

.....
1 9 9 4
.....
.....
a n n u a l
.....

report

Letter to Participants	2
A More Efficient Trading Environment	4
Audited Financial Statements	10
List of Participants	16
Board of Directors and Senior Officers	IBC

MBS Clearing Corporation (MBSCC) was established in 1979 to facilitate the post-trade activities of the mortgage-backed securities market. Today, MBSCC is the market's sole provider of trade comparison, risk assessment and management, and net settlement services.

MBSCC's services are provided to organizations that actively trade in Government National Mortgage Association (GNMA), Federal Home Loan Mortgage Corporation (FHLMC), Federal National Mortgage Association (FNMA), cash, forward and over-the-counter option markets.

Guided by its participants—MBS dealers, inter-dealer brokers and other non-broker/dealers—MBSCC strives to deliver value-added services that minimize the costs and risks associated with MBS trading. More than \$300 billion in MBS trades are processed through MBSCC every month.

MBSCC is a registered clearing agency and is owned jointly by its participants and the National Securities Clearing Corporation.

In 1994, MBS Clearing Corporation (MBSCC) marked its 15th year serving the mortgage-backed securities industry, and another year of record volume and solid financial performance. In addition, two of the most significant events in our history—the industry buy-out of MBSCC from the Chicago Stock Exchange and our subsequent decision to relocate to New York City—took place in 1994.

The buy-out and relocation decisions were driven by a recognition that MBSCC could be both more efficient and responsive to our participants if we were closer to them—both organizationally and physically. MBSCC's new structure was created last August when we became an independent organization owned by 32 securities dealers and banks as well as the National Securities Clearing Corporation (NSCC). As a result, MBSCC will be in a position to enhance our communication among all MBS participants and to find new ways to lower costs and reduce risks inherent in the MBS marketplace.

Our new organization will allow us to better link MBSCC's operating costs and expenditures for new service developments with the fees charged to participants. We are also incorporating monthly volume discounts for members into our pricing policy. In fact, we are pleased to report that discounts of

25 percent were issued to participants in January, February and March of 1995.

The move to New York City, which will be completed in 1995, will enable us to take advantage of operational synergies and further reduce our own costs by sharing office space and certain professional resources with NSCC. Our data processing support and telecommunications activities have already been centralized at the New York-based Securities Industry Automation Corporation (SIAC), a leading provider of such services to most MBS market participants. Over time, we expect to identify additional ways to leverage existing technologies with other securities industry utilities.

While reorganizing was a very significant event, 1994 was also a year filled with success—the 13% increase in trading volume over 1993 was easily accommodated by MBSCC systems. The system, designed to process transactions more efficiently, successfully handled an average monthly volume of MBS trades valued at well over \$300 billion. Netting continued to eliminate the settlement of approximately 90%, or \$2.7 trillion, of all trades entered for this service in 1994.

During 1994, we began beta testing an electronic network—the Electronic Pool Notification (EPN) system—through which users can transmit MBS pool information

more quickly, efficiently and reliably. We expect the use of EPN to grow rapidly in 1995.

Operating revenue in 1994 increased by 19% over the previous year, primarily due to higher trading volume. While expenses increased during 1994, this can be attributed to costs associated with the buy-out, our planned relocation and the development of the EPN system.

Since its inception, MBSCC has been extremely fortunate to have the active participation of many of our members on our Board of Directors. Their foresight and initiative were directly responsible for the participant buy-out of MBSCC and its planned relocation to New York City. We particularly want to thank William Riley and Clifford Goldman for their long dedication to MBSCC. Both retired from the MBSCC Board in late 1994.

The steps taken by MBSCC in the past year leave us better positioned to meet both the current and future needs of our participants. In these endeavors, SLAC and NSCC fully supported MBSCC objectives. Working together with our long-time participants, many of whom have become new owners, and with the support of our Board of Directors and dedicated MBSCC staff, we will strive to continue to deliver high quality and value-added services. We thank all of you for your continued support.



