Examination Year: 2004

Federal Home Loan Mortgage Corporation
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EXAMINATION AUTHORITY AND SCOPE

Examination Authority and Reporting Convention

This Report of Examination contains the results and conclusions of OFHEO's 2004 annual examination of the Federal Home Loan Mortgage Corporation ("Freddie Mac" or the "Enterprise") performed under section 1317(a) of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (12 USC § 4517(a)). The OFHEO annual examination program assesses the Enterprise's financial safety and soundness and overall risk management practices. OFHEO utilizes a "CAMELS" methodology (Capital Adequacy, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to market risk) similar to those adopted by the federal depository institution regulators to report examination results and conclusions to the Board of Directors and to Congress.

2004 Examination Scope

Our examination activities focused heavily on the Enterprise's compliance with the extensive requirements of the Consent Order the Board of Directors executed on December 9, 2003 (the "Consent Order")[1] and with the Enterprise's implementation of plans it submitted in response to the Consent Order requirements. Correspondingly, we targeted our examination resources to evaluate the Board's and management's compliance with specific actions required by the Consent Order that pertain to: the Board of Directors and Senior Management (Article II); Internal Controls (Article III); Internal Audit (Article IV); Internal Accounting (Article V); Risk Management Transactions (Article VI); Public Disclosures and Regulatory Reporting (Article VII); and Consent Order Oversight and Reporting (Article VIII). We performed additional on-site and off-site examination activities necessary to assess credit risk (including asset quality), earnings, capital adequacy, information technology, interest rate risk, liquidity risk, and management processes.

EXAMINATION RESULTS AND CONCLUSIONS

Overall, the Enterprise's condition is improving but continues to warrant supervisory concern. The Enterprise is in process of implementing plans to address the matters in the wide ranging Consent Order and is subject to a Capital Directive as a result of a combination of moderate to severe internal control weaknesses. Although the Enterprise reported 2004 financial results on March 31, 2005, it does not have current financial statements in circulation, and does not expect to be a timely filer until 2006. Ameliorating factors include: (1) a significant capital surplus; (2) risk management strengths in key areas such as credit, interest rate, and liquidity risk that provide the Enterprise with the ability to withstand economic and market fluctuations; and (3) appropriately intensive efforts on the part of the Board of Directors and senior management to correct known control weaknesses.

During 2004 the Board of Directors and senior management made concerted efforts to correct the Enterprise's extensive control weaknesses. OFHEO examiners have observed improvements in both financial reporting and general operational controls. Although the remediation of internal control weaknesses is not complete, action plans are in place, or are being developed and implemented, to address identified weaknesses. The successful completion of those plans will require the continued commitment and intensity of the

Board and management throughout 2005 and beyond. Moreover, improvements to systems capabilities and the successful implementation of re-engineered business processes will be necessary to restore the overall control environment to a satisfactory condition. The process of validating the adequacy of controls and the actions taken to address significant control weaknesses will require substantial continuing efforts on the part of Enterprise personnel and the Enterprise's independent auditor.

Leadership from the Board and senior management has facilitated significant progress over the past year. The reconfigured Board and senior management committees and revised committee charters have provided a foundation for positive change.

MATTERS REQUIRING BOARD ATTENTION

Key matters highlighted in this report requiring strong Board oversight:

- The Board should continue to monitor compliance efforts to ensure remediation targets are met. Considerable progress was made in 2004 to achieve compliance with the provisions of the Consent Order. Aggressive remediation efforts are underway and management anticipates full compliance with the Consent Order's related plans during 2006.

- The Board should ensure management actions to correct internal control weaknesses and deficiencies result in processes that are repeatable and sustainable. The independent auditor, PricewaterhouseCoopers ("PwC"), identified material weaknesses and internal control deficiencies during their audit of the financial statements for the year ending December 31, 2003. Additional material weaknesses were identified in 2004. Concerted undertakings to address control deficiencies and permit the timely preparation of accurate financial statements are underway.

- The Board should continually evaluate the effectiveness of governance practices to ensure they are consistent with leading practices of other large, complex financial services organizations.

