temporary impairment expense on non-agency investment securities totaled $265 million and $297 million in the second quarter and first six months of 2004, respectively, which were primarily related to investments in manufactured housing securities included in our mortgage portfolio. We recorded other-than-temporary impairment expense on non-agency investment securities of $89 million and $165 million in the second quarter and first six months of 2003, primarily related to investments in nonmortgage securities. These other-than-temporary impairment expense amounts impact the results of our Portfolio Investment business.

Subsequent to our initial recognition of other-than-temporary impairment, we will periodically reassess the cash flows expected to be collected on each security. Estimated cash flows expected to be collected in excess of the fair value of the security on the date of our initial recognition of other-than-temporary impairment expense will be accreted into interest income over the remaining life of the security in accordance with the requirements of EITF 03-1 and Statement of Position 03-3, *Accounting for Certain Loans and Debt Securities Acquired in a Transfer* ("SOP 03-3"). Based on our estimate of cash flows expected to be collected at June 30, 2004, we accreted $11 million of previously recognized other-than-temporary impairment expense into interest income during the second quarter of 2004.

We provide additional information on our investments in manufactured housing securities, which account for a substantial portion of the other-than-temporary impairment expense that we have recognized, in "MD&A—Portfolio Investment Business Operations—Mortgage Portfolio."

CORE BUSINESS EARNINGS AND BUSINESS SEGMENT RESULTS

Management relies primarily on core business earnings and related supplemental non-GAAP measures developed in conjunction with our adoption of FAS 133 to evaluate Fannie Mae's financial performance and measure the results of our lines of business.

Core Business Earnings

Core business earnings for the second quarter of 2004 grew 2 percent over the prior year period to $1.896 billion, and core business earnings per diluted common share increased 3 percent to $1.91 driven by reduced losses from the call and repurchase of debt and growth in guaranty fee income that was partially offset by a decline in core net interest income and the recognition of additional other-than-temporary impairment expense during the quarter. Core business earnings for the first six months of 2004 increased 6 percent over the same prior year period to $3.916 billion, and core business earnings per diluted common share increased 6 percent to $3.94 primarily due to reduced losses from the call and repurchase of debt and growth in guaranty fee income that more than offset a decline in core net interest income and fee and other income. Highlights of our performance for the second quarter and first six months of 2004 compared with the same prior year periods include:

Second Quarter 2004 versus Second Quarter 2003:

- *26 basis point decline in the net interest margin to 1.04 percent*
- *4 percent increase in guaranty fee income to $657 million*
- *$402 million decrease in fee and other income, due in part to other-than-temporary impairment expense*
- *Credit-related income of $21 million, versus expense of $23 million in the second quarter of 2003*
- *$764 million reduction in losses from the call and repurchase of debt*

First Six Months of 2004 versus First Six Months of 2003:

- *23 basis point decline in the net interest margin to 1.05 percent*
- *18 percent increase in guaranty fee income to $1.394 billion*
- *$513 million decrease in fee and other income, due in part to other-than-temporary impairment expense*
- *Credit-related income of $13 million, versus expense of $43 million for the first six months of 2003*
- *$1.129 billion reduction in losses from the call and repurchase of debt*

Core business earnings differs from reported net income by using a different method of recognizing the period cost of purchased options. Our core business earnings measure excludes the unpredictable volatility in the time value of purchased options that is included in our reported net income because we generally intend to hold these options to maturity, and we do not believe the period-to-period variability in our reported net income from changes in the time value of our purchased options accurately reflects the underlying risks or economics of our hedging strategy. Core business earnings includes amortization of purchased options premiums over the original expected life of the options and any accelerated expense resulting from options extinguished prior to exercise or expiration. The net amount of purchased options amortization expense recorded under our core business earnings measure will equal the net amount of purchased options expense ultimately recorded under FAS 133 in our reported net income over the life of our options. However, our amortization treatment is more consistent with the accounting for embedded options in our callable debt and more accurately reflects the underlying economics of our use of purchased options as a substitute for issuing callable debt—two alternate hedging strategies that are economically very similar but require different accounting treatment. While core business earnings is not a substitute for GAAP net income, we rely on core business earnings in operating our business because we believe it provides our management and investors with a better measure of our financial results and better reflects our risk management strategies than our GAAP net income.

Management also relies on several other non-GAAP performance measures related to core business earnings to evaluate Fannie Mae's performance. These key performance measures include core taxable-equivalent revenues, core net interest income, and net interest margin. Our core business earnings measures are not defined terms within GAAP and may not be comparable to similarly titled measures reported by other companies. Although we rely on core business earnings to measure and evaluate Fannie Mae's period-to-period results of operations, we do not use core business earnings in calculating our regulatory core capital and total capital measures. We calculate these measures based on stockholders' equity reported in our financial statements, which includes retained earnings based on our reported GAAP net income. We consider our core capital and total capital levels in establishing our dividend policies because they are critical in determining the amount of capital available for distribution to shareholders.

Table 4 shows our line of business and consolidated core business earnings results for the three and six-month periods ended June 30, 2004 and 2003. The only difference in core business earnings and reported net income relates to the FAS 133 accounting treatment for purchased options, which affects our Portfolio Investment business. Core business earnings does not adjust for any other accounting effects related to the application of FAS 133 or other accounting standards under GAAP. The FAS 133 related reconciling items between our core business earnings and reported results have no effect on our Credit Guaranty business. The specific FAS 133 related adjustments affecting our Portfolio Investment business are identified and explained in Table 4.

Table 4: Reconciliation of Core Business Earnings to Reported Results

	Three Months Ended June 30, 2004				
	Portfolio Investment	Credit Guaranty	Total Core Business Earnings	Reconciling Items Related to Purchased Options	Reported Results
	(Dollars in millions)				
Net interest income	**$ 2,944**	**$ 169**	**$ 3,113**	**$ —**	**$ 3,113**
Purchased options amortization expense	**(773)**	**—**	**(773)**	**773(2)**	**—**
Core net interest income	**2,171**	**169**	**2,340**	**773**	**3,113**
Guaranty fee income (expense)	**(421)**	**1,078**	**657**	**—**	**657**
Fee and other income (expense), net	**(144)**	**(26)**	**(170)**	**—**	**(170)**
Credit-related income (expense)(1)	**—**	**21**	**21**	**—**	**21**
Administrative expenses	**(119)**	**(265)**	**(384)**	**—**	**(384)**
Purchased options expense under FAS 133	**—**	**—**	**—**	**(1,980)(3)**	**(1,980)**
Debt extinguishments gain (loss), net	**24**	**—**	**24**	**—**	**24**
Income before federal income taxes	**1,511**	**977**	**2,488**	**(1,207)**	**1,281**
Provision for federal income taxes	**(430)**	**(162)**	**(592)**	**423(4)**	**(169)**
Net income	**$ 1,081**	**$ 815**	**$ 1,896**	**$ (784)**	**$ 1,112**

	Three Months Ended June 30, 2003				
	Portfolio Investment	Credit Guaranty	Total Core Business Earnings	Reconciling Items Related to Purchased Options	Reported Results
Net interest income	$ 3,280	$ 221	$ 3,501	$ —	$ 3,501
Purchased options amortization expense	(716)	—	(716)	716(2)	—
Core net interest income	2,564	221	2,785	716	3,501
Guaranty fee income (expense)	(404)	1,036	632	—	632
Fee and other income (expense), net	231	1	232	—	232
Credit-related income (expense)(1)	—	(23)	(23)	—	(23)
Administrative expenses	(103)	(251)	(354)	—	(354)
Purchased options expense under FAS 133	—	—	—	(1,883)(3)	(1,883)
Debt extinguishments gain (loss), net	(740)	—	(740)	—	(740)
Income before federal income taxes	1,548	984	2,532	(1,167)	1,365
Provision for federal income taxes	(454)	(218)	(672)	409(4)	(263)
Net income	$ 1,094	$ 766	$ 1,860	$ (758)	$ 1,102

	Six Months Ended June 30, 2004				
	Portfolio Investment	Credit Guaranty	Total Core Business Earnings	Reconciling Items Related to Purchased Options	Reported Results
Net interest income	**$ 5,989**	**$ 320**	**$ 6,309**	**$ —**	**$ 6,309**
Purchased options amortization expense	**(1,548)**	**—**	**(1,548)**	**1,548(2)**	**—**
Core net interest income	**4,441**	**320**	**4,761**	**1,548**	**6,309**
Guaranty fee income (expense)	**(884)**	**2,278**	**1,394**	**—**	**1,394**
Fee and other income (expense), net	**(102)**	**(66)**	**(168)**	**—**	**(168)**
Credit-related income (expense)(1)	**—**	**13**	**13**	**—**	**13**
Administrative expenses	**(232)**	**(535)**	**(767)**	**—**	**(767)**
Purchased options expense under FAS 133	**—**	**—**	**—**	**(2,939)(3)**	**(2,939)**
Debt extinguishments gain (loss), net	**(3)**	**—**	**(3)**	**—**	**(3)**
Income before federal income taxes	**3,220**	**2,010**	**5,230**	**(1,391)**	**3,839**
Provision for federal income taxes	**(937)**	**(377)**	**(1,314)**	**487(4)**	**(827)**
Net income	**$ 2,283**	**$1,633**	**$ 3,916**	**$ (904)**	**$ 3,012**

	Six Months Ended June 30, 2003				
	Portfolio Investment	Credit Guaranty	Total Core Business Earnings	Reconciling Items Related to Purchased Options	Reported Results
Net interest income	$ 6,466	$ 403	$ 6,869	$ —	$ 6,869
Purchased options amortization expense	(1,481)	—	(1,481)	1,481 [2]	—
Core net interest income	4,985	403	5,388	1,481	6,869
Guaranty fee income (expense)	(807)	1,986	1,179	—	1,179
Fee and other income (expense), net	353	(8)	345	—	345
Credit-related income (expense) [1]	—	(43)	(43)	—	(43)
Administrative expenses	(204)	(494)	(698)	—	(698)
Purchased options expense under FAS 133.	—	—	—	(2,508) [3]	(2,508)
Debt extinguishments gain (loss), net	(1,132)	—	(1,132)	—	(1,132)
Income before federal income taxes	3,195	1,844	5,039	(1,027)	4,012
Provision for federal income taxes	(938)	(391)	(1,329)	359 [4]	(970)
Net income	$ 2,257	$1,453	$ 3,710	$ (668)	$ 3,042

(1) Credit-related income (expense) includes the income statement line items "Provision for losses" and "Foreclosed property income."

(2) Represents the amortization of purchased options premiums that we allocate to interest expense over the original expected life of the options. We include this amount in core business earnings instead of recording changes in the time value of purchased options because this treatment is more consistent with the accounting for the embedded options in our callable debt and the vast majority of our mortgages.

(3) Represents changes in the fair value of the time value of purchased options recorded in accordance with FAS 133. We exclude this amount from our core business earnings measure because the period-to-period fluctuations in the time value portion of our options do not reflect the economics of our current risk management strategy, which generally is to hold our purchased options to maturity or exercise date. Consequently, we do not expect to realize the period-to-period fluctuations in time value.

(4) Represents the net federal income tax effect of core business earnings adjustments based on the applicable federal income tax rate of 35 percent.

Core Taxable-Equivalent Revenues

Core taxable-equivalent revenues for the second quarter and first six months of 2004 decreased by 18 percent and 11 percent, respectively, from the same prior year periods, primarily due to a reduction in core net interest income that resulted from the compression of our net interest margin and a decline in fee and other income, which were partially offset by growth in guaranty fee income and an increase in tax credits from affordable housing investments. Table 5 shows the components of core taxable-equivalent revenues and provides a comparison between the three and six-month periods ended June 30, 2004 and 2003.

Table 5: Core Taxable-Equivalent Revenues

	Three Months Ended June 30,			Six Months Ended June 30,		
	2004	2003	% Change	2004	2003	% Change
	(Dollars in millions)					
Net interest income	**$3,113**	$3,501	(11)%	**$ 6,309**	$ 6,869	(8)%
Guaranty fee income	**657**	632	4	**1,394**	1,179	18
Fee and other income (expense), net [1]	**(170)**	232	(173)	**(168)**	345	(149)
Total revenues	**3,600**	4,365	(18)	**7,535**	8,393	(10)
Taxable-equivalent adjustments:						
Investment tax credits [2]	**313**	212	48	**561**	429	31
Tax-exempt investments [3]	**119**	119	—	**238**	242	(2)
Taxable-equivalent revenues	**4,032**	4,696	(14)	**8,334**	9,064	(8)
Purchased options amortization expense [4]	**(773)**	(716)	8	**(1,548)**	(1,481)	5
Core taxable-equivalent revenues	**$3,259**	$3,980	(18)	**$ 6,786**	$ 7,583	(11)

(1) Includes net losses on certain tax-advantaged investments totaling $76 million and $52 million for the three months ended June 30, 2004 and 2003, respectively, and $156 million and $124 million for the six months ended June 30, 2004 and 2003, respectively.

(2) Represents non-GAAP taxable-equivalent adjustments for tax credits related to losses on certain affordable housing tax-advantaged equity investments and other investment tax credits using the applicable federal income tax rate of 35 percent.

(3) Represents non-GAAP adjustments to permit comparisons of yields on tax-exempt and taxable assets based on a 35 percent marginal tax rate.

(4) Represents non-GAAP adjustment for amortization of purchased options premiums that would have been recorded prior to the adoption of FAS 133 in 2001.

Core Net Interest Income

Table 6 reconciles our non-GAAP taxable-equivalent core net interest income to reported net interest income and presents an analysis of our net interest margin. Our taxable-equivalent core net interest income and net interest margin are significantly different than our taxable-equivalent net interest income and net interest yield, which are based on our reported results, because our core measures include the amortization of our purchased options premiums over the original estimated life of the option.

Table 6: Net Interest Margin

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	**2004**	2003
	(Dollars in millions)			
Net interest income	**$ 3,113**	$ 3,501	**$ 6,309**	$ 6,869
Purchased options amortization expense[1]	**(773)**	(716)	**(1,548)**	(1,481)
Core net interest income	**2,340**	2,785	**4,761**	5,388
Taxable-equivalent adjustment on tax-exempt investments[2]	**119**	119	**238**	242
Taxable-equivalent core net interest income	**$ 2,459**	$ 2,904	**$ 4,999**	$ 5,630
Average balances:[3]				
Interest-earning assets:[4]				
Mortgage portfolio, net	**$870,229**	$808,215	**$876,615**	$806,510
Liquid investments	**76,732**	81,966	**71,629**	74,550
Total interest-earning assets	**946,961**	890,181	**948,244**	881,060
Interest-free funds[5]	**(20,407)**	(32,431)	**(21,242)**	(30,432)
Total interest-earning assets funded by debt	**$926,554**	$857,750	**$927,002**	$850,628
Interest-bearing liabilities:[6]				
Short-term debt[7]	**$272,263**	$231,718	**$270,470**	$221,063
Long-term debt[8]	**654,291**	626,032	**656,532**	629,565
Total interest-bearing liabilities	**$926,554**	$857,750	**$927,002**	$850,628
Average interest rates:[2,3]				
Interest-earning assets:				
Mortgage portfolio, net	**5.43%**	6.07%	**5.47%**	6.17%
Liquid investments	**1.39**	1.66	**1.40**	1.74
Total interest-earning assets	**5.10**	5.66	**5.16**	5.80
Interest-free funds[5]	**.14**	.20	**.13**	.20
Total interest-earning assets and interest-free return	**5.24**	5.86	**5.29**	6.00
Interest-bearing liabilities:[6]				
Short-term debt[7]	**1.27**	1.43	**1.27**	1.54
Long-term debt[8]	**5.41**	5.72	**5.46**	5.83
Total interest-bearing liabilities	**4.20**	4.56	**4.24**	4.72
Net interest margin, taxable-equivalent basis	**1.04%**	1.30%	**1.05%**	1.28%

(1) Reflects non-GAAP adjustment for amortization of purchased options premiums.

(2) Reflects non-GAAP adjustments to permit comparison of yields on tax-exempt and taxable assets based on 35 percent marginal tax rate.

(3) Averages have been calculated on a monthly basis based on amortized cost.

(4) Includes average balance of nonaccrual loans of $6.6 billion and $5.9 billion for the three months ended June 30, 2004 and 2003, respectively, and $6.6 billion and $5.8 billion for the six months ended June 30, 2004 and 2003, respectively.

(5) Interest-free funds represent the portion of our investment portfolio funded by equity and non-interest bearing liabilities.

(6) Classification of interest expense and interest-bearing liabilities as short-term or long-term is based on effective maturity or repricing date, taking into consideration the effect of derivative financial instruments. The cost of debt includes expense for the amortization of purchased options.

(7) Short-term debt includes debt scheduled to reprice in one year or less, taking into consideration the effect of derivative instruments.

(8) Long-term debt includes debt scheduled to reprice after one year, taking into consideration the effect of derivative instruments.

Core net interest income for the second quarter of 2004 fell by 16 percent from the second quarter of 2003 to $2.340 billion, driven by a 20 percent (26 basis points) decline in our net interest margin to 1.04 percent that was partially offset by a 6 percent increase in our average net investment balance. Core net interest income for the first six months of 2004 declined by 12 percent over the same year-ago period to $4.761 billion, driven by an 18 percent (23 basis points) decline in our net interest margin to 1.05 percent that was partially offset by an 8 percent increase in our average net investment balance.

Table 7 shows a rate/volume analysis of the changes in our core net interest income between the three and six-month periods ended June 30, 2004 and 2003.

Table 7: Rate/Volume Analysis of Core Net Interest Income

	Increase (Decrease)	Attributable to Changes in[1] Volume	Attributable to Changes in[1] Rate
	(Dollars in millions)		
Second Quarter 2004 vs. Second Quarter 2003			
Interest income:			
Mortgage portfolio	$ (462)	$ 899	$(1,361)
Liquid investments	(75)	(21)	(54)
Total interest income	(537)	878	(1,415)
Interest expense:[2]			
Short-term debt	53	115	(62)
Long-term debt	(202)	369	(571)
Total interest expense	(149)	484	(633)
Change in net interest income	$ (388)	$ 394	$ (782)
Change in purchased options amortization expense[3]	(57)		
Change in core net interest income	(445)		
Change in taxable-equivalent adjustment on tax-exempt investments[4]	—		
Change in taxable-equivalent core net interest income	$ (445)		
First Six Months of 2004 vs. First Six Months of 2003			
Interest income:			
Mortgage portfolio	$ (937)	$2,053	$(2,990)
Liquid investments	(152)	(24)	(128)
Total interest income	(1,089)	2,029	(3,118)
Interest expense:[2]			
Short-term debt	16	292	(276)
Long-term debt	(545)	717	(1,262)
Total interest expense	(529)	1,009	(1,538)
Change in net interest income	$ (560)	$1,020	$(1,580)
Change in purchased options amortization expense[3]	(67)		
Change in core net interest income	(627)		
Change in taxable-equivalent adjustment on tax-exempt investments[4]	(4)		
Change in taxable-equivalent core net interest income	$ (631)		

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

(2) Classification of interest expense and interest-bearing liabilities as short-term or long-term is based on effective maturity or repricing date, taking into consideration the effect of derivative financial instruments.

(3) Reflects non-GAAP adjustment for amortization of purchased options premiums that would have been recorded under GAAP prior to our adoption of FAS 133.

(4) Reflects non-GAAP adjustments to permit comparison of yields on tax-exempt and taxable assets based on a 35 percent marginal tax rate.

The compression of our net interest margin in 2004 primarily reflects the decline in yield on our mortgage assets as higher coupon mortgages liquidated during the refinancing wave of 2003 and we purchased current coupon mortgages at lower yields. In addition, as the duration of our mortgage assets lengthened as a result of the rising interest rate environment, we extended the duration of our liabilities to offset the extended duration of our assets.

Based on recent trends in the market, including the continued spirited competition for mortgage assets and a shift by consumers to adjustable-rate mortgages that provide lower initial yields, we expect our net interest margin to compress further during the second half of 2004, and to move lower than we anticipated earlier in the year.

Business Segment Results

Portfolio Investment Business

Our Portfolio Investment business generated core business earnings of $1.081 billion in the second quarter of 2004, a decrease of 1 percent from the second quarter of 2003, and $2.283 billion for the first six months of 2003, an increase of 1 percent over the same prior year period. The $265 million of other-than-temporary impairment expense that we recorded during the second quarter of 2004 as a result of the change in our estimation process for identifying and recognizing other-than-temporary impairment affected the results of our Portfolio Investment business. Excluding the effect of this change in estimate, core business earnings for our Portfolio Investment business grew 15 percent for the second quarter and 9 percent for the first six months of 2004. The key factors that generally affect earnings growth for our Portfolio Investment business are growth in the average balance of our mortgage investments and the interest spread or margin that we earn on those investments. Our objective is to maintain a disciplined approach to growing our portfolio, purchasing mortgages when the spread between our cost of funds and the yield on mortgage assets is attractive and when supply is available in the market.

We experienced positive annualized mortgage portfolio growth for both the month of June 2004 and the second quarter of 2004, following two consecutive quarters and eight consecutive months of portfolio contraction. Our mortgage portfolio grew 5 percent on an annualized basis in the second quarter, reflecting modestly more attractive opportunities for mortgage investment throughout the quarter and a substantial decline in liquidations in June. For the first six months of 2004, our mortgage portfolio contracted by 2 percent on an annualized basis. In comparison, our mortgage portfolio contracted by 1 percent and grew by 5 percent on an annualized basis in the second quarter and first six months of 2003, respectively.

The substantial reduction in our net interest margin from the second quarter and first six months of 2003 was primarily attributable to the liquidation of higher coupon mortgages during the refinancing wave in the second half of 2003 and the purchase of current coupon mortgages at lower yields. The changing product mix of originations in our underlying market—to more hybrid ARMs and floating-rate securities—resulted in a change in the mix of business for our mortgage portfolio and also had an effect on our net interest margin. Hybrid ARMs and floating-rate securities have lower initial purchase spreads relative to 30-year fixed-rate products because of their reduced optionality. The purchase of these products, combined with the effects of a flatter yield curve, lowered our initial mortgage purchase spreads during the second quarter of 2004 and further reduced our net interest margin. Finally, rising interest rates during the second quarter of 2004 extended the duration of mortgage assets. Accordingly, we lengthened the duration of our liabilities.

Credit Guaranty Business

Our Credit Guaranty business generated core business earnings of $815 million in the second quarter of 2004, an increase of 6 percent over the second quarter of 2003, and $1.633 billion for the first six months of 2004, an increase of 12 percent over the same prior year period. Earnings growth in our Credit Guaranty business is driven largely by growth in guaranty fee income and management of credit-related losses. Guaranty fee income growth is affected by growth in average outstanding MBS (MBS held by investors other than Fannie Mae) and the guaranty fee rate we receive for guaranteeing the timely payment of principal and interest on outstanding MBS. Growth in outstanding MBS depends largely on the volume of mortgages made available for securitization and the perceived quality and value of our MBS in the secondary market.

Annualized growth in outstanding MBS slowed to 4 percent for the second quarter of 2004, reflecting lower refinance-driven volume, a substantial increase in the origination of higher-risk forms of hybrid ARMs, and heightened competition from private label issuers. Market share gains by private label issuers have been driven by an increased proportion of sub-prime and Alt-A securitized mortgages, including interest-only hybrid ARMs. The decline in our market share in the second quarter reflects our belief that current market pricing of some of these products does not adequately compensate for credit risk. Despite the slowdown in MBS growth during the second quarter, outstanding MBS expanded by 9 percent on an annualized basis for the first six months of 2004. In comparison, outstanding MBS grew by 56 percent and 44 percent on an annualized basis in the second quarter and first six months of 2003, respectively. Our effective guaranty fee rate declined during the second quarter of 2004 relative to the second quarter of 2003 as rising interest rates slowed the recognition of deferred fee income.

The effectiveness of the credit enhancement and risk sharing techniques employed by our Credit Guaranty business has been clearly evident in our credit-related performance during 2004, with credit-related losses continuing to be exceptionally low compared with historical experience. Because of the extremely low levels of losses in the first six months of 2004, we believe that total losses for the year—on a larger mortgage credit book of business—may be no higher than losses recorded in 2003.

PORTFOLIO INVESTMENT BUSINESS OPERATIONS

Our Portfolio Investment business has primary responsibility for Fannie Mae's investing and funding activities and managing our interest rate risk.

Investments

Mortgage Portfolio

Table 8 summarizes mortgage portfolio activity on a gross basis and compares the average yields for the three and six-month periods ended June 30, 2004 and 2003 of mortgage purchases and liquidations. Our net interest yield and margin have contracted in 2004, partly due to the purchase of lower coupon mortgages and the liquidation of higher coupon mortgages as reflected in Table 8. Table 9 shows the distribution of Fannie Mae's mortgage portfolio by product type at June 30, 2004 and December 31, 2003.

Table 8: Mortgage Portfolio Activity(1)

	Purchases		Sales		Repayments(2)	
	Three Months Ended June 30,		Three Months Ended June 30,		Three Months Ended June 30,	
	2004	2003	2004	2003	2004	2003
			(Dollars in millions)			
Single-family	**$86,234**	$125,497	**$4,148**	$5,425	**$75,277**	$125,452
Multifamily	**5,065**	2,463	**15**	—	**1,509**	494
Total	**$91,299**	$127,960	**$4,163**	$5,425	**$76,786**	$125,946
Average net yield	**4.45%**	5.09%			**5.73%**	6.45%
Annualized repayments as a percentage of average gross mortgage portfolio					**34.8%**	61.8%

	Purchases		Sales		Repayments(2)	
	Six Months Ended June 30,		Six Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003	2004	2003
Single-family	**$125,470**	$255,334	**$8,522**	$6,696	**$128,362**	$230,506
Multifamily	**6,833**	4,631	**15**	—	**2,560**	1,048
Total	**$132,303**	$259,965	**$8,537**	$6,696	**$130,922**	$231,554
Average net yield	**4.41%**	5.22%			**5.81%**	6.52%
Annualized repayments as a percentage of average gross mortgage portfolio					**29.6%**	57.1%

(1) Excludes premiums, discounts, and other deferred price adjustments.

(2) Includes mortgage loan prepayments, scheduled amortization, and foreclosures.

Table 9: Mortgage Portfolio Composition[1]

	June 30, 2004	December 31, 2003
	(Dollars in millions)	
Mortgages		
Single-family:		
Government insured or guaranteed	**$ 8,328**	$ 7,063
Conventional:		
Long-term, fixed-rate	**120,047**	119,877
Intermediate-term, fixed-rate[2]	**72,661**	75,015
Adjustable-rate	**15,172**	13,185
Total conventional single-family	**207,880**	208,077
Total single-family	**216,208**	215,140
Multifamily:		
Government insured or guaranteed	**986**	1,091
Conventional	**21,679**	18,475
Total multifamily	**22,665**	19,566
Total mortgages	**$238,873**	$234,706
Mortgage-related securities		
Single-family:		
Government insured or guaranteed	**$ 18,502**	$ 21,267
Conventional:		
Long-term, fixed-rate	**473,318**	507,661
Intermediate-term, fixed-rate[2]	**74,526**	83,366
Adjustable-rate	**66,561**	35,564
Total conventional single-family	**614,405**	626,591
Total single-family	**632,907**	647,858
Multifamily:		
Government insured or guaranteed	**11,017**	10,150
Conventional	**9,506**	9,231
Total multifamily	**20,523**	19,381
Total mortgage-related securities	**$653,430**	$667,239
Mortgage portfolio, net		
Single-family:		
Government insured or guaranteed	**$ 26,830**	$ 28,330
Conventional:		
Long-term, fixed-rate	**593,365**	627,538
Intermediate-term, fixed-rate[2]	**147,187**	158,381
Adjustable-rate	**81,733**	48,749
Total conventional single-family	**822,285**	834,668
Total single-family	**849,115**	862,998
Multifamily:		
Government insured or guaranteed	**12,003**	11,241
Conventional	**31,185**	27,706
Total multifamily	**43,188**	38,947
Total mortgage portfolio	**892,303**	901,945
Unamortized premium, (discount), and deferred price adjustments, net[3]	**(837)**	(58)
Allowance for loan losses[4]	**(80)**	(85)
Mortgage portfolio, net	**$891,386**	$901,802
Average net yield on mortgage portfolio, net	**5.38%**	5.54%

(1) Data reflects unpaid principal balance adjusted to include mark-to-market gains and losses on available-for-sale securities and any other-than-temporary impairment.

(2) Intermediate-term, fixed-rate consists of portfolio loans with contractual maturities at purchase equal to or less than 20 years and MBS and other mortgage-related securities held in portfolio with maturities of 15 years or less at issue date.

(3) Includes net unamortized discounts of $1,717 million at June 30, 2004 and $1,292 million at December 31, 2003 related to available-for-sale and held-to-maturity mortgage-related securities.

(4) Guaranty liability for probable losses on loans underlying Fannie Mae guaranteed MBS is included on our balance sheet in "Guaranty liability for MBS."

Our mortgage portfolio includes mortgage-related securities backed by manufactured housing loans that were issued by entities other than Fannie Mae. In addition, to a limited extent, we acquired mortgage-related securities that were backed by manufactured housing loans and issued by entities other than Fannie

Mae for securitization into REMIC securities issued and guaranteed by Fannie Mae. When we began investing in and guaranteeing manufactured housing securities, we did so with significant credit enhancements on these investments, including bond insurance and subordination. Table 10 presents the book values or notional balances of these securities at June 30, 2004 and December 31, 2003 and compares the credit ratings of the underlying securities (or for insured securities, the credit rating of the financial institution providing credit enhancement) at each date. Where ratings differ among the major rating agencies, we have used the lowest rating.

Table 10: Credit Ratings of Private Label Mortgage-Related Securities Secured by Manufactured Housing Loans

	June 30, 2004				**December 31, 2003**			
	Book Value or Notional Balance(1)				**Book Value or Notional Balance(1)**			
Credit ratings:	**Portfolio Securities(2)**	**Guaranteed Securities(3)**	**Total**	**% of Total**	**Portfolio Securities(2)**	**Guaranteed Securities(3)**	**Total**	**% of Total**
				(Dollars in millions)				
Investment grade:								
AAA/Aaa	**$1,646**	**$ 77**	**$1,723**	**24.41%**	$2,058	$ 90	$2,148	26.85%
AA+/Aa1 to AA−/Aa3	**980**	**102**	**1,082**	**15.33**	1,259	195	1,454	18.18
A+/A1 to A−/A3	**584**	**137**	**721**	**10.22**	593	112	705	8.81
BBB+/Baa1 to BBB−/Baa3	**1,723**	**59**	**1,782**	**25.25**	2,506	15	2,521	31.51
Total investment grade securities	**4,933**	**375**	**5,308**	**75.21**	6,416	412	6,828	85.35
Non-investment grade:								
BB+/Ba1 to BB−/Ba3	**257**	**—**	**257**	**3.64**	474	—	474	5.93
B/B1 to B−/B3	**1,389**	**33**	**1,422**	**20.15**	633	52	685	8.56
CCC+/Caa1 to CCC−/Caa3	**35**	**33**	**68**	**.96**	—	13	13	.16
CC/Ca	**3**	**—**	**3**	**.04**	—	—	—	—
Total non-investment grade securities	**1,684**	**66**	**1,750**	**24.79**	1,107	65	1,172	14.65
Total securities	**$6,617**	**$441**	**$7,058**	**100.00%**	$7,523	$477	$8,000	100.00%

(1) Book value represents unpaid principal balance adjusted for unamortized premium/discounts and other-than-temporary impairment.
(2) Amount reflects book value. These securities are included on the balance sheet in Fannie Mae's mortgage portfolio.
(3) Amount reflects notional balance. These securities are included in outstanding MBS held by other investors. We maintain a guaranty liability for estimated losses on Fannie Mae guaranteed securities.

We owned or guaranteed manufactured housing securities with a book value (for securities held in our portfolio) or notional amount (for REMIC securities we have guaranteed) totaling $7.1 billion at June 30, 2004, compared with $8.0 billion at December 31, 2003. The decrease in the balance from the end of 2003 resulted from $597 million of principal payments and amortization of deferred price adjustments, $91 million in sales, and $261 million of other-than-temporary impairment, which was partially offset by the accretion of $7 million into interest income related to securities for which other-than-temporary impairment was recognized.

At June 30, 2004 and December 31, 2003, approximately 70 percent of these securities were serviced by Green Tree Investment Holdings LLC (during 2003, Green Tree Investment Holdings LLC succeeded Conseco Finance Corp. as servicer). At the end of 2002, substantially all of these securities had investment grade ratings. Due to weakness in the manufactured housing sector and financial difficulties experienced by certain manufactured housing loan servicers, the major ratings agencies have downgraded many of these securities since 2002. As a result of credit downgrades during the first six months of 2004, the percentage of securities rated investment grade or better was 75 percent and 74 percent as of June 30, 2004 and March 31, 2004, respectively, down from 85 percent as of December 31, 2003. Subsequent to June 30, 2004, additional credit downgrades reduced the percentage of securities we own or guarantee rated investment grade or better to 72 percent as of July 20, 2004, which may result in the recognition of additional other-than-temporary impairment expense based on our revised estimation process.

