

**2005** Annual Report



CONTINUING  
**Progress**

## A MESSAGE FROM THE CHAIRMAN



### **2005 was a year of continuing progress for Freddie Mac.**

Overall, our business performed well. We were successful in improving our position with customers, meeting extraordinary mission demands, and strengthening our capital position and balance sheet. We grew our mortgage portfolio and our share of the market. At the same time, we kept our interest-rate and credit risks exceptionally low. These were all major accomplishments, given rising interest rates and diverse challenges that included increased competition, diminished housing affordability, and widespread storm devastation along the Gulf Coast.

No less important, we provided more support for affordable housing than ever before. And we made this key aspect of our broad mission part of the everyday flow of our business.

When the Gulf hurricanes struck, Freddie Mac demonstrated the kind of leadership and market influence that sets us apart as a government-sponsored enterprise, or GSE. By moving quickly to provide relief to affected homeowners and mortgage servicers — and taking the lead by investing in state and local mortgage revenue bonds — we helped bring stability and hope to the affected region. Although we are a large, national company, our actions in the Gulf region made a real difference, at the local level, for thousands of struggling families and individuals.



## A MESSAGE FROM THE CHAIRMAN

These and other steps underscore our capacity and commitment to help protect homeowners, the housing sector and the economy from the shock of unexpected events. They demonstrate once again how we serve our congressional charter both in good times and in times of crisis.

While the year brought reason for pride, it also brought some disappointment. None of us was satisfied with the company's progress in financial reporting, where we met some of our targets, but fell short of others. This is an area in which we are accelerating our efforts this year, as we focus on a number of internal controls and infrastructure upgrades.

In this and many other ways, Freddie Mac's transformation continues. Let me detail some of the progress we have made:

### **Strong Business Performance**

Even in the face of a challenging financial environment and a competitive secondary market, our business remained strong in 2005.

Freddie Mac's portfolio of issued mortgage securities grew by 10.5 percent and our retained portfolio grew by 8.7 percent. In a robust mortgage market, these were both significant improvements over 2004. Together, they brought our growth almost in line with that of the overall mortgage market. We achieved this healthy growth by executing on our underlying franchise strengths of excellent credit and interest-rate risk management and low debt funding costs.

We met the market's changing needs by improving our ability to purchase non-traditional mortgage products and making core improvements in our business operations. We also took major steps forward in such areas as customer satisfaction and market share.

Our focus on the customer continued to bear fruit. For instance, we cut in half the time it took to get a customer contract. We also expanded our mortgage product line and launched new types of securities (such as the Reference REMIC and whole-loan REMICs). Foreign investors were particularly attracted to these securities — thus continuing our “insourcing” of low-cost global funds to support the U.S. housing market.

Not only did we gain substantial GSE market share, but in the face of stiff competition from the banking sector, we also grew overall market share. And we diversified our customer base by reaching beyond our usual largest customers.

## **Building Shareholder Value**

Increasing market share and customer satisfaction is only part of our strategy to build shareholder value. A strong balance sheet and expert risk management are also essential. In 2005, we built on these enduring strengths.

Turning to our balance sheet, Freddie Mac's regulatory core capital grew to over \$35 billion — well above the capital requirements set by our safety and soundness regulator.

As a result of our strong capital position and confidence in our profitability, we increased our quarterly common stock dividend twice last year. In fact, since December 2003, we have raised this dividend by 81 percent.

Regarding our credit and interest-rate risk management record, it remains a hallmark of the industry. Our ready access to callable debt and specialized mortgage risk expertise are key competitive advantages. The company's interest-rate and credit risks are near historic lows. Our delinquency rates remain low as well. Our key measures of interest-rate risk are disclosed monthly — transparent to all — demonstrating that we continue to manage risk prudently and consistently in a world of rapidly changing rate conditions.

In May we reported 2005 earnings in excess of \$2 billion in GAAP net income. These results reflect a cyclical narrowing of spreads as well as costs associated with the settlement of litigation stemming from the events of 2003, charges related to Hurricane Katrina, and the cumulative impact of a number of accounting changes. Fair value, another very important measure of our performance, grew before capital transactions, but at a rate well below our long-term expectations and continuing guidance.

Creating value for shareholders depends in part on our ability to hold down expenses, and in 2005 we were successful in this area. But I want to be clear: we also have an absolute duty



to make the necessary investments to ensure that Freddie Mac has world-class controls, reporting and accounting systems. Our goal is to reduce our expense ratio over time, so that as the company grows, expenses become a diminishing share of our overall business.

## **Serving Our Mission**

Freddie Mac's statutory mission is a broad one: to provide stability, liquidity and affordability to the nation's housing finance markets. Our response to the Gulf Coast hurricanes was just one example of our commitment to this mission.

Though the U.S. Secretary of Housing and Urban Development makes the final determination, we reported that we met the toughest set of affordable housing goals in the company's history. Our affordable performance was strong — with well over half the units financed by our mortgage purchases being affordable to low- and moderate-income families. In addition, Single Family's purchase of mortgages from underserved areas increased, and our goal-rich Multifamily business set a new record for annual volume.

The next generation of homeowners will need trillions of dollars in mortgage capital, and minorities and immigrants will be the source of most household growth. To meet these growing needs, Freddie Mac has a central role to play. That's why we are focused on our mission. And why, more than ever, what's good for our mission is good for our business.

## **Focusing on the Future**

Freddie Mac is better positioned to compete than it has been in years. We achieved good growth in line with the overall market, increased our penetration of the secondary conforming market that we serve and maintained a very strong balance sheet. We also streamlined our business operations; reinforced corporate governance, ethics and compliance; and added real strength and depth to our management team. These and other developments — including trends in the market — give me confidence in Freddie Mac's long-term business prospects.

Clearly, much more needs to be done. Our most urgent task is to do everything it takes to ensure that our internal controls and accounting systems are of the same high caliber as our financial risk management and reporting. There is no higher priority for Freddie Mac's senior management than completing this work and becoming timely in our financial reporting. This company must become the standard of excellence not only for managing mortgage risk, but for the accounting and internal controls associated with it.

Over the past year, Congress has worked to overhaul regulatory oversight of the housing GSEs, and we have supported this effort in a constructive way. Last fall, acting on a broad bipartisan basis, the U.S. House of Representatives passed tough legislation to enhance GSE oversight. This tough bill goes well beyond current banking law in a number of areas. Going forward, we will continue to support federal legislation that strengthens regulatory oversight and allows us to fulfill our mission.

As part of the ongoing policy discussion, we made good progress last year in publicly articulating the value and vital role of the GSEs. That includes how we insulate households from interest-rate risk and transfer it out to the capital markets; how we provide stability, liquidity and affordability in good times and bad; and how we harness market means — and private capital — to achieve a public mission.

As Freddie Mac stockholders, you share a vital role in making home possible for millions of families. So when I pledge to you that I will finish the job of making a strong franchise run better than ever, that is not a diversion from my mission responsibilities. It is an expression of those responsibilities.

And it is a promise I intend to keep. ■

Sincerely,

A handwritten signature in black ink that reads "Dick Syron". The signature is fluid and cursive, with the first name "Dick" and last name "Syron" clearly distinguishable.

Richard F. Syron

**Chairman and Chief Executive Officer**

# CONTINUING Commitment

**Freddie Mac brings stability, liquidity and affordability** to the nation's housing finance system during good times and tough times. That's our reason for being. And our continuing commitment.

**Stability.** When a trio of hurricanes battered the Gulf Coast in the fall of 2005, Freddie Mac responded decisively — putting both our balance sheet and our expertise to work. We helped jumpstart home rebuilding and community renewal by providing relief to borrowers, originators and servicers. We also brought stability to the market, using our retained portfolio, by committing to buy up to \$1 billion of mortgage revenue bonds issued by state and local housing authorities. With well over half of Freddie Mac's purchases already completed, housing officials are using these low-cost funds to provide affordable housing for thousands of affected families. In these and other ways, we are fulfilling our mission as a government-sponsored enterprise (GSE) to protect homeowners, the housing sector and the economy from the shock of unexpected events. And our leadership has been widely recognized by public officials and lenders alike.

**Liquidity.** Through Freddie Mac's investment and securitization activities, we ensure a ready supply of money for lenders. We excel at tapping global financial markets to support housing in America — and at transferring interest-rate risk from households to these markets, which are much better equipped to handle it. In 2005, we made home possible for millions of families by providing the residential secondary mortgage market with more than



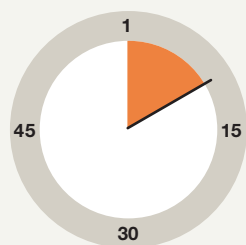
Building hope in the wake of the 2005 hurricanes, more than 800 Freddie Mac employees joined Habitat for Humanity's *America Builds on the National Mall*. Fifty-one homes were shipped to waiting families in the Gulf Coast region.



\$580 billion in liquidity. Our dependable presence in the market lowers rates for consumers of conforming mortgages. And it helps make mortgage-backed securities (MBS) the most widely traded non-sovereign instruments in the world.

**Affordability.** In 2005, Freddie Mac financed homes for more than 4 million borrowers. Our affordable performance was among our strongest on record — with more than 54 percent of the units financed through our mortgage purchases being affordable to low- and moderate-income families. We created new affordable housing opportunities

by launching a product line with special benefits for police officers, firefighters, teachers and health care workers who want to live in the communities they serve. And while the Secretary of HUD makes the final determination, thanks in part to our expanding multifamily business, we reported to HUD that we exceeded the 2005 affordable housing goals — the toughest ever set for us by the federal government.



Every 10 seconds Freddie Mac makes it possible for another family to own a home.

Freddie Mac also maintains a strong philanthropic commitment to America's communities, opening the doors of hope and opportunity to children and their families. Through our Corporate Giving program and the Freddie Mac Foundation, we awarded almost \$35 million to nonprofit organizations in 2005. In fact — with our DC-area grants providing almost a fifth of the top 50 companies' combined giving — the *Washington Business Journal* ranked us first among local corporations in contributions to the community.

Meeting our mission and serving our communities. That's Freddie Mac's continuing commitment. ■

# CONTINUING Strength

## **Freddie Mac continues to build on its strengths.**

In 2005, we buttressed a rock-solid capital position and balance sheet. Throughout the year, we exceeded all regulatory capital requirements. In fact, by year end, Freddie Mac's regulatory core capital grew to more than \$35 billion — well above the capital requirements set by our safety and soundness regulator. And we expect to be able to maintain our strong position across a wide range of market conditions.

Our credit risks remained low, as measured both by single-family delinquency rates and total credit losses. Indeed, despite the effects of the Gulf Coast hurricanes, 90-day delinquencies at the end of 2005 were lower than they were on December 31, 2004.

Prudent and consistent risk management amid a changing interest-rate environment kept our interest-rate risks low as well. Portfolio Market Value Sensitivity Level (PMVS-L), which measures our sensitivity to a 50-basis point parallel shift in the level of interest rates, averaged 1 percent throughout 2005. Our duration gap also remained steady at near zero months. All of which means that Freddie Mac is well positioned to deal with interest-rate swings that would place great stress on many financial institutions.

Freddie Mac's solid business strength grows from its company-wide commitment to shareholders, customers and homebuyers.



To put it simply, Freddie Mac's financial strength is beyond question.

Reflecting our strong capital position and confidence in Freddie Mac's long-term business prospects, we raised the amount of capital returned to shareholders twice in 2005, through dividend increases in March and December. Our senior management is acutely aware that putting shareholder capital to work is a major priority. Since year-end 2003, our quarterly common stock dividend has grown by 81 percent.

Freddie Mac has benefited shareholders by increasing its common stock dividend significantly over the past three years.

*(Dividends per common share)*



And our business is growing, too — with 2005 bringing expansion in key areas. Growth in our share of the market. Growth in our mortgage portfolio. Growth in our product line and ability to serve lender needs. Growth in customer satisfaction.

Results like these from across the company reflect Freddie Mac's business strengths in 2005, as we continued to build long-term shareholder value and deliver on our charter mission

as a leader in the secondary mortgage market.

Much of Freddie Mac's progress is the result of a new, integrated focus on customers. We improved customer service, diversified our lender base and increased our share with key business partners. And we enhanced our value proposition for customers by expanding the types of mortgages we guarantee and launching new products to meet evolving needs.

Abundant capital. Disciplined risk management. Strong customer relationships. An established franchise in a defined and growing market. These are Freddie Mac's continuing strengths. ■

# CONTINUING Transformation

## **A transformation is underway at Freddie Mac.**

We're rebuilding ourselves from the inside out. Strengthening our infrastructure and controls. Designing financial products that meet customer and market needs. Deploying innovative technologies. Developing new strategies and initiatives.

Our goal? To make Freddie Mac a top financial services firm of enduring strength, increased transparency and the highest integrity. A company that leads the industry, delivers first-class financial reporting, provides new levels of customer service and makes both single-family and rental housing more accessible and more affordable for more Americans.

That means optimizing our capital structure and further improving our mortgage security performance. It means revamping our systems, processes and financing tools to better match the market. And it means enhancing our capability to structure and trade credit risk, for both single-family and multifamily loans.

In other words, taking a strong franchise and making it better.

That's our challenge. And while our transformation is not nearly complete, we're making solid progress. Including the essential next step: upgrading Freddie Mac's financial reporting systems and strengthening our internal controls environment, so we can meet all



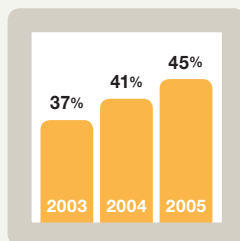
Freddie Mac's transformation into an even stronger franchise begins at its headquarters in McLean, Virginia.



our regulatory and financial reporting commitments. We're taking every step necessary to get this done and to do it right. And we will not rest until the job is complete.