- The Board should closely monitor staffing levels and capacity to ensure day-to-day activities and change initiatives are effectively managed. The aggregate level of change occurring throughout the Enterprise is high. Processes to manage change activities will require the adoption of advanced change control practices to ensure corporate-wide change events are properly controlled and integrated.

COMPLIANCE WITH CONSENT ORDER

Considerable effort has been made by the Board and management to comply with the Consent Order. The rate of progress has been acceptable and, to date, all required reports and plans have been filed in a timely manner. A significant amount of additional work remains before plans submitted in response to the Consent Order are fully implemented. In particular, as contemplated by the plans submitted pursuant to the Consent Order, additional time and effort is needed to fully complete activities associated with Article III - Internal Controls and Article V - Internal Accounting. Consent Order related remediation efforts are expected to continue throughout 2005 and extend into 2006. OFHEO will continue to perform examination activities as necessary to evaluate the effectiveness of actions taken in response to Consent Order requirements.

Article	**Paragraph**	**Consent Order Requirement**	**Status ***
Article I – Cooperation			
I	1	Good faith reasonable efforts to cooperate with OFHEO in pursuit of administrative or enforcement proceedings.	Full Compliance
I	2	Good faith reasonable efforts to cooperate with OFHEO in pursuit of litigation.	Full Compliance
Article II – Board of Directors and Senior Management			
II	3	Board review and revise bylaws as appropriate. Report to OFHEO results of review and any revisions to be made.	Technical compliance
II	4	Board review and revise codes of conduct for Board and employees. Develop and implement employee training program. Report to OFHEO results of review and revisions and on training program. For 24 months following implementation of training program, submit report to OFHEO every 6 months on training implementation.	Partial Compliance
II	5	Prepare and submit succession plan for senior management (shall consult with OFHEO).	Partial Compliance
II	6	Board review and revise committee structure. Review to consider essential functions including implementation of internal controls and operational risk planning. Report to OFHEO any changes.	Technical Compliance
II	7	Board review: (a) frequency of Board meetings; (b) process for full Board consideration of committee reports; and (c) processes for obtaining ongoing information and special reports. Report to OFHEO.	Partial Compliance

Article	Paragraph	Consent Order Requirement	Status *
II	8	Board to determine what term limits necessary for Board members and report to OFHEO such limits and how implemented.	Technical Compliance
II	9	Board to develop required qualifications for directors and report to OFHEO.	Technical Compliance
II	10	Annual review by Board of applicable legal and regulatory requirements.	Technical Compliance
II	11	Annual review by senior management of applicable legal and regulatory requirements.	Technical Compliance
II	12	Board to annually meet with OFHEO representatives.	Full Compliance
II	13	Separate position of Chairman and Chief Executive Officer within reasonable period of time.	Partial Compliance
II	14	Submit acceptable plan to foster culture to consider operational stability and compliance as essential to maximize long-term value. Include: appropriate training, compensation system.	Partial Compliance
Article III - Internal Controls			
III	15	Submit report on status of PwC review of controls with respect to financial reporting. Upon completion, submit report analyzing results and plan for remedial steps to be taken.	Partial Compliance
III	16	(a) Engage consultant to review internal controls with respect to reporting to Board and senior management. (b) Consultant written report due. (c) Submit acceptable written plan to address recommendations of consultant.	(a) Full Compliance (b) Full Compliance (c) Technical Compliance
III	17	Annually, senior management to review effectiveness of internal controls and report to Board/Committee on results. Copy submitted to OFHEO.	Partial Compliance
III	18	Establish Chief Risk Officer position with responsibility for risk	Full Compliance

Article	Paragraph	Consent Order Requirement	Status *
		oversight function. Report to OFHEO function of chief risk officer and reporting structure.	
III	19	Establish a Chief Compliance Officer position and report to OFHEO on functions and reporting structure.	Full Compliance
Article IV - Internal Audit			
IV	20	Submit acceptable plan to address effectiveness of internal audit. Include: independence, adequacy of information to audit committee, staffing, and planning.	Technical Compliance
Article V - Internal Accounting			
V	21	(a) Engage consultant to review: (i) staffing; (ii) plans to augment staffing; (iii) management structure. (b) Written report with recommendations. (c) Submit to OFHEO acceptable plan to address consultant recommendations.	Partial Compliance
Article VI - Risk Management Transactions			
VI	22	(a) Develop procedures: (i) appropriate oversight for risk management transactions; (ii) maintain records for risk management transactions. (b) Submit copy of procedures to OFHEO.	Technical Compliance
Article VII - Public Disclosures and Regulatory Reporting			
VII	23	Submit acceptable plan to address adequacy of public disclosure practices and have in place effective ongoing oversight.	Partial Compliance
VII	24	Review procedures for ensuring reports submitted to OFHEO meet legal and regulatory requirements. Submit report to OFHEO.	Partial Compliance
Article VIII - Oversight and Reporting			
VIII	25	Board to designate committee responsible for overseeing	Full Compliance