In response to the rating downgrades over the last two years and general condition of the manufactured housing sector, we have regularly assessed the recoverability of scheduled principal and interest amounts on certain of these securities to determine if any were other-than-temporarily impaired. We recorded, as a component of fee and other income, other-than-temporary impairment expense on certain of these securities included in our portfolio of $250 million and $261 million in the second quarter and first six months of 2004, respectively, primarily due to the change in our other-than-temporary impairment estimation process in the second quarter of 2004. We recognized no other-than-temporary impairment on manufactured housing securities during the second quarter of 2003 and $67 million for the first six months of 2003. Since the downgrades of these securities began in 2002, we have recognized other-than-temporary impairment of $466 million on our investments in manufactured housing securities, of which $133 million relates to bonds that were subsequently sold at a net gain of $9 million because of the subsequent recovery of a portion of previously recognized other-than-temporary impairment expense.

We continue to rigorously monitor these securities and assess appropriate risk factors to determine the need to record any additional impairment. Despite recent downgrades, the market liquidity and price performance of the manufactured housing bond sector has shown signs of improvements since the end of 2003. However, changes in events or circumstances, such as the performance of the underlying manufactured housing loan collateral and the financial strength of servicers, will influence future credit ratings and may affect market prices or our projected cash flow analyses. See "MD&A—Critical Accounting Policies and Estimates—Other-Than-Temporary Impairment" for a discussion of our revised process for estimating other-than-temporary impairment that we adopted in the second quarter of 2004.

Mortgage Commitments

As a result of our July 1, 2003 adoption of Financial Accounting Standard No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* ("FAS 149"), we are required to account for the majority of our commitments to purchase mortgage loans and to purchase or sell mortgage-related securities, which we enter into in the normal course of business, as derivatives. Table 11 shows the fair value, outstanding notional amount, and average remaining contractual maturity of outstanding mortgage commitments at June 30, 2004 and December 31, 2003 that are accounted for as derivatives and recorded on our balance sheet.

Table 11: Mortgage Commitments

	June 30, 2004			December 31, 2003		
	Change in Fair Value[(1)]	Notional Amount	Average Remaining Contractual Maturity	Change in Fair Value[(1)]	Notional Amount	Average Remaining Contractual Maturity
	(Dollars in millions)					
Forward mortgage loan and mortgage-related security purchase commitments	**$ 137**	**$27,755[(2)]**	**26 days**	$ 103	$18,372[(2)]	24 days
Forward mortgage-related security sell commitments	**(121)**	**15,147[(3)]**	**31**	(145)	20,120[(3)]	28

(1) Represents change in fair value of the commitment since contractual date of the commitment. Included in our balance sheet under either "Derivatives in gain positions" or "Derivatives in loss positions."

(2) Includes $10,796 million and $13,389 million at June 30, 2004 and December 31, 2003, respectively, of purchase commitments not designated for our mortgage portfolio.

(3) Includes $13,359 million and $18,070 million at June 30, 2004 and December 31, 2003, respectively, of sell commitments related to mortgage assets designated for securitization.

We also enter mortgage commitments that are not accounted for as derivatives under FAS 149, primarily master delivery commitments and optional portfolio purchase commitments. Under master delivery commitment agreements, lenders are required to either deliver loans to Fannie Mae for securitization or to enter into mandatory commitments to sell loans or mortgage-related securities to Fannie Mae. Once a lender elects under a master delivery commitment to enter into a mandatory commitment to sell loans or mortgage securities to Fannie Mae, we account for our purchase obligation under the mandatory commitment as a derivative pursuant to FAS 149. Table 12 shows the outstanding balance of these commitments at June 30, 2004 and December 31, 2003.

Table 12: Master Delivery and Optional Purchase Commitments

	June 30, 2004	December 31, 2003
	(Dollars in billions)	
Master delivery commitments:[1]		
Mandatory	**$48**	$60
Optional	**15**	19
Optional portfolio purchase commitments	**7**	5

(1) Master delivery commitments either require or permit lenders to either deliver loans to us for securitization or enter into a mandatory commitment to deliver loans or mortgage-related securities to us for purchase. These arrangements are off-balance sheet and not accounted for as derivatives unless we enter into a mandatory purchase commitment.

Liquid Investments

Our liquid investments include cash and cash equivalents, nonmortgage investments, and mortgage assets designated for securitization. Our liquid investments totaled $52 billion at June 30, 2004, compared with $66 billion at December 31, 2003. Nonmortgage investments, which account for the majority of our liquid investments, totaled $49 billion at June 30, 2004 and $59 billion at December 31, 2003. We met our voluntary commitment to maintain more than 5 percent of on-balance sheet assets in high-quality, liquid assets with a ratio of liquid assets to total assets of 5.2 percent at June 30, 2004 compared with 6.5 percent at December 31, 2003.

Table 13 shows the composition, weighted-average maturities, and credit ratings of our held-to-maturity and available-for-sale nonmortgage investments at June 30, 2004 and December 31, 2003.

Table 13: Nonmortgage Investments

	June 30, 2004					
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Weighted Average Maturity in Months	% Rated A or Better
	(Dollars in millions)					
Held-to-maturity	**$ 5,516**	**$—**	**$ —**	**$ 5,516**	**.7**	**100.0%**
Available-for-sale	**43,376**	**47**	**(66)**	**43,357**	**20.6**	**98.4**
Total	**$48,892**	**$47**	**$(66)**	**$48,873**	**18.3**	**98.6%**

	December 31, 2003					
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Weighted Average Maturity in Months	% Rated A or Better
Held-to-maturity	$ 6,822	$—	$ —	$ 6,822	.4	100.0%
Available-for-sale	52,605	89	(23)	52,671	15.2	97.7
Total	$59,427	$89	$(23)	$59,493	13.5	98.0%

Funding

As part of our interest rate risk management strategy, our Portfolio Investment business issues a variety of noncallable and callable debt securities in the global capital markets in a wide range of maturities to meet our large and consistent funding needs. We use derivative instruments to supplement our issuance of debt in the capital markets and manage interest rate risk.

Debt Securities

Total debt outstanding decreased $22 billion to $940 billion at June 30, 2004 from $962 billion at December 31, 2003. We rely on the issuance of debt securities to fund the purchase of mortgage assets. Generally as growth in our mortgage portfolio slows as in the first six months of 2004 we reduce the level of debt issued. Table 14 compares debt issuances and repayments between the three and six-month periods ended June 30, 2004 and 2003.

Table 14: Debt Activity

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
	(Dollars in millions)			
Issued:				
Amount	**$453,298**	$686,729	**$ 983,617**	$1,337,602
Average cost	**1.84%**	1.23%	**1.36%**	1.32%
Redeemed:				
Amount	**$453,473**	$679,863	**$1,002,826**	$1,308,238
Average cost	**1.56%**	1.78%	**1.63%**	1.75%

Derivative Instruments

Derivatives are important in helping us to manage interest rate risk, supplement our issuance of debt in the global capital markets, add risk management features not obtainable in the debt market, and efficiently rebalance our portfolio. We use only the most straightforward types of derivatives. The principal derivatives we use are priced in deep and liquid markets and are therefore relatively easy to value and evaluate. We do not take speculative positions with derivatives or any other financial instrument. We have derivative transaction policies and controls to minimize our derivative counterparty risk.

Summary of 2004 Derivative Activity

Table 15 shows the additions and maturities of derivatives by type during the first six months of 2004, along with the stated maturities of derivatives outstanding at June 30, 2004.

Table 15: Activity and Maturity Data for Derivative Instruments[(1)]

	Pay-Fixed/ Receive-Variable Swaps[(2)]								
	Amount	Pay Rate[(3)]	Receive Rate[(3)]	Receive-Fixed/ Pay-Variable Swaps	Basis Swaps	Caps and Swaptions	Forward Starting Swaps	Other[(4)]	Total
	(Dollars in millions)								
Notional balance at January 1, 2004	$ 335,102	4.73%	1.17%	$ 202,479	$ 32,260	$435,525	$ 30,475	$ 4,755	$1,040,596
Additions	79,747	4.20	1.28	121,693	26,200	45,075	57,956	4,066	334,737
Maturities[(5)]	(114,235)	4.71	1.15	(137,112)	(12,510)	(49,800)	(57,125)	(2,974)	(373,756)
Notional balance at June 30, 2004	$ 300,614	4.63%	1.23%	$ 187,060	$ 45,950	$430,800	$ 31,306	$ 5,847	$1,001,577
Future maturities of notional amounts:[(6)]									
2004	$ 5,765	5.90%	1.18%	$ 21,298	$ 15,375	$ 50,895	$ 11,756	$ 1,445	$ 106,534
2005	23,695	3.46	1.20	45,063	28,750	94,850	12,200	223	204,781
2006	22,845	3.87	1.20	18,925	200	41,625	4,550	100	88,245
2007	18,970	4.14	1.22	26,110	200	19,200	1,400	2,034	67,914
2008	48,550	3.47	1.24	15,885	—	22,550	—	903	87,888
Thereafter	180,789	5.21	1.24	59,779	1,425	201,680	1,400	1,142	446,215
Total	$ 300,614	4.63%	1.23%	$ 187,060	$ 45,950	$430,800	$ 31,306	$ 5,847	$1,001,577

(1) Excludes mortgage commitments accounted for as derivatives under FAS 149. Dollars represent notional amounts that indicate only the amount on which payments are being calculated and do not represent the amount at risk of loss.

(2) Notional amounts include callable swaps of $19 billion with weighted-average pay rates of 7.00 percent and weighted-average receive rates of 1.22 percent at June 30, 2004. This amount may include other risk management derivatives.

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

(4) Includes foreign currency swaps and other derivative instruments that provide an economic hedge against interest rate fluctuations.

(5) Includes matured, called, exercised, and terminated amounts.

(6) Based on stated maturities. Assumes that variable interest rates remain constant at June 30, 2004 levels.

We decreased the outstanding notional balance of derivatives by $39 billion to $1,002 billion at June 30, 2004 from $1,041 billion at December 31, 2003. The decline in outstanding derivatives resulted primarily from normal portfolio rebalancing activities and the termination of pay-fixed and receive-fixed swap positions with matching durations.

Effect of Derivatives on Our Debt Securities

We use derivatives to change the term, cost, or optionality of our debt. Table 16 reconciles the redemption amounts of variable and fixed-rate debt before and after the use of derivatives at June 30, 2004 and shows how each derivative instrument transforms the characteristics of our debt from one category to another.

Table 16: Effect of Derivatives on Outstanding Debt

		Effect of Derivatives on Outstanding Debt[2]								
	Outstanding Debt[1] June 30, 2004	**Pay-Fixed/ Receive Variable Swaps**	**Receive-Fixed/ Pay Variable Swaps**	**Basis Swaps**	**Caps**	**Pay-Fixed/ Receive Variable Swaptions**	**Receive-Fixed/ Pay Variable Swaptions**	**Other[5]**	**Total Derivative Effect**	**Effective Debt June 30, 2004**
					(Dollars in millions)					
Variable-rate debt:[3]										
With options	**$ 9,469**	$ —	$ (100)	$(2,720)	$ 129,950	$ 156,855	$ —	$ —	$ 283,985	**$293,454**
Without options	**385,293**	(294,914)	152,323	2,720	(129,950)	(156,855)	—	—	(426,676)	**(41,383)**
Total variable rate	**394,762**	(294,914)	152,223	—	—	—	—	—	(142,691)	**252,071**
Fixed-rate debt:[4]										
With options	**211,012**	18,385	(19,105)	—	—	—	143,995	—	143,275	**354,287**
Without options	**331,404**	276,529	(133,118)	—	—	—	(143,995)	—	(584)	**330,820**
Total fixed rate	**542,416**	294,914	(152,223)	—	—	—	—	—	142,691	**685,107**
Total debt	**$937,178**	$ —	$ —	$ —	$ —	$ —	$ —	$ —	$ —	**$937,178**
Total debt:										
With options	**$220,481**	$ 18,385	$ (19,205)	$(2,720)	$ 129,950	$ 156,855	$ 143,995	$ —	$ 427,260	**$647,741**
Without options	**716,697**	(18,385)	19,205	2,720	(129,950)	(156,855)	(143,995)	—	(427,260)	**289,437**
Total debt	**$937,178**	$ —	$ —	$ —	$ —	$ —	$ —	$ —	$ —	**$937,178**
Option-based debt as percentage of net mortgage portfolio	**25%**									**73%**
Outstanding derivatives:										
That affect debt classification		$ 294,914	$ 152,223	$ 2,720	$ 129,950	$ 156,855	$ 143,995	$ —	$ 880,657	
That do not affect debt classification		—	28,800	40,849	—	—	—	37,120	106,769	
Other risk management derivatives		5,700	6,037	2,381	—	—	—	33	14,151	
Total outstanding derivatives		$ 300,614	$ 187,060	$45,950	$ 129,950	$ 156,855	$ 143,995	$37,153	$1,001,577	

(1) Outstanding debt amount represents the redemption value, which excludes the effects of currency adjustments, FAS 133 debt basis adjustments, and unamortized premiums, discounts, issuance costs, and hedging results.

(2) Derivative amounts reflect the notional balance on which underlying interest payments are calculated and do not represent our risk of loss.

(3) Variable-rate debt reflects the amount of debt scheduled to reprice or mature in one year or less.

(4) Fixed-rate debt reflects the amount of debt scheduled to reprice or mature after one year.

(5) Includes forward starting swaps, foreign currency swaps, and other derivative instruments that provide a hedge against interest rate fluctuations.

Table 17 categorizes our outstanding debt between variable rate and fixed rate and compares the outstanding redemption amount, effective term to repricing, and cost of our variable-rate and fixed-rate debt after considering the effect of derivatives at June 30, 2004 and December 31, 2003. Table 18 shows the maturities and cost of our effective long-term debt. The redemption amount of our debt presented in Tables 16, 17, and 18 differs from the debt amounts reported on our balance sheet because it excludes the effects of currency adjustments, FAS 133 debt basis adjustments, and unamortized premiums, discounts, issuance costs, and hedging results.

Table 17: Effective Variable-Rate and Fixed-Rate Debt

	June 30, 2004	December 31, 2003
	(Dollars in millions)	
Outstanding:		
Variable-rate debt:[1]		
Redemption amount[3]	**$252,071**	$258,145
Effective cost at month end	**1.33%**	1.25%
Effective term to repricing (in months)	**2**	3
Percent of total debt outstanding	**27%**	27%
Fixed-rate debt:[2]		
Redemption amount[3]	**$685,107**	$698,012
Effective cost at month end	**4.92%**	5.26%
Effective term to repricing (in months)	**76**	78
Percent of total debt outstanding	**73%**	73%
Total:		
Redemption amount[3]	**$937,178**	$956,157
Effective cost at month end	**3.95%**	4.18%
Effective term to repricing (in months)	**56**	58

(1) Variable-rate debt reflects the amount of debt scheduled to reprice in one year or less, taking into consideration the effect of derivative instruments.

(2) Fixed-rate debt reflects the amount of debt scheduled to reprice after one year, taking into consideration the effect of derivative instruments.

(3) Outstanding debt amount represents the redemption value, which excludes the effects of currency adjustments, FAS 133 debt basis adjustments, and unamortized premiums, discounts, issuance costs, and hedging results.

Table 18: Maturities of Effective Long-Term Debt

	Contractual Maturity		Assuming Callable Debt Redeemed at Initial Call Date	
	Amount Outstanding[1]	Accounting Cost[2]	Amount Outstanding[1]	Accounting Cost[2]
	(Dollars in millions)			
Currently Callable	$ —	—%	$ 56,104	4.13%
2004	27,434	5.87	121,352	4.62
2005	75,354	3.83	149,505	4.61
2006	98,066	3.42	110,550	4.59
2007	70,511	4.36	65,788	5.53
2008 and later	413,742	5.18	181,808	4.84
Effective long-term debt before pay-fixed swaption effect	685,107	4.72	685,107	4.72
Pay-fixed swaption effect	—	.20	—	.20
Total effective long-term debt	$685,107	4.92%	$685,107	4.92%

(1) Amount outstanding includes long-term debt, effective fixed-rate debt, and notional amount of long-term interest rate swaps. Also includes debt linked to swaptions, which transforms it into effective callable debt. Excludes effective variable-rate debt.

(2) Accounting cost represents the monthly equivalent yield that discounts the amount due at maturity to the net proceeds over the expected life of the debt. Includes the effect of pay-fixed and receive-fixed swaps.

Table 19 reconciles the redemption amount of our debt to the total debt reported on our balance sheet.

Table 19: Reconciliation of Debt Redemption Amount to Total Reported Debt

	June 30, 2004	December 31, 2003
	(Dollars in millions)	
Debt redemption amount	**$937,178**	$956,157
FAS 133 and other basis adjustments[1]	**4,464**	7,584
Other debt adjustments[2]	**(1,974)**	(2,009)
Total reported debt[3]	**$939,668**	$961,732

(1) FAS 133 and other basis adjustments include changes in market value of fair value hedges of our debt and adjustment for foreign currency translation.

(2) Other debt adjustments include unamortized premiums, discounts, issuance costs, and hedging results.

(3) Represents total debt reported on Fannie Mae's balance sheet. Amount is based on unamortized book value, which includes the effect of currency adjustments, FAS 133 debt basis adjustments, and unamortized premiums, discounts, issuance costs, and hedging results.

Our use of derivatives had the following impact on Fannie Mae's debt portfolio:

- Interest rate swaps lengthened the weighted-average final maturity of our outstanding debt by 22 months at June 30, 2004 and December 31, 2003. The weighted-average final maturity of our outstanding debt including the effect of derivatives was 56 months at June 30, 2004 and 58 months at December 31, 2003.
- Variable-rate debt totaled $395 billion at June 30, 2004 based on the redemption amount. Pay-fixed interest rate swaps helped in reducing our variable-rate debt by 36 percent to $252 billion at June 30, 2004. Most of our variable-rate debt has options associated with it to protect us against increases in interest rates.
- Without the use of derivatives, the percent of option-based debt financing our net mortgage portfolio would have been only 25 percent at June 30, 2004 and 27 percent at December 31, 2003. With derivatives, we increased the percentage of option-based debt financing our net mortgage portfolio to 73 percent at June 30, 2004 and 72 percent at the end of 2003. The percentages of option-based debt funding our net mortgage portfolio at June 30, 2004 and the end of 2003 are consistent with our general target of maintaining a ratio of optionality in our effective debt to the optionality on new mortgage portfolio business in a range of 50 to 60 percent. The value of an option-based instrument with the same notional or face amount, which is the basis for calculating the percent of option-based debt financing our mortgage portfolio, will differ based on the characteristics of the options. Because the characteristics of our debt options will vary based on our risk management needs, the percentage of the option-based debt financing our mortgage portfolio will change over time.

Credit Exposure from Derivatives

The primary credit exposure that we have on a derivative transaction is that a counterparty might default on payments due, which could result in our having to acquire a replacement derivative from a different counterparty at a higher cost. Notional amount is a commonly used measure of volume in the derivatives market. It generally represents the amount on which interest is calculated, but does not represent the amounts due to or from a counterparty. Therefore, the notional amount is significantly greater than the potential market or credit loss that could result from such transactions. The replacement cost to settle at current market prices all outstanding derivative contracts in a gain position, after consideration of offsetting agreements such as master netting agreements and collateral held, is a more meaningful measure of our credit exposure on derivatives. Table 20 shows the credit exposure on our outstanding derivatives at June 30, 2004 and December 31, 2003, by maturity and counterparty credit ratings on this basis.

Table 20: Credit Loss Exposure of Derivative Instruments[1]

	June 30, 2004				December 31, 2003			
	Credit Rating				Credit Rating			
	AAA	AA	A	Total	AAA	AA	A	Total
				(Dollars in millions)				
Credit loss exposure:[2]								
Less than 1 year	**$ —**	**$ 121**	**$ 190**	**$ 311**	$ —	$ 91	$ 64	$ 155
1 to 5 years	**—**	**1,669**	**1,767**	**3,436**	—	1,261	290	1,551
Over 5 years	**32**	**3,588**	**3,213**	**6,833**	37	2,586	3,335	5,958
Subtotal	**32**	**5,378**	**5,170**	**10,580**	37	3,938	3,689	7,664
Maturity distribution netting[3]	**(10)**	**(43)**	**(778)**	**(831)**	(20)	(369)	(146)	(535)
Exposure	**22**	**5,335**	**4,392**	**9,749**	17	3,569	3,543	7,129
Collateral held[4]	**—**	**4,950**	**4,265**	**9,215**	—	3,184	3,431	6,615
Exposure net of collateral	**$ 22**	**$ 385**	**$ 127**	**$ 534**	$ 17	$ 385	$ 112	$ 514
Additional information:								
Notional amount[5]	**$1,557**	**$457,563**	**$542,457**	**$1,001,577**	$1,807	$491,386	$547,403	$1,040,596
Number of counterparties	**3**	**12**	**8**	**23**	3	12	8	23

(1) Excludes mortgage commitments accounted for as derivatives under FAS 149.

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

(3) Represents impact of netting of derivatives in a gain position and derivatives in a loss position for the same counterparty across maturity categories.

(4) We held collateral of $9.215 billion and $6.615 billion on our derivative contracts at June 30, 2004 and December 31, 2003, respectively. Based on our counterparties' credit exposure to Fannie Mae at June 30, 2004, we did not post any collateral. We posted collateral of $151 million related to our counterparties' credit exposure to Fannie Mae at December 31, 2003.

(5) Reflects notional amounts, which only indicates the amount on which payments are being calculated and does not represent the amount at risk of loss.

Our derivative credit exposure, after consideration of the value of collateral held, was $534 million at June 30, 2004 compared with $514 million at December 31, 2003. We expect the credit exposure on derivative contracts to fluctuate with changes in interest rates, implied volatility, and the collateral thresholds of the counterparties. Assuming the highly unlikely event that all of the derivative counterparties to which Fannie Mae was exposed at June 30, 2004 were to default simultaneously, it would have cost an estimated $534 million to replace the economic value of those contracts. This replacement cost represents approximately 7 percent of our annualized pre-tax reported income for the first six months of 2004.

At June 30, 2004, 61 percent of our net exposure of $534 million after consideration of collateral held was with six counterparties rated AA or better by S&P and Aa or better by Moody's. The percentage of our net exposure with each of these six counterparties ranged from 7 to 15 percent, or $37 million to $81 million. At December 31, 2003, 71 percent of our net exposure after consideration of collateral held of $514 million was with six counterparties rated AA or better by S&P and Aa or better by Moody's.

Fannie Mae has never experienced a loss on a derivative transaction due to credit default by a counterparty. The credit risk on our derivative transactions is low because we have stringent counterparty eligibility requirements, a conservative collateral policy, and an intensive credit exposure monitoring and management process. Our counterparties are of very high credit quality, consisting of large banks, broker-dealers, and other financial institutions that have a significant presence in the derivatives market, most of which are based in the United States. We initiate derivative contracts only with experienced counterparties that have credit ratings of A or better. As an additional precaution, our collateral management policy has provisions for requiring collateral on certain derivative contracts in gain positions.

Accounting for Derivatives

Table 21 shows the notional amounts and fair values of our derivatives by type as of June 30, 2004 and December 31, 2003, based on the hedge classification. This table does not include mortgage commitments that are accounted for as derivatives.

Table 21: Notional and Fair Value of Derivatives by Hedge Designation[1]

	June 30, 2004		December 31, 2003	
	Notional Amounts	Net Values[2]	Notional Amounts	Net Values[2]
	(Dollars in millions)			
Cash flow hedges:				
Pay-fixed swaps	**$ 261,036**	**$(2,389)**	$ 300,536	$(11,400)
Receive-fixed swaps	**82,355**	**642**	148,923	1,510
Basis swaps	**43,569**	**5**	32,260	(2)
Caps and swaptions[3]	**368,076**	**2,720**	358,551	2,361
Forward starting swaps	**30,710**	**(37)**	30,475	(193)
Other[4]	**921**	**9**	854	12
	786,667	**950**	871,599	(7,712)
Fair value hedges:				
Pay-fixed swaps	**33,878**	**37**	34,566	(529)
Receive-fixed swaps	**98,668**	**1,618**	53,556	1,894
Receive-fixed swaptions[3]	**62,724**	**2,168**	76,974	4,429
Forward starting swaps	**596**	**—**	—	—
Other[4]	**4,893**	**301**	3,858	412
	200,759	**4,124**	168,954	6,206
Other risk management derivatives:				
Pay-fixed swaps	**5,700**	**(187)**	—	—
Receive-fixed swaps	**6,037**	**(206)**	—	—
Basis swaps	**2,381**	**(3)**	—	—
Other[4]	**33**	**—**	43	—
	14,151	**(396)**	43	—
Purchased options time value[3]	**—**	**6,287**	—	8,139
Total	**$1,001,577**	**$10,965**	$1,040,596	$ 6,633

(1) Excludes mortgage commitments accounted for as derivatives under FAS 149.

(2) Based on end of period values, estimated by calculating the cost, on a net present value basis, to settle at current market rates all outstanding derivative contracts.

(3) The net value reflected for caps and swaptions reflects only the intrinsic value. The time value is presented separately because we exclude the time value of purchased options from our assessment of hedge effectiveness under FAS 133 and record changes in the time value of purchased options in earnings.

(4) Includes foreign currency swaps and other derivative instruments that provide a hedge against interest rate fluctuations.

Under FAS 133, we recognize all derivatives as either assets or liabilities on the balance sheet at their fair value. FAS 133 requires that all derivatives be marked to market through earnings unless the derivative is designated and qualifies for hedge accounting. Subject to certain qualifying conditions, we may designate a derivative as either a hedge of the cash flows of a variable-rate instrument or anticipated transaction (cash flow hedge) or a hedge of the fair value of a fixed-rate instrument (fair value hedge). For a derivative designated as a cash flow hedge, we report fair value gains or losses in a separate component of accumulated other comprehensive income ("AOCI"), net of deferred taxes, in stockholders' equity to the extent the hedge is effective. We recognize these fair value gains or losses in earnings during the period(s) in which the hedged cash flow affects earnings. For a derivative designated as a fair value hedge, we report fair value gains or losses on the derivative in earnings along with fair value gains or losses on the hedged item attributable to the risk being hedged. For a derivative not designated as a hedge, not qualifying as a hedge, or components of a derivative that are excluded from any hedge effectiveness assessment, we report fair value gains and losses through earnings.

We traditionally have designated and accounted for substantially all of our derivatives as cash flow or fair value hedges. However, we may from time to time terminate, discontinue, or change the designation of the hedging relationship for certain derivative instruments for interest rate risk management purposes. Our interest rate risk management actions are driven by the economics of the transaction and the market environment that exists at that time and generally not by the hedge accounting designations. Regardless of the FAS 133 hedge designation, virtually all of Fannie Mae's derivatives serve as economic hedges because they reduce our interest rate risk by helping us maintain a relative balance between the cash flows of our mortgage assets and the liabilities used to fund those assets through time and across various interest rate scenarios. We do not take speculative positions with derivatives.

FAS 133 imposes hedge effectiveness, documentation, and testing criteria that must be met to qualify for hedge accounting. Beginning January 2004, as part of our routine and ongoing assessment of Fannie Mae's accounting and business practices, we expanded our classification of derivatives not designated for hedge accounting under FAS 133. Even though these derivatives are not designated for hedge accounting, they are subject to Fannie Mae's risk management controls that govern their use, purpose, credit exposure and financial reporting. As shown in Table 21, we refer to this category of derivatives as "other risk management derivatives." This additional classification provides our Portfolio Investment business with increased flexibility and operational efficiency in executing risk management actions. The accounting effect is that we are required under FAS 133 to report changes in the fair value of our other risk management derivatives in earnings. However, because these transactions are economically matched, we anticipate that the gains and losses will largely offset and not have a material impact on our reported net income or core business earnings. Table 22 shows activity related to our other risk management derivatives during the first six months of 2004.

Table 22: Other Risk Management Derivatives Activity[1]

	Pay-Fixed/ Receive Variable Swaps	Receive-Fixed/ Pay Variable Swaps	Basis Swaps	Swaptions	Forward Starting Swaps	Other[2]	Total
			(Dollars in millions)				
Notional balance at December 31, 2003	$ —	$ —	$ —	$ —	$ —	$43	$ 43
Additions	—	1,100	—	—	5,350	—	6,450
Transfers[3]	55,152	52,010	2,951	500	—	—	110,613
Maturities[4]	(31,718)	(34,325)	—	—	—	(5)	(66,048)
Notional balance at March 31, 2004	23,434	18,785	2,951	500	5,350	38	51,058
Additions	250	5,365	—	—	2,075	—	7,690
Transfers[3]	11,200	7,807	7	125	—	—	19,139
Maturities[4]	(29,184)	(25,920)	(577)	(625)	(7,425)	(5)	(63,736)
Notional balance at June 30, 2004	$ 5,700	$ 6,037	$2,381	$ —	$ —	$33	$ 14,151

(1) Excludes mortgage commitments accounted for as derivatives under FAS 149. Dollars represent notional amounts that indicate only the amount on which payments are being calculated and do not represent the amount at risk of loss.
(2) Includes foreign currency swaps and other derivative instruments that provide a hedge against interest rate fluctuations.
(3) Includes derivatives previously designated for hedge accounting under FAS 133 for which the hedge accounting relationship was terminated. These derivatives continue to serve as economic hedges.
(4) Includes matured, called, exercised, and terminated amounts.

We had $14 billion in outstanding notional amount of derivatives not designated for hedge accounting under FAS 133 at June 30, 2004, compared with $51 billion at March 31, 2004 and $43 million at December 31, 2003. Our other risk management derivatives primarily consist of receive-fixed swaps that are economically matched to pay-fixed swaps. The decrease in the balance from the end of the first quarter to the end of the second quarter resulted primarily from opportunities in the market to terminate certain offsetting positions.

With this expanded category of derivatives, we can more efficiently implement strategies to rebalance our portfolio when interest rates change. For example, when interest rates decline and the duration of our mortgage assets shorten, we can enter into a receive-fixed interest rate swap to shorten the duration of our liabilities. The receive-fixed interest rate swap has the effect of offsetting the economics of an existing pay-fixed swap. We then discontinue the designation of the existing pay-fixed swap as a cash flow hedge of discount notes, classify both swaps as other risk management derivatives, and mark both swaps to market through earnings. The future gains and losses on the matched swaps largely offset. In addition, at the time we discontinue the hedge designation of the pay-fixed swap, we classify the existing fair value in AOCI as a closed hedge and amortize the existing fair value over the life of the originally hedged item. We expect the volume of matched pay-fixed and receive-fixed swaps to fluctuate from period to period based on changes in our overall portfolio characteristics. However, our goal is to terminate these offsetting derivative positions as market conditions permit. We recognized as a component of fee and other income a pre-tax net gain of $21 million and $8 million in the second quarter and first six months of 2004, respectively, related to changes in the fair value of our other risk management derivatives.

The fair value of our derivatives increased to $11.0 billion at June 30, 2004 from $6.6 billion at December 31, 2003, as indicated in Table 21. The fair value of our derivatives is affected by changes in the level of interest rates and implied market volatility, together with activity in the derivatives book, which includes additions of new derivative contracts and the maturity or termination of existing contracts. The increase in fair value was primarily related to derivatives designated as cash flow hedges, whose value shifted to a net gain of $1.0 billion at June 30, 2004 from a net loss of $7.7 billion at the end of 2003. Cash flow hedges consist primarily of pay-fixed swaps, caps, and swaptions that are used to create effective fixed-rate debt. These derivatives generally show market value losses when interest rates fall and increases when interest rates rise. Fair value hedges consist largely of receive-fixed swaps and swaptions that typically increase in value as interest rates fall. Under FAS 133 we are required to record the fair value gains and losses on derivatives designated as cash flow hedges in the AOCI component of stockholders' equity. Gains and losses on derivatives designated as fair value hedges and other risk management derivatives are included in current earnings rather than AOCI.

There typically has been a direct correlation between movements in interest rates and the value of our derivatives instruments (as reported in the fair value of derivatives instruments and the FAS 133 component of AOCI). Increases in rates generally have had a positive effect on the fair value of derivatives and, accordingly, the FAS 133 component of AOCI and stockholders' equity; decreases in rates have had the opposite effect.

Between the end of 2003 and the end of the first quarter of 2004, 5-year interest rate swap rates—a key measure affecting the value of our cash flow hedges—fell by 46 basis points to 3.17 percent, contributing to a $3.2 billion decline in the fair value of our derivatives. In the second quarter of 2004, the 5-year swap rate increased 113 basis points to 4.30 percent at the end of June 2004. This increase in rates resulted in an increase in the value of our pay-fixed swaps, which was partially offset by a decline in value of our receive-fixed swaps. As a result, the fair value of our derivatives increased by $7.6 billion during the second quarter of 2004, more than offsetting the first quarter decrease of $3.2 billion. When interest rates rise or fall, AOCI reflects the net gains or losses, respectively, on pay-fixed interest rate swaps, but not the offsetting gains or losses that typically exist on assets funded by those derivatives or the debt that is hedged.