Harvey J. Cartmell
Chairman
of the Board

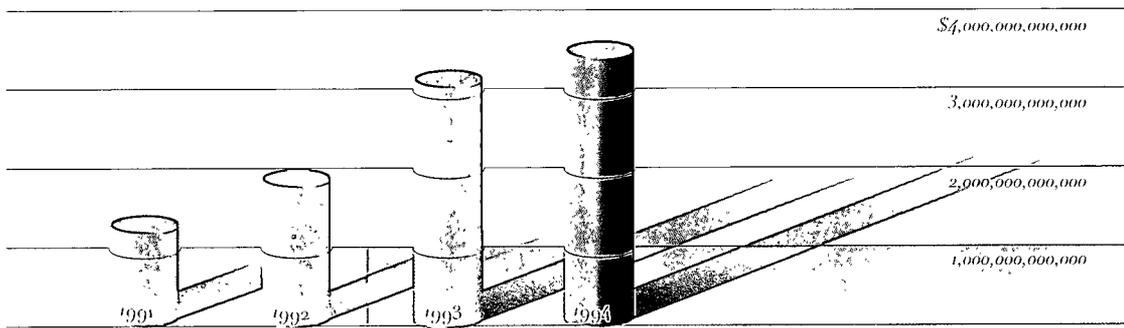
Ronald A. Stewart
President and
Chief Executive
Officer

The primary objective of MBSCC is the same today as it was when the corporation was created in 1979: to reduce the costs and risks of participating in the mortgage-backed securities market.

The MBS market has grown exponentially in the past decade. This growth has been accompanied by an increased concern among industry leaders over the efficiency and risks inherent in the MBS trading environment. MBSCC has embraced these issues, and has steadfastly worked with members, regulators and other industry groups to address them.

A Unique Market with Unique Needs The MBS market is unlike any other securities market, bearing unique characteristics that affect how trades are compared and settled. As MBSCC pursues opportunities to improve existing services and systems, it must consider such market fundamentals as:

- *Long settlement periods:* The average time between an MBS trade and settlement date is 45-90 days—far longer than the one or three day periods for the government bond or equity markets. A lengthy settlement process means longer exposure to fluctuations in the MBS market.
- *High transaction values:* An average MBS trade is notable for its size—more than \$10 million par value—and every point movement in the market is equal to a \$100,000 profit or loss on an average trade. Potential financial exposure is high and requires a sophisticated risk management approach that is tailored to the uniqueness of the market.
- *Variance upon delivery:* Under Public Securities Association (PSA) Guidelines, a seller is permitted to deliver securities that vary from the originally traded face value by a certain percentage (higher or lower). This variance creates post-trading profit opportunities and requires sophisticated accounting systems to track settlements.



**Volume
growth over
a four year
period.**

*Yearly par values
of transactions
entered for
comparison
and settlement.*

Today, MBSCC plays a significant industry role in ensuring an orderly and efficient trading environment with the least amount of risk to the market and its participants. This is achieved through three primary MBSCC services: trade comparison, risk management and netting.

**... Comparing ...
... Trades: Focus ...
... on Productivity ...
... and Accuracy ...** During 1994, the average volume of trades was up 13% compared with 1993, to \$3.6 trillion from \$3.2 trillion. Once a trade is negotiated, whether between dealers directly or via a broker, its terms are submitted electronically to MBSCC for comparison. After trade terms are matched, the MBSCC output—provided electronically—serves as the only legal confirmation of the trade. This process eliminates the need for exchange of confirms/commitment letters.