Article	Paragraph	Consent Order Requirement	Status *
		compliance with Consent Order.	
VIII	26	Management to report quarterly to Board-designated committee regarding progress in complying with Consent Order.	Full Compliance
VIII	27	Copy of quarterly progress report to OFHEO.	Full Compliance
VIII	28	First progress report pursuant to paragraph 27 due to Board committee no later than 3/15/2004.	Full Compliance
Article IX - Civil Money Penalty			
IX	29	Pay $125 million civil money penalty.	Full Compliance

**Status of Compliance*

Full Compliance:	Freddie Mac has met all the requirements of the Article.
Technical Compliance:	Freddie Mac has filed the initial report or plan in a timely manner. OFHEO is in the process of validating corrective actions taken by Freddie Mac.
Partial Compliance:	To date, Freddie Mac has filed the applicable report or plan in a timely manner. Implementation of plans is in process.

BOARD AND MANAGEMENT SUPERVISION

The quality of Board governance is satisfactory. The current senior management team is capable. The Board must continue to hold management accountable for the timely and complete remediation of issues. The Board is also encouraged to continually evaluate the effectiveness of its governance practices to ensure they are consistent with leading practices of other large complex financial service organizations.

The Board has made progress in a number of areas, including hiring executive and senior management, revising bylaws in accordance with the consent order, adopting corporate governance guidelines, and adopting agenda planning and issue/action item tracking reporting. The Board reconfigured its committee structure and revised the committee charters, and has increased the frequency with which committees meet. Production of board/committee meeting minutes has become timelier. The Enterprise also has an initiative underway to improve board and senior management reporting.

Areas for improvement include: the development and implementation of a formal strategic planning process that is integrated throughout the corporation; a further cultural shift toward accountability for controls at all levels of the organization; ongoing succession planning for each key position; continued evolution in the quality and content of board-level reports; and ongoing director training.

Internal Controls

PwC cited a number of broad material weaknesses during their audit of the financial statements for 2003. Each broad material weakness represented numerous detailed weaknesses. Senior management has elevated addressing the weaknesses to a corporate priority and has ensured that sufficient resources with appropriate skill levels have been assigned to the related projects. During 2004, the Enterprise utilized extensive procedures to verify the accuracy of the 2004 financial results rather than rely on internal controls. It is anticipated that the Enterprise will rely more fully on internal controls during 2005 as remediation activities are completed. PwC will not separately evaluate the report on mitigation efforts. PwC plans to issue an internal control letter as part of the completion of the 2004 audit in July 2005.

The significant and pervasive nature of weaknesses in accounting operations along with the substantial manual controls needed to prepare reliable financial information has adversely affected Freddie Mac's ability to release timely quarterly financial information. Large-scale, persistent efforts are underway to create or improve the processes and controls necessary for the ongoing production of timely quarterly financial statements. The aggressive focus on implementing compensating controls intended to mitigate control deficiencies and address accounting policy issues has contributed to an improved timeframe for releasing the year-end 2004 financial statements. Additional progress is needed to allow quarterly financial statements to be prepared and released within an appropriate timeframe.

The ability to release timely financial statements remains a substantial challenge for Freddie Mac. Critical components to successfully reach the goal include:

- Implementing a more disciplined and formal control environment that permeates the organization;

- Moving toward greater reliance on automated, preventative controls rather than manual, detective controls; and

Establishing a reliable self-assessment framework for internal controls that reinforces a strong internal control culture and incorporates responsibility and accountability.