Changes in the FAS 133 component of AOCI and in stockholders' equity reflect only a partial mark to market of some of the instruments we employ to manage interest rate risk. Therefore, we do not believe that short-term fluctuations in the value of these measures represent a meaningful or comprehensive view of our operating results, financial condition, or risk management strategies and actions. Table 23 shows AOCI activity attributable to unrealized (or open) and realized (or closed) cash flow hedges for the six months ended June 30, 2004.

Table 23: AOCI Activity Related to Derivatives Designated as Cash Flow Hedges[1]

	AOCI Balance Related to Cash Flow Hedges		
	Open	Closed[2]	Total
	(Dollars in millions)		
Balance (net of taxes) at December 31, 2003	$(5,334)	$(6,858)	$(12,192)
Losses on cash flow hedges related to derivatives, net	(4,080)	(1,518)[3]	(5,598)
Reclassifications of net losses to earnings, net[4]	1,157	435	1,592
Balance (net of taxes) at March 31, 2004	$(8,257)	$(7,941)	$(16,198)
Gains (losses) on cash flow hedges related to derivatives, net	7,372	(1,067)[3]	6,305
Reclassifications of net losses to earnings, net[4]	1,147	480	1,627
Balance (net of taxes) at June 30, 2004	$ 262	$(8,528)	$ (8,266)

(1) Excludes mortgage commitments accounted for as derivatives under FAS 149.
(2) Includes gains and losses on derivatives that have been terminated and derivatives that remain open but for which the cash flow hedge relationship has been terminated.
(3) Includes fair value of cash flow hedges on date derivative is terminated and settled in cash or the existing derivative is no longer in a cash flow hedge relationship.
(4) Amounts are reclassified into earnings as a component of interest expense.

The balance in AOCI related to closed hedges includes gains and losses on derivatives in a cash flow hedge relationship that have been terminated and settled in cash and gains and losses on derivatives that remain open but the existing derivative is no longer in a cash flow hedge relationship. Regardless of whether the derivative is terminated and settled in cash with the derivative counterparty or remains open but is no longer designated as a cash flow hedge, the gain or loss on the derivative on the date the cash hedge relationship is discontinued will be reported in AOCI as a closed hedge amount. Fluctuations in interest rates and market volatility therefore have no impact on the amounts recorded in AOCI related to closed hedges. Gains and losses in AOCI on open hedges, however, can fluctuate significantly from period to period due to changes in interest rates and market volatility. The increase in AOCI losses attributable to closed hedges during the first six months of 2004 was driven by discontinuing cash flow hedge designations for certain offsetting derivative positions that we reclassified to other risk management derivatives and by mortgage portfolio rebalancing activities that included terminating pay-fixed swaps to reduce the portfolio's interest rate risk exposure.

Many derivative transactions can have similar economics but different accounting effects on open and closed AOCI hedge amounts. For example, entering into a new receive-fixed swap is economically equivalent to terminating a pay-fixed swap, but the accounting on these transactions can be quite different. A receive-fixed swap recorded as a fair value hedge of fixed-rate debt has no effect on AOCI. On the other hand, a receive-fixed swap in combination with an existing longer-term, pay-fixed swap designated as a cash flow hedge of future interest payments is recorded in AOCI as an open hedge. When we terminate or close a cash flow hedge and discontinue hedge accounting prospectively, we transfer the corresponding market value of the derivative into the closed hedge category of AOCI.

Both realized and unrealized AOCI are amortized into net interest income over the same period in which the related hedged item affects earnings. In the case of a cash flow hedge, the original hedged item is generally the repricing of variable-rate debt in the future. The deferred gains and losses on the hedging derivative instrument therefore are recognized in net interest income together with the hedged variable-rate debt expense. We amortize the hedge results from both open and closed hedges out of AOCI and into earnings as a component of interest expense. Table 24 compares the amounts attributable to open and closed cash flow hedges that were amortized from AOCI to earnings as a component of interest expense during the three and six-month periods ended June 30, 2004 and 2003.

Table 24: AOCI Amounts Reclassified to Earnings(1)

	Three Months Ended June 30,				Six Months Ended June 30,			
	2004		2003		2004		2003	
	After-tax	Pre-tax	After-tax	Pre-tax	After-tax	Pre-tax	After-tax	Pre-tax
	(Dollars in millions)							
Amortization of AOCI amounts to earnings related to:(2)								
Open cash flow hedges	**$1,147**	**$1,764**	$ 980	$1,508	**$2,304**	**$3,545**	$2,012	$3,096
Closed cash flow hedges(3)	**480**	**737**	217	334	**915**	**1,406**	427	657
	$1,627	**$2,501**	$1,197	$1,842	**$3,219**	**$4,951**	$2,439	$3,753

(1) Excludes mortgage commitments accounted for as derivatives under FAS 149.
(2) Amounts are amortized into earnings as a component of reported pre-tax interest expense.
(3) Amounts relate to cash flow hedges that have been closed or terminated.

The expense related to open cash flow hedges in combination with the expense from the associated variable-rate debt equals the cost of our effective fixed-rate debt. Over time, all of our closed hedge results, and open hedge results not otherwise extinguished by changes in interest rates, will be reflected in earnings through interest expense.

For additional detail on our accounting for derivatives, see our 2003 Annual Report on Form 10-K, "Notes to Financial Statements—Note 14, *Derivative Instruments and Hedging Activities.*"

Interest Rate Risk Management

Interest rate risk is the risk of loss to future earnings or long-term value that may result from changes in interest rates. We utilize a wide range of risk measures and analyses to manage the interest rate risk inherent in the mortgage portfolio, including ongoing business risk measures and run-off measures of the existing portfolio. We rely on *net interest income at risk* as our primary ongoing business measure of interest rate risk and the *portfolio duration gap* as our primary run-off measure of interest rate risk. Management develops rebalancing actions based on a number of factors that include the relative standing of both net interest income at risk and duration gap, as well as analyses based on additional risk measures and current market conditions.

In 2003 we updated our corporate financial disciplines and adjusted the risk tolerances of our mortgage portfolio. As a result, we committed to managing the portfolio's duration gap within a target range of plus or minus 6 months substantially all of the time, compared to our historical performance of remaining within the target range about two-thirds of the time. We disclose our net interest income at risk and duration gap measures on a monthly basis. We believe these measures together provide a more informative profile of our overall interest rate risk position than either measure alone.

• Net Interest Income at Risk

Net interest income at risk measures the projected impact of changes in the level of interest rates and the shape of the yield curve on the mortgage portfolio's expected or "base" core net interest income over the immediate future one- and four-year periods. Our net interest income at risk disclosure represents the extent to which our core net interest income over the next one-year and four-year periods is at risk due to a plus or minus 50 basis point parallel change in the current Fannie Mae yield curve and from a 25 basis point change in the slope of Fannie Mae's yield curve. We selected these interest rate change scenarios as part of our six voluntary initiatives announced in 2000.

Table 25 compares net interest income at risk over a one-year and four-year period under each of the interest rate scenarios at June 30, 2004 and December 31, 2003. A positive number indicates the percent by which projected core net interest income could be reduced by the rate shock. These calculations reflect management's assumptions of most likely market conditions. Actual changes in portfolio core net interest income may differ from these estimates because of specific interest rate movements, changing business conditions, changing prepayments, and management actions.

Table 25: Net Interest Income at Risk

	Assuming a 50 basis point change in interest rates		Assuming a 25 basis point change in slope of the yield curve	
	One-year	Four-year	One-year	Four-year
June 30, 2004	**1.6%**	**3.5%**	**2.3%**	**4.1%**
December 31, 2003	2.6	2.1	3.6	6.1

We consider our net interest income at risk at June 30, 2004 to be low as our exposure to a 50 basis point instantaneous change in the level of interest rates was estimated not to exceed 1.6 percent and 3.5 percent over a 1-year and 4-year horizon, respectively. Our exposure to a 25 basis point instantaneous change in the slope of the yield curve was estimated not to exceed 2.3 percent and 4.1 percent over a 1-year and 4-year horizon, respectively. The net interest income at risk for a 50 basis point change in the level of interest rates at June 30, 2004 was slightly lower for the one-year horizon and slightly higher for the 4-year horizon as compared to December 31, 2003 while the amount of risk associated with a change in the slope of the yield curve was lower over both horizons. The change in the risk profile during the period was largely driven by the increase in the level of interest rates, the change in the shape of the yield curve, and asset-liability management actions.

• Duration Gap

The duration gap measures the difference between the estimated durations of portfolio assets and liabilities and summarizes the extent to which estimated cash flows for assets and liabilities are matched, on average, over time and across interest rate scenarios. A positive duration gap signals a greater exposure to rising interest rates because it indicates that the duration of our assets exceeds the duration of our liabilities. A negative duration gap signals a greater exposure to declining interest rates because the duration of our assets is less than the duration of our liabilities. The duration gap provides a relatively concise and simple measure of the interest rate risk inherent in the existing mortgage portfolio, but it is not directly linked to expected future earnings performance. Our duration gap reflects the current mortgage portfolio, including priced asset and debt commitments. We apply the same interest rate process, prepayment models, and volatility assumptions used in our net interest income at risk measure to generate the portfolio duration gap. However, we do not incorporate nonmortgage investments or projected future business activity, which can have a significant effect even over a very short horizon, into our duration gap measure.

Fannie Mae's effective duration gap calculated on a weighted average monthly basis shifted to plus 2 months at June 30, 2004 from minus one month at December 31, 2003. Despite continued levels of relatively high volatility in the fixed income markets during second quarter and first half of 2004, we were able to maintain our duration gap within our tighter risk tolerances throughout the period. Our duration gap averaged plus 2 months in June, plus 3 months in May and plus 3 months in April. We accomplished this financial discipline objective by maintaining high levels of optionality in our liability structure and through strategic rebalancing actions that included a reduction in the percentage of our effective short-term debt and extending the duration of our liabilities to offset the extended duration of our mortgage assets. Fannie Mae's duration gap has remained within our target range of plus or minus six months since October 2002.

CREDIT GUARANTY BUSINESS OPERATIONS

Our Credit Guaranty business has primary responsibility for managing Fannie Mae's credit risk on our mortgage credit book of business, which includes both on-balance sheet and off-balance sheet mortgage assets.

Off-Balance Sheet Transactions

In the ordinary course of business, we enter into arrangements to facilitate our statutory purpose of providing mortgage funds to the secondary market and reduce Fannie Mae's exposure to interest rate fluctuations. We structure transactions to meet the financial needs of customers, manage Fannie Mae's credit, market or liquidity risks, diversify funding sources, or optimize our capital. Under GAAP, some of these arrangements are not recorded on Fannie Mae's balance sheet or may be recorded in amounts different than the full contract or notional amount of the transaction. Our primary off-balance sheet arrangements result from mortgage loan securitizations in which Fannie Mae issues MBS and guarantees the timely payment of principal and interest on the MBS to investors in exchange for a guaranty fee. We may also assist state and local governmental entities in issuing taxable and tax-exempt housing bonds to obtain funding for low- and moderate-income multifamily housing by providing credit enhancements and liquidity support for the bonds. Under these agreements, we provide contractual assurance of payment of the bonds, which improves the bond ratings and thereby results in lower-cost financing for multifamily housing.

Outstanding MBS and credit enhancement arrangements totaled $1,374 billion and $1,314 billion at June 30, 2004 and December 31, 2003, respectively. We recorded as part of our combined allowance for loan losses and guaranty liability for MBS a guaranty liability of $677 million and $712 million at June 30, 2004 and December 31, 2003, respectively, based on the probable losses inherent in the mortgages underlying outstanding MBS as well as MBS included in our mortgage portfolio. We also recorded a guaranty fee obligation related to these arrangements of $5.810 billion and $4.391 billion at June 30, 2004 and December 31, 2003, respectively, under FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* ("FIN 45").

Table 26 provides information related to Fannie Mae MBS and credit enhancements.

Table 26: Guaranteed MBS[(1)] and Credit Enhancements

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	**2003**	**2004**	**2003**
	(Dollars in millions)			
MBS issuance activity:				
Acquired by others	**$ 134,595**	$ 282,502	**$256,603**	$486,435
Total issued[(2)]	**168,793**	352,985	**297,757**	645,558

	June 30, 2004	December 31, 2003
Outstanding balance:		
MBS held by other investors	**$1,360,045**	$1,300,166
Total MBS[(3)]	**1,879,009**	1,857,045
Credit enhancements	**13,915**	13,915

(1) MBS may be resecuritized to back Fannie Megas, SMBS, or REMICs. With respect to those MBS, the amounts shown only include the principal amount of the MBS once. Amounts also include REMICs created from whole loans not owned or guaranteed by Fannie Mae.

(2) Total issued includes MBS purchased by Fannie Mae totaling $34 billion and $70 billion for the three months ended June 30, 2004 and 2003, respectively, and $41 billion and $159 billion for the six months ended June 30, 2004 and 2003, respectively. Total issued excludes amounts issued from loans in our portfolio totaling $4 billion and $3 billion for the three months ended June 30, 2004 and 2003, respectively, and $9 billion for each of the six-month periods ended June 30, 2004 and 2003.

(3) Includes $519 billion at June 30, 2004 and $557 billion at December 31, 2003, of MBS in Fannie Mae's mortgage portfolio.

MBS held by investors other than Fannie Mae, which we refer to as outstanding MBS, grew 5 percent to $1.360 trillion at June 30, 2004, from $1.300 trillion at December 31, 2003. MBS issuances acquired by investors other than Fannie Mae totaled $135 billion in the second quarter of 2004, a decrease of over 50 percent from the same prior year quarter, and $257 billion for the first six months of 2004, a decrease of 47 percent from the same prior year period. The decrease in the volume of MBS issuances reflects the market reduction in mortgage originations from the record level of refinancings that occurred in 2003, the sustained high retention of mortgages by depository institutions, and a record level of issuances of private label securities backed largely by loans with higher credit risk.

REMIC issuances totaled $35 billion and $55 billion in the second quarter and first six months of 2004, compared with $72 billion and $145 billion in the second quarter and first six months of 2003. REMIC issuances were down from 2003 levels due in part to the increase in mortgage interest rates that has resulted in a sharp decline in mortgage origination volumes.

Credit Risk Management

Credit risk is the risk of loss to future earnings or future cash flows that may result from the failure of a borrower or institution to fulfill its contractual obligation to make payments to Fannie Mae or an institution's failure to perform a service for us. We assume and manage mortgage credit risk and institutional credit risk that arise through a variety of transactions. We actively manage credit risk to maintain credit losses within levels that generate attractive profitability and returns on capital and meet our expectations for consistent financial performance.

Our mortgage credit risk stems from our mortgage credit book of business, where we bear the risk that borrowers fail to make payments required on their mortgages. Our mortgage credit book of business consists of mortgages, MBS and mortgage-related securities in our mortgage portfolio, outstanding MBS held by other investors, and other contractual arrangements or guarantees. Table 27 presents the composition of our mortgage credit book of business at June 30, 2004 and December 31, 2003.

Table 27: Composition of Mortgage Credit Book of Business

	June 30, 2004		
	Single-family	Multifamily	Total
	(Dollars in millions)		
Mortgage portfolio[1]	**$ 848,030**	**$ 43,180**	**$ 891,210**
Outstanding MBS[2]	**1,294,645**	**65,400**	**1,360,045**
Credit enhancements	**168**	**13,747**	**13,915**
Mortgage credit book of business	**$2,142,843**	**$122,327**	**$2,265,170**

	December 31, 2003		
	Single-family	Multifamily	Total
Mortgage portfolio[1]	$ 859,524	$ 38,921	$ 898,445
Outstanding MBS[2]	1,233,863	66,303	1,300,166
Credit enhancements	1,020	12,895	13,915
Mortgage credit book of business	$2,094,407	$118,119	$2,212,526

(1) Excludes mark-to-market gains of $1.093 billion at June 30, 2004 and $3.500 billion at December 31, 2003.
(2) MBS held by investors other than Fannie Mae. The principal balance on resecuritized MBS is included only once.

Table 28 shows statistics related to our mortgage credit performance. A certain level of credit losses is an inherent consequence of engaging in the Credit Guaranty business. Our risk management focus is on controlling the level and volatility of credit losses that result from changes in economic conditions.

Table 28: Mortgage Credit Performance

	Credit-Related Losses[1]				Serious Delinquency Rate[2]	
	Three Months Ended June 30,		Six Months Ended June 30,			
	2004	2003	2004	2003	June 30, 2004	December 31, 2003
	(Dollars in millions)					
Single-family	**$ 8**	$ 19	**$ 11**	$ 38	**.57%**	.60%
Multifamily	**8**	4	**15**	5	**.14**	.27
Total	**$ 16**	$ 23	**$ 26**	$ 43		
Credit loss ratio[3]	**.003%**	.005%	**.002%**	.004%		
Charge-off ratio[4]	**.005**	.005	**.005**	.005		

	Number of Properties Acquired			
	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
Single-family	**8,146**	6,569	**16,259**	12,487
Multifamily	**4**	2	**14**	3

(1) Includes charge-offs and foreclosed property expense (income).
(2) Serious delinquency rate for conventional single-family includes loans 90 days or more past due and loans in the process of foreclosure and is calculated based on number of loans. Serious delinquency rate for multifamily includes loans and securities 60 days or more past due and is calculated based on the mortgage credit book of business.
(3) Represents annualized credit losses divided by average mortgage credit book of business.
(4) Represents annualized charge-offs divided by average mortgage credit book of business.

Our credit loss ratio—annualized credit-related losses as a percentage of Fannie Mae's average mortgage credit book of business—fell to .3 basis points for the second quarter of 2004 and .2 basis points in the first six months of 2004, from .5 basis points in the second quarter of 2003 and .4 basis points in the first six months of 2003. Despite an increase in the number of properties acquired through foreclosure and the expansion in our mortgage credit book of business over the past few years, our credit-related losses for 2004 have been exceptionally low by historical standards. We had previously anticipated a modest upward trend in credit losses during 2004. However, based on the actual level of credit losses during the first half of 2004, it is possible that our credit losses in 2004 will be no higher than in 2003.

Our conventional single-family serious delinquency rate, an indicator of potential future loss activity, was .57 percent at June 30, 2004, compared with .60 percent at December 31, 2003. Table 29 compares the serious delinquency rates for conventional single-family loans with credit enhancements and without credit enhancements at June 30, 2004 and December 31, 2003.

Table 29: Conventional Single-Family Serious Delinquency Rates

	June 30, 2004		December 31, 2003	
	Book Outstanding[1]	Serious Delinquency Rate[2]	Book Outstanding[1]	Serious Delinquency Rate[2]
Credit enhanced	**20%**	**1.62%**	21%	1.65%
Non-credit enhanced	**80**	**.29**	79	.30
Total conventional loans	**100%**	**.57%**	100%	.60%

(1) Reported based on unpaid principal balance.
(2) Reported based on number of loans.

As part of our voluntary safety and soundness initiatives, we disclose on a quarterly lagged basis the lifetime credit loss sensitivity of the present value of expected future credit losses to an immediate 5 percent decline in home values. We base our lifetime credit loss sensitivity on all single-family mortgages held in Fannie Mae's portfolio and underlying guaranteed MBS and calculate and report the amount before and after the expected receipt of private mortgage insurance claims and any other credit enhancements. The lifetime credit loss sensitivity before and after credit enhancements increased to $3.231 billion and $1.453 billion, respectively, at March 31, 2004, from $2.402 billion and $1.113 billion at December 31, 2003, reflecting the increase in our combined book of business, somewhat slower projected home price appreciation, and greater dispersion between regions within the U.S. in average home price appreciation.

LIQUIDITY AND CAPITAL RESOURCES

Our ability to continually raise low-cost capital is critical to fulfilling our housing mission of providing liquidity to the secondary mortgage market and promoting homeownership to low- and moderate-income families. We primarily rely on debt to purchase mortgage assets and to supply liquidity to the secondary market. Fannie Mae's liquidity and capital position are actively managed to preserve stable, reliable, and cost-effective sources of cash to meet all current and future normal operating financial commitments, meet our regulatory capital requirements, and handle any unforeseen liquidity crisis.

Liquidity

Fannie Mae's primary sources of liquidity include proceeds from the issuance of debt, principal and interest received on our mortgage portfolio, guaranty fees earned on our MBS, and principal and interest received on our liquid investments. Primary uses of liquidity include the purchase of mortgage assets, repayment of debt, interest payments, administrative expenses, taxes, and fulfillment of Fannie Mae's MBS guaranty obligations. Mortgage asset purchases based on unpaid principal balance totaled $91 billion and $132 billion for the second quarter and first six months of 2004, respectively. We issued $453 billion and $984 billion of debt in the second quarter and first six months of 2004, respectively, to fund those purchases and to replace maturing, called or repurchased debt totaling $453 billion and $1,003 billion in each respective period.

Our debt securities, and the interest payable thereon, are not guaranteed by the United States and do not constitute a debt or obligation of the United States or any agency or instrumentality thereof other than Fannie Mae. Our credit quality is continuously monitored by rating agencies. At June 30, 2004, our senior unsecured debt had a rating of AAA by S&P, Aaa by Moody's, and AAA by Fitch, Inc, unchanged from the ratings at December 31, 2003. Our short-term debt was rated A-1+, Prime-1 or P-1, and F1+ by S&P, Moody's, and Fitch, respectively, at June 30, 2004, also unchanged from the ratings at December 31, 2003.

As part of our voluntary commitments, we have publicly pledged to maintain a portfolio of high-quality, liquid assets equal to at least 5 percent of total on-balance sheet assets. Liquid assets, which include liquid investments net of any cash and cash equivalents pledged as collateral, totaled $52 billion at June 30, 2004, compared with $65 billion at December 31, 2003. The ratio of liquid assets to total assets was 5.2 percent at June 30, 2004 and 6.5 percent at December 31, 2003.

Capital Resources

Regulatory Environment

Fannie Mae is subject to capital adequacy standards established by the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 ("1992 Act") and continuous examination by OFHEO. The regulatory capital framework incorporates two different quantitative assessments of capital—a minimum and a risk-based capital standard. While the minimum capital standard is ratio-based, the risk-based capital standard is based on simulated stress test performance. Fannie Mae is required to maintain sufficient capital to meet both of these requirements in order to be deemed "adequately capitalized." OFHEO's examination program provides an assessment of capital adequacy in support of the overall classification process.

For purposes of the minimum capital standard, Fannie Mae is considered adequately capitalized if core capital equals or exceeds the minimum capital requirement and a lower "critical" capital requirement. Core capital is defined by OFHEO as the stated value of common stock, the stated value of outstanding noncumulative perpetual preferred stock, paid-in capital, and retained earnings, less treasury stock. Core capital excludes accumulated other comprehensive income because AOCI incorporates unrealized gains (losses) on derivatives and certain securities, but not the unrealized losses (gains) on the remaining mortgages and securities or liabilities used to fund the purchase of these items.

Fannie Mae's total capital base is used to meet risk-based capital requirements. Total capital is defined by OFHEO as the sum of core capital and the total allowance for loan losses and guaranty liability for MBS, less the specific loss allowance. Table 30 shows our core capital and total capital at June 30, 2004, March 31, 2004, and December 31, 2003. Core capital grew to $36.1 billion at June 30, 2004 from $34.4 billion at December 31, 2003. Total capital grew to $36.9 billion at June 30, 2004 from $35.2 billion at the end of 2003.

Table 30: Capital Requirements

	June 30, 2004[1]	March 31, 2004	December 31, 2003
	(Dollars in millions)		
Core capital[2]	**$36,115**	$35,701	$34,405
Required minimum capital[3]	**31,188**	31,354	31,520
Excess of core capital over minimum capital	**$ 4,927**	$ 4,347	$ 2,885
Total capital[4]	**$36,862**	$36,481	$35,182
Required risk-based capital[5]	**Not available**	25,961	27,221
Excess of total capital over required risk-based capital[5]	**Not available**	10,520	$ 7,960
Required critical capital[6]	**$15,957**	$16,041	$16,113
Excess of core capital over required critical capital	**20,157**	19,660	18,292

(1) Amounts at June 30, 2004 represent estimates, pending OFHEO's certification, which is generally provided no later than three months following the end of each quarter.

(2) The sum of (a) the stated value of outstanding common stock; (b) the stated value of outstanding noncumulative perpetual preferred stock; (c) paid-in capital; and (d) retained earnings, less treasury stock. Core capital excludes AOCI.

(3) The sum of (a) 2.50 percent of on-balance sheet assets; (b) .45 percent of outstanding MBS; and (c) .45 percent of other off-balance sheet obligations, which may be adjusted by the Director of OFHEO under certain circumstances (See 12 CFR 1750.4 for existing adjustments made by the Director of OFHEO).

(4) The sum of (a) core capital and (b) the total allowance for loan losses and guaranty liability for MBS, less (c) the specific loss allowance. The specific loss allowance totaled $10 million, $15 million, and $20 million at June 30, 2004, March 31, 2004 and December 31, 2003, respectively.

(5) Amount at June 30, 2004 will not be available until the end of September 2004. OFHEO reports Fannie Mae's risk-based capital at the end of each quarter on a lagged quarterly basis.

(6) The sum of (a) 1.25 percent of on-balance sheet assets; (b) .25 percent of outstanding MBS; and (c) .25 percent of other off-balance sheet obligations, which may be adjusted by the Director of OFHEO under certain circumstances.

Our total capital exceeded our risk-based capital requirement of $26.0 billion by $10.5 billion at March 31, 2004, the most recent quarter for which OFHEO has published the risk-based standard. OFHEO employs a stress test to formally compute the company's binding risk-based capital requirement. Stress test results indicate the amount of capital required to survive prolonged economically stressful conditions absent new business or active risk management action. OFHEO makes the results of its stress tests publicly available. In each of the quarters for which OFHEO has used risk-based capital in its determination of capital adequacy, we have shown a significant capital surplus relative to our risk-based capital requirements.

Table 31 details the results of our official requirements published to date. Note that results may not be directly correlated with our other risk measures, such as the duration gap, given that stress tests focus on extreme scenarios. Because our risk management strategies are designed to address multiple objectives concurrently, we expect variability in our risk-based reported capital surplus from period to period.

Table 31: Regulatory Stress Test Results

Quarter Ended	Risk-Based Capital Requirement[1]	Total Capital	Reported Capital Surplus[1]
	(Dollars in millions)		
12/31/02	$17,434	$28,871	$11,437
3/31/03	16,555	30,309	13,753
6/30/03	18,114	31,469	13,355
9/30/03	27,853	33,542	5,689
12/31/03	27,221	35,182	7,960
3/31/04	25,961	36,481	10,520
6/30/04	**Not available**	**36,862**	**Not available**

(1) Amount at June 30, 2004 will not be available until the end of September 2004. OFHEO reports Fannie Mae's risk-based capital at the end of each quarter on a lagged quarterly basis.

Capital Activity

Common shares outstanding, net of shares held in treasury, totaled approximately 968 million shares at June 30, 2004, compared with 970 million shares at December 31, 2003. During the second quarter and the first six months of 2004, Fannie Mae issued .4 million and 4.5 million, respectively, of common shares from treasury for employee and other stock compensation plans. As part of the continuation of our capital restructuring program, we repurchased 2.8 million common shares at a weighted average cost per share of $70.63 during the second quarter of 2004 and 6.9 million shares at a weighted average cost per share of $73.78 during the first six months of 2004. We repurchased the stock pursuant to our share repurchase program and to offset the dilutive effect of common shares issued in conjunction with various stock compensation programs. The share repurchase program authorized by Fannie Mae's Board of Directors permits the repurchase of up to 5 percent of common shares outstanding at December 31, 2002 or 49.4 million common shares. Through June 30, 2004, we have repurchased 20.9 million shares of common stock under this program.

We did not issue or redeem any preferred stock during the second quarter or first six months of 2004. Preferred stock represented 11.4 percent of our core capital at June 30, 2004, compared with 11.9 percent at December 31, 2003.

Although it is not a component of core capital, subordinated debt serves as an important risk-bearing supplement to our core capital. As part of our voluntary initiatives we have pledged to issue subordinated debt in an amount that, together with core capital, equals or exceeds 4 percent of on-balance sheet assets, after adjusting for capital required to support the off-balance sheet MBS. We have not issued any subordinated debt during 2004. Total capital and outstanding subordinated debt, after providing for capital to support off-balance sheet MBS, represented 4.4 percent of on-balance sheet assets at June 30, 2004 and 4.1 percent at December 31, 2003.

In July 2004, our Board of Directors approved a dividend for the third quarter of 2004 of $.52 per common share, which is unchanged from the first and second quarters of 2004 but 16 percent higher than the $.45 dividend per common share paid in the third quarter of 2003.

Accumulated Other Comprehensive Income

AOCI, which is not included in our regulatory core capital, totaled negative $10.0 billion at June 30, 2004, compared with a negative balance of $12.0 billion at December 31, 2003. Table 32 shows the components of AOCI.

Table 32: AOCI Components

	June 30, 2004	**December 31, 2003**
	(Dollars in millions)	
Accumulated other comprehensive income (AOCI):		
Unrealized gains on securities, net (FAS 115)	**$ 1,034**	$ 2,618
Losses on cash flow hedges related to derivatives, net (FAS 133)	**(8,266)**	(12,192)
Losses on cash flow hedges related to mortgage commitments accounted for as derivatives, net (FAS 149)	**(2,762)**	(2,458)
Total AOCI	**$(9,994)**	$(12,032)

FAS 133 requires that we record changes in the fair value of derivatives that qualify as cash flow hedges in AOCI, net of taxes, which accounts for a significant portion of the negative amounts reflected in AOCI. In addition, commencing with our July 1, 2003 adoption of FAS 149, we have designated forward commitments to purchase mortgage loans or mortgage-related securities that we intend to retain in our mortgage portfolio as cash flow hedges. Accordingly, changes in the fair value of these commitments are recorded in AOCI, to the extent effective, and amortized into earnings over the estimated life of the loans or securities as an offset to the amortization of the fair value purchase price adjustment. Because the amortization amounts generally are equal and offsetting, there is no material impact on our income statement. We also record unrealized gains and losses on available-for-sale securities in AOCI in accordance with FAS 115.

PENDING ACCOUNTING PRONOUNCEMENTS

SOP 03-3, Accounting for Certain Loans or Debt Securities Acquired in a Transfer

In December 2003, the Accounting Standards Executive Committee ("AcSEC") of the AICPA issued SOP 03-3. SOP 03-3 applies to acquired loans and debt securities where there has been evidence of deterioration in credit quality at the date of purchase and for which it is probable that the investor will not be able to collect all contractually required payments. It addresses the accounting for differences between the contractual cash flows of acquired loans and the cash flows expected to be collected from an investor's initial investment in loans acquired in a transfer if those differences are attributable, at least in part, to credit quality.

SOP 03-3 requires purchased loans and debt securities within its scope to be initially recorded at fair value and prohibits the recording of a valuation allowance at the date of purchase. It limits the yield that may be accreted as interest income on such loans to the excess of an investor's estimate of undiscounted expected principal, interest, and other cash flows from the loan over the investor's initial investment in the loan. Subsequent increases in estimated future cash flows to be collected would be recognized prospectively in interest income through a yield adjustment over the remaining life of the loan. Decreases in estimated future cash flows to be collected would be recognized as an impairment expense or valuation allowance. SOP 03-3 primarily applies prospectively to loans acquired in fiscal years beginning after December 15, 2004. We are evaluating the effect of the adoption of SOP 03-3 on our financial position and results of operations.

Item 1. Financial Statements

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Stockholders of Fannie Mae:

We have reviewed the accompanying balance sheet of Fannie Mae as of June 30, 2004, and the related statements of income for the three and six-month periods ended June 30, 2004 and 2003, and the related statements of changes in stockholders' equity and cash flows for the six-month periods ended June 30, 2004 and 2003. These financial statements are the responsibility of the Company's management.

We conducted our review in accordance with the standards established by the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

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

We have previously audited, in accordance with standards established by the Public Company Accounting Oversight Board (United States), the balance sheet of Fannie Mae as of December 31, 2003 (presented herein) and the related statements of income, changes in stockholders' equity, and cash flows for the year then ended (not presented herein); and in our report dated January 20, 2004, we expressed an unqualified opinion on those financial statements.

/s/ KPMG LLP

KPMG LLP

Washington, D.C.