We have continued to build a strong management team by filling key senior positions. Since our 2004 Annual Report, for example, we've brought in Tim Bitsberger, a widely respected former Treasury Department official and Wall Street veteran, as Treasurer; Paul Mullings, a customer-oriented mortgage industry executive from JP Morgan Chase, as Senior Vice President for Single Family Mortgage Sourcing; Anurag Saksena, a seasoned risk management professional from GMAC, to be our new Chief Enterprise Risk Officer; and Bob Bostrom, a recognized expert on corporate governance and financial institutions compliance matters, as General Counsel.

Freddie Mac has continued to grow its share of the GSE securitization market.



We've made progress in adapting the company culture to a more competitive market environment that requires us to be agile, aggressive and responsive. And we've strengthened our corporate governance.

This is a company doing good things — and *Business Ethics* magazine agrees. It named Freddie Mac to its 2006 list of “Top 100 Corporate Citizens” for best practices in the area of corporate social responsibility.

Today, we have the right team, the right plan and a strong, well-capitalized franchise that's focused on serving our vital housing mission and generating value for shareholders.

Continuing transformation today, to generate new growth and new opportunities tomorrow. That's our aim and our vision. That's Freddie Mac. ■

## Freddie Mac

**2005** Annual Report to Stockholders

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**INFORMATION STATEMENT  
AND  
ANNUAL REPORT TO STOCKHOLDERS  
For the fiscal year ended December 31, 2005**

This Information Statement contains important financial and other information about Freddie Mac. This Information Statement will be supplemented periodically. All available supplements should be read together with this Information Statement. We also provide information about the securities we issue in the Offering Circular for each securities program and any supplement for each particular offering. You can obtain copies of the Information Statement, Offering Circulars, all available supplements, financial reports and other similar information by visiting our Internet website ([www.FreddieMac.com](http://www.FreddieMac.com)) or by writing or calling us at:

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Our principal offices are located at 8200 Jones Branch Drive, McLean, Virginia 22102 (telephone: 703-903-2000).

**THIS INFORMATION STATEMENT IS DATED JUNE 28, 2006**

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*This Information Statement and Annual Report includes forward-looking statements, which may include expectations and objectives for our operating results, financial condition, business, and trends and other matters that could affect our business. You should not unduly rely on our forward-looking statements. Actual results might differ significantly from our forecasts and expectations due to several factors that involve risks and uncertainties, including those described in “BUSINESS,” “RISK FACTORS” and “FORWARD-LOOKING STATEMENTS.” These forward-looking statements are made as of the date of this Information Statement and we undertake no obligation to publicly update any forward-looking statement to reflect events or circumstances after the date of this Information Statement, or to reflect the occurrence of unanticipated events.*

## **BUSINESS**

### **Overview**

Freddie Mac is a stockholder-owned company chartered by Congress in 1970 to stabilize the nation’s residential mortgage markets and expand opportunities for homeownership and affordable rental housing. We are one of the largest purchasers of mortgage loans in the U.S. We bring innovation and efficiency to the mortgage lending process.

Our mission is to provide liquidity, stability and affordability to the U.S. housing market. We fulfill our mission by purchasing residential mortgages and mortgage-related securities in the secondary mortgage market. We purchase mortgages that meet our underwriting and product standards, then bundle them into mortgage-related securities that can be sold to investors. We can use the proceeds to purchase additional mortgages from primary market mortgage lenders, thus providing them with a continuous flow of funds. We also purchase mortgage loans and mortgage-related securities for our investment portfolio, which we finance primarily by issuing a variety of debt instruments in the capital markets.

Though we are chartered by Congress, our business is funded completely with private capital. We are responsible for making payments on our securities. Neither the U.S. government nor any other agency or instrumentality of the U.S. government is obligated to fund our mortgage purchase or financing activities or to guarantee our securities and other obligations.

### **Our Charter and Mission**

The Federal Home Loan Mortgage Corporation Act, which we refer to as our charter, forms the framework for our business activities, shapes the products we bring to market, and drives the services we provide to the nation’s residential housing and mortgage industries. Our charter also prescribes the terms and principal amounts of mortgage loans that we are permitted to purchase, as described in “Business Activities — *Types of Mortgages We Purchase.*”

Our statutory purposes, as stated in our charter, are:

- to provide stability in the secondary market for residential mortgages;
- to respond appropriately to the private capital market;
- to provide ongoing assistance to the secondary market for residential mortgages (including activities relating to mortgages on housing for low- and moderate-income families involving a reasonable economic return that may be less than the return earned on other activities) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing; and
- to promote access to mortgage credit throughout the U.S. (including central cities, rural areas and other underserved areas) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing.

To facilitate our statutory purposes, our charter provides us with special attributes including:

- exemption from the registration and reporting requirements of the Securities Act and the Exchange Act (we are subject to the general antifraud provisions of the federal securities laws and have committed to the voluntary registration of our common stock with the Securities and Exchange Commission under the Exchange Act);
- favorable treatment of our securities under various investment laws and other regulations;
- discretionary authority of the Secretary of the Treasury to purchase up to \$2.25 billion of our securities; and
- exemption from state and local taxes, except for taxes on real property that we own.

Our activities in the secondary mortgage market benefit consumers by providing lenders a steady flow of low-cost mortgage funding. This flow of funds helps moderate cyclical swings in the housing market, equalizes the flow of mortgage funds regionally throughout the U.S. and provides for the availability of mortgage funds in a variety of economic conditions. In addition, the supply of cash made available to lenders through this process drives down mortgage rates on loans within the dollar limits set under our charter. These lower rates help make homeownership affordable for more families and individuals than would be possible without our participation in the secondary mortgage market.

## Residential Mortgage Debt Market

We compete in the large and growing U.S. residential mortgage debt market. This market consists of a primary mortgage market that links homebuyers and lenders, and a secondary mortgage market that links lenders and investors. At December 31, 2005, our Total mortgage portfolio was \$1.7 trillion, while the total U.S. residential mortgage debt outstanding was estimated to be approximately \$9.9 trillion.

The residential mortgage market has grown substantially in recent years, as low interest rates and a strong housing market have resulted in record levels of mortgage loan originations, including refinancings of existing residential mortgage debt. As interest rates have increased, refinancings have declined. Throughout 2005, short-term interest rates increased significantly as a result of the actions of the Board of Governors of the Federal Reserve System, or the Federal Reserve, which regulates the supply of money and credit in the U.S.; however, the Federal Reserve's actions had less of an impact on long-term interest rates. Consequently, the slope of the "yield curve" — or the spread between short-term and long-term interest rates — continued to flatten throughout the year. Despite the rise in interest rates, mortgage rates remained low by historical standards and continued to contribute to demand in the residential mortgage market.

As indicated in Table 1, house prices appreciated nationwide at a rate of approximately 13 percent in 2005 with some regional variation. However, this appreciation rate is expected to moderate. Total residential mortgage debt outstanding in the U.S. grew at an estimated annual rate of 14 percent in both 2005 and 2004. We expect the amount of total residential mortgage debt outstanding will continue to rise in 2006, though at a slower rate than in the past few years.

**Table 1 — Mortgage Market Indicators**

	Year-Ended December 31,		
	2005	2004	2003
Home sale units (in thousands) <sup>(1)</sup>	7,462	7,162	6,529
House price appreciation	13%	12%	8%
Single-family mortgage originations (in billions)	\$2,828	\$2,911	\$3,860
ARM share of single-family mortgage originations	31%	34%	19%
Refinancing share of single-family mortgage originations	44%	46%	65%
U.S. residential mortgage debt outstanding (in billions) <sup>(2)</sup>	\$9,851	\$8,642	\$7,581

(1) Includes sales of new and existing detached single-family homes in the U.S. and excludes condos/co-ops. Source: National Association of Realtors news release dated May 25, 2006 (sales of existing homes) and U.S. Census Bureau news release dated May 24, 2006 (sales of new homes).

(2) Debt outstanding at year-end, not seasonally-adjusted. Source: Federal Reserve Flow of Funds Accounts of the United States dated June 8, 2006.

Growth in the U.S. residential mortgage debt market is affected by several factors, including changes in interest rates, employment rates in various regions of the country, home ownership rates, house price appreciation, and borrower preferences concerning the portion of his or her home's value to finance with mortgage debt. The amount of residential mortgage debt available for us to purchase and the mix of available loan products are also affected by several factors, including the volume of single-family mortgages within the loan limits imposed under our charter and the purchase and securitization activity of other financial institutions. See "RISK FACTORS."

### *Primary Mortgage Market — Our Customers*

Our customers are predominantly lenders in the primary mortgage market that originate mortgages for homebuyers. These lenders include mortgage banking companies, commercial banks, savings banks, community banks, credit unions, state and local housing finance agencies, and savings and loan associations. A lender that originates a mortgage can either hold the mortgage in its own portfolio, securitize the mortgage or sell the mortgage to a secondary mortgage market investor, such as Freddie Mac.

We buy a significant portion of our mortgages from several large mortgage lenders. During 2005, three mortgage lenders each accounted for 10 percent or more of our mortgage purchase volume and in the aggregate they accounted for approximately 47 percent of this volume. These three lenders are among the largest mortgage loan originators in the United States. We have contracts with a number of mortgage lenders, including some large lenders, that include a commitment by the lender to sell us a minimum percentage or dollar amount of its mortgage origination volume. These contracts typically last for one year. If a mortgage lender fails to meet its contractual commitment, we have a variety of contractual remedies, including the right to assess certain fees. As the mortgage industry has been consolidating, we, as well as our competitors, have been seeking business from a decreasing number of key lenders. See "RISK FACTORS — Competitive and Market Risks." We are working to diversify our customer base and thus reduce the risk of losing a key customer.

### *Secondary Mortgage Market*

We participate in the secondary mortgage market generally by buying whole loans (*i.e.*, mortgage loans that have not been securitized) and mortgage-related securities for our Retained portfolio and by issuing guaranteed mortgage-related securities. We do not lend money directly to homebuyers. Our principal competitors are the Federal National Mortgage Association, or Fannie Mae, a similarly chartered government-sponsored enterprise, or GSE, the Federal Home Loan Banks,

and other financial institutions that retain or securitize mortgages, such as banks, dealers and thrift institutions. We compete primarily on the basis of price, products, structure and service.

The dramatic increases in housing prices over the last few years have resulted in the origination of a greater proportion of alternative mortgage products, including initial interest-only loans and option adjustable-rate mortgage loans, or Option ARMs. We have historically purchased limited amounts of these alternative products through our securitization programs. However, recently we have increased our purchases of these products consistent with the increase in their prevalence in the market. We are continuing to explore ways in which we can become more involved with these products and we expect our participation in these products to grow over the coming years. See “MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS, or MD&A — RISK MANAGEMENT — Credit Risks — *Mortgage Credit Risk* — Mortgage Credit Risk Management Strategies.” In addition, we believe the recent rise in short-term interest rates relative to long-term interest rates will increase the proportion of 30-year fixed-rate mortgages originated.

### **Business Activities**

We generate income primarily through two business activities — portfolio investment activities and credit guarantee activities — operating in one business segment. For a summary and description of our financial performance and financial condition, see “MD&A” and “CONSOLIDATED FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA” and the accompanying notes to our consolidated financial statements. At December 31, 2005, we had total assets of \$806.2 billion, and total stockholders’ equity of \$27.2 billion, and for the year ended December 31, 2005, we reported net income of \$2.1 billion. At June 1, 2006, we had 4,905 full-time and 133 part-time employees. Our principal offices are located in McLean, Virginia.

#### ***Types of Mortgages We Purchase***

Our charter establishes general parameters for the terms and principal amounts of the mortgages we may purchase, as described below. We also purchase mortgage-related securities that are backed by single-family or multifamily mortgages. Within our charter parameters, the residential mortgage loans we purchase or that underlie mortgage-related securities we purchase generally fall into one of two categories:

- *Single-Family Mortgages.* Single-family mortgages are secured by one- to four-family properties. The types of single-family mortgages we purchase include 30-year, 20-year, 15-year and 10-year fixed-rate mortgages, interest-only mortgages, ARMs, and balloon/reset mortgages.
- *Multifamily Mortgages.* Multifamily mortgages are secured by structures with five or more residential rental units. These mortgages have terms generally ranging from five to thirty years. Our multifamily mortgage products, services and initiatives are designed primarily to finance affordable rental housing for low- and moderate-income families.

*Conforming Loan Limits.* Our charter places a dollar amount cap, called the “conforming loan limit,” on the size of the original principal balance of single-family mortgage loans we purchase. This limit is established annually pursuant to a methodology prescribed by our safety and soundness regulator, the Office of Federal Housing Enterprise Oversight, or OFHEO, based on year-to-year changes in the national average price of a one-family residence, as surveyed by the Federal Housing Finance Board each October. For 2006, 2005 and 2004, the conforming loan limits for a one-family residence were set at \$417,000, \$359,650 and \$333,700, respectively. Higher limits apply to two- to four-family residences. The conforming loan limits are also 50 percent higher for mortgages secured by properties in Alaska, Guam, Hawaii and the U.S. Virgin Islands. No comparable limits apply to our purchases of multifamily mortgages.