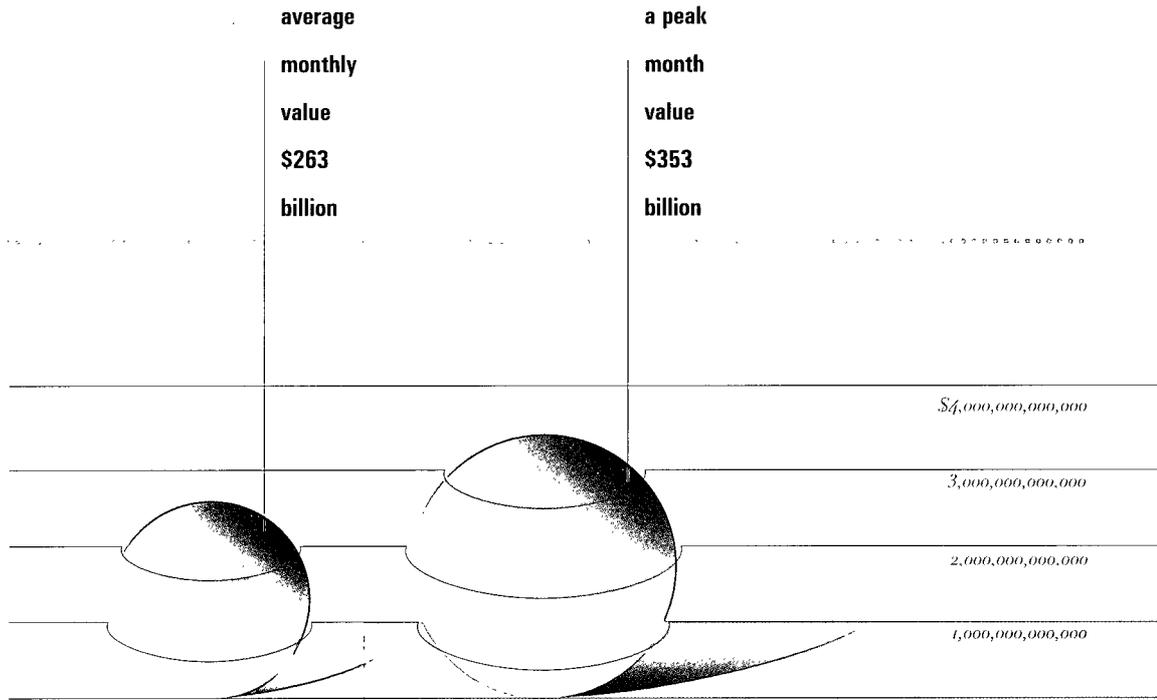
**... Assessing ...
... and ...
... Managing ...
... Risk ...** One of the critical roles MBSCC plays is to help minimize the financial risks to MBS market participants. Unlike other securities markets, the risk that a participant may not be able to meet its financial obligations is not mutualized, and MBSCC—as the clearing agency—cannot guarantee each trade. Instead, MBSCC continually assesses the current value of each underlying trade, and ensures that each participant meets its margin requirements. On average, MBSCC holds approximately \$1 billion in collateral for participants in the event of a contra-side default.

**... Netting ...
... Trades ...
... to Reduce ...
... Costs ...** Last year, MBSCC matched, through its comparison system, trade sides valuing approximately \$3.6 trillion. Of these trades, approximately \$3.2 trillion worth entered MBSCC's netting system, the Settlement Balance Order (SBO) system. Other trades are processed through MBSCC's Trade-for-Trade system, primarily due to nonstandard trading terms.

MBSCC's SBO system eliminated the need to settle more than 90% of all trades submitted for netting—resulting in an elimination of \$2.7 trillion in MBS trades requiring settlement. This meant lower clearing costs, fewer fails and decreased financing costs for participants.

**... Responding ...
... to Industry ...
... Needs: ...
... Electronic Pool ...
... Notification ...** MBSCC's commitment to delivering innovative solutions to the MBS market was demonstrated this past year with the introduction of the Electronic Pool Notification system (EPN). EPN has two objectives: to eliminate costly, unreliable and time-consuming manual processes; and to facilitate equal access to the MBS pool data among all participants.

The majority of MBS trading is done on what is commonly called a TBA (to be announced) basis. Similar in concept to government when-issued trading, the allo-



Capacity to handle peak volume.

Monthly average par value compared with a peak month in 1994.

cation of specific MBS pools (securities) to TBA trades is not done until 48 hours prior to settlement date. At that time, the seller is responsible for advising the buyer of the specific securities it intends to deliver. This communication has traditionally occurred via telephones and fax machines.

With EPN, what has evolved is a sophisticated electronic communications network that can deliver live information immediately to all market participants. Over the long-term, MBSCC expects to link EPN directly to depository organizations, a step which will lead to a more efficient settlement of the securities.

The beta testing phase of EPN, in which 14 leading MBS firms participated, took place during the fourth quarter of 1994. EPN successfully processed \$80 billion worth of live MBS pool information during that period, and more than 7,000 notification messages containing 84,000 MBS pools.