August 9, 2004

FANNIE MAE
Statements of Income
(Dollars and shares in millions, except per share amounts)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	**2004**	2003
	(Unaudited)			
Interest income:				
Mortgage portfolio	**$11,794**	$12,256	**$23,909**	$24,846
Nonmortgage investments and cash equivalents	**261**	336	**490**	642
Total interest income	**12,055**	12,592	**24,399**	25,488
Interest expense:				
Short-term debt	**750**	697	**1,463**	1,447
Long-term debt	**8,192**	8,394	**16,627**	17,172
Total interest expense	**8,942**	9,091	**18,090**	18,619
Net interest income	**3,113**	3,501	**6,309**	6,869
Other income:				
Guaranty fee income (includes imputed interest of $159 million and $292 million for the three and six-months ended June 30, 2004, respectively and $18 million and $21 million for the three and six-months ended June 30, 2003, respectively)	**657**	632	**1,394**	1,179
Fee and other income (expense), net	**(170)**	232	**(168)**	345
Total other income	**487**	864	**1,226**	1,524
Other expenses:				
Provision for losses	**(12)**	26	**20**	49
Foreclosed property income	**(9)**	(3)	**(33)**	(6)
Administrative expenses	**384**	354	**767**	698
Purchased options expense	**1,980**	1,883	**2,939**	2,508
Debt extinguishments (gain) loss, net	**(24)**	740	**3**	1,132
Total other expenses	**2,319**	3,000	**3,696**	4,381
Income before federal income taxes	**1,281**	1,365	**3,839**	4,012
Provision for federal income taxes	**(169)**	(263)	**(827)**	(970)
Net income	**$ 1,112**	$ 1,102	**$ 3,012**	$ 3,042
Preferred stock dividends and issuance costs on redemptions	**(40)**	(34)	**(84)**	(64)
Net income available to common stockholders	**$ 1,072**	$ 1,068	**$ 2,928**	$ 2,978
Basic earnings per common share	**$ 1.11**	$ 1.09	**$ 3.02**	$ 3.03
Diluted earnings per common share	**$ 1.10**	$ 1.09	**$ 3.01**	$ 3.02
Cash dividends per common share	**$ .52**	$ .39	**$ 1.04**	$ .78
Weighted-average common shares outstanding:				
Basic	**969**	979	**970**	983
Diluted	**970**	982	**973**	987

See Notes to Financial Statements.

FANNIE MAE
Balance Sheets
(Dollars in millions, except per share amounts)

	June 30, 2004 (Unaudited)	December 31, 2003
Assets		
Mortgage portfolio:		
Mortgage-related securities:		
Held-to-maturity	**$452,741**	$ 475,152
Available-for-sale	**198,972**	190,795
Total	**651,713**	665,947
Loans held-for-investment	**238,873**	234,699
Allowance for loan losses	**(80)**	(85)
Unamortized premiums (discounts) and deferred price adjustments, net	**880**	1,234
Loans held for sale	**—**	7
Mortgage portfolio, net	**891,386**	901,802
Mortgage assets designated for securitization	**2,637**	4,727
Total mortgage assets	**894,023**	906,529
Nonmortgage investments:		
Held-to-maturity	**5,516**	6,822
Available-for-sale	**43,357**	52,671
Cash and cash equivalents	**340**	1,415
Accrued interest receivable	**6,050**	6,075
Acquired property and foreclosure claims, net	**1,794**	1,486
Derivatives in gain positions	**11,300**	8,191
Guaranty fee receivable	**5,810**	4,391
Other	**21,151**	21,989
Total assets	**$989,341**	$1,009,569
Liabilities and Stockholders' Equity		
Liabilities:		
Debentures, notes and bonds, net:		
Senior debt:		
Due within one year	**$424,372**	$ 483,193
Due after one year	**501,212**	464,529
Subordinated debt:		
Due after one year	**14,084**	14,010
Total	**939,668**	961,732
Accrued interest payable	**9,422**	10,284
Derivatives in loss positions	**318**	1,600
Guaranty liability for MBS	**677**	712
Guaranty fee obligation	**5,810**	4,391
Other	**7,325**	8,477
Total liabilities	**963,220**	987,196
Stockholders' Equity:		
Preferred stock, $50 stated value, 200 million shares authorized—82.2 million shares issued and outstanding at June 30, 2004 and at December 31, 2003	**4,108**	4,108
Common stock, $.525 stated value, no maximum authorization—1,129 million shares issued at June 30, 2004 and December 31, 2003	**593**	593
Additional paid-in capital	**1,925**	1,864
Retained earnings	**37,414**	35,496
Accumulated other comprehensive loss	**(9,994)**	(12,032)
	34,046	30,029
Less: Treasury stock, at cost, 161 million shares at June 30, 2004 and 159 million shares at December 31, 2003	**7,925**	7,656
Total stockholders' equity	**26,121**	22,373
Total liabilities and stockholders' equity	**$989,341**	$1,009,569

See Notes to Financial Statements.

FANNIE MAE
Statements of Changes in Stockholders' Equity
(Dollars and shares in millions)
(Unaudited)

	Net Common Shares Outstanding	Preferred Stock	Common Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total Stockholders' Equity
Balance at December 31, 2003	970	$4,108	$593	$1,864	$35,496	$(12,032)	$(7,656)	$22,373
Comprehensive income:								
Net income	—	—	—	—	3,012	—	—	3,012
Other comprehensive income, net of tax effect:								
Net cash flow hedging gains on derivatives hedging debt	—	—	—	—	—	3,926	—	3,926
Net cash flow hedging losses on commitments accounted for as derivatives	—	—	—	—	—	(304)	—	(304)
Unrealized losses on available-for-sale securities	—	—	—	—	—	(1,584)	—	(1,584)
Total comprehensive income								5,050
Dividends	—	—	—	—	(1,094)	—	—	(1,094)
Shares repurchased	(7)	—	—	—	—	—	(510)	(510)
Treasury stock issued for stock options and benefit plans	5	—	—	61	—	—	241	302
Balance at June 30, 2004	968	$4,108	$593	$1,925	$37,414	$ (9,994)	$(7,925)	$26,121
Balance at December 31, 2002	989	$2,678	$593	$1,839	$29,385	$(11,792)	$(6,415)	$16,288
Comprehensive income:								
Net income	—	—	—	—	3,042	—	—	3,042
Other comprehensive income, net of tax effect:								
Net cash flow hedging losses on derivatives hedging debt	—	—	—	—	—	(702)	—	(702)
Unrealized losses on available-for-sale securities	—	—	—	—	—	(817)	—	(817)
Total comprehensive income								1,523
Dividends	—	—	—	—	(832)	—	—	(832)
Shares repurchased	(14)	—	—	—	—	—	(906)	(906)
Preferred stock issued	—	1,205	—	(11)	—	—	—	1,194
Treasury stock issued for stock options and benefit plans	1	—	—	14	—	—	83	97
Balance at June 30, 2003	976	$3,883	$593	$1,842	$31,595	$(13,311)	$(7,238)	$17,364

See Notes to Financial Statements.

FANNIE MAE
Statements of Cash Flows
(Dollars in millions)

	Six Months Ended June 30, 2004	Six Months Ended June 30, 2003
	(Unaudited)	
Cash flows from operating activities:		
Net income	**$ 3,012**	$ 3,042
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Amortization of discount/premium and deferred price adjustments	**2,012**	2,495
Provision for losses	**20**	49
Loss on debt extinguishments	**3**	1,132
Purchased options expense	**2,939**	2,507
Deferred income taxes	**(852)**	(1,041)
Other increases, net	**55**	1,544
Net cash provided by operating activities	**7,189**	9,728
Cash flows from (used in) investing activities:		
Mortgage portfolio purchases	**(132,524)**	(261,474)
Proceeds from sales from mortgage portfolio	**8,609**	6,923
Mortgage portfolio principal repayments	**128,782**	229,852
Net proceeds from disposition of foreclosed properties	**1,868**	1,476
Purchases of held-to-maturity liquid investments	**(1,086,401)**	(1,363,754)
Maturities of held-to-maturity liquid investments	**1,087,818**	1,354,756
Purchases of available-for-sale liquid investments	**(58,842)**	(130,084)
Maturities of available-for-sale liquid investments	**69,468**	129,522
Proceeds from sales of available-for-sale liquid investments	**487**	1,426
Net cash provided by (used in) investing activities	**19,265**	(31,357)
Cash flows from (used in) financing activities:		
Proceeds from issuance of long-term debt	**183,424**	154,759
Payments to redeem long-term debt	**(168,839)**	(163,435)
Proceeds from issuance of short-term debt	**798,285**	1,180,619
Payments to redeem short-term debt	**(833,690)**	(1,145,879)
Net payments to purchase or settle hedge instruments	**(5,301)**	(3,465)
Net payments from stock activities	**(1,408)**	(515)
Net cash provided by (used in) financing activities	**(27,529)**	22,084
Net (decrease) increase in cash and cash equivalents	**(1,075)**	455
Cash and cash equivalents at beginning of period	**1,415**	1,710
Cash and cash equivalents at end of period	**$ 340**	$ 2,165
Supplemental disclosures of cash flow information:		
Cash paid during the period for:		
Interest, including loss on debt extinguishments	**$ 18,468**	$ 20,948
Income taxes	**1,713**	2,015

See Notes to Financial Statements.

FANNIE MAE
Notes to Financial Statements
(Unaudited)

1. Summary of Significant Accounting Policies

For a complete discussion of Fannie Mae's significant accounting policies, refer to our 2003 Annual Report on Form 10-K.

Basis of Presentation

The accompanying unaudited condensed financial statements have been prepared in accordance with generally accepted accounting principles in the United States of America ("GAAP") for interim financial information. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments of a normal recurring nature considered necessary for a fair presentation have been included. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates. Results for the three and six-month periods ended June 30, 2004 may not necessarily be indicative of the results for the year ending December 31, 2004. We have reclassified certain prior period amounts to conform to our current period presentation. The unaudited financial statements should be read in conjunction with Fannie Mae's audited financial statements and related notes included in the 2003 Annual Report on Form 10-K filed with the Securities Exchange Commission ("SEC") on March 15, 2004.

Our significant interim accounting policies include the recognition of income taxes using an estimated annual effective tax rate except for the amount of taxes related to changes in the time value of purchased options, which we reflect in our income statement as purchased options expense. Purchased options expense may vary substantially from period to period with changes in interest rates, expected interest rate volatility, and derivatives activity, and often results in significant period-to-period variability in our reported net income. Because we cannot reliably project purchased options expense on an annual basis, we recognize income taxes for purchased options expense based on the actual expense reported each period using a 35 percent marginal tax rate.

Cash and Cash Equivalents

We may pledge cash equivalent securities as collateral. The majority of these pledged securities are short-term U.S. Treasury bills and are primarily related to collateral posting provisions under our interest rate swap agreements. We pledged collateral of $186 million and $487 million at June 30, 2004 and December 31, 2003, respectively.

Mortgage Assets Designated for Securitization

Fannie Mae buys loans or securities that we do not retain in our portfolio. The interest rate risk associated with non-retained purchase commitments is economically hedged with offsetting sale commitments. In some cases, a counterparty may deliver mortgage loans to us that already have been pooled for securitization and designated for sale to a third party. We include these loans that we temporarily hold on our balance sheet under "Mortgage assets designated for securitization."

We classify and account for the pooled loans that have been designated for sale as a trading security under Financial Accounting Standard No. 115, *Accounting for Certain Investments in Debt and Equity Securities* ("FAS 115") and record changes in the fair value of the security in earnings as a component of fee and other income. The forward commitment to sell the security is accounted for as a derivative that serves as an economic hedge by largely offsetting changes in the fair value of the mortgage assets designated for securitization. We also mark to market changes in the fair value of the forward commitment through earnings. We expect the mark to market gains and losses on the forward commitment to largely offset the gains and losses on the pooled loans and have an immaterial effect on our earnings.

Stock-Based Compensation

Effective January 1, 2003, Fannie Mae adopted prospectively the expense recognition provisions of the fair value method of accounting for employee stock compensation pursuant to Financial Accounting Standard No. 123, *Accounting for Stock-Based Compensation* ("FAS 123"). If compensation cost for all options granted had been determined based on the fair value at grant date consistent with the FAS 123 fair value method, our net income and earnings per share would have been as follows for the second quarter and first half of 2004 and 2003.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	**2003**	**2004**	**2003**
	(Dollars in millions, except per share amounts)			
Net income available to common stockholders, as reported	**$1,072**	$1,068	**$2,928**	$2,978
Plus: Stock-based employee compensation expense included in reported net income, net of related tax effects	**21**	19	**39**	33
Less: Stock-based employee compensation expense determined under fair value based method, net of related tax effects	**(27)**	(30)	**(53)**	(58)
Pro forma net income available to common stockholders	**$1,066**	$1,057	**$2,914**	$2,953
Earnings per share:				
Basic—as reported	**$ 1.11**	$ 1.09	**$ 3.02**	$ 3.03
Basic—pro forma	**1.10**	1.08	**3.00**	3.00
Diluted—as reported	**1.10**	1.09	**3.01**	3.02
Diluted—pro forma	**1.10**	1.08	**2.99**	2.99

2. Recently Adopted or Pending Changes in Accounting Standards or Estimates

Consolidation of Variable Interest Entities

Fannie Mae adopted Financial Accounting Standards Board ("FASB") Interpretation No. 46R, *Consolidation of Variable Interest Entities* ("FIN 46R") as of March 31, 2004. Based on the guidance of FIN 46R, certain entities that Fannie Mae is involved with—primarily low-income housing tax credit partnerships—meet the definition of a VIE. However, we do not consolidate our interests in these VIEs under FIN 46R, as we are not considered the primary beneficiary. Fannie Mae invests primarily in upper-tier low-income housing tax credit partnerships that are themselves limited partners in operating low-income housing tax credit partnerships ("operating partnerships"). The primary activities of upper-tier partnerships include the identification and asset management of suitable investments in operating partnerships. Fannie Mae has invested directly in operating partnerships as a limited partner. The primary activities of operating partnerships include the identification, development and operation of affordable housing that qualifies for the Low Income Housing Tax Credit of the Internal Revenue Code. The total committed equity capital (both Fannie Mae and other equity investors' commitments) of all low-income housing tax credit partnerships that Fannie Mae invests in was $15.2 billion and $14.7 billion at June 30, 2004 and December 31, 2003, respectively. The total assets of the low-income housing tax credit partnerships are funded through a combination of debt and equity, with equity typically comprising 30 percent to 60 percent of the total funding of partnership assets. Fannie Mae has been a limited partner investor in low-income housing tax credit partnerships since 1987. As a limited partner investor, Fannie Mae is entitled to receive (or obligated to absorb) its portion of the operating income (or operating loss) and tax credits of the partnerships; however, Fannie Mae's ability to control the activities of the partnerships is limited. We currently record the amount of our investment in these partnerships as an asset on our balance sheet and recognize our share of partnership income or losses in our income statement. If an investment grade third party guarantees the return on these investments, we account for the investments using the effective yield method according to Emerging Issues Task Force Issue No. 94-1, *Accounting for Tax Benefits Resulting from Investments in Affordable Housing Projects.* Under this method, we recognize tax credits as they are allocated to us and amortize the initial cost of the investment to provide a level yield over the expected investment term. We recognize both the tax credits and the amortization of the investment, net of taxes, in the provision for federal income taxes.

Our investment balance of $4.7 billion and $4.3 billion at June 30, 2004 and December 31, 2003, respectively, plus the risk of recapture of tax credits previously recognized on these investments represents our maximum exposure to loss. We believe the risk of recapture of previously recognized tax credits is minimal. Our exposure to loss on these partnerships is mitigated by the strength of our investment sponsors and third party asset managers as well as the condition and financial performance of the underlying properties. In certain of these partnerships, our exposure to loss is further mitigated by a guaranteed economic return from investment grade counterparties.

Other-Than-Temporary Impairment

In the second quarter of 2004, OFHEO directed Fannie Mae to incorporate additional criteria into our process for estimating when other-than-temporary impairment has occurred on non-agency securities. After meeting with OFHEO staff to discuss the implementation of its directive and to refine the prescribed estimation process, we modified our process for identifying and recognizing other-than-temporary impairment on all of Fannie Mae's non-agency securities, including manufactured housing and certain asset-backed securities, effective April 1, 2004. In accordance with the provisions of Accounting Principles Board Opinion No. 20, *Accounting Changes* ("APB 20"), we accounted for this change prospectively as a change in accounting estimate, which resulted in the additional recognition of pre-tax other-than-temporary impairment expense of $265 million on certain manufactured housing and asset-backed securities in the second quarter of 2004 and reduced diluted EPS by $.18 per share for the three and six-month periods ended June 30, 2004.

We estimate other-than-temporary impairment guidance in accordance with the guidance provided in FAS 115, SEC Staff Accounting Bulletin No. 59, *Noncurrent Marketable Equity Securities* ("SAB 59") and EITF 03-1,*The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments* ("EITF 03-1"). Prior to the April 1, 2004 modification of our estimation process, we generally recognized other-than-temporary impairment on our investments in debt securities when we determined that it was probable that we would be unable to collect all of the contractual principal and interest cash flows based on ongoing monitoring of our securities, extensive analysis, and consideration of the facts and circumstances related to each specific security, such as our ability and intent to hold the security to recover its value and the probability, extent, and timing of a valuation recovery.

In addition to the estimation process described above, we now apply a series of objective tests to recognize other-than-temporary impairment that include the current credit ratings of the security and the extent to which the fair value is below our current book value. We will continue to rigorously monitor all of our securities for potential other-than-temporary impairment. As we have previously done, at the end of each quarter we will perform a detailed analysis of both held-to-maturity and available-for-sale non-agency securities in our mortgage and nonmortgage investment portfolios that have unrealized losses to assess whether the losses are other than temporary. We will rely primarily on quoted market prices to estimate the fair value of our securities and determine the amount of unrealized losses.

When a held-to-maturity or available-for sale security has an unrealized loss that is deemed to be other than temporary, we reduce the book value of the security to its current market value and recognize the decline as other-than-temporary impairment expense and include in our income statement as a component of fee and other income. Any unrealized gains or losses on available-for-sale securities are reflected in stockholders' equity as a component of accumulated other comprehensive income ("AOCI").

Other-than-temporary impairment expense on non-agency securities totaled $265 million and $297 million in the second quarter and the first six months of 2004, respectively, which were primarily related to investments in manufactured housing securities included in our mortgage portfolio. We recorded other-than-temporary impairment expense on non-agency securities of $89 million and $165 million in the second quarter and the first six months of 2003, primarily related to investments in nonmortgage securities. These other-than-temporary impairment expense amounts impact the results of our Portfolio Investment business.

Statement of Position (SOP) 03-3, Accounting for Certain Loans or Debt Securities Acquired in a Transfer

In December 2003, the Accounting Standards Executive Committee ("AcSEC") of the AICPA issued Statement of Position 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer* ("SOP 03-3"). SOP 03-3 applies to acquired loans and debt securities where there has been evidence of deterioration in credit quality at the date of purchase and for which it is probable that the investor will not be able to collect all contractually required payments. It addresses the accounting for differences between the contractual cash flows of acquired loans and the cash flows expected to be collected from an investor's initial investment in loans acquired in a transfer if those differences are attributable, at least in part, to credit quality.

SOP 03-3 requires purchased loans and debt securities within its scope to be initially recorded at fair value and prohibits the recording of a valuation allowance at the date of purchase. It limits the yield that may be accreted as interest income on such loans to the excess of an investor's estimate of undiscounted expected principal, interest, and other cash flows from the loan over the investor's initial investment in the loan. Subsequent increases in estimated future cash flows to be collected would be recognized prospectively in interest income through a yield adjustment over the remaining life of the loan. Decreases in estimated future cash flows to be collected would be recognized as an impairment expense or valuation allowance. SOP 03-3 primarily applies prospectively to loans acquired in fiscal years beginning after December 15, 2004. We are evaluating the effect of the adoption of SOP 03-3 on our financial position and results of operations.

3. Mortgage Portfolio, Net

We include mortgage loans and securities backed by loans in our mortgage portfolio, net. We classify and account for mortgage loans in our mortgage portfolio as either held-for-investment or held-for-sale. We classify and account for MBS and other mortgage-related securities in our mortgage portfolio as either held-to-maturity or available-for-sale. The following table shows the gross unrealized gains and losses and fair values of mortgage-related securities in our portfolio at June 30, 2004 and December 31, 2003.

	June 30, 2004			
	Amortized Cost[(1)]	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(Dollars in millions)			
Held-to-maturity portfolio	**$452,741**	**$6,600**	**$(4,829)**	**$454,512**
Available-for-sale portfolio	**197,879**	**2,468**	**(1,375)**	**198,972**
Total	**$650,620**	**$9,068**	**$(6,204)**	**$653,484**

	December 31, 2003			
	Amortized Cost[(1)]	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Held-to-maturity portfolio	$475,152	$12,403	$(1,461)	$486,094
Available-for-sale portfolio	187,295	4,203	(703)	190,795
Total	$662,447	$16,606	$(2,164)	$676,889

(1) Amortized cost includes unamortized premiums, discounts, and deferred price adjustments.

The fair value of our mortgage-related securities will change from period to period with changes in interest rates and credit performance. We recorded other-than-temporary impairment expense on certain mortgage-related securities in our portfolio—all of which were from investments in manufactured housing securities—of $250 million and $261 million for the three and six-month periods ended June 30, 2004, respectively, the majority of which related to the change in our other-than-temporary impairment estimation process described in "Note 2—Recently Adopted or Pending Changes in Accounting Standards or Estimates." We recorded other-than-temporary impairment on investments in mortgage-related securities of $5 million and $72 million for the three and six-month periods ended June 30, 2003, respectively.

Based on our process at June 30, 2004 of recognizing other-than-temporary impairment, we believe that the majority of the $157 million of gross unrealized losses at June 30, 2004 were not other than temporary because the decline in market value was primarily attributable to changes in interest rates and not credit quality, and we have the ability and intent to hold the securities until a recovery of fair value. Subsequent to June 30, 2004, there were additional credit downgrades of certain manufactured housing securities that we own, which may result in the recognition of additional other-than-temporary impairment expense based on our revised estimation process.

The following table shows the gross realized gains and losses and proceeds from the sale of MBS and other mortgage-related securities classified as available-for-sale for the three and six-month periods ended June 30, 2004 and 2003.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	**2003**	**2004**	**2003**
	(Dollars in millions)			
Gross realized gains	**$ 61**	$ 100	**$ 125**	$ 112
Gross realized losses	**47**	1	**90**	2
Total proceeds	**4,184**	5,610	**8,594**	6,923

We transferred $1 million and $7 billion of mortgage-related securities classified as available-for-sale to held-to-maturity, which is permitted under FAS 115, during the three months ended June 30, 2004 and 2003, respectively and $358 million and $7 billion of mortgage related securities for the six months ended June 30, 2004 and 2003, respectively.

4. Allowance for Loan Losses and Guaranty Liability for MBS

We maintain a separate allowance for loan losses for our mortgage portfolio as well as a guaranty liability for our guaranty of MBS. The following table summarizes changes during the three and six-month periods ended June 30, 2004 and 2003.

	Three Months Ended June 30, 2004			Three Months Ended June 30, 2003		
	Allowance for Loan Losses	Guaranty Liability for MBS	Combined Allowance for Loan Losses and Guaranty Liability for MBS	Allowance for Loan Losses	Guaranty Liability for MBS	Combined Allowance for Loan Losses and Guaranty Liability for MBS
	(Dollars in millions)					
Balance at March 31,	**$85**	**$710**	**$795**	$79	$729	$808
Provision	**(2)**	**(10)**	**(12)**	6	20	26
Charge-offs	**(3)**	**(23)**	**(26)**	(2)	(24)	(26)
Balance at June 30,	**$80**	**$677**	**$757**	$83	$725	$808

	Six Months Ended June 30, 2004			Six Months Ended June 30, 2003		
	Allowance for Loan Losses	Guaranty Liability for MBS	Combined Allowance for Loan Losses and Guaranty Liability for MBS	Allowance for Loan Losses	Guaranty Liability for MBS	Combined Allowance for Loan Losses and Guaranty Liability for MBS
Balance at January 1,	**$85**	**$712**	**$797**	$79	$729	$808
Provision	**1**	**19**	**20**	8	41	49
Charge-offs	**(6)**	**(54)**	**(60)**	(4)	(45)	(49)
Balance at June 30,	**$80**	**$677**	**$757**	$83	$725	$808

5. Financial Guarantees

Our primary financial guarantee arrangements result from mortgage loan securitizations in which Fannie Mae issues MBS and guarantees the timely payment of principal and interest on the MBS to investors in exchange for a guaranty fee. We may also assist state and local governmental entities in issuing taxable and tax-exempt housing bonds to obtain funding for low- and moderate-income multifamily housing by providing credit enhancements and liquidity support for the bonds. Under these agreements, we provide contractual assurance of payment of the bonds, which improves the bond ratings and thereby results in lower-cost financing for multifamily housing.

Fannie Mae issues MBS through the process of securitization. We receive a guaranty fee and float for assuming the credit risk on the loans underlying the MBS pool and for our unconditional guarantee of the timely payment of principal and interest to MBS investors. The guaranty fee we receive varies, depending on factors such as the risk profile of the loans securitized as well as the level of credit risk we assume. We are ultimately responsible for guaranteeing timely payment of principal and interest to investors whether or not we share primary default risk on loans underlying outstanding MBS. Thus, we have both a noncontingent obligation related to the compensation we receive for assuming the credit risk on loans underlying an MBS pool and a contingent obligation related to our guarantee of payment in the event the mortgages underlying our outstanding MBS do not perform according to contractual terms.

Under FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* ("FIN 45"), we are required to recognize the fair value of guarantees issued or modified after December 31, 2002 as a noncontingent guaranty obligation. FIN 45 applies primarily to MBS issued and guaranteed by Fannie Mae, acting as trustee, to investors other than Fannie Mae on or after January 1, 2003. We also accrue a liability on our balance sheet for our contingent guaranty obligation based on the probability that mortgages underlying our outstanding MBS will not perform according to contractual terms as detailed in "Note 4—Allowance for Loan Losses and Guaranty Liability for MBS."

Outstanding MBS and credit enhancement arrangements totaled $1,374 billion and $1,314 billion at June 30, 2004 and December 31, 2003, respectively, representing our maximum potential exposure to loss. However, we believe the maximum exposure is not representative of Fannie Mae's actual potential loss based on our historical loss experience. We recorded, as part of our combined allowance for loan losses and guaranty liability for MBS, a guaranty liability of $677 million and $712 million at June 30, 2004 and December 31, 2003, respectively, based on the probable losses inherent in the mortgages underlying outstanding MBS as well as MBS included in our mortgage portfolio.

We recorded a guaranty fee obligation under FIN 45 related to our noncontingent obligation of $5.810 billion at June 30, 2004 and a corresponding guaranty fee receivable of the same amount, compared with $4.391 billion at December 31, 2003. When we record the guaranty fee obligation under FIN 45, we also record a corresponding asset on our balance sheet because we are compensated for assuming the guaranty obligation. We impute and recognize interest income on the guaranty fee receivable using an imputed interest rate calculated based on the present value of the estimated future cash flows of the guaranty fee receivable. We include the imputed interest income in our income statement as a component of "Guaranty fee income." We reduce the guaranty receivable and related interest receivable as we receive cash compensation for our guaranty, which also reduces our guaranty obligation. Accordingly, we amortize the guaranty fee obligation by an amount corresponding to the reduction in the guaranty fee receivable and recognize the reduction of the guaranty fee obligation in our income statement as "Guaranty fee income." Hence, the guaranty fee income reported in our income statement under FIN 45 equals the cash received on our guaranty obligation and is comparable to guaranty fee income reported prior to the application of FIN 45.

The following table shows changes in our noncontingent guaranty fee obligation during the six months ended June 30, 2004 and 2003.

	2004	2003
	(Dollars in millions)	
Balance at January 1,	**$4,391**	$ —
Fair value of newly-issued guaranty obligations	**1,755**	1,829
Amortization of guaranty obligation into guaranty fee income[1]	**(336)**	(39)
Balance at June 30,	**$5,810**	$1,790

[1] The guaranty fee obligation is amortized by an amount corresponding to the reduction in the guaranty fee receivable.

We recognized as a component of guaranty fee income imputed interest on the guaranty fee receivable of $159 million and $18 million for the three months ended June 30, 2004 and 2003, respectively, and $292 million and $21 million for the six months ended June 30, 2004 and 2003, respectively. We amortized into guaranty fee income $174 million and $35 million of the related guaranty fee obligation for the three months ended June 30, 2004 and 2003, respectively, and $336 million and $39 million for the six months ended June 30, 2004 and 2003, respectively.

6. Nonmortgage Investments

We classify and account for nonmortgage investments as either available-for-sale or held-to-maturity in accordance with FAS 115. The following table shows the classification of these securities along with the gross unrealized gains and losses and fair values at June 30, 2004 and December 31, 2003.

	June 30, 2004			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(Dollars in millions)			
Held-to-maturity portfolio	**$ 5,516**	**$ —**	**$ —**	**$ 5,516**
Available-for-sale portfolio	**43,376**	**47**	**(66)**	**43,357**
Total	**$48,892**	**$ 47**	**$(66)**	**$48,873**

	December 31, 2003			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Held-to-maturity portfolio	$ 6,822	$—	$ —	$ 6,822
Available-for-sale portfolio	52,605	89	(23)	52,671
Total	$59,427	$89	$(23)	$59,493

The following table shows the amortized cost, fair value, and yield of nonmortgage investments by investment classification and remaining maturity as well as the amortized cost, fair value, and yield of our asset-backed securities at June 30, 2004 and December 31, 2003.

	June 30, 2004			December 31, 2003		
	Amortized Cost[1]	Fair Value	Yield	Amortized Cost[1]	Fair Value	Yield
	(Dollars in millions)					
Held-to-maturity:						
Due within one year	**$ 5,516**	**$ 5,516**	**1.12%**	$ 6,822	$ 6,822	1.10%
Total held-to-maturity	**5,516**	**5,516**	**1.12**	6,822	6,822	1.10
Available-for-sale:						
Due within one year	**8,971**	**8,984**	**1.75**	19,447	19,464	1.38
Due after one year through five years	**8,161**	**8,142**	**1.84**	6,179	6,206	1.66
Due after five through ten years	**—**	**—**	**—**	101	101	1.27
	17,132	**17,126**	**1.79**	25,727	25,771	1.45
Asset-backed securities[2]	**26,244**	**26,231**	**1.55**	26,878	26,900	1.56
Total available-for-sale	**43,376**	**43,357**		52,605	52,671	
Total	**$48,892**	**$48,873**	**1.59%**	$59,427	$59,493	1.46%

(1) Amortized cost includes unamortized premiums, discounts, and other deferred price adjustments.

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

We recognized other-than-temporary impairment expense on certain asset-backed securities in our nonmortgage investment portfolio of $15 million in the second quarter of 2004, resulting in other-than-temporary impairment on nonmortgage investment securities of $37 million for the six months ended June 30, 2004. We recorded other-than-temporary impairment on certain nonmortgage investment securities of $84 million and $93 million for the three and six-month periods ended June 30, 2003, respectively.

We did not record any gross realized gains or losses from the sale of nonmortgage securities classified as available-for-sale for the three months ended June 30, 2004 and 2003 or any gross realized losses for the six months ended June 30, 2004 and 2003. We recorded gross realized gains from sales of $2 million and $3 million for the six months ended June 30, 2004 and 2003, respectively.

7. Earnings per Common Share

The following table shows the computation of basic and diluted earnings per common share.

	Three Months Ended June 30,				Six Months Ended June 30,			
	2004		2003		2004		2003	
	Basic	Diluted	Basic	Diluted	Basic	Diluted	Basic	Diluted
	(Dollars and shares in millions, except per share amounts)							
Net income	**$1,112**	**$1,112**	$1,102	$1,102	**$3,012**	**$3,012**	$3,042	$3,042
Preferred stock dividends and issuance costs on redemptions	**(40)**	**(40)**	(34)	(34)	**(84)**	**(84)**	(64)	(64)
Net income available to common stockholders	**$1,072**	**$1,072**	$1,068	$1,068	**$2,928**	**$2,928**	$2,978	$2,978
Weighted average common shares outstanding	**969**	**969**	979	979	**970**	**970**	983	983
Dilutive potential common shares[1]	**—**	**1**	—	3	**—**	**3**	—	4
Average number of common shares outstanding used to calculate earnings per common share	**969**	**970**	979	982	**970**	**973**	983	987
Net earnings per common share	**$ 1.11**	**$ 1.10**	$ 1.09	$ 1.09	**$ 3.02**	**$ 3.01**	$ 3.03	$ 3.02

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

8. Employee Retirement Benefits

The following table shows components of our net periodic benefit cost for our pension and postretirement benefit plans for the three and six-month periods ended June 30, 2004 and 2003. The net periodic benefit expense for each period is calculated based on assumptions at the end of the prior year.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	**2004**	2003
	(Dollars in millions)			
Service cost	**$13**	$10	**$ 27**	$ 22
Interest cost	**12**	10	**24**	20
Expected return on plan assets	**(7)**	(5)	**(13)**	(10)
Other	**2**	1	**5**	3
Net periodic benefit expense recognized	**$20**	$16	**$ 43**	$ 35

While we are not required to make a minimum contribution to our qualified pension plan, we previously disclosed that we anticipated making a discretionary tax-deductible contribution of up to $20 million in 2004. We made an actual contribution to our qualified pension plan of $42 million during the second quarter of 2004. We expect to make another discretionary contribution in the second half of 2004 to the extent that it is tax deductible; however, we have not yet determined the contribution amount.