*Loan-to-Value Ratios and Mortgage Insurance.* Under our charter, mortgages that are not guaranteed or insured by any agency or instrumentality of the U.S. government are referred to as “conventional mortgages.” Our charter requires that we have additional credit protection if the unpaid principal balance of a conventional single-family mortgage that we purchase exceeds 80 percent of the value of the property securing the mortgage. See “MD&A — RISK MANAGEMENT — Credit Risks — *Mortgage Credit Risks* — Mortgage Credit Risk Management Strategies — *Credit Enhancements*” for more information regarding the credit enhancements and other credit protections we obtain.

*Loan Quality.* Under our charter, our mortgage purchases are limited, so far as practicable, to mortgages we deem to be of a quality, type and class that generally meet the purchase standards of private institutional mortgage investors.

To manage credit risks with respect to our mortgage purchases, we have developed internal credit policies and appraisal, underwriting and other purchase policies and guidelines set forth in our Single-family Seller/Servicer Guide and our Multifamily Seller/Servicer Guide. We design mortgage loan underwriting guidelines to assess the creditworthiness of the borrower and the borrower’s capacity to fulfill the obligations of the mortgage. We continuously review these guidelines in an effort to ensure their effectiveness and to address the needs of the changing marketplace — including the needs of minorities, low- and moderate-income borrowers and other borrowers who are underserved by the traditional housing finance

system. See “MD&A — RISK MANAGEMENT — Credit Risks — *Mortgage Credit Risks* — Mortgage Credit Risk Management Strategies — *Underwriting Requirements and Quality Control Standards*” for additional information.

### ***Investment and Funding Activities***

We purchase mortgage loans and mortgage-related securities and hold them in our Retained portfolio for investment purposes. We invest in mortgage-related securities issued by GSEs or government agencies, referred to as agency securities. We also invest in non-agency mortgage-related securities. Our portfolio purchases replenish the capital available for mortgage lending. We face competition from other financial institutions that are aggressively buying mortgage-related securities backed by both GSE and non-agency issuers.

We manage our Retained portfolio through a strategy of long-term capital deployment. We apply our expertise in mortgage markets and mortgage assets to support attractive and timely asset selection while managing our interest-rate risk. We issue short-, medium- and long-term debt securities, subordinated debt securities and equity securities to finance purchases of mortgages and mortgage-related securities and other business activities. Our debt funding program is designed to offer liquid securities to the global capital markets in a transparent and predictable manner. By diversifying our investor base and the types of debt securities we offer, we believe we enhance our ability to maintain continuous access to the debt markets under a variety of conditions. We manage our debt funding costs by issuing debt of various maturities that is either callable (*i.e.*, redeemable at our option at one or more times before its scheduled maturity) or non-callable. Recently, our funding costs compared to the London Interbank Offered Rate, or LIBOR, have improved. Our funding mix also helps us manage our interest-rate risk by closely matching the interest obligations on our debt with the expected cash inflows from our mortgage-related investments. To further manage interest-rate risks, we use a variety of derivatives. We also use Structured Securities, described below, to restructure cash flows from mortgage-related securities, retaining a portion of these restructured cash flows. See “MD&A — RISK MANAGEMENT — Interest-Rate Risk and Other Market Risks” for more information.

Because of our GSE status and the special attributes granted to us under our charter, noted above in “Our Charter and Mission,” our debt securities and those of other GSE issuers trade in the so-called “agency sector” of the debt markets. This highly liquid market segment exhibits its own yield curve reflecting our ability to borrow at lower rates than many other corporate debt issuers. As a result, we mainly compete for funds in the debt issuance markets with Fannie Mae and the Federal Home Loan Banks, who issue debt securities of comparable quality and ratings. The demand for, and liquidity of, our debt securities, and those of other GSEs, also benefit from their status as permitted investments for banks, investment companies and other financial institutions under their regulatory framework. Other investors also finance portfolio investments in mortgage assets. Competition for funding with these entities can vary with economic, financial market and regulatory environments.

For additional information about our debt securities, see “MD&A — LIQUIDITY AND CAPITAL RESOURCES — Liquidity — *Debt Securities*.”

### ***Credit Guarantee Activities***

We guarantee the payment of principal and interest on mortgage-related securities in exchange for a fee, which we refer to as a guarantee fee. The types of mortgage-related securities we guarantee include the following:

- mortgage Participation Certificates, or PCs, we issue;
- single-class and multi-class Structured Securities we issue; and
- securities related to tax-exempt multifamily housing revenue bonds.

We have recently increased our share of the GSE securitization market by improving our customer service, diversifying our customer base, tailoring securities to a broader group of global investors, expanding the types of mortgages that we guarantee and introducing program enhancements, new forms of Structured Securities, such as the Reference REMIC<sup>SM</sup> securities, and through other initiatives.

We support our credit guarantee business volume by adjusting our guarantee fee or other transaction fees. For example, if the price performance of, and demand for, our PCs is not comparable to Fannie Mae’s securities on future mortgage deliveries by sellers, we may use market-adjusted pricing where we provide guarantee fee or other transaction fee price adjustments to partially offset weaknesses in prevailing security prices. We believe these price-adjustment features increase the competitiveness of our credit guarantee business. The use of such market-adjusted pricing could have a material adverse effect on the profitability of our new credit guarantee business over its life.

***Guarantees of PCs.*** We issue single-class mortgage-related securities that represent undivided interests in pools of mortgages we have purchased. We refer to these mortgage-related securities as PCs. We guarantee the payment of principal and interest on all of our PCs. We issue most of our PCs in transactions in which our customers sell us mortgage loans in



exchange for PCs. Investors in PCs may include the lenders that sold us the underlying mortgages, as well as pension funds, insurance companies, securities dealers and other fixed-income investors. Investors may choose to hold these PCs in their portfolios or sell them to others. Our guarantee increases the marketability of our PCs, providing additional liquidity to the mortgage market.

*Guarantees of Structured Securities.* We also issue securities representing beneficial interests in pools of PCs and certain other types of mortgage-related assets. We refer to these mortgage-related securities as Structured Securities. We guarantee the payment of principal and interest on most of the Structured Securities we issue. By issuing Structured Securities, we seek to provide liquidity to alternative segments of the mortgage market. We issue many of our Structured Securities in transactions in which securities dealers or investors sell us the mortgage-related assets underlying the Structured Securities in exchange for the Structured Securities. We also sell Structured Securities to securities dealers or investors in exchange for cash.

We issue single-class Structured Securities and multi-class Structured Securities. Single-class Structured Securities pass through the cash flows on the underlying mortgage-related assets. Multi-class Structured Securities divide the cash flows of the underlying mortgage-related assets into two or more classes that meet the investment criteria and portfolio needs of different investors. Our principal multi-class Structured Securities qualify for tax treatment as Real Estate Mortgage Investment Conduits, or REMICs. For purposes of this Information Statement, multi-class Structured Securities include Structured Securities backed by non-agency mortgage-related securities.

*Guarantees Related to Tax-Exempt Multifamily Housing Revenue Bonds.* We guarantee the payment of principal and interest on tax-exempt multifamily housing revenue bonds that support pass-through certificates issued by third parties. These housing revenue bonds are collateralized by mortgage loans on low- and moderate-income multifamily housing projects. In addition, we guarantee the payment of principal and interest related to low- and moderate-income multifamily mortgage loans underlying tax-exempt multifamily housing revenue bonds.

*PC and Structured Securities Support Activities.* We support the liquidity and depth of the market for PCs through a variety of activities, including educating dealers and investors about the merits of trading and investing in PCs, and introducing new mortgage-related securities products and initiatives. We support the price performance of our PCs through a variety of strategies, including the issuance of Structured Securities and the purchase and sale by our Retained portfolio of PCs and other agency securities, including Fannie Mae securities. While some purchases of PCs may result in a return on equity substantially below our normal thresholds, this strategy is not expected to have a material effect on the long-term value of the company. Depending upon market conditions, including the relative prices, supply of, and demand for PCs and comparable Fannie Mae securities, there may be substantial variability in any period in the total amount of securities we purchase or sell for our Retained portfolio in accordance with this strategy. We may increase, reduce or discontinue these or other related activities at any time, which could affect the liquidity and depth of the market for PCs.

In the fourth quarter of 2004, as part of our effort to realign our activities around our mission and core business, we ceased our PC market making and support activities accomplished through our Securities Sales & Trading Group, or SS&TG, and our external Money Manager program. For more information, see “MD&A — CONSOLIDATED RESULTS OF OPERATIONS — Net Interest Income.”

*The To Be Announced Market.* In connection with our credit guarantee activities, we issue PCs that represent pools of mortgages with similar characteristics. Because these PCs are homogeneous and are issued in high volume, they are highly liquid and trade with similar securities on a “generic” basis, also referred to as trading in the To Be Announced, or TBA, market. A TBA trade in Freddie Mac securities represents a contract for the purchase or sale of PCs to be delivered at a future date; however, the specific PCs that will be delivered to fulfill the trade obligation, and thus the specific characteristics of the mortgages underlying those PCs, are not known (*i.e.*, “announced”) at the time of the trade, but only shortly before the trade is settled. During 2005, we issued approximately \$282.0 billion of PCs backed by single-family mortgage loans that were eligible to be delivered to settle TBA trades, representing approximately 71 percent of our total guaranteed PC and Structured Security issuances. The use of the TBA market increases the liquidity of mortgage investments and improves the distribution of investment capital available for residential mortgage financing, thereby helping us to accomplish our statutory mission.

#### **Available Information**

Our Information Statements, Supplements and other financial disclosure documents are available free of charge on our website at [www.FreddieMac.com](http://www.FreddieMac.com). (We do not intend this internet address to be an active link and are not using references to this internet address here or elsewhere in this Information Statement to incorporate additional information into this Information Statement.) Our corporate governance guidelines, Codes of Conduct for employees and members of the board of directors (and any amendments or waivers that would be required to be disclosed), and the charters of the board’s five standing committees (the Audit; Finance and Capital Deployment; Mission and Sourcing; Governance, Nominating and

Risk Oversight; and Compensation and Human Resources Committees) are also available on our website. Printed copies of these documents may be obtained upon request from our Investor Relations department.

## REGULATION AND SUPERVISION

### Department of Housing and Urban Development

The U.S. Department of Housing and Urban Development, or HUD, has general regulatory power over Freddie Mac, including power over new programs, affordable housing goals and fair lending.

#### *Housing Goals*

We are subject to affordable housing goals set by HUD. The goals, which are set as a percentage of the total number of dwelling units underlying our total mortgage purchases, have risen steadily since they became permanent in 1995. The goals are intended to expand housing opportunities for low- and moderate-income families, low-income families living in low-income areas and very low-income families, and families living in HUD-defined underserved areas. The goal relating to low-income families living in low-income areas and very low-income families is referred to as the “special affordable” housing goal. This special affordable housing goal also includes a multifamily subgoal that sets an annual minimum dollar volume of qualifying multifamily mortgage purchases.

Effective January 1, 2005, HUD:

- established new and increasing affordable housing goal levels for the years 2005 through 2008;
- established three new subgoals for mortgages that count towards the goals and that finance purchases of single-family, owner-occupied properties located in metropolitan areas;
- increased the multifamily special affordable volume target to \$3.92 billion, based on HUD’s established formula; and
- required the certification of information provided in Freddie Mac’s Annual Mortgage Report and Annual Housing Activities Report submitted to HUD.

In total, beginning in 2005 and continuing through 2008, we are required to achieve six different and increasing HUD goals and subgoals and a higher multifamily special affordable volume target, as summarized in Table 2 below.

**Table 2 — Housing Goals and Home Purchase Subgoals for 2005 through 2008<sup>(1)</sup>**

	Housing Goals			
	2008	2007	2006	2005
Low- and moderate-income goal .....	56%	55%	53%	52%
Underserved areas goal .....	39	38	38	37
Special affordable goal .....	27	25	23	22
Multifamily special affordable volume target (dollars in billions) .....	\$3.92	\$3.92	\$3.92	\$3.92
	Home Purchase Subgoals <sup>(2)</sup>			
	2008	2007	2006	2005
Low- and moderate-income goal .....	47%	47%	46%	45%
Underserved areas goal .....	34	33	33	32
Special affordable goal .....	18	18	17	17

(1) An individual mortgage may qualify for more than one of the goals or subgoals. Each of the goal and subgoal percentages will be determined independently and cannot be aggregated to determine a percentage of total purchases that qualifies for these goals or subgoals.

(2) These home purchase subgoals are expressed as percentages of the total number of mortgages we purchased that finance the purchase of single-family, owner-occupied properties located in metropolitan areas.

Meeting these goals and subgoals in future years will be challenging and there can be no assurance that we will do so. See “RISK FACTORS — Legal and Regulatory Risks.” However, we view the purchase of mortgage loans benefiting low- and moderate-income families and neighborhoods as a principal part of our mission and business, and we are committed to fulfilling the needs of these borrowers and markets.

We have reported to HUD that we achieved each of the affordable housing goals and subgoals as applicable to 2005, 2004 and 2003. HUD has determined that we met the goals for 2004 and 2003, and is evaluating our performance with

respect to the goals and subgoals for 2005. Our performance with respect to the goals and subgoals, as reported to HUD, is set forth in Table 3 below.