Success is contingent on significant improvements to existing information technology systems and business processes. Information technology systems and business process related initiatives are expected to be a significant, ongoing effort.

ASSET QUALITY
The credit risk management function remains satisfactory. Credit quality is strong based on internal asset quality indicators. Credit losses are expected to rise, but remain low by historical standards. Mortgage delinquencies are well controlled. Counterparty financial strength is satisfactory. Vulnerability exists due to industry, competitive, regulatory, operational and technological factors.

The inability of the Enterprise to aggregate counterparty risks at the corporate level has been a long-standing finding of Internal Audit and OFHEO. Management should fulfill their commitment to a comprehensive counterparty risk management program which includes: appropriate eligibility standards, risk rating capabilities, and exposure limits.

Single-family
Credit risk management practices coupled with a number of positive economic factors contribute to Freddie Mac's strong single-family credit quality. Although the quality of single-family purchases remains strong, certain underwriting standards have been relaxed to increase market share and achieve affordable housing goals. Examples include the purchase of non-Loan Prospector and No Income/No Asset documentation loans. OFHEO has encouraged management to identify and implement strategies to quantify the impact of rising caution and defect rates on profitability, ROE, market share and affordable housing goals.

While not a significant supervisory concern at this time the following issues merit attention:

- **Non-LP Purchases.** The percentage of non-LP purchases has steadily increased since 4Q2003. As a result, Freddie Mac is acquiring loans with higher risk attributes which exceed the Enterprise's modeling and costing capabilities. In addition, the early warning system does not adequately identify the risk characteristics of new or non-standard products in the early life of the loan. No thresholds or portfolio limits have been finalized on non-LP loans or loans with higher risk characteristics.

- **No Income/No Asset Purchases**. The Enterprise is purchasing No Income/No Asset loans either pursuant to a negotiated credit policy waiver for flow business or in negotiated transactions. Offering this product introduces considerable risk and management reports indicate that lenders and mortgage insurers are seeing abusive behavior with these programs. Management should ensure that the Enterprise's ability to identify, measure, monitor and control risks related to this product are in place.

- **ABS Purchases**. Freddie Mac has purchased a significant amount of AAA-rated non-agency sub-prime mortgage asset-backed securities (ABS). Purchase volume in 2004 was substantial at $102 billion. The mortgage ABS outstanding balance increased to $133 billion in 2004 – an increase of 60% since 2003. Management should ensure they can adequately model and monitor this portfolio.

- **Counterparty Concentrations**. The Top 10 counterparties represent 75% of the total exposures with the Top 5 representing 58%. Loss or failure of one of the Top 10 counterparties could have a serious impact on the Enterprise.

Multifamily
The quality of Multifamily purchases is strong and is within corporate targets. Delinquencies are well-controlled. There were $4.8 million in net recoveries versus a 2004 net credit loss target of $15 - $25 million and 2003 net credit losses at $10.5 million. Management has reported that credit quality and returns may decline in 2005 due to pressures to meet HUD's affordable housing goals.

EARNINGS

Freddie Mac's fundamental earnings were constrained in 2004 due to market forces and higher levels of administrative expenses. Market forces related to continued competition for mortgage assets caused compression in asset yields. Total yields on interest-earning assets declined to 4.66%, from 4.93% in 2003. Freddie Mac reduced its purchases of 30-year products due to lower spreads and increased its level of lower yielding ARM products. The trade-off in purchasing ARMS was lower hedging costs related to reduced prepayment sensitivity. Freddie Mac expects net interest income to be materially lower in 2005 due to compression in net interest margin on its existing mortgage portfolio and lower nominal margins on floating rate mortgage-related security purchases. Management expects this decrease to be significantly offset by decreased losses in non-interest income, assuming current forward rates are realized.

Freddie Mac's administrative expenses increased by $400 million. Administrative expenses were higher due to continued infrastructure and control remediation efforts underway to improve Freddie Mac's financial reporting.