The next testing phase is currently underway and is expected to attract more users and increase message volume. Also being refined and tested are EPN's back-up and disaster recovery systems.

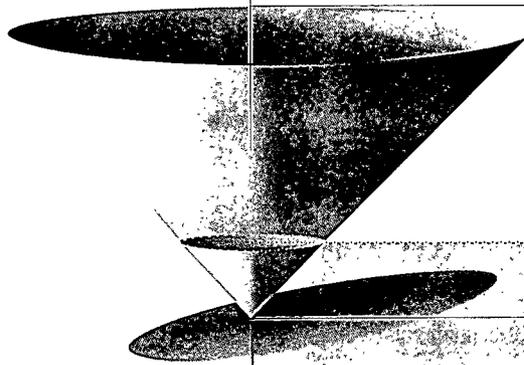
**...Anticipating
Future
Technological
Demands...** The MBS market is continually evolving, with changing technological and operational demands. Efforts to implement new enhancements and further streamline processing systems are being pursued with an eye toward evolving market changes and technological developments.

Another strategic initiative completed in 1994 was the relocation of MBSCC's data processing activities to the Securities Industry Automation Corporation (SIAC). All participants are now connected to the new data site, and appropriate security systems have been tested and put in place. Most MBSCC participants use SIAC, which is based in New York City, for other processing, and the potential synergies are compelling. Key benefits include considerable cost savings and an improved disaster recovery plan which provides a fully redundant and dedicated data center.

**...Leveraging
Recent
Organizational
Changes...** MBSCC's new ownership structure and planned relocation to New York City, which will be completed by mid-1995, present exciting opportunities to capitalize on operational and administrative synergies.

With the new operating system in place, and new service enhancements like EPN, MBSCC is positioned to continue meeting the challenges presented by the MBS market. As MBSCC pursues new potential members—institutional investors, originators and non-U.S. MBS market participants—we do so with confidence that our efforts will help further reduce risk and will facilitate growth in this market.

a peak
volume
month in
1994



Effect of netting.

MBSCC reduces or nets the total number of financial obligations requiring settlement.

MBS Clearing Corporation

Statement of Income

Period from August 13, 1994 through December 31, 1994

Revenues	
.. Operations	\$ 4,237,000
.. Interest	202,000
.. Amortization of excess of net assets acquired over purchase price	406,000
Total revenues	4,845,000
Expenses	
.. Employee compensation	655,000
.. Systems and related support	297,000
.. Rent, maintenance and utilities	662,000
.. Professional and other services	2,214,000
.. General and administrative	362,000
.. Depreciation and amortization	163,000
Total expenses	4,353,000
Income before income taxes	492,000
Income tax expense (benefit):	
.. Current	595,000
.. Deferred	(721,000)
Total income tax benefit	(126,000)
Net Income	\$ 618,000

See accompanying notes.

MBS Clearing Corporation

Balance Sheet

December 31, 1994

Assets

Cash and cash equivalents	\$ 9,776,000
Accounts receivable	926,000
Participants' deposits	387,280,000
Office equipment, net	36,000
Deferred income taxes	1,458,000
Other assets	81,000
	\$ 399,557,000

Liabilities and Stockholders' Equity

Accounts payable and accrued liabilities	\$ 4,322,000
Participants' deposits	387,280,000
Note payable	3,325,000
Deferred income taxes	735,000
	Total liabilities 395,662,000

Excess of net assets acquired over purchase price 2,844,000

Stockholders' equity:

Capital stock, no par value:	
42,606 shares outstanding	433,000
Retained earnings	618,000
	Total stockholders' equity 1,051,000

\$ 399,557,000

See accompanying notes.