**Table 3 — Housing Goals and Home Purchase Subgoals and Reported Results<sup>(1)</sup>**

*Housing Goals and Reported Results*

	Year Ended December 31,					
	2005		2004		2003	
	Goal	Result	Goal	Result <sup>(2)</sup>	Goal	Result <sup>(2)</sup>
Low- and moderate-income goal . . . . .	52%	54.1%	50%	51.6%	50%	51.2%
Underserved areas goal . . . . .	37	42.2	31	32.3	31	32.7
Special affordable goal . . . . .	22	24.5	20	22.7	20	21.4
Multifamily special affordable volume target (dollars in billions) . . . . .	\$3.92	\$11.41	\$2.11	\$7.77	\$2.11	\$8.79

*Home Purchase Subgoals and Reported Results*

	Year Ended December 31, 2005	
	Subgoal	Result
Low- and moderate-income subgoal . . . . .	45%	46.9%
Underserved areas subgoal . . . . .	32	35.4
Special affordable subgoal . . . . .	17	17.8

(1) An individual mortgage may qualify for more than one of the goals or subgoals. Each of the goal and subgoal percentages and each of our percentage results is determined independently and cannot be aggregated to determine a percentage of total purchases that qualifies for these goals or subgoals.

(2) The 2004 and 2003 results reflected in this table have been revised from the numbers reflected in our Information Statement dated June 14, 2005 to reflect adjustments and corrections to the information we originally reported to HUD for those years.

We are engaged in ongoing discussions with HUD regarding interpretive issues relating to the purchase and counting of mortgages for purposes of housing goals performance for 2005. If the Secretary of HUD were to find that we failed, or that there was a substantial probability that we would fail, to meet a housing goal and that achievement of the housing goal was feasible, the Secretary could require us to submit a housing plan. The housing plan would describe the actions we would take to achieve the goal in the future. HUD also has the authority to take enforcement actions against us, including issuing a cease and desist order or assessing civil money penalties, if we: (a) fail to submit a required housing plan or fail to make a good faith effort to comply with a plan approved by HUD; or (b) fail to submit certain data relating to our mortgage purchases, information or reports required by law.

***Fair Lending***

Our mortgage purchase activities are subject to federal anti-discrimination laws. In addition, the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, or the GSE Act, prohibits discriminatory practices in our mortgage purchase activities, requires us to submit data to HUD to assist it in its fair lending investigations of primary market lenders, and requires us to undertake remedial actions against lenders found to have engaged in discriminatory lending practices. In addition, HUD periodically reviews and comments on our underwriting and appraisal guidelines for consistency with the Fair Housing Act and the GSE Act.

***Predatory Lending***

A core component of our mission is to facilitate the financing of affordable housing for low- and moderate-income families. Predatory lending is in direct opposition to our mission, our goals and our practices. Since 2000, we have taken a number of voluntary steps to combat predatory lending and support responsible lending. We have instituted anti-predatory lending policies intended to prevent the purchase or assignment of mortgage loans with unacceptable terms or conditions or resulting from unacceptable practices. In accordance with these policies, we will not purchase:

- mortgages originated with single-premium credit insurance;
- mortgages with terms that exceed either the annual percentage rate or the points and fees threshold under the Home Ownership and Equity Protection Act of 1994;
- subprime mortgages with prepayment penalty terms that exceed three years; or
- subprime mortgages originated on or after August 1, 2004 with mandatory arbitration clauses.

In addition to the purchase policies we have instituted, we promote consumer education and financial literacy efforts to help borrowers avoid abusive lending practices and we provide competitive mortgage products to reputable mortgage originators so that borrowers have a greater choice of financing options.

We also require our servicers to report all borrower credit information, including monthly mortgage payments. Several states have enacted laws aimed at curbing predatory lending practices, generally with regard to loans exceeding thresholds based on annual percentage rates or financing costs. These loans are typically referred to as “high-cost home loans.” The high-cost home loan thresholds trigger state law liabilities for subsequent purchasers or assignees of such loans that may be

broadly than liabilities imposed upon such purchasers or assignees under the Home Ownership and Equity Protection Act. Currently, we do not purchase high-cost home loans in Arkansas, Georgia, Illinois, Indiana, Kentucky, Maine, Massachusetts, Nevada, New Jersey, New Mexico, New York and Oklahoma. We continue to assess newly enacted and proposed state laws to determine our policies with respect to the purchase of loans affected by those laws.

### ***New Program Approval***

We are required under our charter and the GSE Act to obtain the approval of the Secretary of HUD for any new program for the purchasing, servicing, selling, lending on the security of, or otherwise dealing in, conventional mortgages that is significantly different from programs that have been approved by HUD or that were approved or engaged in before the date the GSE Act was enacted; or that represents an expansion of programs above limits expressly contained in any prior approval regarding the dollar volume or number of mortgages or securities involved. HUD must approve any new program unless the Secretary determines that the new program is not authorized under our charter or that the program is not in the public interest. Recently, HUD announced that it will soon initiate a review of certain of our investments and other assets and liabilities to ensure conformity with our charter and investment guidelines.

### **Office of Federal Housing Enterprise Oversight**

OFHEO is the safety and soundness regulator for Freddie Mac and Fannie Mae. The GSE Act established OFHEO as a separate office within HUD, substantially independent of the HUD Secretary. OFHEO is headed by a Director who is appointed by the President. The OFHEO Director is responsible for ensuring that Freddie Mac and Fannie Mae are adequately capitalized and operating safely in accordance with the GSE Act.

OFHEO's authority with regard to Freddie Mac and Fannie Mae includes authority to:

- issue regulations to carry out its responsibilities;
- conduct examinations;
- require reports of financial condition and operation;
- develop and apply critical, minimum and risk-based capital standards, including classifying the capital levels not less than quarterly;
- prohibit excessive executive compensation under prescribed standards; and
- impose temporary and final cease-and-desist orders and civil money penalties, provided certain conditions are met.

OFHEO also has exclusive administrative enforcement authority that is generally similar to that of other federal financial regulators. That authority can be triggered by a failure to meet regulatory capital requirements; a violation of our charter, the GSE Act, OFHEO regulations or a written agreement with OFHEO; or conduct or conditions that significantly threaten our core capital.

In June 2003, OFHEO commenced a special investigation of the company in connection with the revision and restatement of our financial results for 2002, 2001 and 2000. On December 9, 2003, we entered into a consent order and settlement with OFHEO that concluded OFHEO's investigation of the company. Under the terms of the consent order, we agreed to pay a civil money penalty as well as to undertake certain remedial actions relating to governance, corporate culture, internal controls, accounting practices, disclosure and oversight. We have taken actions to comply with the terms of the consent order and OFHEO continues to monitor our progress. For additional information concerning OFHEO's enforcement actions and regulatory proceedings in which we have been involved, see "NOTE 13: LEGAL CONTINGENCIES" to our consolidated financial statements. OFHEO is considering whether additional remedial actions may be appropriately applied to us, and has asked us to consider agreeing to limitations on our portfolio activities for some period of time.

### ***Capital Standards***

OFHEO's oversight of our safety and soundness includes the implementation, monitoring and enforcement of capital standards. OFHEO's regulatory capital requirements include ratio-based minimum and critical capital requirements and a risk-based capital requirement designed to ensure that we maintain sufficient capital to survive a sustained severe downturn in the economic environment. OFHEO is required to classify our capital adequacy at least quarterly. OFHEO has always classified us as "adequately capitalized," the highest possible classification.

If we were classified as less than adequately capitalized, our ability to pay dividends on common or preferred stock could be restricted. Also, if a dividend payment on our common or preferred stock would cause us to fail to meet our minimum capital or risk-based capital requirements, we would not be able to make the payment without prior written approval from OFHEO. For additional information about our regulatory capital requirements, see "NOTE 10: REGULATORY CAPITAL" to our consolidated financial statements.



In a letter dated January 28, 2004, OFHEO created a framework for monitoring our capital due to our higher operational risk, including our inability to produce timely financial statements in accordance with GAAP. The letter directed that we maintain a mandatory target capital surplus of 30 percent over our minimum capital requirement, subject to certain conditions and variations; that we submit weekly reports concerning our capital levels; and that we obtain prior approval of certain capital transactions. We do not expect the current OFHEO framework to adversely affect our ability to grow in most market scenarios. However, our portfolio activities may be affected by OFHEO's assertion of further regulatory authority. For additional information about the OFHEO mandatory target capital surplus framework, see "NOTE 10: REGULATORY CAPITAL" to our consolidated financial statements. Also, see "RISK FACTORS — Legal and Regulatory Risks — *Developments affecting our legislative and regulatory environment could materially harm our business prospects or competitive position,*" for more information.

### **Department of the Treasury**

Under our charter, the Secretary of the Treasury has approval authority over our issuances of notes, debentures and substantially identical types of unsecured debt obligations (including the interest rates and maturities of these securities), as well as new types of mortgage-related securities issued subsequent to the enactment of the Financial Institutions Reform, Recovery and Enforcement Act of 1989. The Secretary of the Treasury has performed this debt securities approval function by coordinating GSE debt offerings with Treasury funding activities. Recently, Treasury announced that it will conduct a review of its process for approving our debt offerings.

### **Securities and Exchange Commission**

While we are exempt from the Securities Act and Exchange Act registration and reporting requirements, we are dedicated to fulfilling our commitment to register our common stock under the Exchange Act. Once this process is complete, we will be subject to the financial reporting requirements applicable to registrants under the Exchange Act, including the requirement to file with the SEC annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K. After we resume regular quarterly reporting, we will begin the process of registering our common stock with the SEC.

In addition, OFHEO has issued a supplemental disclosure regulation that will obligate us to submit proxy statements and insider transaction reports to the SEC in accordance with rules promulgated under the Exchange Act. Our securities will continue to be exempt from the securities offering registration requirements of the Securities Act and certain other provisions of the federal securities laws.

### **GSE Regulatory Oversight Legislation**

We face an uncertain regulatory environment in light of legislative reforms currently being considered in Congress. On October 26, 2005, the House of Representatives passed a bill concerning GSE regulatory oversight. The Senate Committee on Banking, Housing, and Urban Affairs passed a bill concerning GSE regulatory oversight on July 28, 2005. The bills that have been passed by the full House of Representatives and by the Senate Committee on Banking, Housing, and Urban Affairs differ in various respects, although each in its current form would result in significant changes in the existing GSE regulatory oversight structure.

We currently generate a significant portion of our net income through our portfolio investment activities. Current legislative proposals would give our regulator substantial authority to regulate the amount and composition of our portfolio investments and to require substantial reductions in those investments. Additional provisions under consideration would increase the regulator's authority to require us to maintain higher capital levels and to approve new programs and business activities, and would modify our affordable housing goals and require that a specified percentage of our profits be placed in a fund to support affordable housing.

We believe the enactment into law of these provisions, depending on their final terms and on how they would be applied by our regulator, could have a material adverse effect on our ability to fulfill our mission, our future earnings, stock price and stockholder returns, the rate of growth in our fair value, and our ability to recruit qualified officers and directors. See "RISK FACTORS — Legal and Regulatory Risks — *Developments affecting our legislative and regulatory environment could materially harm our business prospects or competitive position.*"

We believe appropriate GSE regulatory oversight legislation would strengthen market confidence and promote our mission. While we continue to work toward enactment of appropriate regulatory oversight legislation, we cannot predict the prospects for the enactment, timing or content of any final legislation or its impact on our financial prospects.

## **RISK FACTORS**

Before you invest in our securities, you should know that making such an investment involves risks, including the risks described below and in "BUSINESS," "FORWARD-LOOKING STATEMENTS," "MD&A" and elsewhere in this

Information Statement. The risks that we have highlighted here are not the only ones that we face. If any of the risks actually occur, our business, financial condition and/or results of operations could be adversely affected. In that case, the trading price of our securities could decline, and you may lose all or part of your investment. Some of these risks are managed under the risk management framework, as described in “MD&A — RISK MANAGEMENT.” We may also encounter risks of which we are currently not aware or that we currently deem immaterial. These risks also may impair our business operations, financial results, or your investment in our securities.

### **Business and Operational Risks**

***Material weaknesses and other control deficiencies related to financial reporting could result in errors and a loss of market confidence in our reported results.***

Effective internal controls are an important component of the process for producing timely, reliable financial reports, preventing fraud and operating successfully as a publicly traded company. If we cannot provide reliable financial reports or prevent fraud, our reputation and operating results could be adversely affected. We have discovered, and may in the future discover, material weaknesses and significant deficiencies in our internal controls that require remediation. Due to these weaknesses and deficiencies, management determined that, as of December 31, 2005, our internal control over financial reporting was not effective. Although we are not an SEC registrant, our classification of internal control deficiencies is consistent with the definitions established under standards adopted by the Public Company Accounting Oversight Board, or PCAOB. Under the PCAOB standards, a “material weakness” is a significant deficiency or combination of significant deficiencies that results in a more than remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. A “significant deficiency” is a control deficiency or combination of control deficiencies that adversely affects a company’s ability to initiate, authorize, record, process, or report external financial data reliably in accordance with GAAP such that there is a more than remote likelihood that a misstatement of our annual or interim financial statements that is more than inconsequential will not be prevented or detected. For a description of our existing material weaknesses and certain of our significant deficiencies and our efforts to mitigate and remediate them, see “MD&A — RISK MANAGEMENT — Operational Risks — *Internal Control over Financial Reporting.*”

We have not completed our evaluation of our internal control over financial reporting. Accordingly, we are unable to determine whether additional weaknesses or deficiencies that require remediation exist. We face continuing challenges because of the deficiencies in our accounting infrastructure and the operational complexities caused by the volume of revised and new accounting policies that we have adopted in recent years. Our ability to identify, manage, mitigate and/or remedy internal control weaknesses and deficiencies and other risks may continue to delay our return to regular, timely reporting.