Freddie Mac's GAAP earnings fell 40% to $2.9 billion, from $4.8 billion in 2003. The primary driver of the decline was $4.5 billion in mark-to-market derivative losses. The derivative losses were partly due to Freddie Mac's movement of substantially all pay-fixed swaps to no hedge designation in 2Q04. The Enterprise determined that substantially all pay-fixed swaps and other derivatives that previously had been in cash flow hedge accounting relationships no longer met the hedge accounting requirements of SFAS 133. The change in notional amount of derivatives not designated in hedge accounting relationships is likely to produce continued earnings volatility, as periodic changes in the fair value of these derivatives are reflected through derivatives gains or losses.

The difficulty in assessing the underlying economic strength of earnings based on reported GAAP data highlights the need to improve disclosures by use of alternative metrics and more detailed analysis. One such alternative is the change in the fair value of net assets, adjusted for dividends and capital transactions. By this measure the Enterprise accrued $4.5 billion of gains in 2004. However, this amount was significantly affected by changes in mortgage-to-debt option-adjusted spreads.

LIQUIDITY

Liquidity is satisfactory. The Enterprise has access to sufficient sources of funds on acceptable terms to meet present and anticipated liquidity needs. Management is able to effectively forecast liquidity needs and sources; and to identify, measure, monitor, and control the Enterprise's liquidity position. Liquidity management policies, procedures and a liquidity contingency plan are in place and identify authorized investments, exposure limit rules, and independent review requirements. Management has consistently maintained its liquidity and contingency threshold of five percent of on-balance sheet assets. Management has appropriate policies and procedures for forecasting short-and long-term liquidity needs**.** Risk limits are in place to ensure sufficient liquidity levels, and management evaluates limits and pertinent metrics on a daily, weekly, and monthly basis. Market Risk Oversight provides effective monitoring of risk limits as a form of independent risk oversight.

SENSITIVITY TO MARKET RISK

Interest rate risk management is satisfactory. Sensitivity to market risk reflects the degree to which changes in interest rates can adversely affect the Enterprise's earnings and capital. During 2004, Enterprise management demonstrated an appropriate ability to identify, measure, monitor, and control market risk in a manner commensurate with the nature and complexity of the Enterprise's activities. Quantitative measures of the Enterprise's sensitivity to market risk exposures—primarily, Portfolio Market Value Sensitivity ("PMVS"), duration gap, convexity, yield curve risk, and basis risk—reflect that earnings and capital are appropriately protected against significant movements in market rates.

PMVS is the Board's approved measure of interest rate risk exposure, and measures the estimated loss in the market value of the Enterprise's common equity resulting from defined adverse changes in LIBOR rates. PMVS is measured in two ways: PMVS-L estimates the loss in portfolio market value from an immediate 50 basis point parallel shift in LIBOR rates, and PMVS-YC estimates the loss in portfolio market value from a 25 basis point change in the slope of the LIBOR yield curve. PMVS is a measure that encompasses both the duration and convexity components of interest rate risk. The Board of Directors has established a PMVS limit of 15 percent; and management has established an operating limit of 10 percent. In 2004, management maintained PMVS at a monthly average of 2 percent; thus, the Enterprise's PMVS exposure was well-below prescribed limits. The PMVS levels and other metrics observed in 2004 indicate that market risk sensitivity is well-controlled and that there is limited potential that the Enterprise's earnings performance or capital position will be adversely affected.

CAPITAL ADEQUACY

Regulatory capital is adequate. OFHEO's Office of Capital Supervision formally classifies capital adequacy on a quarterly basis in accordance with Subtitle B of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 and with the requirements set forth in OFHEO's Minimum Capital and Risk-Based Capital regulations. The Enterprise currently is subject to an OFHEO capital directive that requires the Enterprise to maintain a capital surplus of 30 percent over its minimum capital requirement. The capital directive will remain in place until such time as the OFHEO Director determines the directive should be modified or terminated.

On March 31, 2005, OFHEO announced that it had classified Freddie Mac as Adequately Capitalized as of December 31, 2004, and that the Enterprise was adequately capitalized during all periods in 2004. As of that date, the Enterprise's core capital exceeded its minimum capital requirement by approximately 45 percent. OFHEO supports its capital classifications through a combination of compulsory capital reporting and weekly monitoring, and ongoing analyses of market and other factors, risk management practices, and other factors that could impact the adequacy of capital.

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[1] See OFHEO Consent Order No. 2003-02, dated December 9, 2003.