9. Line of Business Reporting

We have two lines of business that generate revenue: *Portfolio Investment* business and *Credit Guaranty* business. The following tables reconcile our line of business core business earnings to our reported income for the three and six-month periods ended June 30, 2004 and 2003.

	Three Months Ended June 30, 2004				
	Portfolio Investment	Credit Guaranty	Total Core Business Earnings	Reconciling Items Related to Purchased Options	Reported Results
	(Dollars in millions)				
Net interest income	**$2,944**	**$ 169**	**$3,113**	**$ —**	**$3,113**
Purchased options amortization expense	**(773)**	**—**	**(773)**	**773[2]**	**—**
Core net interest income	**2,171**	**169**	**2,340**	**773**	**3,113**
Guaranty fee income (expense)	**(421)**	**1,078**	**657**	**—**	**657**
Fee and other income (expense), net	**(144)**	**(26)**	**(170)**	**—**	**(170)**
Credit-related income (expense)[1]	**—**	**21**	**21**	**—**	**21**
Administrative expenses	**(119)**	**(265)**	**(384)**	**—**	**(384)**
Purchased options expense under FAS 133	**—**	**—**	**—**	**(1,980)[3]**	**(1,980)**
Debt extinguishments gain (loss), net	**24**	**—**	**24**	**—**	**24**
Income before federal income taxes	**1,511**	**977**	**2,488**	**(1,207)**	**1,281**
Provision for federal income taxes	**(430)**	**(162)**	**(592)**	**423[4]**	**(169)**
Net income	**$1,081**	**$ 815**	**$1,896**	**$ (784)**	**$1,112**

	Three Months Ended June 30, 2003				
	Portfolio Investment	Credit Guaranty	Total Core Business Earnings	Reconciling Items Related to Purchased Options	Reported Results
Net interest income	$3,280	$ 221	$3,501	$ —	$3,501
Purchased options amortization expense	(716)	—	(716)	716[2]	—
Core net interest income	2,564	221	2,785	716	3,501
Guaranty fee income (expense)	(404)	1,036	632	—	632
Fee and other income (expense), net	231	1	232	—	232
Credit-related income (expense)[1]	—	(23)	(23)	—	(23)
Administrative expenses	(103)	(251)	(354)	—	(354)
Purchased options expense under FAS 133	—	—	—	(1,883)[3]	(1,883)
Debt extinguishments gain (loss), net	(740)	—	(740)	—	(740)
Income before federal income taxes	1,548	984	2,532	(1,167)	1,365
Provision for federal income taxes	(454)	(218)	(672)	409[4]	(263)
Net income	$1,094	$ 766	$1,860	$ (758)	$1,102

	Six Months Ended June 30, 2004				
	Portfolio Investment	**Credit Guaranty**	**Total Core Business Earnings**	**Reconciling Items Related to Purchased Options**	**Reported Results**
			(Dollars in millions)		
Net interest income	**$ 5,989**	**$ 320**	**$ 6,309**	**$ —**	**$ 6,309**
Purchased options amortization expense	**(1,548)**	**—**	**(1,548)**	**1,548**[(2)]	**—**
Core net interest income	**4,441**	**320**	**4,761**	**1,548**	**6,309**
Guaranty fee income (expense)	**(884)**	**2,278**	**1,394**	**—**	**1,394**
Fee and other income (expense), net	**(102)**	**(66)**	**(168)**	**—**	**(168)**
Credit-related income (expense)[(1)]	**—**	**13**	**13**	**—**	**13**
Administrative expenses	**(232)**	**(535)**	**(767)**	**—**	**(767)**
Purchased options expense under FAS 133	**—**	**—**	**—**	**(2,939)**[(3)]	**(2,939)**
Debt extinguishments gain (loss), net	**(3)**	**—**	**(3)**	**—**	**(3)**
Income before federal income taxes	**3,220**	**2,010**	**5,230**	**(1,391)**	**3,839**
Provision for federal income taxes	**(937)**	**(377)**	**(1,314)**	**487**[(4)]	**(827)**
Net income	**$ 2,283**	**$1,633**	**$ 3,916**	**$ (904)**	**$ 3,012**

	Six Months Ended June 30, 2003				
	Portfolio Investment	**Credit Guaranty**	**Total Core Business Earnings**	**Reconciling Items Related to Purchased Options**	**Reported Results**
Net interest income	$ 6,466	$ 403	$ 6,869	$ —	$ 6,869
Purchased options amortization expense	(1,481)	—	(1,481)	1,481[(2)]	—
Core net interest income	4,985	403	5,388	1,481	6,869
Guaranty fee income (expense)	(807)	1,986	1,179	—	1,179
Fee and other income (expense), net	353	(8)	345	—	345
Credit-related income (expense)[(1)]	—	(43)	(43)	—	(43)
Administrative expenses	(204)	(494)	(698)	—	(698)
Purchased options expense under FAS 133	—	—	—	(2,508)[(3)]	(2,508)
Debt extinguishments gain (loss), net	(1,132)	—	(1,132)	—	(1,132)
Income before federal income taxes	3,195	1,844	5,039	(1,027)	4,012
Provision for federal income taxes	(938)	(391)	(1,329)	359[(4)]	(970)
Net income	$ 2,257	$1,453	$ 3,710	$ (668)	$ 3,042

(1) Credit-related income (expense) includes the income statement line items "Provision for losses" and "Foreclosed property income."

(2) Represents the amortization of purchased options premiums that we allocate to interest expense over the original expected life of the options. We include this amount in core business earnings instead of recording changes in the time value of purchased options because this treatment is more consistent with the accounting for the embedded options in our callable debt and the vast majority of our mortgages.

(3) Represents changes in the fair value of the time value of purchased options recorded in accordance with FAS 133. We exclude this amount from our core business earnings measure because the period-to-period fluctuations in the time value portion of our options do not reflect the economics of our current risk management strategy, which generally is to hold our purchased options to maturity or exercise date. Consequently, we do not expect to realize the period-to-period fluctuations in time value.

(4) Represents the net federal income tax effect of core business earnings adjustments based on the applicable federal income tax rate of 35 percent.

The only difference between core business earnings and reported net income relates to the Financial Accounting Standard No. 133, *Accounting for Derivative Instruments and Hedging Activities* ("FAS 133") accounting treatment for purchased options. Core business earnings does not exclude any other accounting effects related to the application of FAS 133 or any other non-FAS 133 related adjustments. This difference only affects our *Portfolio Investment* business. Core business earnings and reported net income are the same for our *Credit Guaranty* business.

The Portfolio Investment business represented $959 billion, or 97 percent of total assets, at June 30, 2004 and $980 billion, or 97 percent of total assets, at December 31, 2003.

10. Derivative Instruments and Hedging Activities

Under FAS 133, we recognize all derivatives as either assets or liabilities on the balance sheet at their fair value. FAS 133 requires that all derivatives be marked to market through earnings unless the derivative is designated and qualifies for hedge accounting. Subject to certain qualifying conditions, we may designate a derivative as either a hedge of the cash flows of a variable-rate instrument or anticipated transaction (cash flow hedge) or a hedge of the fair value of a fixed-rate instrument (fair value hedge). For a derivative designated as a cash flow hedge, we report fair value gains or losses in a separate component of AOCI, net of deferred taxes, in stockholders' equity to the extent the hedge is effective. We recognize these fair value gains or losses in earnings during the period(s) in which the hedged cash flow affects earnings. For a derivative designated as a fair value hedge, we report fair value gains or losses on the derivative in earnings along with fair value gains or losses on the hedged item attributable to the risk being hedged. For a derivative not designated as a hedge, not qualifying as a hedge, or components of a derivative that are excluded from any hedge effectiveness assessment, we report fair value gains and losses through earnings.

We traditionally have designated and accounted for substantially all of our derivatives as cash flow or fair value hedges. However, we may from time to time terminate, discontinue, or change the designation of the hedging relationship for certain derivative instruments for interest rate risk management purposes. Our interest rate risk management actions are driven by the economics of the transaction and the market environment that exists at that time and generally not by the hedge accounting designations. Regardless of the FAS 133 hedge designation, virtually all of Fannie Mae's derivatives serve as economic hedges because they reduce our interest rate risk by helping us maintain a relative balance between the cash flows of our mortgage assets and the liabilities used to fund those assets through time and across various interest rate scenarios. We do not take speculative positions with derivatives.

FAS 133 imposes hedge effectiveness, documentation, and testing criteria that must be met to qualify for hedge accounting. Beginning January 2004, as part of our routine and ongoing assessment of Fannie Mae's accounting and business practices, we expanded our classification of derivatives not designated for hedge accounting under FAS 133. Even though these derivatives are not designated for hedge accounting, they are subject to Fannie Mae's risk management controls that govern their use, purpose, credit exposure, and financial reporting. We refer to this category of derivatives as "other risk management derivatives." This additional classification provides our Portfolio Investment business with increased flexibility and operational efficiency in executing risk management actions. The accounting effect is that we are required under FAS 133 to report changes in the fair value of our other risk management derivatives in earnings. However, because these transactions are economically matched, we anticipate that the gains and losses will largely offset and not have a material impact on our reported net income or core business earnings.

The following table shows the outstanding notional balances of our derivative instruments and mortgage commitments accounted for as derivatives at June 30, 2004 and December 31, 2003 based on the hedge classification. We had no open hedge positions on the anticipatory issuance of debt at June 30, 2004.

However, we had open commitment positions for the forecasted purchase of mortgage loans or mortgage-related securities with a maximum length of time over which we were hedging of 90 days at June 30, 2004.

	June 30, 2004				December 31, 2003			
	Cash Flow Hedges	Fair Value Hedges	Other Risk Management Derivatives	Total	Cash Flow Hedges	Fair Value Hedges	Other Risk Management Derivatives	Total
	(Dollars in millions)							
Derivative instruments:								
Interest rate swaps:								
Pay-fixed	**$261,036**	**$ 33,878**	**$ 5,700**	**$ 300,614**	$300,536	$ 34,566	$ —	$ 335,102
Receive-fixed	**82,355**	**98,668**	**6,037**	**187,060**	148,923	53,556	—	202,479
Basis	**43,569**	**—**	**2,381**	**45,950**	32,260	—	—	32,260
Forward starting	**30,710**	**596**	**—**	**31,306**	30,475	—	—	30,475
Interest rate caps	**129,950**	**—**	**—**	**129,950**	130,350	—	—	130,350
Swaptions:								
Pay-fixed	**156,855**	**—**	**—**	**156,855**	163,980	—	—	163,980
Receive-fixed	**81,271**	**62,724**	**—**	**143,995**	64,221	76,974	—	141,195
Other[1]	**921**	**4,893**	**33**	**5,847**	854	3,858	43	4,755
Total	**$786,667**	**$200,759**	**$14,151**	**$1,001,577**	$871,599	$168,954	$ 43	$1,040,596
Mortgage commitments:[2]								
Forward contracts to purchase whole loans and mortgage-related securities	**$ 16,948**	**$ —**	**$10,807**	**$ 27,755**	$ 4,953	$ —	$13,419	$ 18,372
Forward contracts to sell mortgage-related securities	**1,788**	**—**	**13,359**	**15,147**	2,050	4,669	13,401	20,120

(1) Includes foreign currency swaps and other derivative instruments that provide a hedge against interest rate fluctuations.
(2) Effective with our July 1, 2003 adoption of FAS 149, mandatory mortgage purchase and sell commitments are accounted for as derivatives and recorded on Fannie Mae's balance sheet at fair value.

Excluding mortgage commitments accounted for as derivatives, we had $14 billion in outstanding notional amount of derivatives not designated for hedge accounting under FAS 133 at June 30, 2004, compared with $43 million at December 31, 2003. We recognized as a component of fee and other income a pre-tax net gain of $21 million and $8 million related to changes in the fair value of these derivatives for the three and six-month periods ended June 30, 2004, respectively. We expect the volume of activity in our other risk management derivatives to fluctuate from period to period based on changes in our overall portfolio characteristics.

The following reconciliation shows AOCI activity, net of taxes, for the six months ended June 30, 2004 related to all contracts accounted for as derivatives:

	AOCI Activity
	(Dollars in millions)
Impact on AOCI (net of taxes):	
Balance at December 31, 2003	**$(14,650)**
Gains on cash flow hedges related to derivatives, net	**707**
Losses on cash flow hedges related to mortgage commitments, net	**(390)**
Reclassifications to earnings, net	**3,305**
Balance at June 30, 2004	**$(11,028)**
Balance related to:	
Losses on cash flow hedges related to derivatives, net	**$ (8,266)**
Losses on cash flow hedges related to mortgage commitments, net	**(2,762)**
	$(11,028)

The time value portion of purchased options excluded from the assessment of hedge effectiveness for derivatives designated as cash flow hedges resulted in pre-tax losses of $1.6 billion and $1.4 billion for the three months ended June 30, 2004 and 2003, respectively, and $2.4 billion and $1.8 billion for the six months ended June 30, 2004 and 2003, respectively. The time value portion of purchased options excluded from the assessment of hedge effectiveness for derivatives designated as fair value hedges resulted in pre-tax losses of $367 million and $507 million for the three months ended June 30, 2004 and 2003, respectively, and $573 million and $703 million for the six months ended June 30, 2004 and 2003, respectively. These amounts are recorded in our income statement under purchased options expense.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Quantitative and qualitative disclosure about market risk is set forth on pages 35 to 36 of this Form 10-Q under the caption "Management's Discussion and Analysis of Financial Condition and Results of Operations" and is incorporated herein by reference.

Item 4. Controls and Procedures

We maintain disclosure controls and procedures that are designed to provide reasonable assurance that material information and other information required under the securities laws to be disclosed is recorded, processed, summarized and reported on a timely basis. We carried out an evaluation, under the supervision and with the participation of our Chief Executive Officer and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures as of the end of the period covered by this quarterly report. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective in providing such reasonable assurance as of the end of the period covered by this quarterly report. Additionally, there were no changes in our internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II—OTHER INFORMATION

Item 1. Legal Proceedings

In the ordinary course of business, we are involved in legal proceedings that arise in connection with properties acquired either through foreclosure on properties securing delinquent mortgage loans we own or by receiving deeds to those properties in lieu of foreclosure. For example, claims related to possible tort liability arise from time to time, primarily in the case of single-family real estate owned properties ("REO").

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

Fannie Mae is the subject of a lawsuit filed on September 13, 2002, as a class action in the United States District Court for the District of Columbia seeking declaratory and injunctive relief, as well as statutory and punitive damages. The complaint identified as a class all minority borrowers who have been denied loans as a result of Fannie Mae's automated underwriting systems ("AUS"). The lawsuit alleges that Fannie Mae's AUS unlawfully fails to give adverse action notices to borrowers who are not approved for the loans for which they apply, and unlawfully discriminates against minorities.

Fannie Mae moved to dismiss the complaint in its entirety based upon the pleadings and the court granted that motion in part and denied it in part. The court held that Fannie Mae did not have a legal obligation to provide adverse action notices and the court declined the plaintiff's motion to reconsider that decision or certify it for appeal. The court held that the plaintiff had met the minimal requirements for pleading the discrimination claim, but that plaintiff must demonstrate that she was qualified to obtain a loan at the interest rate she requested. Fannie Mae then moved for summary judgment against the plaintiff based upon undisputed record evidence that plaintiff has not demonstrated that she was injured because she has not proven that she was qualified to obtain a loan at the interest rate she requested. Plaintiff obtained from the court leave to obtain additional discovery limited to deposing Fannie Mae's experts, and retaining her own experts. Plaintiff and Fannie Mae will file responsive pleadings once discovery is complete.

Fannie Mae is the subject of a lawsuit filed on June 24, 2004, as a class action in the United States District Court for the Eastern District of Texas seeking injunctive relief, as well as statutory and punitive damages. The complaint identified as a class low- and moderate-income apartment building developers who maintained uninvested escrow accounts with Fannie Mae for the benefit of the Department of Housing and Urban Development ("HUD") and the housing project. The lawsuit alleges that Fannie Mae unlawfully retained interest on the escrow account balances, and has failed to account for use of the interest.

Fannie Mae filed two motions in this matter, and plaintiffs have not filed responsive pleadings as of this date. First, Fannie Mae moved to dismiss the complaint in its entirety based upon the pleadings. Fannie Mae's position is that the legal duty plaintiffs allege Fannie Mae to have violated does not exist. Second, Fannie Mae moved for summary judgment against plaintiffs based upon undisputed record evidence that plaintiffs' claims are time-barred by the applicable statute of limitations, or, in the alternative, that plaintiffs are barred by the legal doctrines of mitigation and avoidable consequences.

Claims and proceedings of all types are subject to many uncertain factors that generally cannot be predicted with assurance. However, in the case of the legal proceedings and claims that are currently pending against us, management believes that their outcome will not have a material adverse effect on our financial condition, results of operations, or cashflows.

Item 2. Changes in Securities, Use of Proceeds and Issuer Purchases of Equity Securities

The securities Fannie Mae issues are "exempted securities" under laws administered by the SEC to the same extent as securities that are obligations of, or are guaranteed as to principal and interest by, the United States. As a result, Fannie Mae does not file registration statements with the SEC with respect to offerings of Fannie Mae securities.

During the quarter ended June 30, 2004, Fannie Mae issued 233,417 shares of common stock upon the exercise of stock options for an aggregate exercise price of approximately $9.5 million and, in consideration for services rendered or to be rendered, granted options to purchase an aggregate of 57,244 shares of common stock at a weighted average exercise price of $68.05 per share, and awarded 66,413 shares of common stock as "restricted stock" under the Fannie Mae Stock Compensation Plan of 2003. Options granted under the Stock Compensation Plan typically vest 25 percent per year beginning on the first anniversary of the date of grant, and expire ten years after grant. All options and shares of restricted stock have been granted to persons who are employees or directors of Fannie Mae. In addition, during the quarter ended June 30, 2004, Fannie Mae issued 3,465 shares of common stock under the performance share program, a program that compensates senior management for meeting financial and non-financial performance objectives over a three-year period. Objectives are set at the beginning of the three-year period, and the Compensation Committee of the Board of Directors determines achievement against the goals at the end of such period, setting the amount of the award at that time. The performance shares are then paid out over a two-year period.

The following table shows shares of Fannie Mae common stock we repurchased during the second quarter of 2004.

Issuer Purchases of Equity Securities
(Shares in millions)

For the 2004 Period:	Total Number of Shares Purchased[1]	Average Price Paid per Share[1]	Total Number of Shares Purchased as Part of Publicly Announced Program[2]	Maximum Number of Shares that May Yet Be Purchased Under the Program[3]
April 1-30	1.5	$72.78	1.5	59.5
May 1-31	1.0	68.48	1.0	58.5
June 1-30	.3	67.43	.3	58.0
Second quarter	2.8	$70.62	2.8	58.0

(1) Consists of shares purchased pursuant to Fannie Mae's publicly announced share repurchase program in open market transactions effected in compliance with SEC Rule 10b-18, and approximately 9,700 shares repurchased in the second quarter of 2004 outside of Fannie Mae's repurchase program at fair market value from the recipients of restricted stock grants in connection with tax withholding obligations upon vesting of their shares.

(2) On January 21, 2003, Fannie Mae publicly announced the approval by the Board of Directors of a share repurchase program under which up to 49.4 million shares (5 percent of common shares outstanding as of December 31, 2002) could be purchased by Fannie Mae (the "General Repurchase Authority"). At the same time, the Board approved the repurchase of additional shares to offset stock issued (or expected to be issued) under Fannie Mae's employee benefit plans. Repurchased shares are first offset against any issuances of stock under Fannie Mae's employee benefit plans. To the extent that we repurchase more shares than have been issued under our plans, the excess number of shares is deducted from the 49.4 million shares approved for repurchase under the General Repurchase Authority. This share repurchase program replaced the repurchase program adopted in 1996 and has no specified expiration date. Of the 2.8 million shares repurchased in the second quarter of 2004, .4 million shares were repurchased to offset stock issued under Fannie Mae's employee benefit plans.

(3) Reflects the combined total of the maximum number of shares that may yet be purchased under the General Repurchase Authority and the number of shares that may be repurchased to offset stock issued pursuant to option, performance share, and certain other grants made under Fannie Mae's Stock Compensation Plan of 1993, the Stock Compensation Plan of 2003, and the Employee Stock Purchase Plan. See "Notes to Financial Statements—Note 9, Stock-Based Compensation Plans," in Fannie Mae's Annual Report on Form 10-K for the fiscal year ended December 31, 2003, for information about shares issued, or expected to be issued, under Fannie Mae's employee benefit plans. At the Annual Meeting of Shareholders on May 25, 2004, shareholders approved the amendment to the Fannie Mae Stock Purchase Plan to increase the number of shares available for issuance by 9 million shares. These shares have not yet been granted and are not included in the 58 million shares that may yet be purchased as of June 30, 2004.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Submission of Matters to a Vote of Security Holders

The shareholders of the company voted on four matters at the Annual Meeting of Shareholders held on May 25, 2004:

1. The election of 13 directors;
2. Ratification of the appointment of KPMG LLP as independent auditors for 2004;
3. Approval of an amendment to the Fannie Employee Stock Purchase Plan; and
4. A shareholder proposal to reinstate cumulative voting for directors.

The following persons were elected as directors of Fannie Mae by the respective votes indicated following their names:

	Votes For	Votes Withheld
Stephen B. Ashley	863,694,992	17,199,221
Kenneth M. Duberstein	829,636,459	51,257,754
Thomas P. Gerrity	846,413,458	34,480,755
J. Timothy Howard	847,111,322	33,782,891
Ann Korologos	862,288,730	18,605,483
Frederic V. Malek	846,653,632	34,240,581
Donald B. Marron	863,234,893	17,659,320
Daniel H. Mudd	854,153,712	26,740,501
Anne M. Mulcahy	851,043,179	29,851,034
Joe K. Pickett	851,085,970	29,808,243
Leslie Rahl	863,722,681	17,171,532
Franklin D. Raines	855,751,378	25,142,835
H. Patrick Swygert	855,973,206	24,921,007

In addition to the directors elected by the shareholders, the President of the United States has the authority to appoint five members of Fannie Mae's board. The terms of the five directors of our board who were previously appointed by the President expired on May 25, 2004, the date of our annual shareholders' meeting. Pursuant to our Charter Act, these five board positions will remain open unless and until the President names new appointees.

The ratification of KPMG LLP as independent auditors for 2004 was approved as follows:

Votes for ratification:	849,661,698
Votes against ratification:	25,197,785
Abstentions:	6,034,730

The amendment to the Fannie Mae Employee Stock Purchase Plan was approved as follows:

Votes for approval:	753,575,404
Votes against approval:	21,825,053
Abstentions:	5,796,262
Broker non-votes:	99,697,494

The shareholder proposal to reinstate cumulative voting for directors was defeated as follows:

Votes for reinstatement:	308,460,554
Votes against reinstatement:	457,323,542
Abstentions:	15,412,623
Broker non-votes:	99,697,494

Item 5. Other Information

Employment Agreements

Fannie Mae entered into new employment agreements with Franklin D. Raines, Daniel H. Mudd, and J. Timothy Howard in May 2004. Pursuant to Section 309(d) of the Federal National Mortgage Association Charter Act, as amended by the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (as so amended, the "Act"), 12 U.S.C. 1723a(d), provisions of the agreements relating to benefits upon termination of employment shall be effective only upon review and approval by the Director of OFHEO. The original agreements were filed with our quarterly report on Form 10-Q for the quarter ended March 31, 2004. On June 30, 2004, the agreements were amended. The amended agreements with Messrs. Raines, Mudd, and Howard are Exhibits 10.1, 10.2 and 10.3, respectively, to this Report. Certain provisions of the agreements remain subject to the review and approval of the Director of OFHEO.

Information about our Issuances of Debt Securities and MBS

The debt securities and MBS that Fannie Mae issues are "exempted securities" under laws administered by the SEC to the same extent as securities that are obligations of, or are guaranteed as to principal and interest by, the United States. As a result, Fannie Mae does not file registration statements with the SEC with respect to offerings of such securities, and prospectuses and other offering documents relating to these securities are not available on the SEC's EDGAR Web site.

Fannie Mae issues notes, bonds and other debt securities pursuant to a universal debt facility. Detailed information regarding our obligations under these securities is contained in an offering circular and supplements thereto, including supplements for individual issuances of debt securities, that may be found by visiting our Web site at www.fanniemae.com/markets/debtsearch.

Detailed information about the various MBS that we issue is contained in prospectuses and prospectus supplements that may be found on our Web site at www.fanniemae.com/mbs/index.jhtml.

We do not intend the internet addresses in the preceding paragraphs to be active links. Therefore, the information that appears on these Web sites is not incorporated into this Form 10-Q.

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

An index to exhibits has been filed as part of this Report beginning on page 68 and is incorporated herein by reference.

(b) Reports on Form 8-K

On April 19, 2004, we furnished a Current Report on Form 8-K reporting our earnings for the first quarter of fiscal year 2004, and certain other financial data, under Items 9 and 12.

On May 12, 2004, we furnished a Current Report on Form 8-K disclosing our quarterly business activity supplement for the first quarter of 2004, under Item 9.

On May 17, 2004, we furnished a Current Report on Form 8-K reporting selected financial information for the month of April 2004, under Item 9.

On June 16, 2004, we furnished a Current Report on Form 8-K reporting selected financial information for the month of May 2004, under Item 9.

No other reports on Form 8-K were furnished during the second quarter of 2004; however, we furnished the following report on Form 8-K subsequent to June 30, 2004:

On July 21, 2004, we furnished a Current Report on Form 8-K reporting our earnings for the second quarter of fiscal year 2004, and certain other financial data, under Items 9 and 12.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Federal National Mortgage Association

Date: August 9, 2004

By: /s/ J. TIMOTHY HOWARD

J. Timothy Howard
Vice Chairman and Chief Financial Officer

By: /s/ LEANNE G. SPENCER

Leanne G. Spencer
Senior Vice President and Controller

INDEX TO EXHIBITS

Exhibit 10.1	Employment Agreement between Fannie Mae and Franklin D. Raines.*
Exhibit 10.2	Employment Agreement between Fannie Mae and Daniel H. Mudd.*
Exhibit 10.3	Employment Agreement between Fannie Mae and J. Timothy Howard.*
Exhibit 31.1	Certification of CEO pursuant to Securities Exchange Act of 1934 Rule 13a-14
Exhibit 31.2	Certification of CFO pursuant to Securities Exchange Act of 1934 Rule 13a-14
Exhibit 32.1	Certification of CEO pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
Exhibit 32.2	Certification of CFO pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

* This exhibit is a management contract or compensatory plan or arrangement.

Exhibit 10.1

EMPLOYMENT AGREEMENT

between

FANNIE MAE

and

FRANKLIN D. RAINES

As Amended on June 30, 2004

TABLE OF CONTENTS

EMPLOYMENT AGREEMENT

THIS EMPLOYMENT AGREEMENT (this "Agreement") is between FANNIE MAE (the "Corporation") and FRANKLIN D. RAINES ("Employee").

WHEREAS, the Corporation and Employee are parties to an employment agreement dated as of May 21, 1998, which as extended provides for termination on June 30, 2004 (the "Existing Agreement");

WHEREAS, under the termination provisions of the Existing Agreement, which were approved by OFHEO, Employee is contractually entitled to certain compensation and benefits if, among other circumstances, Employee's employment is not extended; and

WHEREAS, Employee has successfully discharged his responsibilities under the Existing Agreement and has earned certain vested amounts, as described in his Existing Agreement, over the course of his employment;

NOW, THEREFORE, the Corporation and Employee agree as follows:

ARTICLE 1

DEFINITIONS

The following terms shall have the meanings set forth below:

Section 1.1. Agreement Term means the period of time beginning on the Effective Date and ending on June 30, 2007 or such later date as may be agreed to pursuant to Section 2.1.

Section 1.2. Annual Incentive Plan means the Federal National Mortgage Association Annual Incentive Plan as from time to time amended and in effect, or any successor plan.

Section 1.3. Award Period is defined in the Stock Compensation Plan.

Section 1.4. Base Salary means the dollar amount of Employee's annual base compensation as determined by the Board. Employee's Base Salary may be paid or provided, as the Board determines, either entirely in cash or partly in cash and partly in long-term, equity-based compensation valued as determined by the Board in its reasonable discretion.

Section 1.5. Board means the Board of Directors of the Corporation, acting without the participation of those of its members who are also officers of the Corporation.

Section 1.6. Cause is defined in Section 4.1(b).

Section 1.7. Compete means directly or indirectly to manage, operate, control, participate in the ownership, management, operation or control of, be connected as an officer, employee, partner, director, consultant or otherwise with, or have any financial interest in, (i) any business if a substantial part of such business involves originating, purchasing, selling, servicing or otherwise dealing in the residential mortgage market (provided, that Employee shall not be deemed, directly or indirectly, to Compete solely by virtue of Employee's employment by a business that engages in transactions in the residential mortgage market so long as Employee himself does not participate directly in the residential mortgage business), (ii) Freddie Mac, or (iii) any part of the Federal Home Loan Bank System (including any one of the Federal Home Loan Banks or the Federal Home Loan Banks Office of Finance). Employee shall not be deemed to Compete solely by reason of ownership, for personal investment purposes only, of less than 2% of the voting interests of any business.

Section 1.8. Corporation means Fannie Mae.

Section 1.9. Effective Date means July 1, 2004, subject, however, to the provisions of Section 6.14 ("Regulatory Approval").

Section 1.10. Employee means Franklin D. Raines.

Section 1.11. Employment means Employee's employment by the Corporation under this Agreement.

Section 1.12. Executive Pension Plan means the Executive Pension Plan of the Federal National Mortgage Association as from time to time amended and in effect, or any successor plan.

Section 1.13. Existing Agreement is defined in the preamble to this Agreement.

Section 1.14. Good Reason means (a) a material reduction by the Corporation of Employee's authority or a material change in Employee's functions, duties or responsibilities that in any material way would cause Employee's position to become less important, (b) a reduction in Employee's Base Salary or the dollar amount of the cash salary portion thereof, (c) a requirement by the Corporation that Employee relocate his office outside of the Washington, D.C. area, or (d) a breach by the Corporation of any material obligation of the Corporation under this Agreement, unless, within 30 days of the written notice given by Employee and specifying a circumstance constituting Good Reason, the Corporation eliminates such circumstance.

Section 1.15. OFHEO means the Office of Federal Housing Enterprise Oversight.

Section 1.16. Option is defined in the Stock Compensation Plan.

Section 1.17. Performance Share Award is defined in the Stock Compensation Plan.

Section 1.18. Qualifying Termination means Termination of Employment (i) by the Corporation without Cause, (ii) by Employee for Good Reason, (iii) by Retirement, (iv) by reason of Serious Illness or Disability or (v) by reason of Employee's death.

Section 1.19. Restricted Stock is defined in the Stock Compensation Plan.

Section 1.20. Retirement means (i) Employee's voluntary retirement pursuant to prior written notice as specified in Section 4.2(b) from service with Fannie Mae at or after the attainment of age 55, or (ii) Termination of Employment by reason of the expiration of the

Agreement Term, or (iii) Termination of Employment by Employee by reason of Employee's acceptance of an appointment to a senior position in the U.S. Federal Government.

Section 1.21. Serious Illness or Disability means a serious physical or mental illness or disability which, in the reasonable determination of the Board, prevents Employee from performing his duties under this Agreement for a period of at least six months in any twelve-month period.

Section 1.22. Stock Compensation Plan means either or both, as the context requires, of the Fannie Mae Stock Compensation Plan of 1993 and the Fannie Mae Stock Compensation Plan of 2003, in each case as from time to time amended and in effect, or any successor plan.

Section 1.23. Surviving Spouse is defined in the Executive Pension Plan.

Section 1.24. Termination of Employment means the cessation of Employment for any reason.

ARTICLE 2

PERIOD OF EMPLOYMENT AND DUTIES

Section 2.1. Period of Employment. The Corporation shall continue to employ Employee, and Employee shall continue to serve, as Chairman of the Corporation's Board of Directors and Chief Executive Officer of the Corporation, upon the terms and conditions of this Agreement, for the period July 1, 2004 through the last day of the Agreement Term unless there is an earlier Termination of Employment. The Agreement Term may be extended by mutual written agreement of the parties entered into at any time prior to the date the Agreement Term would otherwise expire.

Section 2.2. Duties. Employee shall serve the Corporation under this Agreement as Chairman of the Corporation's Board of Directors and as Chief Executive Officer. Employee shall devote his full business time and attention to the Corporation and shall faithfully and diligently perform such duties for the Corporation, consistent with his position as Chairman of the Corporation's Board of Directors and as Chief Executive Officer, as may be determined from time to time by the Board. Employee shall be subject to the Corporation's standards of conduct and similar policies and procedures applicable generally to members of the Board of Directors or to the Corporation's executive officers, as the case may be. Employee may (a) serve on corporate, civic or charitable boards or committees or (b) manage personal investments, so long as such activities do not materially interfere with the performance of his responsibilities under this Agreement and so long as such activities comply with the aforementioned standards, policies and procedures of the Corporation. During his Employment, Employee shall be nominated for election to the Corporation's Board of Directors and shall be identified as a nominee recommended for election by the Board, at each annual meeting of the stockholders of the Corporation.