Any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives. Furthermore, we cannot be certain that our efforts to improve our control environment will be successful or that we will be able to maintain adequate controls over our financial processes and reporting in the future. A failure to establish and maintain an adequate control environment could result in a material error in our reported financial results and additional delay in our financial reporting timeline, and could have a material adverse affect on our business depending on the nature of the failure and any required remediation. An ineffective control environment, including our disclosure controls and procedures, could also cause investors to lose confidence in our reported financial information, which would likely have an adverse effect on the trading price of our securities. If we fail to meet our reporting obligations, this could affect our ability to maintain the listing of our securities on the New York Stock Exchange, or the NYSE. Further, OFHEO could seek to require us to implement a remediation plan, hold additional capital, limit the growth of our Retained portfolio or take other actions. In addition, a failure to effectively and timely implement the remediation plan undertaken as a result of the prior restatement of our consolidated financial statements and the consent order entered into with OFHEO, including particular initiatives relating to technical infrastructure and internal control over financial reporting, could similarly adversely affect our business.

***We rely on internal models for financial accounting and reporting purposes, to make business decisions, and to manage risks, and our business could be adversely affected if those models fail to produce reliable results.***

We make significant use of business and financial models for financial accounting and reporting purposes and to manage risk. For example, we use models in determining the fair value of financial instruments for which independent price quotations are not available or reliable or to extrapolate third-party values to our portfolio. We also use models to measure and monitor our exposures to interest-rate and other market risks and credit risk. The information provided by these models is also used in making business decisions relating to strategies, initiatives, transactions and products.

Models are inherently imperfect predictors of actual results because they are based on assumptions about future performance. Our models could produce unreliable results for a number of reasons, including invalid or incorrect assumptions underlying the models during periods of market stress and economic change or in general. The valuations, risk

metrics, amortization results and loan loss reserve estimations produced by our internal models may be very different from actual results, which could adversely affect our business results, cash flows, fair value of net assets, business prospects and future earnings. Changes in any of our models or in any of the assumptions, judgments or estimates used in the models may cause the results generated by the model to be materially different. The different results could cause a revision or restatement of previously reported financial results or condition, depending on how and when the change to the model, judgment or assumption is implemented. Changes may also cause difficulties in comparisons of the financial results or condition of prior or future periods. If our models are not reliable we could also make poor business decisions, including loan purchase decisions, guarantee fee pricing decisions or other decisions, which could result in an adverse financial impact. Furthermore, any strategies we employ to attempt to manage the risks associated with our use of models may not be effective. See “MD&A — CRITICAL ACCOUNTING POLICIES AND ESTIMATES — Fair Value Measurement” and “RISK MANAGEMENT — Interest-Rate Risk and Other Market Risks” for more information on our use of models.

***A failure in our operational systems or infrastructure, or those of third parties, could impair our liquidity, disrupt our business, damage our reputation and cause losses.***

Shortcomings or failures in our internal processes, people or systems could lead to impairment of our liquidity, financial loss, disruption of our business, liability to customers, legislative or regulatory intervention or reputational damage. For example, our business is highly dependent on our ability to process a large number of transactions on a daily basis. The transactions we process have become increasingly complex and are subject to various legal and regulatory standards. Our financial, accounting, data processing or other operating systems and facilities may fail to operate properly or become disabled, adversely affecting our ability to process these transactions. The inability of our systems to accommodate an increasing volume of transactions or new types of transactions or products could constrain our ability to pursue new business initiatives. In addition, as a result of our existing material weaknesses, we have delayed implementation of some pending systems initiatives.

We also face the risk of operational failure or termination of any of the clearing agents, exchanges, clearing houses or other financial intermediaries we use to facilitate our securities and derivatives transactions. Any such failure or termination could adversely affect our ability to effect transactions, service our customers and manage our exposure to risk.

Despite the contingency plans and facilities we have in place, our ability to conduct business may be adversely impacted by a disruption in the infrastructure that supports our business and the communities in which we are located. Potential disruptions may include those involving electrical, communications, transportation or other services we use or that are provided to us. If a disruption occurs and our employees are unable to occupy our offices or communicate with or travel to other locations, our ability to service and interact with our customers may suffer and we may not be able to successfully implement contingency plans that depend on communication or travel.

Our operations rely on the secure processing, storage and transmission of confidential and other information in our computer systems and networks. Although we take protective measures and endeavor to modify them as circumstances warrant, our computer systems, software and networks may be vulnerable to unauthorized access, computer viruses or other malicious code and other events that could have a security impact. If one or more of such events occur, this potentially could jeopardize confidential and other information processed and stored in, and transmitted through, our computer systems and networks, or otherwise cause interruptions or malfunctions in our operations or the operations of our customers or counterparties, which could result in significant losses or reputational damage. We may be required to expend significant additional resources to modify our protective measures or to investigate and remediate vulnerabilities or other exposures, and we may be subject to litigation and financial losses that are not fully insured. For a discussion of our material weaknesses related to our information technology and systems and our plans to remediate such weaknesses, see “MD&A — RISK MANAGEMENT — Operational Risks — *Internal Control over Financial Reporting*.”

***We rely on third parties for certain functions that are critical to financial reporting, our Retained portfolio activity and mortgage loan underwriting. Any failures by those vendors could disrupt our business operations.***

We outsource certain key functions to external parties, including processing functions for trade capture, market risk management analytics, and asset valuation (Blackrock Financial Management, Inc.), and processing functions for mortgage loan underwriting (Electronic Data Systems Corporation). We may enter into other key outsourcing relationships in the future. If one or more of these key external parties were not able to perform their functions for a period of time or at an acceptable service level, our business operations could be disrupted or otherwise negatively impacted. Our use of vendors also exposes us to the risk of a loss of intellectual property or of confidential information or other harm. Financial or operational difficulties of an outside vendor could also hurt our operations if those difficulties interfere with the vendor’s ability to provide services to us. In addition, because of a material weakness in our systems integration, including those that connect us with external service providers, we are exposed to an increased risk of errors in our financial reporting. See “MD&A — RISK MANAGEMENT — Operational Risks — *Internal Control over Financial Reporting*” for a description

of this material weakness. Also, we use a process of delegated underwriting for the single-family mortgages we purchase or securitize. In this process, we provide originators with a series of mortgage underwriting guidelines and they represent and warrant to us that the mortgages sold to us meet these guidelines. See “MD&A — RISK MANAGEMENT — Credit Risks — *Mortgage Credit Risk* — Mortgage Credit Risk Management Strategies — *Underwriting Requirements and Quality Control Standards*” and “— *Institutional Credit Risk* — Mortgage Seller/Servicers” for information about how we mitigate the risks associated with delegated underwriting.

***Our risk management efforts may prove to be ineffective at mitigating the risks we seek to manage.***

We must effectively identify, manage, monitor and mitigate operational risks, interest-rate and other market risks and credit risks related to our business. Although we have devoted significant resources to develop our risk management policies and procedures and expect to continue to do so in the future, our risk management policies, procedures and techniques may not be sufficient to mitigate the risks we have identified or to appropriately identify additional risks to which we are subject. In the area of operational risk, we have identified a number of material weaknesses and significant deficiencies in our internal control over financial reporting. We may identify additional weaknesses and deficiencies. In addition, there are a number of risk factors that may impede our efforts to remediate our internal control weaknesses and deficiencies, including: the complexity associated with the interdependent nature of the remediation activities; uncertainty regarding the quality and sustainability of newly established controls; potentially ineffective compensating controls; the number of simplifying assumptions; and controls remediation work that is focused on controls related to financial reporting and not on other non-financial statement related controls. See “MD&A — RISK MANAGEMENT” for a discussion of our approach to managing the risks we face. Furthermore, there is a risk that we may not have sufficient personnel or personnel with sufficient training in these key roles.

***Our inability to hire, train and retain qualified employees could impair our business and operations.***

Our continued success depends, in large part, on our ability to hire and retain highly qualified people. Our business is complex and many of our positions require specific skills. Our turnover rates have been high in recent periods and have strained our existing resources. If we continue to experience high turnover rates or are unable to attract, train and retain talented people, our business and operations could be impaired or disrupted. Competition for highly qualified personnel is intense and there can be no assurances that we will retain our key personnel or that we will be successful in attracting, training or retaining other highly qualified personnel in the future. See “MD&A — RISK MANAGEMENT — Operational Risks” for a description of deficiencies and weaknesses related to our staffing and turnover.

## **Legal and Regulatory Risks**

***Developments affecting our legislative and regulatory environment could materially harm our business prospects or competitive position.***

Developments affecting our applicable legislative or regulatory environment, including our charter, affordable housing goals, or regulatory capital requirements (including the 30 percent mandatory target capital surplus OFHEO imposed on us in January 2004), the interpretation of these requirements by our regulators, the adequacy of internal systems, controls and processes related to these requirements, the exercise or assertion of regulatory or administrative authority beyond current practice, or the enactment of proposed legislation (in whole or in part) as discussed in “BUSINESS — REGULATION AND SUPERVISION — GSE Regulatory Oversight Legislation” could adversely affect: our ability to fulfill our mission; our ability to meet our affordable housing goals; our ability or intent to retain investments; the size and growth of our mortgage portfolios; our future earnings, stock price and stockholder returns; the value of our assets; the rate of growth of the fair value of our assets; and our ability to recruit qualified officers and directors. OFHEO is considering whether additional remedial actions may be appropriately applied to us, and has asked us to consider agreeing to limitations on our portfolio activities for some period of time. See “MD&A — CONSOLIDATED RESULTS OF OPERATIONS — Gains (Losses) on Investment Activity — *Total security impairments*” for a description of OFHEO’s directive to divest certain mortgage-backed securities. HUD has also indicated that it will soon initiate a review of certain of our investments and other assets and liabilities to ensure conformity with our charter and investment guidelines. In addition, Treasury announced that it will conduct a review of its process for approving our debt offerings.

We are also exposed to the risk that weaknesses in our internal systems, controls and processes could affect the accuracy of the data we provide to HUD or OFHEO or our compliance with legal requirements, and could ultimately lead to regulatory actions (by HUD, OFHEO or both) or other adverse impacts on our business (including our ability or intent to retain investments).

Furthermore, we could be required, or may find it advisable, to change the nature or extent of our business activities if our various exemptions and special attributes were modified or eliminated, new or additional fees or substantive regulation of our business activities were imposed, our relationship to the federal government were altered or eliminated, or our charter,



the GSE Act, or other federal legislation affecting us were significantly amended. Any of these changes could have a material adverse effect on the scope of our activities, financial condition and results of operations. For example, such changes could (a) reduce the supply of mortgages available to us, (b) limit a significant revenue source by restricting the size of our Retained portfolio or (c) make us less competitive by otherwise limiting our business activities or our ability to create new products. We cannot predict when or whether any potential legislation will be enacted or regulation will be promulgated or the effect that any such legislation or regulation would have on our financial condition or results of operations.

***We are making certain changes to our business to meet HUD's new housing goals and subgoals, which may adversely affect our profitability.***

We are making significant adjustments to our mortgage sourcing and purchase strategies in an effort to meet the housing goals and subgoals made effective in 2005, including changes to our underwriting guidelines and the expanded use of targeted initiatives to reach underserved populations. For example, we may have to purchase loans that offer lower expected returns on our investment and increase our exposure to credit losses. In addition, our purchases of goal-eligible loans will need to increase as a percentage of total new mortgage purchases, which may cause us to forego other purchase opportunities that we would expect to be more profitable. If our current efforts to meet the new goals and subgoals prove to be insufficient, we may need to take additional steps that could lead to a significant reduction of service to portions of the conventional conforming mortgage market, and also a reduction in our profitability. See "REGULATION AND SUPERVISION — Department of Housing and Urban Development" for additional information about HUD's regulation of our business.

***We are involved in legal proceedings that could result in the payment of substantial damages or otherwise harm our business.***

We are a party to various legal actions. In addition, former directors, officers and employees are involved in legal proceedings for which they may be entitled to reimbursement for the costs and expenses of the proceedings. The defense of these or any future claims or proceedings could divert management's attention and resources from the needs of the business. We may be required to make substantial payments in the event of adverse judgments or settlements of any such claims, investigations or proceedings. Any legal proceeding, even if resolved in our favor, could result in negative publicity or cause us to incur significant legal and other expenses. Furthermore, developments in, outcomes of, impacts of, and costs, expenses, settlements and judgments related to these legal proceedings may differ from our expectations and exceed any amounts for which we have reserved or require adjustments to such reserves. See "NOTE 13: LEGAL CONTINGENCIES" to our consolidated financial statements for information about our ongoing legal proceedings and related reserves.

***Legislation or regulation affecting the financial services industry generally may adversely affect our business activities.***

Our business activities may be affected by a variety of legislative and regulatory actions related to the activities of banks, savings institutions, insurance companies, securities dealers and other regulated entities that comprise a significant part of our customer base. Among the legislative and regulatory provisions applicable to these entities are capital requirements for federally insured depository institutions and regulated bank holding companies. For example, the Basel Committee on Banking Supervision, composed of representatives of certain central banks and bank supervisors, has developed a new set of risk-based capital standards for banking organizations. The U.S. banking regulators have stated their intent to propose new capital standards for certain banking organizations that would incorporate the new risk-based capital standards into existing requirements. If final rules adopted by the U.S. banking regulators revise the capital treatment of mortgage assets, decisions by U.S. banking organizations about whether to hold or sell such assets could be affected. However, the contents and timing of any final rules remain uncertain, as does the manner in which U.S. banking organizations may respond to them.

Legislative or regulatory provisions that create or remove incentives for these entities either to sell mortgage loans to us or to purchase our securities could have a material adverse effect on our business results. In addition, our business could also be adversely affected by any modification, reduction or repeal of the federal income tax deductibility of mortgage interest payments.