Statement of Cash Flows

Period from August 13, 1994 through December 31, 1994

Cash flows from operating activities:	
Net income	\$ 618,000
Adjustments to reconcile net income to net cash used in operating activities:	
Amortization of excess of net assets acquired over purchase price	(406,000)
Depreciation	45,000
Decrease (increase) in assets:	
Accounts receivable	(429,000)
Deferred income taxes	(1,209,000)
Other assets	(76,000)
Increase (decrease) in liabilities:	
Accounts payable and accrued liabilities	702,000
Deferred income taxes	626,000
Other liabilities	(68,000)
Net cash used in operating activities	(197,000)
Cash flows from investing activities:	
Capital expenditures	(80,000)
Decrease in participants' deposits	292,071,000
Investment made through purchase transaction	(3,325,000)
Net cash provided by investing activities	288,666,000
Cash flows from financing activities:	
Decrease in participants' deposits	(292,071,000)
Proceeds from issuance of common stock	433,000
Note payable on purchase transaction	3,325,000
Net cash used in financing activities	(288,313,000)
Net increase in cash and cash equivalents	156,000
Cash and cash equivalents at beginning of period	9,620,000
Cash and cash equivalents at end of period	\$ 9,776,000
Supplemental disclosure:	
Cash paid during the period for income taxes	\$ 1,384,000

See accompanying notes.

I. Basis of Presentation

MBS Clearing Corporation, ("MBSCC"), provides trade comparison and settlement processing for mortgage-backed securities. Through August 12, 1994, MBS Clearing Corporation ("Old MBS") was wholly owned by the Chicago Stock Exchange (the "Exchange"). Under a Stock Purchase Agreement (the "Agreement"), dated August 12, 1994, by and between the Exchange and MBSCC Acquisition Corporation (the "Purchaser"), the Exchange agreed to sell all the outstanding stock (the "Shares") of Old MBSCC to the Purchaser. The sale closed on August 12, 1994, at which time the Exchange delivered to the Purchaser stock certificates representing the Shares, duly endorsed for transfer. At the close of business on such date, the name of the Purchaser was changed to MBS Clearing Corporation ("MBSCC").

The accompanying financial statements include expenses charged to MBSCC by the Exchange and certain of its subsidiaries, consisting primarily of data processing services, facilities and corporate services, on bases agreed upon between the entities.

2. Summary of significant accounting policies

Cash equivalents Corporate short-term investments, consisting principally of securities purchased under resale agreements and U.S. Government securities, which have a maturity of three months or less at date of purchase are considered to be cash equivalents.

Depreciation Depreciation on office equipment is provided on the straight-line basis over three to ten years.

Negative goodwill The fair value of net assets acquired by MBSCC exceeded the purchase price by \$4,738,000. The negative goodwill was allocated to reduce office equipment by \$1,488,000. The remaining \$3,250,000 is being amortized to operations on a straight-line basis over three years.

Income taxes Income taxes are determined in accordance with Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes", which requires an asset and liability approach for financial accounting and reporting for income taxes.

Financial instruments Management believes that the carrying value of all financial instruments approximates market value.

3. Participants' deposits

The Rules of MBSCC require its participants to maintain a minimum deposit in cash and to make additional deposits to cover market margin differentials to secure participants' obligations. Additional amounts may be assessed against participants in accordance with the Rules.

Participants' deposits consist of cash, letters of credit, and securities issued or guaranteed by the U.S. Government. Participant deposit requirements that were

met by letters of credit issued by authorized banks were \$510,085,000 at December 31, 1994. Interest income on participants' deposits in excess of established minimums accrues to the participants.

4 Benefit plans

MBSCC is a participant in National Securities Clearing Corporation's ("NSCC") noncontributory defined benefit pension plan covering all eligible employees. Benefits under this plan are based on employees' years of service and compensation during the years immediately preceding retirement. MBSCC's funding policy is to make contributions under the plan that meet or exceed the minimum funding standards under the Employee Retirement Income Security Act of 1974 and the Internal Revenue Code of 1986, as amended. MBSCC incurred no expense under the pension plan in 1994.

MBSCC is also a participant in NSCC's supplemental executive retirement plan ("SERP") which provides for certain benefits to identified executives of MBSCC upon retirement. MBSCC's funding policy with regard to SERP is to fund benefits accruing to employees meeting certain requirements of the SERP. MBSCC's expense under SERP was \$13,000 for the period ended December 31, 1994.