ARTICLE 3

COMPENSATION AND BENEFITS

Section 3.1. Base Salary. During Employee's Employment, the Corporation shall pay (or, in the case of non-cash compensation, provide) to Employee Base Salary of not less than his base salary at June 30, 2004. The cash component of Employee's Base Salary shall be paid on the same periodic basis as payments of base salary to other senior executives of the Corporation and shall not be less than the cash component of Employee's base salary at June 30, 2004. The non-cash component, if any, of Employee's Base Salary shall be provided in such form or forms and subject to such terms and conditions as the Board may determine in its reasonable discretion, including, if it so determines, vesting or performance conditions (which, if such non-cash component is part of another award, shall be consistent with the vesting or performance conditions applicable generally to such other award). The Board shall from time to time review Employee's Base Salary and may increase (but in no event decrease) the aggregate dollar amount of such Base Salary by such amounts as it deems proper.

Section 3.2. Benefits.

(a) Executive Pension Plan. The parties acknowledge that the Corporation has previously designated Employee as a participant in the Executive Pension Plan. Notwithstanding any provision of the Executive Pension Plan to the contrary, the following provisions shall apply to Employee:

(i) Employee's "Pension Goal" under the Executive Pension Plan shall at all times be equal to at least 60% of his "High-Three Total Compensation." High-Three Total Compensation shall be as defined in the Executive Pension Plan, except that in determining "Total Compensation" for purposes of such definition, (A) the base salary component of that term shall be determined by Employee's Base Salary hereunder (and, for prior years, by his base salary under prior agreements with the Corporation), whether or not currently taxable, and (B) the "other taxable compensation" component of that term shall include, for any year, up to 100 percent of Employee's Base Salary (or, under prior agreements, base salary) for such year, except as provided in Section 5.3. There shall be no actuarial adjustment to any benefits payable under the Executive Pension Plan by reason of the commencement of benefit payments prior to Employee's reaching age 60. If Employee dies after Termination of Employment, his Surviving Spouse shall receive (regardless of her age at the time of Employee's death) monthly payments, commencing on the first day of the month coincident with or next following the date of

Employee's death and continuing for her lifetime, equal to 100% of the monthly amount that was being paid to Employee at the time of his death (or, if Employee dies after Termination of Employment but before commencement of payments under the Executive Pension Plan, that Employee would have received had payments commenced prior to his death).

(ii) The Corporation may amend the Executive Pension Plan from time to time; provided, however, that no such amendment shall decrease Employee's Pension Goal or the vested benefits to which Employee or his Surviving Spouse, if any, would have been entitled under such Plan, as modified in this Agreement, as in effect on the Effective Date or, if benefits are improved, as of the date of such improvement.

(b) Options. Employee shall be considered for grants of Options consistent with the compensation philosophy of the Corporation set forth in the charter of the Compensation Committee of the Board.

(c) Annual Incentive Plan. Employee shall be considered for a potential award under the Annual Incentive Plan for each year during Employment consistent with the compensation philosophy of the Corporation set forth in the charter of the Compensation Committee of the Board.

(d) Performance Share Awards. Employee shall be considered for grants of Performance Share Awards consistent with the compensation philosophy of the Corporation set forth in the charter of the Compensation Committee of the Board.

(e) Restricted Stock. Employee shall be considered for grants of Restricted Stock consistent with the compensation philosophy of the Corporation set forth in the charter of the Compensation Committee of the Board.

(f) Life Insurance and Death Benefits. Employee shall receive life insurance benefits consistent with the Corporation's life insurance policies and programs as from time to time in effect.

(g) Other Benefits. The Corporation shall provide Employee with the following additional benefits during Employment:

(i) The Corporation shall pay or reimburse Employee for reasonable expenses incurred by Employee in obtaining tax and investment assistance and advice.

(ii) The Corporation shall pay or reimburse the legal expenses incurred by Employee in connection with the negotiation of this Agreement.

(iii) The Corporation shall provide Employee with access to a car and driver for transportation relating to the Corporation's business purposes.

(iv) The Corporation shall pay or reimburse Employee for actual expenses incurred by Employee for a complete annual physical examination at a medical facility of his choice.

(h) General Rights Under Benefit Plans.

(i) Employee shall at all times during the Employment Term be entitled to participate in all long- or short-term bonus, stock option, restricted stock, and other executive compensation plans, and in all perquisite programs and disability, retirement, stock purchase, thrift and savings, health, medical, life insurance, expense reimbursement and similar plans of the Corporation which are from time to time in effect and in which other senior officers of the Corporation generally are entitled to participate. Except as otherwise provided in this Agreement, Employee's participation in such plans and programs shall be in accordance with the provisions of such plans and programs applicable from time to time, it being the intent of the parties hereto that nothing in this Agreement shall decrease the rights and benefits of Employee under any such plans and programs as may be in effect from time to time. Employee's rights as a participant under any compensation, benefit or fringe benefit plan or arrangement of the Corporation that is from time to time in effect and in which other senior officers of the Corporation generally are entitled to participate shall be subject to this Agreement and modified to the extent expressly provided herein, but except as so modified shall be determined under the applicable provisions of such plans and programs; provided, that all such plans and programs and this Agreement shall be construed and administered to avoid any duplication of benefits under any such plan or program and this Agreement.

(ii) Except as specifically set forth in this Agreement, or as specifically permitted by the terms of any such plan or program, no right or benefit under any such plan or program shall become vested or exercisable after Termination of Employment.

ARTICLE 4

TERMINATION OF EMPLOYMENT

Section 4.1. Termination of Employment By the Corporation.

(a) Without Cause. The Corporation shall have the right to terminate Employee's Employment without Cause at any time for any reason in the Corporation's sole discretion by giving thirty (30) days' prior written notice to Employee.

(b) For Cause. The Corporation may terminate Employee's Employment for Cause. For purposes of this Agreement, termination for "Cause" shall have the meaning set forth at Section 4.1(b)(i) below, and Employee's Employment shall not be treated as having been terminated for Cause unless such termination is accomplished in accordance with Section 4.1(b)(ii) below.

(i) For purposes of this Agreement, Employee shall be treated as having been terminated for "Cause" only if Employee has (A) been convicted of, or pleaded *nolo contendere* with respect to, a felony, or (B) participated personally in an act of fraud in the discharge of his duties under this Agreement that demonstrably discredits the Corporation and that cannot be cured, or (C) continued for 30 days following written notice from the Corporation to engage in activities that are not contemplated or permitted by this Agreement and that involve a material conflict of interest with Employee's duties and responsibilities under this Agreement, or (D) continued for 30 days following written notice from the Corporation to fail substantially to perform the material duties of his office (other than as a result of total or partial incapacity due to physical or mental illness or disability), or (E) failed to cure, within 30 days following written notice from the Corporation, any material breach of the material terms of this Agreement or of any written noncompetition, nondisclosure or nonsolicitation policy or agreement to which Employee is at the time subject or by which he is at the time bound. The Corporation's written notice to Employee referred to in (C), (D) and (E) above will not be deemed to have been given unless it identifies with particularity the asserted basis or bases for a for-Cause termination and requests, with specific reference to this Section 4.1(b)(i), that it or they be corrected or cured.

(ii) The Corporation by written notice may terminate Employee's employment for Cause at any time following the occurrence of an event described in Section 4.1(b)(i)(A) above. Within 10 days following the occurrence of an act described in Section 4.1(b)(i)(B) above, or following the end of the 30-day correction or cure period described in any of Section 4.1(b)(i)(C), (D) or (E) above, if the basis or bases asserted by the Board for a for-Cause termination thereunder have not been corrected or cured, the Board shall give written notice to Employee setting forth with particularity the asserted basis or bases for a for-Cause termination and giving Employee a reasonable opportunity, including reasonable access to information and documents, to appear with counsel before the Board to contest the asserted basis or bases for such termination. Employee shall not be treated as having been terminated for Cause unless, following such opportunity to contest the basis or bases for termination, the Board determines in writing by the affirmative vote of a majority of its members that the asserted basis or bases for termination exist under Section 4.1(b)(i)(B) through (E), as applicable, above and that Employee is therefore terminated for Cause. During the pendency of any process described in the immediately preceding sentence, the Corporation may transfer some or all of Employee's duties and responsibilities to one or more other officers of the Corporation, but until Employee's employment is terminated in accordance with the preceding provisions of this Section 4.1(b)(ii) he shall continue during the Agreement Term to be entitled to all the remuneration and employee benefits to which he would otherwise be entitled as an active employee under this Agreement. In any proceeding before the Board described in this Section 4.1(b)(ii), where Employee's good faith in the performance of his duties is in question, such good faith shall be presumed unless the preponderance of the evidence indicates otherwise.

(c) By Reason of Serious Illness or Disability. In the event of Employee's Serious Illness or Disability during Employment, the Corporation may terminate Employee's Employment by giving Employee at least 60 days' advance written notice specifying the date of termination. If, on or before the date of termination specified in such notice, Employee recovers and is again able to perform his duties hereunder, such notice shall be void, and Employee's Employment shall not be terminated thereby.

Section 4.2. Termination of Employment By Employee.

(a) For Good Reason. Employee shall have the right to terminate his Employment for Good Reason, unless the Corporation prior to such termination shall have cured the asserted basis for the Good Reason claim, by giving not less than 30 days' prior written notice to the Corporation, which notice must be given within six calendar months after the event giving rise to the Good Reason.

(b) By Retirement. Employee shall have the right to terminate his Employment by Retirement by giving not less than six months' prior written notice to the Corporation, which notice may not be given after the Corporation has provided a written notice of termination to Employee under Section 4.1(b). Voluntary termination by Employee of his Employment, other than as set forth in Section 1.20, shall not constitute Retirement for purposes of this Agreement but may result in a termination described in Section 4.2(c).

(c) Other Than For Good Reason or Retirement. Employee shall have the right to terminate his Employment at any time for any reason other than Good Reason or Retirement in his sole discretion by giving not less than 30 days' prior written notice to the Corporation, which notice may not be given after the Corporation has provided a written notice of termination to Employee under Section 4.1(b). Upon receipt of any such notice from Employee, the Corporation shall have the option, exercisable by giving Employee written notice within 30 days of such receipt, to designate any date (not earlier than 30 days after the date of Employee's notice) as the date on which Employee's Employment shall cease. The effective date of the Termination of Employment hereunder shall be the date so designated by the Corporation if earlier than the date specified by Employee. In no event shall the Termination of Employment by the Corporation without Cause, by Employee for Good Reason or by reason of Retirement, be deemed to be a Termination of Employment by Employee pursuant to this Section 4.2(c).

Section 4.3. Other Termination of Employment. Employee's Employment shall also terminate on Employee's death.

Section 4.4. Resignation as Member of the Board of Directors. A Termination of Employment shall constitute, unless otherwise requested by the Board, Employee's resignation as a member of the Corporation's Board of Directors and as a member of the Board of Directors of the Fannie Mae Foundation, effective on the date of the Termination of Employment.

ARTICLE 5

COMPENSATION AND BENEFITS FOLLOWING TERMINATION OF EMPLOYMENT

Section 5.1. Termination of Employment (Other Than By Reason of Death). If there is a Termination of Employment for any reason other than Employee's death, Employee shall be entitled to receive, and within 30 days of such Termination of Employment shall commence to receive, his vested normal retirement benefit under the Executive Pension Plan as modified by this Agreement and in the form provided in the Executive Pension Plan. Except as provided in the preceding sentence (relating to benefits under the Executive Pension Plan), upon a Termination of Employment Employee shall be entitled to receive only those vested benefits, if any, to which he is entitled under any pension, profit-sharing or stock plan or plans maintained by the Corporation (except as otherwise expressly provided in Sections 5.2 through 5.5, as applicable) and to those payments and benefits, if any, as are specified in Sections 5.2 through 5.5, as applicable.

Section 5.2. Voluntary Termination Pursuant to Section 4.2(c). If the Termination of Employment is a voluntary termination pursuant to Section 4.2(c), then in addition to the benefits payable under Section 5.1 and payment of all accrued but unpaid Base Salary amounts, plus all amounts payable (but unpaid) under any Performance Share Award with respect to an Award Period that had ended on or prior to the Termination of Employment, Employee shall be entitled to the benefits described in Section 5.4(e) (Medical and Dental Coverage) and Section 5.4(f) (Administration), in each case on the same basis as if his Termination of Employment had been by reason of a Qualifying Termination, and to the benefits described in Section 5.4(c) (Performance Share Awards) determined by applying the provisions of Section 5.4(c) as if Employee's Termination of Employment had been by reason of a Qualifying Termination. Employee shall be entitled to such rights, if any, under any awards of Restricted Stock as are set forth in the applicable awards.

Section 5.3. Termination for Cause. In the event of a Termination of Employment for Cause, except as provided in Section 5.1 Employee shall not be entitled to any payments or benefits except as follows: Employee shall be entitled to all amounts payable (but unpaid) under any Performance Share Award with respect to an Award Period commencing prior to July 1, 2004 that had ended on or prior to the Termination of Employment. In addition, Employee shall be entitled to the benefits described in Section 5.4(c) (Performance Share Awards) with respect to Award Periods commencing prior to July 1, 2004 in which at least 18 months had elapsed prior to the date of the Termination of Employment determined by applying the provisions of Section 5.4(c) as if Employee had incurred a Qualifying Termination. Any Performance Share Awards with respect to Award Periods commencing on or after July 1, 2004 shall be forfeited. All Options, vested and unvested, that are granted on or after July 1, 2004 and that are held by

Employee at Termination of Employment shall be immediately and automatically canceled. Vested Options granted prior to July 1, 2004 shall continue to be exercisable for the remainder of their stated term, and all unvested Options that were granted prior to July 1, 2004 and that are held by Employee at Termination of Employment shall be immediately and automatically canceled. Employee shall be entitled to such rights, if any, under any awards of Restricted Stock as are set forth in the applicable awards. In the event of a Termination of Employment for Cause, the benefit payable to Employee and/or his Surviving Spouse under the Executive Pension Plan shall be determined by applying Section 3.2(a)(i)(B) for all periods relevant to the determination of the benefit under the Executive Pension Plan with the following modification: in lieu of the words "up to 100 percent" under Section 3.2(a)(i)(B), there shall be substituted the words "up to 50 percent".

Section 5.4. Qualifying Termination (Other Than by Reason Of Death). If there is a Qualifying Termination (other than by reason of Employee's death) then in addition to the benefits payable under Section 5.1 Employee shall be entitled to prompt payment of all accrued but unpaid Base Salary amounts, all amounts payable (but unpaid) under the Annual Incentive Plan with respect to any year ended on or prior to the Qualifying Termination, and all amounts payable (but unpaid) under any Performance Share Award with respect to an Award Period that had ended on or prior to the Qualifying Termination, plus the following:

(a) Options. In the event of a Qualifying Termination, Employee's Options shall become exercisable as provided in (i) through (iv) below, as applicable, and except as so provided shall be immediately and automatically cancelled:

(i) If the Qualifying Termination occurs by reason of Serious Illness or Disability or by Employee for Good Reason, all of Employee's Options shall become immediately exercisable.

(ii) If the Qualifying Termination occurs by reason of a termination by the Corporation without Cause, all of Employee's Options granted prior to July 1, 2004 shall become immediately exercisable. Employee's Options granted on or after July 1, 2004 shall also become immediately exercisable, except that the Board in its discretion may determine, taking into account Employee's performance and the interests of the Corporation, that any portion of such Options that would have become exercisable (had Employee continued in employment) more than one year following the date of the Termination of Employment shall be canceled, in which event such portion shall be canceled.

(iii) If the Qualifying Termination is by reason of Retirement occurring at the end of the Agreement Term, all of Employee's Options shall become immediately exercisable. If the Retirement occurs prior to the end of the Agreement Term, Employee's Options granted on or after January 1, 2003 and before July 1, 2004 shall become immediately exercisable and his Options granted on or after July 1, 2004 shall become exercisable only for the number of additional shares for which they would have become exercisable had Employee continued in employment for one additional year.

In each of the foregoing cases, Employee's Options, to the extent exercisable, shall remain exercisable for the remainder of their stated term.

(b) Annual Incentive Plan. The Corporation shall pay to Employee at the time of payment of awards to other participants in the Annual Incentive Plan for the year in which the

Qualifying Termination occurs (even if Employee is not employed by the Corporation on the last day of such year), except as hereinafter provided, a prorated amount equal to (i) the award that would have been payable to Employee for such year had he remained in Employment, based on actual results for such year, multiplied by (ii) a fraction, the numerator of which is the number of days of Employment during such year and the denominator of which is 365. In the case of a Qualifying Termination by reason of a Retirement described in clause (iii) of Section 1.20, the Corporation shall promptly accelerate the payment of the prorated Annual Incentive Plan payment described in this Section 5.4(b). In the case of any other Qualifying Termination subject to this Section 5.4, the Corporation in its discretion may accelerate the payment of any portion or all of such prorated Annual Incentive Plan payment. In any case where payment under this Section 5.4(b) is accelerated, the amount determined under clause (i) above shall be the award that the Board determines Employee would have received for the year in which the Qualifying Termination occurs based on the Board's determination of the likelihood of the Corporation's achievement of targets for such year.

(c) Performance Share Awards. Notwithstanding any provision of the Stock Compensation Plan to the contrary, in the case of any Qualifying Termination, the Corporation shall deliver to Employee, with respect to each Performance Share Award then held by Employee, after the end of the Award Period applicable to such Award, the product of (i) the award that would have been payable to Employee for such Award Period had he remained in Employment, based on actual results for such Award Period, and (ii) a fraction, the numerator of which is the number of days of Employment in such Award Period and the denominator of which is the total number of days in such Award Period. In the case of a Qualifying Termination by reason of a Retirement described in clause (iii) of Section 1.20, the Corporation shall promptly accelerate the payment of all prorated Performance Share Award payments described in this Section 5.4(c). In the case of any other Qualifying Termination subject to this Section 5.4, the Corporation in its discretion may accelerate the payment of any portion or all of any such payments. In any case where payment under this Section 5.4(c) is accelerated, the amount determined under clause (i) above shall be the award that the Board determines Employee would have received for the Award Period in which the Qualifying Termination occurs based on the Board's determination of the likelihood of the Corporation's achievement of targets for such Award Period.

(d) Restricted Stock. Employee shall be entitled to such rights, if any, under any awards of Restricted Stock as are set forth in the applicable awards.

(e) Medical and Dental Coverage. Employee and Employee's family shall continue to receive medical and dental insurance coverage as follows. To the extent permitted under the Corporation's medical and dental plans, the Corporation shall continue the medical and dental coverage elected by Employee for Employee and Employee's spouse and dependents (but in the case of employee's dependents only for so long as they remain dependents or until age 21 if later), without premium payments by Employee, for Employee's life. After Employee's death, the Corporation shall continue the medical and dental coverage elected by Employee, without premium payments by Employee's family, for Employee's Surviving Spouse for her life, and for the other dependents of Employee on the date of his death, so long as such dependents are under the age of 21 or, under the definitions set forth in such medical and dental plan, such dependents remain dependents of Employee's Surviving Spouse. If, for any reason, it is not possible for Employee, Employee's Surviving Spouse or the other eligible dependents of Employee to participate in medical and dental coverage pursuant to this Agreement, the Corporation shall make arrangements to provide comparable coverage.

(f) Administration. During such time following Employee's Qualifying Termination (during his lifetime) as he is not employed by any person on a full-time basis, the Corporation shall provide administrative services to support the provision of an office and related secretarial and administrative services for Employee's benefit, provided that Employee reimburses the Corporation for the fair market value of such office and services as reasonably determined by the Corporation.

Section 5.5. Termination of Employment By Reason of Death. If there is a Termination of Employment by reason of Employee's death, then in addition to the benefits payable under Section 5.1 and the payment to Employee's estate of Employee's accrued but unpaid Base Salary:

(a) Executive Pension Plan. Employee's Surviving Spouse shall receive (regardless of her age at the time of Employee's death) monthly payments, commencing within 30 days of Employee's death and continuing for her lifetime, equal to the monthly normal retirement benefit that Employee would have received under the Executive Pension Plan as modified in this Agreement had he terminated employment on the date of his death.

(b) Options. All Employee's Options shall become immediately exercisable by the person or persons to whom Employee's rights under such Options pass by will or applicable law and shall remain exercisable for the remainder of their respective terms.

(c) Annual Incentive Plan. The Corporation shall pay to Employee's designated beneficiary or, if none, to Employee's estate, as soon as is practicable after the date of Employee's death, all amounts payable (but unpaid) under the Annual Incentive Plan with respect to any year ended on or prior to death plus, for the year of death, a prorated amount equal to (i) the award that the Board determines Employee (had he lived) would have received for the year in which his death occurs based on the Board's determination of the likelihood of the Corporation's achievement of targets for such year multiplied by (ii) a fraction, the numerator of which is the number of days of Employment during such year prior to his death and the denominator of which is 365.

(d) Performance Share Awards. The Corporation shall pay to Employee's designated beneficiary or, if none, to Employee's estate, as soon as is practicable after the date of Employee's death, all amounts payable (but unpaid) under any Performance Share Award with respect to an Award Period that had ended on or prior to the date of death, plus an amount with respect to Performance Share Awards made for each Award Period that had not ended prior to the date of death equal to the award that the Board determines Employee (had he lived) would have received for the Award Period in which his death occurs based on the Board's determination of the likelihood of the Corporation's achievement of targets for such Award Period multiplied by a fraction, the numerator of which is the number of days in the Award Period that had elapsed prior to Employee's death and the denominator of which is the total number of days in the Award Period.

(e) Restricted Stock. Any outstanding awards of Restricted Stock shall be treated in accordance with the terms set forth in the applicable awards.

(f) Medical and Dental Benefits. The Corporation shall continue the medical and dental coverage elected by Employee, without premium payments by Employee's family, for Employee's Surviving Spouse for her life, and for the other dependents of Employee on the date of his death, so long as such dependents are under the age of 21 or, under the definitions set forth in such medical and dental plan, such dependents remain dependents of Employee's Surviving Spouse. If, for any reason, it is not possible for Employee's Surviving Spouse or the other eligible dependents of Employee to participate in medical and dental coverage pursuant to this Agreement, the Corporation shall make arrangements to provide comparable coverage.

ARTICLE 6

MISCELLANEOUS

Section 6.1. Noncompetition.

(a) Following Termination of Employment for any reason, during the one-year period following the date of the Termination of Employment, Employee shall not, directly or indirectly, (i) Compete in the United States, (ii) solicit any officer or employee of the Corporation or any of its affiliates to engage in any conduct prohibited hereby for Employee or to terminate any existing relationship with the Corporation or such affiliate or (iii) assist any other person to engage in any activity in any manner prohibited hereby to Employee.

(b) The need to protect the Corporation against Employee's competition, as well as the nature and scope of such protection, has been carefully considered by the parties hereto in light of the uniqueness of Employee's talent and his importance to the Corporation. Accordingly, Employee agrees that, in addition to any other relief to which the Corporation may be entitled, the Corporation shall be entitled to seek and obtain injunctive relief (without the requirement of a bond) from a court of competent jurisdiction for the purpose of restraining Employee from any actual or threatened breach of the covenant contained in Section 6.1(a).

(c) If for any reason a final decision of any court determines that the restrictions under this Section 6.1 are not reasonable or that the consideration therefore is inadequate, such restrictions shall be interpreted, modified or rewritten by such court to include as much of the duration, scope and geographic area identified in this Section 6.1 as will render such restrictions valid and enforceable.

Section 6.2. Payment of Certain Expenses. As promptly as permitted by law the Corporation shall pay or advance to Employee all legal fees and expenses that Employee may reasonably incur as a result of any contest or arbitration requested by the Corporation, Employee or others of the validity or enforceability of, or liability under, any provision of this Agreement (including any contest initiated by Employee concerning the amount of any payment due pursuant to this Agreement), plus in each case interest at the applicable federal rate provided for in Section 7872(f)(2)(A) of the Internal Revenue Code of 1986, as amended, on any payment of legal fees and expenses that is delayed by more than 10 days following delivery by Employee to the Corporation of a proper request for payment. If as to any such contest or arbitration Employee does not prevail, and only in such case, within 10 days following written demand from the Corporation Employee shall repay any advance made by the Corporation pursuant to the immediately preceding sentence with respect to such contest or arbitration, with interest at the applicable federal rate provided for in Section 7872(f)(2)(A) of the Internal Revenue Code of 1986, as amended, from the date of the Corporation's payment.

Section 6.3. Assignment by Employee. Except as otherwise expressly provided herein or in the Corporation's benefit plans, the obligations, rights and benefits of Employee hereunder are personal to him, and no such obligation, right or benefit shall be subject to voluntary or involuntary alienation, assignment, delegation or transfer.

Section 6.4. No Funding Required. Nothing in this Agreement shall be construed as requiring the Corporation to establish a trust or otherwise to fund any payments to be made under this Agreement, but the Corporation in its discretion may establish such nonqualified trusts or other arrangements as it determines to be appropriate to assist it in meeting its obligations under this Agreement.

Section 6.5. Nondisclosure of Confidential Information. Employee acknowledges that he is bound by the terms of an Agreement on Ideas, Inventions and Confidential Information dated April 2001. Nothing in this Agreement shall be construed as limiting Employee's obligations under the aforesaid Agreement on Ideas, Inventions and Confidential Information or any successor thereto, which shall be treated for all purposes also as obligations of Employee under this Agreement. This Agreement in no way limits the ability of Employee to provide information covered by this Agreement to a government entity in order to assist the government entity in the fulfillment of its duties.

Section 6.6. Waiver. The failure of either party hereto to insist upon strict compliance by the other party with any term, covenant or condition of this Agreement shall not be deemed a waiver of such term, covenant or condition, nor shall any waiver or relinquishment or failure to insist upon strict compliance of any right or power hereunder at any one time or more times be deemed a waiver or relinquishment of such right or power at any other time or times.

Section 6.7. Notice. Any notice required or desired to be given pursuant to this Agreement shall be sufficient if transmitted in writing by hand delivery or sent by prepaid courier or by registered or certified mail, postage prepaid, (i) if notice is to the Corporation, to the Corporation's address hereinafter set forth, or (ii) if notice is to Employee, to Employee's address in the metropolitan District of Columbia area contained in the records of the Corporation, or, in either such case, to such other address of a party as such party may designate in writing and transmit to the other party in such manner. Any such notice shall be deemed given, if transmitted by hand delivery, one business day after deposit with a prepaid courier service or, if sent by registered or certified mail, three business days after deposit in the United States mail.

Section 6.8. Applicable Law. This Agreement shall be governed by the laws of the District of Columbia without regard to any otherwise applicable conflict of laws principles.

Section 6.9. Taxes. The Corporation shall deduct from all amounts payable under this Agreement all federal, state, local and other taxes required by law to be withheld with respect to such amounts.

Section 6.10. Benefit. Except as otherwise expressly provided herein, this Agreement shall inure to the benefit of and be binding upon the Corporation, its successors and assigns, and upon Employee, his spouse, heirs, executors and administrators. The Corporation shall require any successor (whether direct or indirect, by purchase, merger, reorganization, consolidation, acquisition of property or stock, liquidation or otherwise) to all or a substantial portion of its assets, by agreement in form and substance reasonably satisfactory to Employee, expressly to assume and agree to perform this Agreement in the same manner and to the same extent that the Corporation would be required to perform this Agreement if no such succession had taken place. Regardless of whether such an agreement is executed, this Agreement shall be binding upon any successor of the Corporation, and such successor shall be deemed the "Corporation" for purposes of this Agreement.

Section 6.11. Entire Agreement. This Agreement contains the entire understanding and agreement between the parties relating to the terms of Employee's employment by the Corporation and, except as otherwise provided in Section 6.14, supersedes all prior written or oral agreements between them, other than the Agreement on Ideas, Inventions and Confidential Information dated April 2001 and an Indemnification Agreement between the Corporation and

Employee. This Agreement cannot be amended, modified or supplemented in any respect except by an agreement in writing signed by both parties hereto.

Section 6.12. Arbitration. Any controversy or claim arising out of or relating to this Agreement or the breach of this Agreement shall be settled by arbitration in the District of Columbia in accordance with the laws of the District of Columbia. The arbitration shall be conducted in accordance with the applicable rules of the American Arbitration Association. The costs and expenses of the arbitrator(s) shall be borne by the Corporation. Except as otherwise provided in Section 6.2, each party shall pay his or its own legal costs and other expenses (other than the costs and expenses of the arbitrator(s)) relating to an arbitration. The award of the arbitrator(s) shall be binding upon the parties. Judgment upon the award rendered by the arbitrator(s) may be entered in any court having jurisdiction.

Section 6.13. Severability. Except as otherwise provided in Section 6.14, it is the intent and understanding of each party hereto that, if any term, restriction, covenant or promise herein is found to be invalid or otherwise unenforceable, then such term, restriction, covenant or promise shall not thereby be invalid or unenforceable but shall be deemed modified to the extent necessary to make it enforceable and, if it cannot be so modified, shall be deemed amended to delete therefrom such provision or portion found to be invalid or unenforceable, such modification or amendment in any event to apply only with respect to the operation of this Agreement in the particular jurisdiction in which such finding is made.

Section 6.14. Regulatory Approval

The parties hereto acknowledge and agree that pursuant to Section 309(d) of the Federal National Mortgage Association Charter Act, as amended by the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (as so amended, the “Act”), 12 U.S.C. 1723a(d), no provision of this Agreement relating to Employee's benefits upon termination of employment shall be effective unless and until such provision has been reviewed and approved by the Director (the "Director") of the Office of Federal Housing Enterprise Oversight ("OFHEO"). If, following OFHEO's review and approval of such provisions, any benefit plans of the Corporation affecting final termination benefits under this Agreement are altered, such alteration will require OFHEO's review and approval at the time of termination of the Employee's employment with the Corporation and prior to the payment of any such benefits. Upon determining that Employee's Employment is terminating or has terminated, the Corporation shall timely seek OFHEO's review and approval of any alteration referred to in the immediately preceding sentence.

The parties therefore agree as follows:

(a) The Corporation shall promptly hereafter submit this Agreement to the Director for his review and approval of those terms hereof relating to benefits upon termination of employment and shall seek diligently to obtain such approval;

(b) This Agreement shall take effect as of the Effective Date if the Director's approval of terms hereof relating to benefits upon termination of employment is given by January 1, 2005.

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Exhibit 10.2

EMPLOYMENT AGREEMENT

between

FANNIE MAE

and

DANIEL H. MUDD

As Amended on June 30, 2004

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EMPLOYMENT AGREEMENT

THIS EMPLOYMENT AGREEMENT (this "Agreement") is between FANNIE MAE (the "Corporation") and DANIEL H. MUDD ("Employee").

WHEREAS, the Corporation and Employee are parties to an employment agreement dated as of February 23, 2000, which as extended terminates on June 30, 2004 (the "Existing Agreement");

WHEREAS, under the termination provisions of the Existing Agreement, which were approved by OFHEO, Employee is contractually entitled to certain compensation and benefits if, among other circumstances, Employee's employment is not extended; and

WHEREAS, Employee has successfully discharged his responsibilities under the Existing Agreement and has earned certain vested amounts, as described in his Existing Agreement, over the course of his employment;

NOW, THEREFORE, the Corporation and Employee agree as follows:

ARTICLE 1

DEFINITIONS

The following terms shall have the meanings set forth below:

Section 1.1. Agreement Term means the period of time beginning on the Effective Date and ending on June 30, 2007 or such later date as may be agreed to pursuant to Section 2.1.

Section 1.2. Annual Incentive Plan means the Federal National Mortgage Association Annual Incentive Plan as from time to time amended and in effect, or any successor plan.

Section 1.3. Award Period is defined in the Stock Compensation Plan.

Section 1.4. Base Salary means the dollar amount of Employee's annual base compensation as determined by the Board.

Section 1.5. Board means the Board of Directors of the Corporation, acting without the participation of the Vice Chairmen of the Board of Directors.

Section 1.6. Cause is defined in Section 4.1(b).

Section 1.7. Compete means directly or indirectly to manage, operate, control, participate in the ownership, management, operation or control of, be connected as an officer, employee, partner, director, consultant or otherwise with, or have any financial interest in, (i) any business if a substantial part of such business involves originating, purchasing, selling, servicing or otherwise dealing in the residential mortgage market (provided, that Employee shall not be deemed, directly or indirectly, to Compete solely by virtue of Employee's employment by a business that engages in transactions in the residential mortgage market so long as Employee himself does not participate directly in the residential mortgage business), (ii) Freddie Mac, or (iii) any part of the Federal Home Loan Bank System (including any one of the Federal Home Loan Banks or the Federal Home Loan Banks Office of Finance). Employee shall not be deemed to Compete solely by reason of ownership, for personal investment purposes only, of less than 2% of the voting interests of any business.

Section 1.8. Corporation means Fannie Mae.

Section 1.9. Effective Date means July 1, 2004, subject, however, to the provisions of Section 6.15 ("Regulatory Approval").