## **Competitive and Market Risks**

***Changes in general business and economic conditions may adversely affect our business and earnings.***

Our business and earnings may be adversely affected by changes in general business and economic conditions. These conditions include employment rates, fluctuations in both debt and equity capital markets, the value of the U.S. dollar as compared to foreign currencies, and the strength of the U.S. economy and the local economies in which we conduct business. An economic downturn or increase in the unemployment rate could result in an increase in mortgage delinquencies or defaults and a higher level of credit-related losses than we estimated, which could reduce our earnings. Various factors could cause the economy to slow down or even recede, including higher energy costs, higher interest rates, pressure on housing prices, reduced consumer or corporate spending, natural disasters such as hurricanes, terrorist activities, military conflicts, and the normal cyclical nature of the economy.

***A general decline in U.S. housing prices or in activity in the U.S. housing market could negatively impact our earnings.***

House prices have risen significantly over the last ten years, and have grown very dramatically over the last three years. This house price appreciation has increased the values of properties underlying the mortgages in our portfolio. A reversal of this strong house price appreciation in any of the geographic markets we serve could result in an increase in delinquencies or defaults and a higher level of credit-related losses, which could reduce our earnings. For more information, see “MD&A — RISK MANAGEMENT — Credit Risks.”

Our business volumes are closely tied to the rate of growth in total outstanding U.S. residential mortgage debt and the size of the U.S. residential mortgage market. If the rate of growth in total outstanding U.S. residential mortgage debt were to decline, there could be fewer mortgage loans available for us to purchase. This decline could reduce our earnings and margins, as we could face more competition to purchase a smaller number of loans.

***Competition from banking and non-banking companies may harm our business.***

We operate in a highly competitive environment and we expect competition to increase as financial services companies combine to produce larger companies that are able to offer similar mortgage-related products at competitive prices. Our principal competitors in the secondary mortgage market are Fannie Mae, the Federal Home Loan Banks and other financial institutions that retain or securitize mortgages, such as banks, dealers and thrift institutions. Increased competition in the secondary mortgage market may make it more difficult for us to purchase mortgages to meet our mission objectives while providing favorable returns for our business. Furthermore, competitive pricing pressures may make our products less attractive in the market and negatively impact our profitability.

We also compete for low-cost debt funding with Fannie Mae, the Federal Home Loan Banks and other institutions that hold mortgage portfolios. Competition from these entities can vary with changes in economic, financial market and regulatory environments. Increased competition for low-cost debt funding may result in a higher cost to finance our business, which could decrease our net income.

***We may face limited availability of financing, variation in our funding costs and uncertainty in our securitization financing.***

The amount, type and cost of our funding, including financing from other financial institutions and the capital markets, directly impacts our interest expense and results of operations and can therefore affect our ability to grow our assets. A number of factors could make such financing more difficult to obtain, more expensive or unavailable on any terms, both domestically and internationally (where funding transactions may be on terms more or less favorable than in the U.S.), including adverse financial results, specific events that adversely impact our reputation, changes in the activities of our business partners, disruptions in the capital markets, specific events that adversely impact the financial services industry, counterparty availability, changes in the preferences of the holders of our securities, changes affecting our assets, our corporate and regulatory structure, interest-rate fluctuations, ratings agencies actions, and the legal, regulatory, accounting and tax environments governing our funding transactions, the general state of the U.S., Asian and other world economies, and factors affecting those economies.

Our PCs and Structured Securities are an integral part of our mortgage purchase program and any decline in the price performance of or demand for our PCs could have a material adverse effect on the profitability of our new credit guarantee business. There is a risk that our PC and Structured Securities support activities may not be sufficient to support the liquidity and depth of the market for PCs.

***A reduction in our credit ratings could adversely affect our liquidity.***

Ratings agencies play an important role in determining, by means of the ratings they assign to issuers and their debt, the availability and cost of debt funding. We currently receive ratings from several ratings agencies for our unsecured borrowings. Our credit ratings are important to our liquidity. Actions by governmental entities or others could adversely affect our credit ratings. A reduction in our credit ratings could adversely affect our liquidity, competitive position, or the supply or cost of equity capital or debt financing available to us. A significant increase in our borrowing costs could cause us to sustain losses and impair our liquidity by requiring us to find other sources of financing.

***Fluctuations in interest rates could negatively impact our reported net interest income, earnings and fair value of net assets.***

Our portfolio investment activities and credit guarantee activities expose us to interest rate and other market risks. Changes in interest rates — up or down — could adversely affect our net interest yield. Although the yield we earn on our assets and our funding costs tend to move in the same direction in response to changes in interest rates, one can rise or fall faster than the other, causing our net interest yield to expand or compress. For example, when interest rates rise, our funding costs may rise faster than the yield we earn on our assets, causing our net interest yield to compress until the effect of the increase is fully reflected in asset yields. Changes in the slope of the yield curve could also reduce our net interest yield.

Changes in interest rates could reduce our earnings in material amounts, especially if actual conditions turn out to be materially different than our expectations. For example, if interest rates rise or fall faster than we expect or the slope of the yield curve changes in ways different than we anticipated, we may incur significant losses. Changes in interest rates can also affect prepayment assumptions and the fair value of our assets, including investments in our Retained portfolio, our derivative portfolio and our Guarantee asset. When interest rates fall, borrowers are more likely to prepay their mortgage loans by refinancing them at a lower rate. An increased likelihood of prepayment on the mortgages underlying our mortgage-related securities may adversely impact the performance of these securities. An increased likelihood of prepayment on the mortgages we hold may also negatively impact the performance of our Retained portfolio and the fair value of our Guarantee asset. Interest rates can fluctuate for a number of reasons, including changes in the fiscal and monetary policies of the federal government and its agencies, such as the Federal Reserve. Federal Reserve policies directly and indirectly influence the yield on our interest-earning assets and the cost of our interest-bearing liabilities. The availability of derivative financial instruments (such as options and interest-rate and foreign-currency swaps) from acceptable counterparties of the types and in the quantities needed could also affect our ability to effectively manage the risks related to our investment funding.

Our strategies and efforts to manage our exposures to these risks may not be as effective as they have been in the past. See “MD&A — RISK MANAGEMENT — Interest-Rate Risk and Other Market Risks” for a description of the types of market risks to which we are exposed and how we manage those risks.

***Higher credit losses could require us to increase our allowance for credit losses through a charge to earnings.***

We face primarily two types of credit risk — mortgage credit risk and institutional credit risk. As described in “MD&A — RISK MANAGEMENT — Credit Risks,” we employ a number of credit risk management strategies. However, there can be no assurances that our risk management strategies will be effective to manage our credit risks or that our credit losses will not be higher than expected. Higher credit losses on our guarantees could require us to increase our allowance for credit losses through a charge to earnings and other credit exposures could result in financial losses. Although we regularly review credit exposures to specific customers and counterparties, default risk may arise from events or circumstances that are difficult to detect or foresee. In addition, concerns about, or default by, one institution could lead to significant liquidity problems, losses or defaults by other institutions. This risk may also adversely affect financial intermediaries, such as clearing agencies, clearinghouses, banks, securities firms and exchanges with which we interact. These potential risks could ultimately cause liquidity problems or losses for us as well.

***The loss of business volume from one or more key lenders could result in a decline in market share and revenues.***

Our business depends on our ability to acquire a steady flow of mortgage loans from the originators of those loans. We purchase a significant percentage of our single-family mortgages from several large mortgage lenders. The mortgage industry has been consolidating and a decreasing number of large lenders originate most single-family mortgages. We could lose significant business volume and may be unable to replace it if one or more of our key lenders significantly reduces the volume of mortgages it delivers to us or is acquired or otherwise ceases to exist. The loss of business from any one of our key lenders could adversely affect our market share, our revenues, the use of our technology by participants in the mortgage market and the performance of our mortgage-related securities.

***Negative publicity causing damage to our reputation could adversely affect our business prospects, earnings or capital.***

Reputation risk, or the risk to our earnings and capital from negative public opinion, is inherent in our business. Negative public opinion could adversely affect our ability to keep and attract customers or otherwise impair our customer relationships; adversely affect our ability to obtain financing or hinder our business prospects. Perceptions regarding the practices of our competitors or our industry as a whole may also adversely impact our reputation. Adverse reputation impacts on third parties with whom we have important relationships may impair market confidence or investor confidence in our business operations as well. In addition, negative publicity could expose us to adverse legal and regulatory consequences. Negative public opinion could result from our actual or alleged action or failure to act in any number of activities, including corporate governance, regulatory compliance, financial reporting and disclosure, or from actions taken by government regulators and community organizations in response to our actual or alleged conduct. Adverse impacts on our reputation, or the reputation of our industry, may also result in greater regulatory and/or legislative scrutiny or adverse regulatory or legislative changes.

## **PROPERTIES**

We own a 75 percent interest in a limited partnership that owns our principal offices, consisting of four office buildings in McLean, Virginia, that comprise approximately 1.2 million square feet. We occupy this headquarters complex under a long-term lease from the partnership.

## LEGAL PROCEEDINGS

We are involved as a party to a variety of legal proceedings arising from time to time in the ordinary course of business including, among other things, contractual disputes, personal injury claims, employment-related litigation and other legal proceedings incidental to our business.

Furthermore, we are frequently involved, directly or indirectly, in litigation involving mortgage foreclosures. We also are involved in proceedings arising from our termination of a seller/servicer's eligibility to sell mortgages to, and service mortgages for, us. In these cases, the former seller/servicer sometimes seeks damages against us for wrongful termination under a variety of legal theories. In addition, we are sometimes sued in connection with the origination or servicing of mortgages. These suits generally involve claims alleging wrongful actions of seller/servicers. Our contracts with our seller/servicers generally provide for them to indemnify us against liability arising from their wrongful actions.

We are also subject to various legal proceedings, including regulatory investigations and administrative and civil litigation, arising from the restatement of our 2002 and prior consolidated financial statements. In addition, we have been named in multiple lawsuits alleging violations of federal and state antitrust laws and state consumer protection laws in connection with the setting of our guarantee fees.

Litigation and claims resolution are subject to many uncertainties and are not susceptible to accurate prediction. For additional information on our legal proceedings, see "NOTE 13: LEGAL CONTINGENCIES" and "NOTE 14: INCOME TAXES" to our consolidated financial statements.

## SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

The following matters were presented for stockholder vote at the July 15, 2005 Annual Meeting of Stockholders:

(a) election of 13 members to our board of directors, each for a term ending on the date of the next annual meeting of our stockholders; and (b) ratification of the appointment of PricewaterhouseCoopers LLP as our independent auditors for 2005. As shown in Table 4 below, the following persons were elected to our board of directors at the meeting by the respective votes indicated:

**Table 4 — Election of Directors**

	<u>Votes For</u>	<u>Votes Withheld</u>
Barbara T. Alexander .....	609,767,531	7,869,236
Geoffrey T. Boisi .....	611,270,805	6,365,962
Joan E. Donoghue .....	605,739,672	11,897,095
Michelle Engler .....	611,030,851	6,605,916
Richard Karl Goeltz .....	612,664,614	4,972,153
Thomas S. Johnson .....	583,989,898	33,646,869
William M. Lewis, Jr. ....	612,128,085	5,508,682
Eugene M. McQuade .....	607,518,568	10,118,199
Shaun F. O'Malley .....	582,111,156	35,525,611
Ronald F. Poe .....	607,396,192	10,240,575
Stephen A. Ross .....	582,191,897	35,444,870
Richard F. Syron .....	607,489,912	10,146,855
William J. Turner .....	577,712,718	39,924,049

The appointment of PricewaterhouseCoopers LLP was ratified at the meeting by the following votes:

<u>Votes for</u>	<u>Votes Against</u>	<u>Abstentions</u>
613,265,113	874,878	3,496,775

## MARKET FOR THE COMPANY'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

### Market Information

Our common stock, par value \$0.21 per share, is listed on the NYSE and the Pacific Exchange under the symbol "FRE". From time to time, our common stock may be admitted to unlisted trading status on other national securities exchanges. Put and call options on our common stock are traded on U.S. options exchanges. At December 31, 2005, there were 692,717,422 shares outstanding of our common stock.



Table 5 sets forth the high and low sale prices of our common stock for the periods indicated.

**Table 5 — Quarterly Common Stock Information**

	Sale Prices <sup>(1)</sup>	
	High	Low
<b>2006 Quarter Ended</b>		
March 31 .....	\$68.75	\$60.64
<b>2005 Quarter Ended</b>		
December 31 .....	\$67.49	\$54.85
September 30 .....	66.91	54.50
June 30 .....	67.87	58.51
March 31 .....	73.91	59.74
<b>2004 Quarter Ended</b>		
December 31 .....	\$74.20	\$64.15
September 30 .....	69.50	61.73
June 30 .....	64.62	56.45
March 31 .....	65.15	57.60

(1) The principal market is the NYSE, and prices are based on the Composite Tape.

At June 1, 2006, the closing price for our common stock was \$60.66 per share.

### Issuer Purchases of Equity Securities

On October 5, 2005, our board of directors authorized us to repurchase up to \$2 billion of outstanding shares of our common stock and to issue up to \$2 billion of non-cumulative, perpetual preferred stock, in each case, from time to time depending on market conditions and other factors. We do not expect the completion of the authorized capital transactions to have a material impact on our regulatory minimum capital surplus, including the 30 percent mandatory target set in January 2004 by OFHEO. In accordance with the existing capital monitoring framework established by OFHEO in January 2004, we obtained OFHEO's approval for this common stock repurchase. This repurchase authorization replaces all unused repurchase authority remaining under the common stock repurchase plan approved by the board of directors in September 1997. We did not repurchase any common stock during 2005.