MBSCC is a participant in a savings plan pursuant to Section 401(k) of the Internal Revenue Code whereby all employees are participants and have the option to contribute to the plan. MBSCC matches employee contributions at the rate of 50 percent of up to 6 percent of the employees' salary. MBSCC's expense under this plan was \$14,000 for the period ended December 31, 1994.

5. Product development costs

Development costs of new or improved products and systems amounted to \$258,000 for the period ended December 31, 1994 and were expensed as incurred.

6 Income taxes

The provision for income taxes differs from an amount based upon the statutory federal income tax rate of 34 percent due principally to the amortization of unallocated negative goodwill and to state income taxes, net of federal tax effect, for the period ended December 31, 1994. The tax effect on temporary differences that give rise to significant portions of deferred tax assets and liabilities consist primarily of employee benefit costs and allocated negative goodwill, and depreciation, respectively.

7 Lease arrangements

Rent expense, due to the Exchange, for the period ended December 31, 1994 was \$72,000.

Independent Auditors' Report

The Board of Directors
MBS Clearing Corporation



We have audited the accompanying balance sheet of MBS Clearing Corporation ("MBSCC") as of December 31, 1994, and the related statements of income and of cash flows for the period from August 13, 1994, through December 31, 1994. These financial statements are the responsibility of MBSCC's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, such financial statements present fairly, in all material respects, the financial position of MBSCC at December 31, 1994, and the results of its operations and its cash flows for the period ended December 31, 1994, in conformity with generally accepted accounting principles.

Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The additional information on page 15 is presented for the purpose of additional analysis and is not a required part of the basic financial statements. This additional information is the responsibility of MBSCC's management. Such information has been subjected to the auditing procedures applied in our audit of the basic financial statements and in our audits of the financial statements for the period from January 1, 1994, through August 12, 1994 and for the year ended December 31, 1993, not presented herein, on which we have rendered our reports dated October 14, 1994, and February 28, 1994, respectively, which reports contained unqualified opinions and, in our opinion, is fairly stated in all material respects when considered in relation to the basic financial statements taken as a whole.

Deloitte & Touche LLP

Chicago, Illinois
February 28, 1995

MBS Clearing Corporation

Schedule of Combined Operations

for MBS Clearing Corporation ("Old MBS") and MBS Clearing Corporation ("MBSCC")

for the Year Ended December 31, 1994,

and for Old MBS

for the Year Ended December 31, 1993

	Old MBS	MBSCC	Combined 1994	1993
Revenues				
Operations	\$ 11,861,000	\$ 4,237,000	\$ 16,098,000	\$ 6,960,000
Interest	375,000	202,000	577,000	336,000
Amortization of excess of net assets acquired over purchase price	—	406,000	406,000	—
Total revenues	12,236,000	4,845,000	17,081,000	7,296,000
Expenses				
Employee compensation	966,000	655,000	1,621,000	1,230,000
Systems and related support	54,000	297,000	351,000	29,000
Rent, maintenance and utilities	450,000	662,000	1,112,000	226,000
Professional and other	1,050,000	2,214,000	3,264,000	1,485,000
General and administrative	596,000	362,000	958,000	728,000
Depreciation and amortization	274,000	163,000	437,000	83,000
Charges from affiliates	930,000	—	930,000	1,400,000
Total expenses	4,320,000	4,353,000	8,673,000	5,181,000
Income before income taxes	7,916,000	492,000	8,408,000	2,115,000
Income tax expense (benefit):				
Current	3,401,000	595,000	3,996,000	772,000
Deferred	(222,000)	(721,000)	(943,000)	49,000
Total income tax expense (benefit)	3,179,000	(126,000)	3,053,000	821,000
Net income	\$ 4,737,000	\$ 618,000	\$ 5,355,000	\$ 1,294,000

The above schedule presents the combination of the operations of Old MBS from January 1, 1994, through August 12, 1994, the date of its acquisition by MBSCC, with the operations of MBSCC, which are a continuation of the operations of Old MBS, from August 13, 1994, through December 31, 1994. The operations of Old MBS for the year ended December 31, 1993, are presented for comparative purposes. The executive management and members of the Board of Directors of MBSCC and Old MBS have remained essentially unchanged throughout this two year period.