Section 1.10. Employee means Daniel H. Mudd.

Section 1.11. Employment means Employee's employment by the Corporation under this Agreement.

Section 1.12. Executive Pension Plan means the Executive Pension Plan of the Federal National Mortgage Association as from time to time amended and in effect, or any successor plan.

Section 1.13. Existing Agreement is defined in the preamble to this Agreement.

Section 1.14. Failure to Extend means notification of Employee by the Corporation that it does not desire to extend the Agreement Term (or the term of any successor agreement) or that it desires to do so only on terms in the aggregate that are materially less favorable to Employee than those applicable to Employee at the time of said notice. The Corporation shall give Employee notice with respect to extension or non-extension of the Agreement Term (or the term of any successor agreement) not less than six months before the expiration of the Agreement Term or the term of any successor agreement, as the case may be. Failure to provide any notice on or before the six month period shall also constitute a Failure to Extend. If the Corporation notifies Employee that it desires to extend the Agreement Term (or the term of any successor agreement) on terms that are in the aggregate substantially similar to or more favorable than those applicable to Employee at the time of said notice, any nonextension shall not be deemed to be a Failure to Extend.

Section 1.15. Good Reason means (a) a material reduction by the Corporation of Employee's authority or a material change in Employee's functions, duties or responsibilities that in any material way would cause Employee's position to become less important, (b) a reduction in Employee's Base Salary, (c) a requirement that Employee report to anyone other than the Chairman of the Board of Directors, or the appointment by the Corporation of any person other than Employee to the position of President, Deputy Chairman or similar position superior to Employee's position and inferior to the position of Chairman of the Corporation, (d) a requirement by the Corporation that Employee relocate his office outside of the Washington, D.C. area, or (e) a breach by the Corporation of any material obligation of the Corporation under this Agreement, unless, within 30 days of the written notice given by Employee and specifying a circumstance constituting Good Reason, the Corporation eliminates such circumstance.

Section 1.16. <u>OFHEO</u> means the Office of Federal Housing Enterprise Oversight.

Section 1.17. <u>Option</u> is defined in the Stock Compensation Plan.

Section 1.18. <u>Performance Share Award</u> is defined in the Stock Compensation Plan.

Section 1.19. <u>Qualifying Termination</u> means Termination of Employment (i) by the Corporation without Cause, (ii) by Employee for Good Reason, (iii) upon expiration of the Agreement Term (or the term of any successor agreement) if there has been a Failure to Extend, (iv) by reason of Employee's acceptance of an appointment to a senior position in the U.S. Federal Government, (v) by reason of Serious Illness or Disability or (vi) by reason of Employee's death.

Section 1.20. <u>Restricted Stock</u> is defined in the Stock Compensation Plan.

Section 1.21. <u>Serious Illness or Disability</u> means a serious physical or mental illness or disability which, in the reasonable determination of the Board, prevents Employee from performing his duties under this Agreement for a period of at least six months in any twelve-month period.

Section 1.22. <u>Stock Compensation Plan</u> means either or both, as the context requires, of the Fannie Mae Stock Compensation Plan of 1993 and the Fannie Mae Stock Compensation Plan of 2003, in each case as from time to time amended and in effect, or any successor plan.

Section 1.23. <u>Surviving Spouse</u> is defined in the Executive Pension Plan.

Section 1.24. Termination of Employment means the cessation of Employment for any reason.

ARTICLE 2

PERIOD OF EMPLOYMENT AND DUTIES

Section 2.1. Period of Employment. The Corporation shall continue to employ Employee, and Employee shall continue to serve, as Vice Chairman of the Corporation's Board of Directors and Chief Operating Officer of the Corporation, upon the terms and conditions of this Agreement, for the period July 1, 2004 through the last day of the Agreement Term unless there is an earlier Termination of Employment. The Agreement Term may be extended by mutual written agreement of the parties entered into at any time prior to the date the Agreement Term would otherwise expire.

Section 2.2. Duties. Employee shall serve the Corporation under this Agreement as Vice Chairman of the Corporation's Board of Directors and as Chief Operating Officer. Employee shall devote his full business time and attention to the Corporation and shall faithfully and diligently perform such duties for the Corporation as may be determined from time to time by the Chairman of the Board of Directors, provided that such duties are reasonable and customary for a corporate vice chairman and chief operating officer. Employee shall be subject to the Corporation's standards of conduct and similar policies and procedures applicable generally to members of the Board of Directors or to the Corporation's executive officers, as the case may be. Employee may (a) serve on corporate, civic or charitable boards or committees or (b) manage personal investments, so long as such activities do not materially interfere with the performance of his responsibilities under this Agreement and so long as such activities comply with the aforementioned standards, policies and procedures of the Corporation. During his

Employment, Employee shall be nominated for election to the Corporation's Board of Directors and shall be identified as a nominee recommended for election by the Board, at each annual meeting of the stockholders of the Corporation.

ARTICLE 3

COMPENSATION AND BENEFITS

Section 3.1. Base Salary. During Employee's Employment, the Corporation shall pay to Employee Base Salary of not less than his base salary at June 30, 2004. The Board shall from time to time review Employee's Base Salary and may increase (but in no event decrease) such Base Salary by such amounts as it deems proper.

Section 3.2. Benefits.

(a) Executive Pension Plan. The parties acknowledge that the Corporation has previously designated Employee as a participant in the Executive Pension Plan. Employee's "Pension Goal" under the Executive Pension Plan shall at all times be equal to at least 50% of his "High-Three Total Compensation," as those terms are defined in the Executive Pension Plan. The Corporation may amend the Executive Pension Plan from time to time; provided, however, that no such amendment shall decrease Employee's Pension Goal or the vested benefits to which Employee or his Surviving Spouse, if any, would have been entitled under such Plan, as modified in this Agreement, as in effect on the Effective Date or, if benefits are improved, as of the date of such improvement.

(b) Options. Employee shall be considered for grants of Options consistent with the compensation philosophy of the Corporation set forth in the charter of the Compensation Committee of the Board.

(c) Annual Incentive Plan. Employee shall be considered for a potential award under the Annual Incentive Plan for each year during Employment consistent with the compensation philosophy of the Corporation set forth in the charter of the Compensation Committee of the Board.

(d) Performance Share Awards. Employee shall be considered for grants of Performance Share Awards consistent with the compensation philosophy of the Corporation set forth in the charter of the Compensation Committee of the Board.

(e) Restricted Stock. Employee shall be considered for grants of Restricted Stock consistent with the compensation philosophy of the Corporation set forth in the charter of the Compensation Committee of the Board.

(f) Life Insurance and Death Benefits. Employee shall receive life insurance benefits consistent with the Corporation's life insurance policies and programs as from time to time in effect.

(g) Other Benefits. The Corporation shall provide Employee with the following additional benefits during Employment:

(i) The Corporation shall pay or reimburse Employee for reasonable expenses incurred by Employee in obtaining tax and investment assistance and advice, up to $25,000 per calendar year.

(ii) The Corporation shall pay or reimburse the legal expenses incurred by Employee in connection with the negotiation of this Agreement.

(iii) The Corporation shall provide Employee with access to a car and driver for transportation relating to the Corporation's business purposes.

(iv) The Corporation shall pay or reimburse Employee for actual expenses incurred by Employee for a complete annual physical examination at a medical facility of his choice.

(h) General Rights Under Benefit Plans.

(i) Employee shall at all times during the Employment Term be entitled to participate in all long- or short-term bonus, stock option, restricted stock, and other executive compensation plans, and in all perquisite programs and disability, retirement, stock purchase, thrift and savings, health, medical, life insurance, expense reimbursement and similar plans of the Corporation which are from time to time in effect and in which other senior officers of the Corporation generally are entitled to participate. Except as otherwise provided in this Agreement, Employee's participation in such plans and programs shall be in accordance with the provisions of such plans and programs applicable from time to time, it being the intent of the parties hereto that nothing in this Agreement shall decrease the rights and benefits of Employee under any such plans and programs as may be in effect from time to time. Employee's rights as a participant under any compensation, benefit or fringe benefit plan or arrangement of the Corporation that is from time to time in effect and in which other senior officers of the Corporation generally are entitled to participate shall be subject to this Agreement and modified to the extent expressly provided herein, but except as so modified shall be determined under the applicable provisions of such plans and programs, including, without limitation, the provisions thereof applicable to retirement; provided, that all such plans and programs and this Agreement shall be construed and administered to avoid any duplication of benefits under any such plan or program and this Agreement.

(ii) Except as specifically set forth in this Agreement, or as specifically permitted by the terms of any such plan or program, no right or benefit under any such plan or program shall become vested or exercisable after Termination of Employment.

ARTICLE 4

TERMINATION OF EMPLOYMENT

Section 4.1. Termination of Employment By the Corporation.

(a) Without Cause. The Corporation shall have the right to terminate Employee's Employment without Cause at any time for any reason in the Corporation's sole discretion by giving at least 90 days' prior written notice to Employee.

(b) For Cause. The Corporation may terminate Employee's Employment for Cause. For purposes of this Agreement, termination for "Cause" shall have the meaning set forth at Section 4.1(b)(i) below, and Employee's Employment shall not be treated as having been terminated for Cause unless such termination is accomplished in accordance with Section 4.1(b)(ii) below.

(i) For purposes of this Agreement, Employee shall be treated as having been terminated for "Cause" only if Employee has (A) been convicted of, or pleaded *nolo contendere* with respect to, a felony, or (B) participated personally in an act of fraud in the discharge of his duties under this Agreement that demonstrably discredits the Corporation and that cannot be cured, or (C) continued for 30 days following written notice from the Corporation to engage in activities that are not contemplated or permitted by this Agreement and that involve a material conflict of interest with Employee's duties and responsibilities under this Agreement, or (D) continued for 30 days following written notice from the Corporation to fail substantially to perform the material duties of his office (other than as a result of total or partial incapacity due to physical or mental illness or disability), or (E) failed to cure, within 30 days following written notice from the Corporation, any material breach of the material terms of this Agreement or of any written noncompetition, nondisclosure or nonsolicitation policy or agreement to which

Employee is at the time subject or by which he is at the time bound. The Corporation's written notice to Employee referred to in (C), (D) and (E) above will not be deemed to have been given unless it identifies with particularity the asserted basis or bases for a for-Cause termination and requests, with specific reference to this Section 4.1(b)(i), that it or they be corrected or cured.

(ii) The Corporation by written notice may terminate Employee's employment for Cause at any time following the occurrence of an event described in Section 4.1(b)(i)(A) above. Within 10 days following the occurrence of an act described in Section 4.1(b)(i)(B) above, or following the end of the 30-day correction or cure period described in any of Section 4.1(b)(i)(C), (D) or (E) above, if the basis or bases asserted by the Board for a for-Cause termination thereunder have not been corrected or cured, the Board shall give written notice to Employee setting forth with particularity the asserted basis or bases for a for-Cause termination and giving Employee a reasonable opportunity, including reasonable access to information and documents, to appear with counsel before the Board to contest the asserted basis or bases for such termination. Employee shall not be treated as having been terminated for Cause unless, following such opportunity to contest the basis or bases for termination, the Board determines in writing by the affirmative vote of a majority of its members that the asserted basis or bases for termination exist under Section 4.1(b)(i)(B) through (E), as applicable, above and that Employee is therefore terminated for Cause. During the pendency of any process described in the immediately preceding sentence, the Corporation may transfer some or all of Employee's duties and responsibilities to one or more other persons, but until Employee's employment is terminated in accordance with the preceding provisions of this Section 4.1(b)(ii) he shall continue during the Agreement Term to be entitled to all the remuneration and employee benefits to which he would otherwise be entitled as an active employee under this Agreement. In any proceeding before the Board described in this Section 4.1(b)(ii), where Employee's good faith in the performance of his duties is in question, such good faith shall be presumed unless the preponderance of the evidence indicates otherwise.

(c) By Reason of Serious Illness or Disability. In the event of Employee's Serious Illness or Disability during Employment, the Corporation may terminate Employee's Employment by giving Employee at least 60 days' advance written notice specifying the date of termination. If, on or before the date of termination specified in such notice, Employee recovers and is again able to perform his duties hereunder, such notice shall be void, and Employee's Employment shall not be terminated thereby.

Section 4.2. Termination of Employment By Employee.

(a) For Good Reason, *etc*. Employee shall have the right to terminate his Employment for Good Reason, unless the Corporation prior to such termination shall have cured the asserted basis for the Good Reason claim, by giving not less than 30 days' prior written notice to the Corporation, which notice must be given within six calendar months after the event giving rise to the Good Reason. Employee shall also have the right to terminate his Employment at any time by written notice to the Corporation in the circumstances described in Section 1.19(iv).

(b) Other Than For Good Reason. Employee shall have the right to terminate his Employment at any time for any reason other than as described in Section 4.2(a) above in his sole discretion by giving not less than 90 days' prior written notice to the Corporation, which notice may not be given after the Corporation has provided a written notice of termination to

Employee under Section 4.1(b). Upon receipt of any such notice from Employee, the Corporation shall have the option, exercisable by giving Employee written notice within 30 days of such receipt, to designate any date (not earlier than 30 days after the date of Employee's notice) as the date on which Employee's Employment shall cease. The effective date of the Termination of Employment hereunder shall be the date so designated by the Corporation if earlier than the date specified by Employee. In no event shall the Termination of Employment by the Corporation without Cause, by Employee as described in Section 4.2(a) or by reason of a Failure to Extend be deemed to be a Termination of Employment by Employee pursuant to this Section 4.2(b).

Section 4.3. Other Termination of Employment. Employee's Employment shall also terminate on Employee's death.

Section 4.4. Resignation as Member of the Board of Directors. A Termination of Employment shall constitute, unless otherwise requested by the Board, Employee's resignation as a member of the Corporation's Board of Directors and as a member of the Board of Directors of the Fannie Mae Foundation, effective on the date of the Termination of Employment.

ARTICLE 5

COMPENSATION AND BENEFITS FOLLOWING TERMINATION OF EMPLOYMENT

Section 5.1. Voluntary Termination Pursuant to Section 4.2(b). If the Termination of Employment is a voluntary termination pursuant to Section 4.2(b), Employee shall be entitled to payment of all accrued but unpaid Base Salary amounts.

Section 5.2. Termination for Cause. In the event of a Termination of Employment for Cause, Employee shall be entitled to payment of all accrued but unpaid Base Salary amounts.

Any award made on or after the Effective Date under the Annual Incentive Plan that is outstanding at the time of the Termination of Employment, and all awards, if any, of Options, Performance Share Awards, and/or Restricted Stock that were made on or after the Effective Date and that are outstanding at the time of the Termination of Employment shall be forfeited or canceled without payment.

Section 5.3. Qualifying Termination (Other Than by Reason Of Death). If there is a Qualifying Termination (other than by reason of Employee's death), Employee shall be entitled to prompt payment of all accrued but unpaid Base Salary amounts and all amounts payable (but unpaid) under the Annual Incentive Plan with respect to any year ended on or prior to the Qualifying Termination, plus the following:

(a) Continuation of Base Salary. Unless such Qualifying Termination shall have been by reason of a Qualifying Termination described in Section 1.19(iv):

(i) The Corporation shall pay to Employee in cash, on the normal payroll schedule applicable to his Base Salary, cash compensation at an annual rate equal to his Base Salary as in effect at the time of the Qualifying Termination. Such cash compensation shall continue to be paid until the later of the expiration of the Agreement Term or the first anniversary of the date of the Qualifying Termination. The Corporation may accelerate the payment of any portion or all of any amount payable under this Section 5.3(a)(i).

(ii) Notwithstanding (i) above, if Employee obtains other employment (including self-employment, but excluding service on boards of directors) following his Termination of Employment hereunder, any income received by Employee from such employment shall reduce, on a dollar-for-dollar basis (but not below zero), the

Corporation's obligation to pay cash compensation to Employee pursuant to this Section 5.3(a). If the Corporation has already paid any cash compensation under Section 5.3(a)(i) to which an offset would otherwise have applied, Employee shall promptly reimburse the Corporation the amount of such compensation. In the event of a Qualifying Termination by reason of Serious Illness or Disability, if Employee becomes entitled to and receives disability benefits under any disability payment plan, including disability insurance, the amount of cash compensation otherwise payable by the Corporation to Employee pursuant to Section 5.3(a) shall be paid at a rate equal to the excess of (A) the rate at which such cash compensation would otherwise be paid over (B) the disability benefits for which Employee is eligible under such plan or insurance to the extent those benefits are attributable to premium payments made by the Corporation.

(b) Annual Incentive Plan. Except in the case of a Qualifying Termination by reason of a Failure to Extend and except as hereinafter provided, the Corporation shall pay to Employee at the time of payment of awards to other participants in the Annual Incentive Plan for the year in which the Qualifying Termination occurs (even if Employee is not employed by the Corporation on the last day of such year) a prorated amount equal to (i) the award that would have been payable to Employee for such year had he remained in Employment, based on actual results for such year, multiplied by (ii) a fraction, the numerator of which is the number of days of Employment during such year and the denominator of which is 365. In the case of a Qualifying Termination described in Section 1.19(iv), the Corporation shall promptly accelerate the payment of the prorated Annual Incentive Plan payment described in this Section 5.3(b). In the case of any other Qualifying Termination subject to this Section 5.3, the Corporation in its discretion may accelerate the payment of any portion or all of such prorated Annual Incentive

Plan payment. In any case where payment under this Section 5.3(b) is accelerated, the amount determined under clause (i) above shall be the award that the Board determines Employee would have received for the year in which the Qualifying Termination occurs based on the Board's determination of the likelihood of the Corporation's achievement of targets for such year.

(c) Performance Share Awards. Notwithstanding any provision of the Stock Compensation Plan to the contrary, in the case of any Qualifying Termination, the Corporation shall deliver to Employee all amounts payable (but unpaid) under any Performance Share Award with respect to an Award Cycle that had ended as of the date of the Termination of Employment plus, with respect to each Performance Share Award then held by Employee as to which at least 18 months of the related Award Period has elapsed as of the date of the Termination of Employment, after the end of such Award Period, the product of (i) the award that would have been payable to Employee for such Award Period had he remained in Employment, based on actual results for such Award Period, and (ii) a fraction, the numerator of which is the number of days of Employment in such Award Period and the denominator of which is the total number of days in such Award Period. In the case of a Qualifying Termination described in Section 1.19(iv), the Corporation shall promptly accelerate the payment of all prorated Performance Share Award payments described in this Section 5.3(c). In the case of any other Qualifying Termination subject to this Section 5.3, the Corporation in its discretion may accelerate the payment of any portion or all of any such payments. In any case where payment under this Section 5.3(c) is accelerated, the amount determined under clause (i) above shall be the award that the Board determines Employee would have received for the Award Period in which the Qualifying Termination occurs based on the Board's determination of the likelihood of the Corporation's achievement of targets for such Award Period.

(d) Restricted Stock. The shares of Restricted Stock awarded on February 23, 2000, to the extent not already vested, shall become immediately vested, and all Restricted Stock granted to Employee after February 23, 2000 shall continue to vest on the same basis as if Employee had remained employed through June 30, 2007.

(e) Medical and Dental Coverage. In the case of a Qualifying Termination by reason of a termination by the Corporation without Cause or by Employee for Good Reason, to the extent permitted under the Corporation's medical and dental plans the Corporation shall continue the medical and dental coverage elected by Employee for Employee and Employee's spouse and dependents (but in the case of employee's dependents only for so long as they remain dependents or until age 21 if later), without premium payments by Employee, until the end of the Agreement Term. If, for any reason, it is not possible for Employee, Employee's spouse or the other eligible dependents of Employee to participate in medical and dental coverage pursuant to the immediately preceding sentence, the Corporation shall make arrangements to provide comparable coverage.

Section 5.4. Termination of Employment By Reason of Death. If there is a Termination of Employment by reason of Employee's death, then in addition to the payment to Employee's estate of Employee's accrued but unpaid Base Salary:

(a) Annual Incentive Plan. The Corporation shall pay to Employee's designated beneficiary or, if none, to Employee's estate, as soon as is practicable after the date of Employee's death, all amounts payable (but unpaid) under the Annual Incentive Plan with respect to any year ended on or prior to death plus, for the year of death, a prorated amount equal to (i) the award that the Board determines Employee (had he lived) would have received for the year in which his death occurs based on the Board's determination of the likelihood of the

Corporation's achievement of targets for such year, multiplied by (ii) a fraction, the numerator of which is the number of days of Employment during such year prior to his death and the denominator of which is 365.

(b) Performance Share Awards. The Corporation shall pay to Employee's designated beneficiary or, if none, to Employee's estate, as soon as is practicable after the date of Employee's death, all amounts payable (but unpaid) under any Performance Share Award with respect to an Award Cycle that had ended on or prior to the date of death, plus an amount with respect to Performance Share Awards made for each Award Period that had not ended prior to the date of death and as to which at least 18 months had elapsed prior to the date of death equal to the award that the Board determines Employee (had he lived) would have received for the Award Period in which his death occurs based on the Board's determination of the likelihood of the Corporation's achievement of targets for such Award Period, multiplied by a fraction, the numerator of which is the number of days in the Award Period that had elapsed prior to Employee's death and the denominator of which is the total number of days in the Award Period.

(c) Restricted Stock. The shares of Restricted Stock awarded on February 23, 2000, to the extent not already vested, shall become immediately vested, and all Restricted Stock granted to Employee after February 23, 2000 shall continue to vest on the same basis as if Employee had remained employed through June 30, 2007.

ARTICLE 6

MISCELLANEOUS

Section 6.1. Noncompetition.

(a) Following Termination of Employment for any reason other than for Cause or by reason of a voluntary termination by Employee pursuant to Section 4.2(b), during the period from the date of the Termination of Employment to the later of the last day of the Agreement Term or the first anniversary of the date of the Termination of Employment Employee shall not, directly or indirectly, (i) Compete in the United States, (ii) solicit any officer or employee of the Corporation or any of its affiliates to engage in any conduct prohibited hereby for Employee or to terminate any existing relationship with the Corporation or such affiliate or (iii) assist any other person to engage in any activity in any manner prohibited hereby to Employee. Following Termination of Employment for Cause or by reason of a voluntary termination by Employee pursuant to Section 4.2(b), Employee shall not, directly or indirectly, engage in any of the activities described in (i), (ii) or (iii) of the immediately preceding sentence during the one-year period following the date of the Termination of Employment. In any case where Employee is contemplating an activity described in Section 6.1(a)(i) above, other than an activity described in Section 1.7(ii) or (iii) or an activity described in Section 1.7(i) as it relates to the secondary mortgage market, the Board, upon the request of Employee for a waiver, shall determine in good faith whether Employee’s engaging in the proposed activity would prejudice the interests of the Corporation and shall not unreasonably withhold its consent to such request for a waiver if it determines that the proposed activity would not prejudice the interests of the Corporation.

(b) The need to protect the Corporation against Employee’s competition, as well as the nature and scope of such protection, has been carefully considered by the parties hereto in light of the uniqueness of Employee’s talent and his importance to the Corporation. Accordingly, Employee agrees that, in addition to any other relief to which the Corporation may be entitled, the Corporation shall be entitled to seek and obtain injunctive relief (without the requirement of a bond) from a court of competent jurisdiction for the purpose of restraining Employee from any actual or threatened breach of the covenant contained in Section 6.1(a).

(c) If for any reason a final decision of any court determines that the restrictions under this Section 6.1 are not reasonable or that the consideration therefore is inadequate, such restrictions shall be interpreted, modified or rewritten by such court to include as much of the duration, scope and geographic area identified in this Section 6.1 as will render such restrictions valid and enforceable.

Section 6.2. Payment of Certain Expenses. As promptly as permitted by law the Corporation shall pay or advance to Employee all legal fees and expenses that Employee may reasonably incur as a result of any contest or arbitration requested by the Corporation, Employee or others of the validity or enforceability of, or liability under, any provision of this Agreement (including any contest initiated by Employee concerning the amount of any payment due pursuant to this Agreement), plus in each case interest at the applicable federal rate provided for in Section 7872(f)(2)(A) of the Internal Revenue Code of 1986, as amended, on any payment of legal fees and expenses that is delayed by more than 10 days following delivery by Employee to the Corporation of a proper request for payment. If as to any such contest or arbitration Employee does not prevail, and only in such case, within 10 days following written demand from the Corporation Employee shall repay any advance made by the Corporation pursuant to the immediately preceding sentence with respect to such contest or arbitration, with interest at the applicable federal rate provided for in Section 7872(f)(2)(A) of the Internal Revenue Code of 1986, as amended, from the date of the Corporation's payment.

Section 6.3. Assignment by Employee. Except as otherwise expressly provided herein or in the Corporation's benefit plans, the obligations, rights and benefits of Employee hereunder are personal to him, and no such obligation, right or benefit shall be subject to voluntary or involuntary alienation, assignment, delegation or transfer.

Section 6.4. No Funding Required. Nothing in this Agreement shall be construed as requiring the Corporation to establish a trust or otherwise to fund any payments to be made under this Agreement, but the Corporation in its discretion may establish such nonqualified trusts or other arrangements as it determines to be appropriate to assist it in meeting its obligations under this Agreement.

Section 6.5. Disclosure of Information to the Corporation. In the event Section 5.3 becomes applicable, Employee or, in the event of Employee's incapacity or death, his personal representative shall make available to the Corporation on a confidential basis such records, documents and other information reasonably necessary to enable the Corporation to verify the amount of income available to offset the payments otherwise due Employee.

Section 6.6. Nondisclosure of Confidential Information. Employee acknowledges that he is bound by the terms of an Agreement on Ideas, Inventions and Confidential Information dated March 22, 2001. Nothing in this Agreement shall be construed as limiting Employee's obligations under the aforesaid Agreement on Ideas, Inventions and Confidential Information or any successor thereto, which shall be treated for all purposes also as obligations of Employee under this Agreement. This Agreement in no way limits the ability of Employee to provide information covered by this Agreement to a government entity in order to assist the government entity in the fulfillment of its duties.

Section 6.7. Waiver. The failure of either party hereto to insist upon strict compliance by the other party with any term, covenant or condition of this Agreement shall not be deemed a waiver of such term, covenant or condition, nor shall any waiver or relinquishment or failure to insist upon strict compliance of any right or power hereunder at any one time or more times be deemed a waiver or relinquishment of such right or power at any other time or times.

Section 6.8. Notice. Any notice required or desired to be given pursuant to this Agreement shall be sufficient if transmitted in writing by hand delivery or sent by prepaid courier or by registered or certified mail, postage prepaid, (i) if notice is to the Corporation, to the Corporation's address hereinafter set forth, or (ii) if notice is to Employee, to Employee's address in the metropolitan District of Columbia area contained in the records of the Corporation, or, in either such case, to such other address of a party as such party may designate in writing and transmit to the other party in such manner. Any such notice shall be deemed given, if transmitted by hand delivery, one business day after deposit with a prepaid courier service or, if sent by registered or certified mail, three business days after deposit in the United States mail.

Section 6.9. Applicable Law. This Agreement shall be governed by the laws of the District of Columbia without regard to any otherwise applicable conflict of laws principles.

Section 6.10. Taxes. The Corporation shall deduct from all amounts payable under this Agreement all federal, state, local and other taxes required by law to be withheld with respect to such amounts.

Section 6.11. Benefit. Except as otherwise expressly provided herein, this Agreement shall inure to the benefit of and be binding upon the Corporation, its successors and assigns, and upon Employee, his spouse, heirs, executors and administrators. The Corporation shall require any successor (whether direct or indirect, by purchase, merger, reorganization, consolidation, acquisition of property or stock, liquidation or otherwise) to all or a substantial portion of its assets, by agreement in form and substance reasonably satisfactory to Employee, expressly to assume and agree to perform this Agreement in the same manner and to the same extent that the Corporation would be required to perform this Agreement if no such succession had taken place.

Regardless of whether such an agreement is executed, this Agreement shall be binding upon any successor of the Corporation, and such successor shall be deemed the "Corporation" for purposes of this Agreement.

Section 6.12. Entire Agreement. This Agreement contains the entire understanding and agreement between the parties relating to the terms of Employee's employment by the Corporation and, except as otherwise provided in Section 6.15, supersedes all prior written or oral agreements between them, other than the Agreement on Ideas, Inventions and Confidential Information dated March 22, 2001 and an Indemnification Agreement between the Corporation and Employee. This Agreement cannot be amended, modified or supplemented in any respect except by an agreement in writing signed by both parties hereto.

Section 6.13. Arbitration. Any controversy or claim arising out of or relating to this Agreement or the breach of this Agreement shall be settled by arbitration in the District of Columbia in accordance with the laws of the District of Columbia. The arbitration shall be conducted in accordance with the applicable rules of the American Arbitration Association. The costs and expenses of the arbitrator(s) shall be borne by the Corporation. Except as otherwise provided in Section 6.2, each party shall pay his or its own legal costs and other expenses (other than the costs and expenses of the arbitrator(s)) relating to an arbitration. The award of the arbitrator(s) shall be binding upon the parties. Judgment upon the award rendered by the arbitrator(s) may be entered in any court having jurisdiction.

Section 6.14. Severability. Except as otherwise provided in Section 6.15, it is the intent and understanding of each party hereto that, if any term, restriction, covenant or promise herein is found to be invalid or otherwise unenforceable, then such term, restriction, covenant or promise shall not thereby be invalid or unenforceable but shall be deemed modified to the extent necessary to make it enforceable and, if it cannot be so modified, shall be deemed amended to delete therefrom such provision or portion found to be invalid or unenforceable, such modification or amendment in any event to apply only with respect to the operation of this Agreement in the particular jurisdiction in which such finding is made.

Section 6.15. Regulatory Approval.

The parties hereto acknowledge and agree that pursuant to Section 309(d) of the Federal National Mortgage Association Charter Act, as amended by the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (as so amended, the "Act"), 12 U.S.C. 1723a(d), no provision of this Agreement relating to Employee's benefits upon termination of employment shall be effective unless and until such provision has been reviewed and approved by the Director (the "Director") of the Office of Federal Housing Enterprise Oversight ("OFHEO"). If, following OFHEO's review and approval of such provisions, any benefit plans of the Corporation affecting final termination benefits under this Agreement are altered, such alteration will require OFHEO's review and approval at the time of termination of the Employee's employment with the Corporation and prior to the payment of any such benefits. Upon determining that Employee's Employment is terminating or has terminated, the Corporation shall timely seek OFHEO's review and approval of any alteration referred to in the immediately preceding sentence.

The parties therefore agree as follows:

(a) The Corporation shall promptly hereafter submit this Agreement to the Director for his review and approval of those terms hereof relating to benefits upon termination of employment and shall seek diligently to obtain such approval;

(b) This Agreement shall take effect as of the Effective Date if the Director's approval of terms hereof relating to benefits upon termination of employment is given by January 1, 2005.

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Exhibit 10.3

EMPLOYMENT AGREEMENT

between

FANNIE MAE

and

J. TIMOTHY HOWARD

As Amended on June 30, 2004

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EMPLOYMENT AGREEMENT

THIS EMPLOYMENT AGREEMENT (this "Agreement") is between FANNIE MAE (the "Corporation") and J. TIMOTHY HOWARD ("Employee").

WHEREAS, the Corporation and Employee are parties to an employment agreement dated as of July 1, 2003, which terminates on June 30, 2004 (the "Existing Agreement");

WHEREAS, under the termination provisions of the Existing Agreement, which were approved by OFHEO, Employee is contractually entitled to certain compensation and benefits if, among other circumstances, Employee's employment is not extended; and

WHEREAS, Employee has successfully discharged his responsibilities under the Existing Agreement and has earned certain vested amounts, as described in his Existing Agreement, over the course of his employment;

NOW, THEREFORE, the Corporation and Employee agree as follows:

ARTICLE 1

DEFINITIONS

The following terms shall have the meanings set forth below:

Section Section 1.1. Agreement Term means the period of time beginning on the Effective Date and ending on June 30, 2007 or such later date as may be agreed to pursuant to Section 2.1.

Section 1.2. Annual Incentive Plan means the Federal National Mortgage Association Annual Incentive Plan as from time to time amended and in effect, or any successor plan.

Section 1.3. Award Period is defined in the Stock Compensation Plan.

Section 1.4. Base Salary means the dollar amount of Employee's annual base compensation as determined by the Board.

Section 1.5. Board means the Board of Directors of the Corporation, acting without the participation of the Vice Chairmen of the Board of Directors.

Section 1.6. Cause is defined in Section 4.1(b).

Section 1.7. Compete means directly or indirectly to manage, operate, control, participate in the ownership, management, operation or control of, be connected as an officer, employee, partner, director, consultant or otherwise with, or have any financial interest in, (i) any business if a substantial part of such business involves originating, purchasing, selling, servicing or otherwise dealing in the residential mortgage market (provided, that Employee shall not be deemed, directly or indirectly, to Compete solely by virtue of Employee's employment by a business that engages in transactions in the residential mortgage market so long as Employee himself does not participate directly in the residential mortgage business), (ii) Freddie Mac, or (iii) any part of the Federal Home Loan Bank System (including any one of the Federal Home Loan Banks or the Federal Home Loan Banks Office of Finance). Employee shall not be deemed to Compete solely by reason of ownership, for personal investment purposes only, of less than 2% of the voting interests of any business.