### Dividends

Table 6 sets forth the cash dividend per common share that we have declared for the periods indicated.

**Table 6 — Dividends Per Common Share**

	Regular Cash Dividend Per Share
<b>2006 Quarter Ended</b>	
June 30 .....	\$0.47
March 31 .....	\$0.47
<b>2005 Quarter Ended</b>	
December 31 .....	\$0.47
September 30 .....	\$0.35
June 30 .....	\$0.35
March 31 .....	\$0.35
<b>2004 Quarter Ended</b>	
December 31 .....	\$0.30
September 30 .....	\$0.30
June 30 .....	\$0.30
March 31 .....	\$0.30

We have historically paid dividends to our stockholders in each quarter. Our board of directors will determine the amount of dividends, if any, declared and paid in any quarter after considering our capital position and earnings and growth prospects, among other factors. See "NOTE 10: REGULATORY CAPITAL" to the consolidated financial statements for additional information regarding dividend payments and potential restrictions on such payments and "NOTE 9: STOCKHOLDERS' EQUITY" to the consolidated financial statements for additional information regarding our preferred stock dividend rates.

### Holders

As of June 1, 2006, we had 2,343 common stockholders of record.

### Transfer Agent and Registrar

Computershare Trust Company, N.A.  
P.O. Box 43078  
Providence, RI 02940-3078  
Telephone: 781-575-2879  
<http://www.computershare.com>

## NYSE Corporate Governance Listing Standards

On August 4, 2005, our Chief Executive Officer submitted to the NYSE the certification required by Section 303A.12(a) of the NYSE Listed Company Manual regarding our compliance with the NYSE's corporate governance listing standards.

### FORWARD-LOOKING STATEMENTS

We regularly communicate information concerning our business activities to investors, securities analysts, the news media and others as part of our normal operations. Some of these communications include "forward-looking statements" pertaining to our current expectations and objectives for financial reporting, future business plans, results of operations, financial condition and trends. Forward-looking statements are typically accompanied by, and identified with, terms such as "estimates," "continue," "promote," "consider," "enables," "currently," "priorities," "remain," "anticipate," "initiative," "preliminary," "ongoing," "believes," "expects," "intend," "plan," "future," "seek," "potential," "objectives," "long-term," "ultimately," "goal," "will," "may," "might," "should," "could," "would," "likely" and similar phrases. This Information Statement includes forward-looking statements. These statements are not historical facts, but rather represent our expectations based on current information, plans, estimates and projections. Forward-looking statements involve known and unknown risks, uncertainties and other factors, some of which are beyond our control. You should be careful about relying on any forward-looking statements and should also consider all risks, uncertainties and other factors described in this Information Statement in considering any forward-looking statements. Actual results may differ materially from those discussed as a result of various factors, including those factors described in the "RISK FACTORS" section of this Information Statement. Factors that could cause actual results to differ materially from the expectations expressed in these and other forward-looking statements by management include, among others:

- our ability to effectively and timely implement the remediation plan undertaken as a result of the restatement of our consolidated financial statements and the consent order entered into with OFHEO, including particular initiatives relating to technical infrastructure and controls over financial reporting;
- our ability to effectively implement our business strategies and manage the risks in our business;
- changes in our assumptions regarding rates of growth in our business, spreads we expect to earn, required capital levels, the timing and impact of capital transactions;
- our ability to effectively manage and implement changes; developments or impacts of accounting standards and interpretations;
- the availability of debt financing and equity capital in sufficient quantity and at attractive rates to support continued growth in our Retained portfolio, to refinance maturing debt and to meet regulatory capital requirements;
- changes in pricing or valuation methodologies, models, assumptions and/or estimates;
- volatility of reported results due to changes in fair value of certain instruments or assets;
- the rate of growth in total outstanding U.S. residential mortgage debt and the size of the U.S. residential mortgage market;
- preferences of originators in selling into the secondary market;
- borrower preferences for fixed-rate mortgages or ARMs;
- investor preferences for mortgage loans and mortgage-related and debt securities versus other investments;
- the occurrence of a major natural or other disaster in geographic areas in which portions of our Total mortgage portfolio are concentrated;
- other factors and assumptions described in this Information Statement, including in the sections titled "BUSINESS," "RISK FACTORS" and "MD&A;"
- our assumptions and estimates regarding the foregoing; and
- market reactions to the foregoing.

We undertake no obligation to update forward-looking statements we make to reflect events or circumstances after the date of this Information Statement, or to reflect the occurrence of unanticipated events.

# SELECTED FINANCIAL DATA<sup>(1)</sup>

	At or for the Year Ended December 31,				
	2005	2004	2003	2002	2001
	(dollars in millions, except share-related amounts)				
<b>Income Statement Data</b>					
Net interest income	\$ 5,370	\$ 9,137	\$ 9,498	\$ 9,525	\$ 7,448
Non-interest income (loss)	199	(3,039)	(244)	7,154	(1,591)
Net income before cumulative effect of changes in accounting principles	2,189	2,937	4,816	10,090	3,115
Cumulative effect of changes in accounting principles, net of taxes	(59)	—	—	—	43
Net income	2,130	2,937	4,816	10,090	3,158
Preferred stock dividends and issuance costs on redeemed preferred stock	(223)	(210)	(216)	(239)	(217)
Net income available to common stockholders	\$ 1,907	\$ 2,727	\$ 4,600	\$ 9,851	\$ 2,941
Earnings per common share before cumulative effect of changes in accounting principles:					
Basic	\$ 2.84	\$ 3.96	\$ 6.69	\$ 14.22	\$ 4.19
Diluted	2.83	3.94	6.68	14.17	4.17
Earnings per common share after cumulative effect of changes in accounting principles:					
Basic	\$ 2.76	\$ 3.96	\$ 6.69	\$ 14.22	\$ 4.25
Diluted	2.75	3.94	6.68	14.17	4.23
Dividends per common share	\$ 1.52	\$ 1.20	\$ 1.04	\$ 0.88	\$ 0.80
Weighted average common shares outstanding (in thousands):					
Basic	691,582	689,282	687,094	692,727	692,603
Diluted	693,511	691,521	688,675	695,116	695,973
<b>Balance Sheet Data</b>					
Total assets	\$ 806,222	\$ 795,284	\$ 803,449	\$ 752,249	\$ 641,100
Senior debt, net due within one year	288,532	282,303	295,262	244,429	264,227
Senior debt, net due after one year	454,627	443,772	438,738	415,662	311,013
Subordinated debt, net due after one year	5,633	5,622	5,613	5,605	3,128
Miscellaneous liabilities <sup>(2)</sup>	29,290	30,662	30,420	52,914	40,489
Minority interests in consolidated subsidiaries	949	1,509	1,929	2,309	2,619
Stockholders' equity	27,191	31,416	31,487	31,330	19,624
<b>Portfolio Balances<sup>(3)</sup></b>					
Retained portfolio (unpaid principal balances) <sup>(4)</sup>	\$ 710,017	\$ 652,936	\$ 645,466	\$ 567,272	\$ 497,639
Total Guaranteed PCs and Structured Securities issued (unpaid principal balances) <sup>(5)</sup>	1,335,524	1,208,968	1,162,068	1,090,624	961,511
Total mortgage portfolio (unpaid principal balances)	1,684,217	1,505,206	1,414,399	1,316,609	1,150,723
<b>Ratios</b>					
Return on average assets <sup>(6)</sup>	0.3%	0.4%	0.6%	1.4%	0.6%
Return on common equity <sup>(7)</sup>	7.7	10.2	17.2	47.2	20.2
Return on total equity <sup>(8)</sup>	7.3	9.3	15.3	39.6	17.1
Dividend payout ratio on common stock <sup>(9)</sup>	56.4	30.7	15.6	6.2	18.9
Equity to assets ratio <sup>(10)</sup>	3.7	3.9	4.0	3.7	3.4

(1) Effective January 1, 2005, we changed our method of accounting for interest expense related to callable debt instruments to recognize interest expense using an effective interest method over the contractual life of the debt and changed our method for determining gains and losses upon the re-sale of PCs and Structured Securities related to deferred items recognized in connection with our guarantee of those securities. See "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES" to our consolidated financial statements. Effective January 1, 2003, we adopted the provisions of FASB Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others," or FIN 45, and FASB Staff Position FIN 45-2, "Whether FASB Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others," Provides Support for Subsequently Accounting for a Guarantor's Liability at Fair Value." We also adopted the provisions of Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities," or SFAS 133, and the provisions of Emerging Issues Task Force No. 99-20, "Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets," or EITF 99-20, as of January 1, 2001 and April 1, 2001, respectively.

(2) Includes (a) Due to Participation Certificate investors, (b) Accrued interest payable, (c) Guarantee obligation, (d) Derivative liabilities, at fair value, (e) Reserve for guarantee losses on Participation Certificates and (f) Other liabilities, as presented on our consolidated balance sheets.

(3) Excludes mortgage loans and mortgage-related securities traded, but not yet settled.

(4) The Retained portfolio presented in our consolidated balance sheets differs from the Retained portfolio on this table because the consolidated balance sheet caption includes valuation adjustments and deferred balances. See "MD&A — CONSOLIDATED RESULTS OF OPERATIONS — Table 17 — Characteristics of Mortgage Loans and Mortgage-Related Securities in the Retained Portfolio" for more information.

(5) Excludes Structured Securities where we have restructured PCs and other previously issued Structured Securities. These excluded Structured Securities do not increase our credit-related exposure and consist of single-class Structured Securities backed by PCs, REMICs and principal-only strips. The notional balances of interest-only strips are excluded because this line item is based on unpaid principal balance. Also excluded from this line item are modifiable and combinable REMIC tranches and interest and principal classes where the holder has the option to exchange the security tranches for other pre-defined security tranches.

(6) Ratio computed as Net income divided by the simple average of beginning and ending Total assets.

(7) Ratio computed as Net income available to common stockholders divided by the simple average of beginning and ending Stockholders' equity, net of Preferred stock, at redemption value.

(8) Ratio computed as Net income divided by the simple average of beginning and ending Stockholders' equity.

(9) Ratio computed as Common stock dividends declared divided by Net income available to common stockholders.

(10) Ratio computed as the simple average of beginning and ending Stockholders' equity divided by the simple average of beginning and ending Total assets.

**MANAGEMENT'S DISCUSSION AND ANALYSIS  
OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS  
EXECUTIVE SUMMARY**

**Our Business**

Freddie Mac is one of the leading institutions financing residential mortgage loans in the United States. We purchase residential mortgages and mortgage-related securities in the secondary market and use them to issue our own mortgage-related securities. We also purchase residential mortgages and mortgage-related securities in the secondary market to hold for investment purposes in our Retained portfolio. We finance our purchases primarily by issuing a variety of debt instruments in the capital markets.

In general, our purchases of mortgage loans are driven by the growth in total residential mortgage debt outstanding, the requirements of our charter, the affordable housing goals and subgoals set for us by HUD, the attractiveness of the returns available to us from securitization and portfolio investment activities and our level of customer service. In 2005, our share of the total residential mortgage debt market improved as we increased our single-family mortgage purchases and our purchases of non-agency mortgage-related securities for our Retained portfolio. Our share of the portion of the mortgage securitization market attributable to the GSEs increased from about 41 percent in 2004 to about 45 percent in 2005. Our market share will vary from period to period. We continue to seek lasting improvements in our overall market share and our GSE market share over time by improving customer service, diversifying our customer base and expanding the types of mortgages we guarantee and products we offer.

**Our Mission**

Our mission is to provide liquidity, stability and affordability in the secondary market for residential mortgages. Our activities contribute to the availability of affordable mortgage products in the U.S. We view the purchase of mortgage loans benefiting low- and moderate-income families and neighborhoods as an integral part of our mission and business, and we are committed to fulfilling the needs of these borrowers and markets. We are also subject to affordable housing goals set by HUD. We have reported to HUD that we achieved each of the affordable housing goals and subgoals for 2005, although HUD will make the final determination.

Responding to events such as the devastation on the Gulf Coast is at the core of our mission. In the immediate aftermath of Hurricane Katrina, we provided temporary mortgage payment relief, expedited the release of insurance proceeds, and modified our policies to accommodate our sellers and servicers, and ultimately the homeowners and renters, affected by the hurricanes. We committed to infuse up to \$300 million of liquidity into the affected Gulf area and took humanitarian steps — committing more than \$10 million to hurricane relief efforts and providing temporary housing assistance to approximately 1,100 families. We are also using our Retained portfolio to buy up to \$1 billion in mortgage revenue bonds, enabling state housing finance authorities to make low-cost mortgages and home repair loans for up to 10,000 low- and moderate-income families.

**Fair Value Management**

We believe fair value measures provide an important view of our business economics and risks because fair value takes a consistent approach to the representation of substantially all financial assets and liabilities, rather than an approach that combines historical cost and fair value measurements, as is the case with our GAAP-based consolidated financial statements. Fair value is defined as the amount at which an asset or liability could be exchanged between willing parties, other than in a forced or liquidation sale. We use estimates of fair value on a routine basis to make decisions about our business activities. In addition, we use fair value derived performance measures to establish corporate objectives and as a factor in determining management compensation. Our consolidated fair value balance sheets are an important component of our risk management processes, as we use estimates of the changes in fair value to calculate our Portfolio Market Value Sensitivity, or PMVS, and duration gap measures. For information about how we estimate the fair value of financial instruments, see “NOTE 16: FAIR VALUE DISCLOSURES” to our consolidated financial statements.