Participants

- Alex Brown & Sons, Inc.
- Anchor National Life Insurance Co.
- Bankers Trust (Delaware)
- Bankers Trust Company
- Barclays de Zoete Wedd Securites Inc.
- Bear Stearns & Co. Inc.
- BT Securities Corporation
- Cantor Fitzgerald Securities Corporation
- Chase Securities, Inc.
- Chase Manhattan Mortgage Corporation
- Chemical Residential Mortgage Corporation
- Chemical Securities, Incorporated
- Chemical Bank
- Citibank, N.A.
- Citicorp Securities, Inc.
- Citicorp Mortgage, Inc.
- CNA Financial Corporation/FAO
- Continental Casualty Corporation
- Countrywide Funding Corporation
- CS First Boston Corp.
- Daiwa Securities America, Inc.
- Dean Witter Reynolds Inc.
- Deutsche Bank Securities Corporation
- Directors Mortgage Loan Corporation
- Donaldson, Lufkin & Jenrette Securities Corporation
- Federal Home Loan Mortgage Corporation
- First Union Capital Markets Corporation
- Garban Ltd.
- Goldman, Sachs & Company
- Greenwich Capital Markets, Inc.
- Gruntal & Company, Inc.
- Hilliard Farber & Company, Inc.
- HSBC Securities, Inc.
- J.P. Morgan Securities, Inc.
- Kemper Clearing Corporation
- Kidder Peabody & Company, Inc.
- Lehman Government Securities Inc.
- Liberty Brokerage Inc. FAO Patriot Securities, L.P.
- Long Term Capital Portfolio LP
- Mabon Securities Corporation
- McDonald & Company Securities, Inc.
- Merrill Lynch GSI
- Morgan Stanley Market Products Inc.
- Morgan Guaranty Trust Co. of New York
- Morgan Keegan & Company, Inc.
- National Westminster Bank, U.S.A.
- Nationsbanc Capital Markets, Inc.
- Nationsbank, N.A. (Carolinas)
- Nikko Securities Co. International, Inc.
- Nomura Securities International, Inc.
- Oppenheimer & Co., Inc.
- PaineWebber, Inc.
- Prudential Securities, Inc.
- Rauscher Pierce Refsnes, Inc.
- Residential Funding Corporation
- RMJ Securities Corporation
- Salomon Brothers, Inc.
- Sanwa Securities (U.S.A.) Co., LP
- Smith Barney, Inc.
- Spear Leeds & Kellogg
- Stephens Inc.
- Sun Life Insurance Co. of America
- SunAmerica, Inc.
- UBS Securities, Inc.
- Yamaichi International (America), Inc.

.....MBS Clearing Corporation.....

.....The Board of.....
.....Directors.....

.....Senior.....
.....Officers.....

Harvey J. Cartmell
Chairman of the Board
Vice President
Goldman, Sachs &
Company

Ronald A. Stewart
President & Chief
Executive Officer
MBS Clearing Corporation

Edward Almeida
Senior Managing Director
Bear Stearns & Co. Inc.

Joseph Bzezinski
Managing Director
Donaldson, Lufkin &
Jenrette Securities
Corporation

Frank J. DeCongelio
Managing Director
CS First Boston Corp.

Patricia Dodson
Vice President
Federal Home Loan
Mortgage Corp.

James Dooley
Managing Director
Lehman Brothers, Inc

Ronald G. Keenan
Managing Director
Chemical Securities, Inc.

David M. Kelly
President, National
Securities Clearing
Corporation

Eric N. Miller
Vice President
Salomon Brothers, Inc

John G. Moran
Principal
Morgan Stanley Market
Products Inc.

Edwin F. Payne
Senior Vice President
Prudential Securities, Inc.

Arthur L. Thomas
Senior Vice President
Merrill Lynch, Pierce,
Fenner & Smith

Harvey J. Cartmell
Chairman of the Board

Ronald A. Stewart
President & Chief
Executive Officer

Lynn Douglas
Senior Vice President &
Chief Operating Officer

Virginia Hanson
Vice President,
Planning & Development

Dennis J. Paganucci
Vice President,
Marketing & Sales

Marvin B. Koehler
Chief Financial Officer &
Treasurer

Robert J. Woldow
General Counsel & Secretary