Section 1.8. Corporation means Fannie Mae.

Section 1.9. Effective Date means July 1, 2004, subject, however, to the provisions of Section 6.15 ("Regulatory Approval").

Section 1.10. Employee means J. Timothy Howard.

Section 1.11. Employment means Employee's employment by the Corporation under this Agreement.

Section 1.12. Executive Pension Plan means the Executive Pension Plan of the Federal National Mortgage Association as from time to time amended and in effect, or any successor plan.

Section 1.13. Existing Agreement is defined in the preamble to this Agreement.

Section 1.14. Failure to Extend means notification of Employee by the Corporation that it does not desire to extend the Agreement Term (or the term of any successor agreement) or that it desires to do so only on terms in the aggregate that are materially less favorable to Employee than those applicable to Employee at the time of said notice. If the Corporation notifies Employee that it desires to extend the Agreement Term (or the term of any successor agreement) on terms that are in the aggregate substantially similar to or more favorable than those applicable to Employee at the time of said notice, any nonextension shall not be deemed to be a Failure to Extend.

Section 1.15. Good Reason means (a) a material reduction by the Corporation of Employee's authority or a material change in Employee's functions, duties or responsibilities that in any material way would cause Employee's position to become less important, (b) a reduction in Employee's Base Salary, (c) a requirement by the Corporation that Employee relocate his office outside of the Washington, D.C. area, or (d) a breach by the Corporation of any material obligation of the Corporation under this Agreement, unless, within 30 days of the written notice given by Employee and specifying a circumstance constituting Good Reason, the Corporation eliminates such circumstance.

Section 1.16. OFHEO means the Office of Federal Housing Enterprise Oversight.

Section 1.17. Option is defined in the Stock Compensation Plan.

Section 1.18. Performance Share Award is defined in the Stock Compensation Plan.

Section 1.19. Qualifying Termination means Termination of Employment (i) by the Corporation without Cause, (ii) by Employee for Good Reason, (iii) upon expiration of the Agreement Term (or the term of any successor agreement) if there has been a Failure to Extend, (iv) by reason of Employee's acceptance of an appointment to a senior position in the U.S. Federal Government, (v) by reason of Serious Illness or Disability or (vi) by reason of Employee's death.

Section 1.20. Restricted Stock is defined in the Stock Compensation Plan.

Section 1.21. Serious Illness or Disability means a serious physical or mental illness or disability which, in the reasonable determination of the Board, prevents Employee from performing his duties under this Agreement for a period of at least six months in any twelve-month period.

Section 1.22. Stock Compensation Plan means either or both, as the context requires, of the Fannie Mae Stock Compensation Plan of 1993 and the Fannie Mae Stock Compensation Plan of 2003, in each case as from time to time amended and in effect, or any successor plan.

Section 1.23. Surviving Spouse is defined in the Executive Pension Plan.

Section 1.24. Termination of Employment means the cessation of Employment for any reason.

ARTICLE 2

PERIOD OF EMPLOYMENT AND DUTIES

Section 2.1. Period of Employment. The Corporation shall continue to employ Employee, and Employee shall continue to serve, as Vice Chairman of the Corporation's Board of Directors and Chief Financial Officer of the Corporation, upon the terms and conditions of this Agreement, for the period July 1, 2004 through the last day of the Agreement Term unless there is an earlier Termination of Employment. The Agreement Term may be extended by mutual written agreement of the parties entered into at any time prior to the date the Agreement Term would otherwise expire.

Section 2.2. Duties. Employee shall serve the Corporation under this Agreement as Vice Chairman of the Corporation's Board of Directors and as Chief Financial Officer. Employee shall devote his full business time and attention to the Corporation and shall faithfully and diligently perform such duties for the Corporation as may be determined from time to time by the Chairman of the Board of Directors, provided that such duties are reasonable and customary for a corporate vice chairman and chief financial officer. Employee shall be subject to the Corporation's standards of conduct and similar policies and procedures applicable generally to members of the Board of Directors or to the Corporation's executive officers, as the case may be. Employee may (a) serve on corporate, civic or charitable boards or committees or (b) manage personal investments, so long as such activities do not materially interfere with the performance of his responsibilities under this Agreement and so long as such activities comply with the aforementioned standards, policies and procedures of the Corporation. During his Employment, Employee shall be nominated for election to the Corporation's Board of Directors and shall be identified as a nominee recommended for election by the Board, at each annual meeting of the stockholders of the Corporation.

ARTICLE 3

COMPENSATION AND BENEFITS

Section 3.1. Base Salary. During Employee's Employment, the Corporation shall pay to Employee Base Salary of not less than his base salary at June 30, 2004. The Board shall from time to time review Employee's Base Salary and may increase (but in no event decrease) such Base Salary by such amounts as it deems proper. Section 3.2. Benefits.

(a) Executive Pension Plan. The parties acknowledge that the Corporation has previously designated Employee as a participant in the Executive Pension Plan. Employee's "Pension Goal" under the Executive Pension Plan shall at all times be equal to at least 50% of his "High-Three Total Compensation," as those terms are defined in the Executive Pension Plan. The Corporation may amend the Executive Pension Plan from time to time; provided, however, that no such amendment shall decrease Employee's Pension Goal or the vested benefits to which Employee or his Surviving Spouse, if any, would have been entitled under such Plan, as modified in this Agreement, as in effect on the Effective Date or, if benefits are improved, as of the date of such improvement.

(b) Options. Employee shall be considered for grants of Options consistent with the compensation philosophy of the Corporation set forth in the charter of the Compensation Committee of the Board.

(c) Annual Incentive Plan. Employee shall be considered for a potential award under the Annual Incentive Plan for each year during Employment consistent with the compensation philosophy of the Corporation set forth in the charter of the Compensation Committee of the Board.

(d) Performance Share Awards. Employee shall be considered for grants of Performance Share Awards consistent with the compensation philosophy of the Corporation set forth in the charter of the Compensation Committee of the Board.

(e) Restricted Stock. Employee shall be considered for grants of Restricted Stock consistent with the compensation philosophy of the Corporation set forth in the charter of the Compensation Committee of the Board.

(f) Life Insurance and Death Benefits. Employee shall receive life insurance benefits consistent with the Corporation's life insurance policies and programs as from time to time in effect.

(g) Other Benefits. The Corporation shall provide Employee with the following additional benefits during Employment:

(i) The Corporation shall pay or reimburse Employee for reasonable expenses incurred by Employee in obtaining tax and investment assistance and advice, up to $25,000 per calendar year.

(ii) The Corporation shall pay or reimburse the legal expenses incurred by Employee in connection with the negotiation of this Agreement.

(iii) The Corporation shall provide Employee with access to a car and driver for transportation relating to the Corporation's business purposes.

(iv) The Corporation shall pay or reimburse Employee for actual expenses incurred by Employee for a complete annual physical examination at a medical facility of his choice.

(h) General Rights Under Benefit Plans.

(i) Employee shall at all times during the Employment Term be entitled to participate in all long- or short-term bonus, stock option, restricted stock, and other executive compensation plans, and in all perquisite programs and disability, retirement, stock purchase, thrift and savings, health, medical, life insurance, expense reimbursement and similar plans of the Corporation which are from time to time in effect and in which other senior officers of the Corporation generally are entitled to participate. Except as otherwise provided in this Agreement, Employee’s participation in such plans and programs shall be in accordance with the provisions of such plans and programs applicable from time to time, it being the intent of the parties hereto that nothing in this Agreement shall decrease the rights and benefits of Employee under any such plans and programs as may be in effect from time to time. Employee’s rights as a participant under any compensation, benefit or fringe benefit plan or arrangement of the Corporation that is from time to time in effect and in which other senior officers of the Corporation generally are entitled to participate shall be subject to this Agreement and modified to the extent expressly provided herein, but except as so modified shall be determined under the applicable provisions of such plans and programs, including, without limitation, the provisions thereof applicable to retirement; provided, that all such plans and programs and this Agreement shall be construed and administered to avoid any duplication of benefits under any such plan or program and this Agreement.

(ii) Except as specifically set forth in this Agreement, or as specifically permitted by the terms of any such plan or program, no right or benefit under any such plan or program shall become vested or exercisable after Termination of Employment.

ARTICLE 4

TERMINATION OF EMPLOYMENT

Section 4.1. Termination of Employment By the Corporation.

(a) Without Cause. The Corporation shall have the right to terminate Employee's Employment without Cause at any time for any reason in the Corporation's sole discretion by giving at least 90 days' prior written notice to Employee.

(b) For Cause. The Corporation may terminate Employee's Employment for Cause. For purposes of this Agreement, termination for "Cause" shall have the meaning set forth at Section 4.1(b)(i) below, and Employee's Employment shall not be treated as having been terminated for Cause unless such termination is accomplished in accordance with Section 4.1(b)(ii) below.

(i) For purposes of this Agreement, Employee shall be treated as having been terminated for "Cause" only if Employee has (A) been convicted of, or pleaded *nolo contendere* with respect to, a felony, or (B) participated personally in an act of fraud in the discharge of his duties under this Agreement that demonstrably discredits the Corporation and that cannot be cured, or (C) continued for 30 days following written notice from the Corporation to engage in activities that are not contemplated or permitted by this Agreement and that involve a material conflict of interest with Employee's duties and responsibilities under this Agreement, or (D) continued for 30 days following written notice from the Corporation to fail substantially to perform the material duties of his office (other than as a result of total or partial incapacity due to physical or mental illness or disability), or (E) failed to cure, within 30 days following written notice from the Corporation, any material breach of the material terms of this Agreement or of any written noncompetition, nondisclosure or nonsolicitation policy or agreement to which

Employee is at the time subject or by which he is at the time bound. The Corporation's written notice to Employee referred to in (C), (D) and (E) above will not be deemed to have been given unless it identifies with particularity the asserted basis or bases for a for-Cause termination and requests, with specific reference to this Section 4.1(b)(i), that it or they be corrected or cured.

(ii) The Corporation by written notice may terminate Employee's employment for Cause at any time following the occurrence of an event described in Section 4.1(b)(i)(A) above. Within 10 days following the occurrence of an act described in Section 4.1(b)(i)(B) above, or following the end of the 30-day correction or cure period described in any of Section 4.1(b)(i)(C), (D) or (E) above, if the basis or bases asserted by the Board for a for-Cause termination thereunder have not been corrected or cured, the Board shall give written notice to Employee setting forth with particularity the asserted basis or bases for a for-Cause termination and giving Employee a reasonable opportunity, including reasonable access to information and documents, to appear with counsel before the Board to contest the asserted basis or bases for such termination. Employee shall not be treated as having been terminated for Cause unless, following such opportunity to contest the basis or bases for termination, the Board determines in writing by the affirmative vote of a majority of its members that the asserted basis or bases for termination exist under Section 4.1(b)(i)(B) through (E), as applicable, above and that Employee is therefore terminated for Cause. During the pendency of any process described in the immediately preceding sentence, the Corporation may transfer some or all of Employee's duties and responsibilities to one or more other persons, but until Employee's employment is terminated in accordance with the preceding provisions of this Section 4.1(b)(ii) he shall continue during the Agreement Term to be entitled to all the remuneration and employee benefits to which he would otherwise be entitled as an active employee under this Agreement. In any proceeding before the Board described in this Section 4.1(b)(ii), where Employee's good faith in the performance of his duties is in question, such good faith shall be presumed unless the preponderance of the evidence indicates otherwise.

(c) By Reason of Serious Illness or Disability. In the event of Employee's Serious Illness or Disability during Employment, the Corporation may terminate Employee's Employment by giving Employee at least 60 days' advance written notice specifying the date of termination. If, on or before the date of termination specified in such notice, Employee recovers and is again able to perform his duties hereunder, such notice shall be void, and Employee's Employment shall not be terminated thereby.

Section 4.2. Termination of Employment By Employee.

(a) For Good Reason, *etc.* Employee shall have the right to terminate his Employment for Good Reason, unless the Corporation prior to such termination shall have cured the asserted basis for the Good Reason claim, by giving not less than 30 days' prior written notice to the Corporation, which notice must be given within six calendar months after the event giving rise to the Good Reason. Employee shall also have the right to terminate his Employment at any time by written notice to the Corporation in the circumstances described in Section 1.19(iv).

(b) Other Than For Good Reason. Employee shall have the right to terminate his Employment at any time for any reason other than as described in Section 4.2(a) above in his sole discretion by giving not less than 90 days' prior written notice to the Corporation, which notice may not be given after the Corporation has provided a written notice of termination to

Employee under Section 4.1(b). Upon receipt of any such notice from Employee, the Corporation shall have the option, exercisable by giving Employee written notice within 30 days of such receipt, to designate any date (not earlier than 30 days after the date of Employee's notice) as the date on which Employee's Employment shall cease. The effective date of the Termination of Employment hereunder shall be the date so designated by the Corporation if earlier than the date specified by Employee. In no event shall the Termination of Employment by the Corporation without Cause, by Employee as described in Section 4.2(a) or by reason of a Failure to Extend be deemed to be a Termination of Employment by Employee pursuant to this Section 4.2(b).

Section 4.3. Other Termination of Employment. Employee's Employment shall also terminate on Employee's death.

Section 4.4. Resignation as Member of the Board of Directors. A Termination of Employment shall constitute, unless otherwise requested by the Board, Employee's resignation as a member of the Corporation's Board of Directors, effective on the date of the Termination of Employment.

ARTICLE 5

COMPENSATION AND BENEFITS FOLLOWING TERMINATION OF EMPLOYMENT

Section 5.1. Voluntary Termination Pursuant to Section 4.2(b). If the Termination of Employment is a voluntary termination pursuant to Section 4.2(b), Employee shall be entitled to payment of all accrued but unpaid Base Salary amounts.

Section 5.2. Termination for Cause. In the event of a Termination of Employment for Cause, Employee shall be entitled to payment of all accrued but unpaid Base Salary amounts.

Any award made on or after the Effective Date under the Annual Incentive Plan that is outstanding at the time of the Termination of Employment, and all awards, if any, of Options, Performance Share Awards, and/or Restricted Stock that were made on or after the Effective Date and that are outstanding at the time of the Termination of Employment shall be forfeited or canceled without payment.

Section 5.3. Qualifying Termination (Other Than by Reason Of Death). If there is a Qualifying Termination (other than by reason of Employee's death), Employee shall be entitled to prompt payment of all accrued but unpaid Base Salary amounts and all amounts payable (but unpaid) under the Annual Incentive Plan with respect to any year ended on or prior to the Qualifying Termination, plus the following:

(a) Continuation of Base Salary. Unless such Qualifying Termination shall have been by reason of a Qualifying Termination described in Section 1.19(iv):

(i) The Corporation shall pay to Employee in cash, on the normal payroll schedule applicable to his Base Salary, cash compensation at an annual rate equal to his Base Salary as in effect at the time of the Qualifying Termination. Such cash compensation shall continue to be paid until the later of the expiration of the Agreement Term or the first anniversary of the date of the Qualifying Termination; provided, that if the Qualifying Termination is by reason of a Failure to Extend, such cash compensation shall continue to be paid following the date of the Termination of Employment only until the first anniversary of the date of notification by the Corporation constituting the Failure to Extend. The Corporation may accelerate the payment of any portion or all of any amount payable under this Section 5.3(a)(i).

(ii) Notwithstanding (i) above, if Employee obtains other employment (including self-employment, but excluding service on boards of directors) following his Termination of Employment hereunder, any income received by Employee from such employment shall reduce, on a dollar-for-dollar basis (but not below zero), the Corporation's obligation to pay cash compensation to Employee pursuant to this Section 5.3(a). If the Corporation has already paid any cash compensation under Section 5.3(a)(i) to which an offset would otherwise have applied, Employee shall promptly reimburse the Corporation the amount of such compensation. In the event of a Qualifying Termination by reason of Serious Illness or Disability, if Employee becomes entitled to and receives disability benefits under any disability payment plan, including disability insurance, the amount of cash compensation otherwise payable by the Corporation to Employee pursuant to Section 5.3(a) shall be paid at a rate equal to the excess of (A) the rate at which such cash compensation would otherwise be paid over (B) the disability benefits for which Employee is eligible under such plan or insurance to the extent those benefits are attributable to premium payments made by the Corporation.

(b) Annual Incentive Plan. Except in the case of a Qualifying Termination by reason of a Failure to Extend and except as hereinafter provided, the Corporation shall pay to Employee at the time of payment of awards to other participants in the Annual Incentive Plan for the year in which the Qualifying Termination occurs (even if Employee is not employed by the Corporation on the last day of such year) a prorated amount equal to (i) the award that would have been payable to Employee for such year had he remained in Employment, based on actual results for such year, multiplied by (ii) a fraction, the numerator of which is the number of days of Employment during such year and the denominator of which is 365. In the case of a Qualifying

Termination described in Section 1.19(iv), the Corporation shall promptly accelerate the payment of the prorated Annual Incentive Plan payment described in this Section 5.3(b). In the case of any other Qualifying Termination subject to this Section 5.3, the Corporation in its discretion may accelerate the payment of any portion or all of such prorated Annual Incentive Plan payment. In any case where payment under this Section 5.3(b) is accelerated, the amount determined under clause (i) above shall be the award that the Board determines Employee would have received for the year in which the Qualifying Termination occurs based on the Board's determination of the likelihood of the Corporation's achievement of targets for such year.

(c) Performance Share Awards. Notwithstanding any provision of the Stock Compensation Plan to the contrary, in the case of any Qualifying Termination, the Corporation shall deliver to Employee all amounts payable (but unpaid) under any Performance Share Award with respect to an Award Cycle that had ended as of the date of the Termination of Employment plus, with respect to each Performance Share Award then held by Employee as to which at least 18 months of the related Award Period has elapsed as of the date of the Termination of Employment, after the end of such Award Period, the product of (i) the award that would have been payable to Employee for such Award Period had he remained in Employment, based on actual results for such Award Period, and (ii) a fraction, the numerator of which is the number of days of Employment in such Award Period and the denominator of which is the total number of days in such Award Period. In the case of a Qualifying Termination described in Section 1.19(iv), the Corporation shall promptly accelerate the payment of all prorated Performance Share Award payments described in this Section 5.3(c). In the case of any other Qualifying Termination subject to this Section 5.3, the Corporation in its discretion may accelerate the payment of any portion or all of any such payments. In any case where payment under this Section 5.3(c) is accelerated, the amount determined under clause (i) above shall be the award that the Board determines Employee would have received for the Award Period in which the Qualifying Termination occurs based on the Board's determination of the likelihood of the Corporation's achievement of targets for such Award Period.

(d) Restricted Stock. All Restricted Stock granted to Employee after July 1, 2003 shall continue to vest on the same basis as if Employee had remained employed through June 30, 2007.

(e) Medical and Dental Coverage. In the case of a Qualifying Termination by reason of a termination by the Corporation without Cause or by Employee for Good Reason, to the extent permitted under the Corporation's medical and dental plans the Corporation shall continue the medical and dental coverage elected by Employee for Employee and Employee's spouse and dependents (but in the case of employee's dependents only for so long as they remain dependents or until age 21 if later), without premium payments by Employee, until the end of the Agreement Term. If, for any reason, it is not possible for Employee, Employee's spouse or the other eligible dependents of Employee to participate in medical and dental coverage pursuant to the immediately preceding sentence, the Corporation shall make arrangements to provide comparable coverage.

Section 5.4. Termination of Employment By Reason of Death. If there is a Termination of Employment by reason of Employee's death, then in addition to the payment to Employee's estate of Employee's accrued but unpaid Base Salary:

(a) Annual Incentive Plan. The Corporation shall pay to Employee's designated beneficiary or, if none, to Employee's estate, as soon as is practicable after the date of Employee's death, all amounts payable (but unpaid) under the Annual Incentive Plan with respect to any year ended on or prior to death plus, for the year of death, a prorated amount equal to (i) the award that the Board determines Employee (had he lived) would have received for the year in which his death occurs based on the Board's determination of the likelihood of the Corporation's achievement of targets for such year, multiplied by (ii) a fraction, the numerator of which is the number of days of Employment during such year prior to his death and the denominator of which is 365.

(b) Performance Share Awards. The Corporation shall pay to Employee's designated beneficiary or, if none, to Employee's estate, as soon as is practicable after the date of Employee's death, all amounts payable (but unpaid) under any Performance Share Award with respect to an Award Cycle that had ended on or prior to the date of death, plus an amount with respect to Performance Share Awards made for each Award Period that had not ended prior to the date of death and as to which at least 18 months had elapsed prior to the date of death equal to the award that the Board determines Employee (had he lived) would have received for the Award Period in which his death occurs based on the Board's determination of the likelihood of the Corporation's achievement of targets for such Award Period, multiplied by a fraction, the numerator of which is the number of days in the Award Period that had elapsed prior to Employee's death and the denominator of which is the total number of days in the Award Period.

(c) Restricted Stock. All Restricted Stock granted to Employee after July 1, 2003 shall continue to vest on the same basis as if Employee had remained employed through June 30, 2007.

ARTICLE 6

MISCELLANEOUS

Section 6.1. Noncompetition.

(a) Following Termination of Employment for any reason other than for Cause or by reason of a voluntary termination by Employee pursuant to Section 4.2(b), during the period from the date of the Termination of Employment to the later of the last day of the Agreement Term or the first anniversary of the date of the Termination of Employment Employee shall not, directly or indirectly, (i) Compete in the United States, (ii) solicit any officer or employee of the Corporation or any of its affiliates to engage in any conduct prohibited hereby for Employee or to terminate any existing relationship with the Corporation or such affiliate or (iii) assist any other person to engage in any activity in any manner prohibited hereby to Employee. Following Termination of Employment for Cause or by reason of a voluntary termination by Employee pursuant to Section 4.2(b), Employee shall not, directly or indirectly, engage in any of the activities described in (i), (ii) or (iii) of the immediately preceding sentence during the one-year period following the date of the Termination of Employment. In any case where Employee is contemplating an activity described in Section 6.1(a)(i) above, other than an activity described in Section 1.7(ii) or (iii) or an activity described in Section 1.7(i) as it relates to the secondary mortgage market, the Board, upon the request of Employee for a waiver, shall determine in good faith whether Employee's engaging in the proposed activity would prejudice the interests of the Corporation and shall not unreasonably withhold its consent to such request for a waiver if it determines that the proposed activity would not prejudice the interests of the Corporation.

(b) The need to protect the Corporation against Employee's competition, as well as the nature and scope of such protection, has been carefully considered by the parties hereto in light of the uniqueness of Employee's talent and his importance to the Corporation. Accordingly, Employee agrees that, in addition to any other relief to which the Corporation may be entitled, the Corporation shall be entitled to seek and obtain injunctive relief (without the requirement of a bond) from a court of competent jurisdiction for the purpose of restraining Employee from any actual or threatened breach of the covenant contained in Section 6.1(a).

(c) If for any reason a final decision of any court determines that the restrictions under this Section 6.1 are not reasonable or that the consideration therefore is inadequate, such restrictions shall be interpreted, modified or rewritten by such court to include as much of the duration, scope and geographic area identified in this Section 6.1 as will render such restrictions valid and enforceable.

Section 6.2. Payment of Certain Expenses. As promptly as permitted by law the Corporation shall pay or advance to Employee all legal fees and expenses that Employee may reasonably incur as a result of any contest or arbitration requested by the Corporation, Employee or others of the validity or enforceability of, or liability under, any provision of this Agreement (including any contest initiated by Employee concerning the amount of any payment due pursuant to this Agreement), plus in each case interest at the applicable federal rate provided for in Section 7872(f)(2)(A) of the Internal Revenue Code of 1986, as amended, on any payment of legal fees and expenses that is delayed by more than 10 days following delivery by Employee to the Corporation of a proper request for payment. If as to any such contest or arbitration Employee does not prevail, and only in such case, within 10 days following written demand from the Corporation Employee shall repay any advance made by the Corporation pursuant to the immediately preceding sentence with respect to such contest or arbitration, with interest at the applicable federal rate provided for in Section 7872(f)(2)(A) of the Internal Revenue Code of 1986, as amended, from the date of the Corporation's payment.

Section 6.3. Assignment by Employee. Except as otherwise expressly provided herein or in the Corporation's benefit plans, the obligations, rights and benefits of Employee hereunder are personal to him, and no such obligation, right or benefit shall be subject to voluntary or involuntary alienation, assignment, delegation or transfer.

Section 6.4. No Funding Required. Nothing in this Agreement shall be construed as requiring the Corporation to establish a trust or otherwise to fund any payments to be made under this Agreement, but the Corporation in its discretion may establish such nonqualified trusts or other arrangements as it determines to be appropriate to assist it in meeting its obligations under this Agreement.

Section 6.5. Disclosure of Information to the Corporation. In the event Section 5.3 becomes applicable, Employee or, in the event of Employee's incapacity or death, his personal representative shall make available to the Corporation on a confidential basis such records, documents and other information reasonably necessary to enable the Corporation to verify the amount of income available to offset the payments otherwise due Employee.

Section 6.6. Nondisclosure of Confidential Information. Employee acknowledges that he is bound by the terms of an Agreement on Ideas, Inventions and Confidential Information dated March 16, 2001. Nothing in this Agreement shall be construed as limiting Employee's obligations under the aforesaid Agreement on Ideas, Inventions and Confidential Information or any successor thereto, which shall be treated for all purposes also as obligations of Employee under this Agreement. This Agreement in no way limits the ability of Employee to provide information covered by this Agreement to a government entity in order to assist the government entity in the fulfillment of its duties.

Section 6.7. Waiver. The failure of either party hereto to insist upon strict compliance by the other party with any term, covenant or condition of this Agreement shall not be deemed a waiver of such term, covenant or condition, nor shall any waiver or relinquishment or failure to insist upon strict compliance of any right or power hereunder at any one time or more times be deemed a waiver or relinquishment of such right or power at any other time or times.

Section 6.8. Notice. Any notice required or desired to be given pursuant to this Agreement shall be sufficient if transmitted in writing by hand delivery or sent by prepaid courier or by registered or certified mail, postage prepaid, (i) if notice is to the Corporation, to the Corporation's address hereinafter set forth, or (ii) if notice is to Employee, to Employee's address in the metropolitan District of Columbia area contained in the records of the Corporation, or, in either such case, to such other address of a party as such party may designate in writing and transmit to the other party in such manner. Any such notice shall be deemed given, if transmitted by hand delivery, one business day after deposit with a prepaid courier service or, if sent by registered or certified mail, three business days after deposit in the United States mail.

Section 6.9. Applicable Law. This Agreement shall be governed by the laws of the District of Columbia without regard to any otherwise applicable conflict of laws principles.

Section 6.10. Taxes. The Corporation shall deduct from all amounts payable under this Agreement all federal, state, local and other taxes required by law to be withheld with respect to such amounts.

Section 6.11. Benefit. Except as otherwise expressly provided herein, this Agreement shall inure to the benefit of and be binding upon the Corporation, its successors and assigns, and upon Employee, his spouse, heirs, executors and administrators. The Corporation shall require any successor (whether direct or indirect, by purchase, merger, reorganization, consolidation, acquisition of property or stock, liquidation or otherwise) to all or a substantial portion of its assets, by agreement in form and substance reasonably satisfactory to Employee, expressly to assume and agree to perform this Agreement in the same manner and to the same extent that the Corporation would be required to perform this Agreement if no such succession had taken place. Regardless of whether such an agreement is executed, this Agreement shall be binding upon any successor of the Corporation, and such successor shall be deemed the "Corporation" for purposes of this Agreement.

Section 6.12. Entire Agreement. This Agreement contains the entire understanding and agreement between the parties relating to the terms of Employee's employment by the Corporation and, except as otherwise provided in Section 6.15, supersedes all prior written or oral agreements between them, other than the Agreement on Ideas, Inventions and Confidential Information dated March 16, 2001 and an Indemnification Agreement between the Corporation and Employee. This Agreement cannot be amended, modified or supplemented in any respect except by an agreement in writing signed by both parties hereto.

Section 6.13. Arbitration. Any controversy or claim arising out of or relating to this Agreement or the breach of this Agreement shall be settled by arbitration in the District of Columbia in accordance with the laws of the District of Columbia. The arbitration shall be conducted in accordance with the applicable rules of the American Arbitration Association. The costs and expenses of the arbitrator(s) shall be borne by the Corporation. Except as otherwise provided in Section 6.2, each party shall pay his or its own legal costs and other expenses (other than the costs and expenses of the arbitrator(s)) relating to an arbitration. The award of the arbitrator(s) shall be binding upon the parties. Judgment upon the award rendered by the arbitrator(s) may be entered in any court having jurisdiction.

Section 6.14. Severability. Except as otherwise provided in Section 6.15, it is the intent and understanding of each party hereto that, if any term, restriction, covenant or promise herein is found to be invalid or otherwise unenforceable, then such term, restriction, covenant or promise shall not thereby be invalid or unenforceable but shall be deemed modified to the extent necessary to make it enforceable and, if it cannot be so modified, shall be deemed amended to delete therefrom such provision or portion found to be invalid or unenforceable, such modification or amendment in any event to apply only with respect to the operation of this Agreement in the particular jurisdiction in which such finding is made.

Section 6.15. Regulatory Approval.

The parties hereto acknowledge and agree that pursuant to Section 309(d) of the Federal National Mortgage Association Charter Act, as amended by the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (as so amended, the “Act”), 12 U.S.C. 1723a(d), no provision of this Agreement relating to Employee’s benefits upon termination of employment shall be effective unless and until such provision has been reviewed and approved by the Director (the “Director”) of the Office of Federal Housing Enterprise Oversight (“OFHEO”). If, following OFHEO’s review and approval of such provisions, any benefit plans of the Corporation affecting final termination benefits under this Agreement are altered, such alteration will require OFHEO’s review and approval at the time of termination of the Employee’s employment with the Corporation and prior to the payment of any such benefits. Upon determining that Employee’s Employment is terminating or has terminated, the Corporation shall timely seek OFHEO’s review and approval of any alteration referred to in the immediately preceding sentence.

The parties therefore agree as follows:

(a) The Corporation shall promptly hereafter submit this Agreement to the Director for his review and approval of those terms hereof relating to benefits upon termination of employment and shall seek diligently to obtain such approval;

(b) This Agreement shall take effect as of the Effective Date if the Director's approval of terms hereof relating to benefits upon termination of employment is given by January 1, 2005.

EXHIBIT 31.1

CERTIFICATION

PURSUANT TO SECURITIES EXCHANGE ACT RULE 13a-14

I, Franklin D. Raines, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Fannie Mae (formally, the Federal National Mortgage Association);

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:

   (a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   (b) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   (c) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

   (a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

   (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 9, 2004

/s/ FRANKLIN D. RAINES

Franklin D. Raines
Chairman of the Board of Directors and
Chief Executive Officer

EXHIBIT 31.2

CERTIFICATION

PURSUANT TO SECURITIES EXCHANGE ACT RULE 13a-14

I, J. Timothy Howard, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Fannie Mae (formally, the Federal National Mortgage Association);

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:

   (a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   (b) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   (c) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

   (a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

   (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 9, 2004

/s/ J. TIMOTHY HOWARD

J. Timothy Howard
Vice Chairman and Chief Financial Officer

EXHIBIT 32.1

Certification by the Chief Executive Officer
Pursuant to 18 U. S. C. Section 1350,
As Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

Pursuant to 18 U. S. C. Section 1350, I, Franklin D. Raines, hereby certify that, to the best of my knowledge,

(a) the Quarterly Report of Fannie Mae (formally, the Federal National Mortgage Association) on Form 10-Q for the quarter ended June 30, 2004 (the "Report"), as filed with the Securities and Exchange Commission on August 9, 2004, fully complies with the requirements of Section 13(a) or Section 15(d) of the Securities Exchange Act of 1934, and

(b) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of Fannie Mae.

/s/ FRANKLIN D. RAINES

Franklin D. Raines
Chairman of the Board of Directors and
Chief Executive Officer

Date: August 9, 2004

A signed original of this written statement required by Section 906 has been provided to Fannie Mae and will be retained by Fannie Mae and furnished to the Securities and Exchange Commission or its staff upon request.

EXHIBIT 32.2

Certification by the Chief Financial Officer
Pursuant to 18 U. S. C. Section 1350,
As Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

Pursuant to 18 U. S. C. Section 1350, I, J. Timothy Howard, hereby certify that, to the best of my knowledge,

(a) the Quarterly Report of Fannie Mae (formally, the Federal National Mortgage Association) on Form 10-Q for the quarter ended June 30, 2004 (the "Report"), as filed with the Securities and Exchange Commission on August 9, 2004, fully complies with the requirements of Section 13(a) or Section 15(d) of the Securities Exchange Act of 1934, and

(b) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of Fannie Mae.

/s/ J. TIMOTHY HOWARD

J. Timothy Howard
Vice Chairman and Chief Financial Officer

Date: August 9, 2004

A signed original of this written statement required by Section 906 has been provided to Fannie Mae and will be retained by Fannie Mae and furnished to the Securities and Exchange Commission or its staff upon request.