We promote long-term growth in the fair value of net assets primarily by seeking investment portfolio opportunities that offer attractive net mortgage-to-debt option-adjusted spreads and credit guarantee opportunities that offer attractive spreads relative to anticipated credit risks. We actively manage risks to long-term fair value growth inherent in these portfolios. Our long-term expectation is to generate returns, before capital transactions, over time on the average fair value of net assets attributable to common stockholders in the low- to mid-teens.

**Capital Management**

Our objective in managing capital is to preserve our safety and soundness, while maintaining sufficient capital to take advantage of new business opportunities and support our mission at attractive long-term returns. If available, we consider

returning excess capital to stockholders. At December 31, 2005, our estimated regulatory core capital was \$36.0 billion, with an estimated minimum capital surplus of \$11.0 billion and an estimated surplus in excess of the 30 percent mandatory target of approximately \$3.5 billion. We expect to be able to maintain a surplus over both our regulatory minimum capital requirement and the 30 percent mandatory target across a wide range of market conditions.

In 2005, we increased our quarterly common stock dividend on two occasions: a 17 percent increase in the first quarter (from \$0.30 per share to \$0.35 per share) and an additional 34 percent increase in the fourth quarter (from \$0.35 per share to \$0.47 per share). In October 2005, our board authorized us to repurchase up to \$2 billion of outstanding shares of common stock and to issue up to \$2 billion of non-cumulative perpetual preferred stock. With the release of our 2005 financial results in May, we have moved forward with the repurchase of common stock and we expect to issue the authorized preferred stock from time to time depending on market conditions and other factors.

## **Risk Management**

Our portfolio investment and credit guarantee activities expose us to three broad categories of risk: (a) operational risks, (b) interest-rate and other market risks, and (c) credit risks. Risk management is a critical aspect of our business. Effectively managing risk enables us to accomplish our mission and generate revenue and long-term value. Our strategies for managing these risks are discussed in “RISK MANAGEMENT.”

### *Operational Risks and Internal Controls*

We have devoted substantial financial and personnel resources to improving our internal controls. We continue to remediate material weaknesses and other deficiencies in internal control over financial reporting. Although we accelerated a number of previously planned control initiatives, we have a significant number of internal control deficiencies that have not been fully remediated and considerable challenges remain. See “RISK MANAGEMENT — Operational Risks — Internal Control over Financial Reporting” and “RISK FACTORS — Business and Operational Risks.”

### *Interest-Rate Risk*

Our interest-rate risk remains low. For all of 2005 and through May of 2006, PMVS and duration gap have averaged one percent and zero months, respectively. See “RISK MANAGEMENT — Interest-Rate Risk and Other Market Risks” for more information about these risks and our strategies for managing them.

### *Credit Risk*

Our credit losses also remain low. Our single-family delinquency rate declined to 69 basis points at December 31, 2005 from 73 basis points at the end of 2004. At April 30, 2006 our single-family delinquency rate declined further to 56 basis points. For 2005, our credit losses totaled \$149 million or 1.1 basis points of our average Total mortgage portfolio. Our credit-related expenses, which include changes in our provision for loan losses and expenses related to real estate owned, or REO, increased in 2005 primarily as a result of Hurricane Katrina. See “RISK MANAGEMENT — Credit Risks” for more information about these risks and our strategies for managing them.

## **Summary of 2005 Financial Results**

### *GAAP Results*

Changes in the level and volatility of interest rates continue to cause significant volatility in our reported financial results primarily because only a portion of our balance sheet is marked to fair value. Net income after the cumulative effect of a change in accounting principle was \$2,130 million for 2005, down from \$2,937 million for 2004. Diluted earnings per common share after the cumulative effect of a change in accounting principle was \$2.75 for 2005, down from \$3.94 for 2004. The decline in net income for 2005 compared to 2004 was primarily due to lower net interest income as a result of narrowing spreads on fixed-rate assets and a greater proportion of variable-rate assets purchased in 2005, an agreement to settle the securities class action and shareholder derivative litigation, charges related to Hurricane Katrina, and the net impact of certain accounting changes, partially offset by lower losses related to our derivative instruments not in qualifying hedge accounting relationships. Our derivatives portfolio continued to be an effective component of our risk management activities. See “NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES” to our consolidated financial statements for information about our changes in accounting principles and changes in estimates.

### *Fair Value Balance Sheets*

During 2005, the fair value of net assets attributable to common stockholders, before capital transactions, increased by \$1.0 billion, which represents a return on the average fair value of net assets attributable to common stockholders of approximately 3.7 percent. The fair value of net assets attributable to common stockholders at December 31, 2005 was unchanged, after capital transactions, at \$26.8 billion, from December 31, 2004. Subsequent to the issuance of our Information Statement Supplement dated May 30, 2006, we increased the fair value of net assets at December 31, 2005 by \$0.1 billion to correct an error in the calculation of the fair value of our debt securities issued.



Looking beyond 2005, our long-term expectation is to generate returns, before capital transactions, on the average fair value of net assets attributable to common stockholders, in the low- to mid-teens, although period-to-period returns may fluctuate substantially due to market conditions. Our expectations are based upon assumptions regarding rates of growth in our business, spreads we expect to earn on our business, and required capital levels, among other factors. We have assumed no adverse impacts from legislative or regulatory actions. Our actual results may differ materially from our expectations for a number of reasons, including those discussed in “RISK FACTORS” and “FORWARD-LOOKING STATEMENTS.”

The primary drivers of our fair value results during 2005 were core spread income from the Retained portfolio (defined as the net revenue resulting from the option-adjusted spread, or OAS, between mortgage-related investments and debt) and fee-based income (including guarantee fees and credit fees related to our guaranteed mortgage-related securities), substantially offset by a decrease from wider net mortgage-to-debt OAS, which we estimate reduced fair value by approximately \$1.3 billion (after-tax). We believe disclosing the estimated impact of changes in OAS on the fair value of net assets is helpful to understanding our current-period fair value results in the context of our long-term fair value return expectations. Our estimate of the impact of changes in OAS is discussed further in “CONSOLIDATED FAIR VALUE BALANCE SHEETS ANALYSIS — Discussion of Fair Value Results.”

Our fair value results also were affected by the net effect of changes in our approach for estimating the fair values of certain financial instruments implemented as of the first quarter 2005, which we estimate reduced fair value by approximately \$0.5 billion (after-tax). This reduction includes the net effect of changes we made to our fair value estimates for our guarantee-related assets and liabilities, where we implemented an approach that uses more market data for determining these fair values. We estimate that our improved approach for valuing guarantee-related assets and liabilities reduced fair value in the first quarter of 2005 by approximately \$0.8 billion (after-tax). Our approach for estimating fair values and the recent improvements are discussed in more detail in “NOTE 2: TRANSFERS OF SECURITIZED INTERESTS IN MORTGAGE-RELATED ASSETS” to our consolidated financial statements. During 2005, we also improved our approach for estimating the fair values of multifamily whole loans and the minority interests in consolidated real estate investment trusts, or REITs, as well as other securities by increasing the amount of market data used in the valuation process.

In addition, our fair value results were affected by the agreement to settle the securities class action and shareholder derivative litigation, the effect of which reduced fair value by approximately \$0.2 billion (after-tax), and the effect of charges related to Hurricane Katrina, which reduced fair value by approximately \$0.2 billion (after-tax).

## CONSOLIDATED RESULTS OF OPERATIONS

The following discussion of our consolidated results of operations should be read in conjunction with our consolidated financial statements, including the accompanying notes. Also see “CRITICAL ACCOUNTING POLICIES AND ESTIMATES” for more information concerning the most significant accounting policies and estimates applied in determining our reported financial position and results of operations.

### Net Interest Income

Table 7 summarizes our Net interest income and net interest yield and provides an attribution of changes in annual results to changes in rates or changes in volumes of our interest-earning assets and interest-bearing liabilities. Average balance sheet information is presented because we believe end-of-period balances are not representative of activity throughout the periods presented. For most components of the average balances, a daily weighted average balance is calculated for the period. When daily weighted average balance information is not available, a simple monthly average balance is calculated.

**Table 7 — Average Balance, Net Interest Income and Rate/Volume Analysis**

	Year Ended December 31,								
	2005			2004			2003		
	Average Balance <sup>(1)(2)</sup>	Interest Income (Expense) <sup>(1)</sup>	Average Rate <sup>(3)(4)</sup>	Average Balance <sup>(1)(2)(5)</sup>	Interest Income (Expense) <sup>(1)</sup>	Average Rate <sup>(3)(4)(5)</sup>	Average Balance <sup>(1)(2)(5)</sup>	Interest Income (Expense) <sup>(1)</sup>	Average Rate <sup>(3)(4)(5)</sup>
(dollars in millions)									
<b>Interest-earning assets:</b>									
Mortgage loans <sup>(6)(7)(8)</sup>	\$ 61,248	\$ 4,037	6.59%	\$ 61,576	\$ 4,007	6.51%	\$ 63,893	\$ 4,251	6.65%
Mortgage-related securities <sup>(8)(9)</sup>	611,452	29,684	4.85	590,213	28,460	4.82	544,359	29,051	5.34
Total Retained portfolio	672,700	33,721	5.01	651,789	32,467	4.98	608,252	33,302	5.47
Investments <sup>(10)</sup>	53,252	1,773	3.33	81,833	2,716	3.32	94,768	3,246	3.43
Securities purchased under agreements to resell and Federal funds sold	25,344	833	3.28	29,996	420	1.40	49,085	550	1.12
Total interest-earning assets	\$751,296	\$ 36,327	4.83	\$763,618	\$ 35,603	4.66	\$752,105	\$ 37,098	4.93
<b>Interest-bearing liabilities:</b>									
Short-term debt	\$192,497	\$ (6,102)	(3.17)	\$205,072	\$ (2,908)	(1.42)	\$226,850	\$ (2,785)	(1.23)
Long-term debt <sup>(11)</sup>	524,270	(23,246)	(4.43)	530,816	(22,950)	(4.32)	478,028	(22,083)	(4.62)
Total debt securities	716,767	(29,348)	(4.09)	735,888	(25,858)	(3.51)	704,878	(24,868)	(3.53)
Due to Participation Certificate investors	10,399	(551)	(5.30)	12,401	(708)	(5.71)	26,234	(1,641)	(6.26)
Total interest-bearing liabilities	727,166	(29,899)	(4.11)	748,289	(26,566)	(3.55)	731,112	(26,509)	(3.63)
Income (expense) related to derivatives <sup>(12)</sup>		(1,058)	(0.15)		100	0.01		(1,091)	(0.15)
Impact of net non-interest-bearing funding	24,130	—	0.14	15,329	—	0.07	20,993	—	0.11
Total funding of interest-earning assets	\$751,296	\$ (30,957)	(4.12)	\$763,618	\$ (26,466)	(3.47)	\$752,105	\$ (27,600)	(3.67)
Net interest income/yield	\$ 5,370	0.71		\$ 9,137	1.20		\$ 9,498	1.26	
Fully taxable-equivalent adjustment <sup>(13)</sup>	339	0.05		267	0.03		227	0.03	
Net interest income/yield (fully taxable-equivalent basis)	\$ 5,709	0.76%		\$ 9,404	1.23%		\$ 9,725	1.29%	
2005 vs. 2004 Variance Due to									
2004 vs. 2003 Variance Due to <sup>(5)</sup>									
	Rate <sup>(14)</sup>	Volume <sup>(14)</sup>	Total Change	Rate <sup>(14)</sup>	Volume <sup>(14)</sup>	Total Change	Rate <sup>(14)</sup>	Volume <sup>(14)</sup>	Total Change
(in millions)									
<b>Interest-earning assets:</b>									
Mortgage loans	\$ 51	\$ (21)	\$ 30	\$ (92)	\$ (152)	\$ (244)			
Mortgage-related securities	194	1,030	1,224	(2,928)	2,337	(591)			
Total Retained portfolio	245	1,009	1,254	(3,020)	2,185	(835)			
Investments	9	(952)	(943)	(98)	(432)	(530)			
Securities purchased under agreements to resell and Federal funds sold	487	(74)	413	116	(246)	(130)			
Total interest-earning assets	\$ 741	\$ (17)	\$ 724	\$ (3,002)	\$ 1,507	\$ (1,495)			
<b>Interest-bearing liabilities:</b>									
Short-term debt	\$(3,383)	\$ 189	\$(3,194)	\$ (406)	\$ 283	\$(123)			
Long-term debt	(581)	285	(296)	1,472	(2,339)	(867)			
Total debt securities	(3,964)	474	(3,490)	1,066	(2,056)	(990)			
Due to Participation Certificate investors	48	109	157	133	800	933			
Total interest-bearing liabilities	(3,916)	583	(3,333)	1,199	(1,256)	(57)			
Income (expense) related to derivatives	(1,158)	—	(1,158)	1,191	—	1,191			
Total funding of interest-earning assets	\$(5,074)	\$ 583	\$(4,491)	\$ 2,390	\$ (1,256)	\$ 1,134			
Net interest income	\$(4,333)	\$ 566	\$(3,767)	\$ (612)	\$ 251	\$(361)			
Fully taxable-equivalent adjustment	76	(4)	72	38	2	40			
Net interest income (fully taxable-equivalent basis)	\$(4,257)	\$ 562	\$(3,695)	\$ (574)	\$ 253	\$(321)			

(1) Excludes mortgage loans and mortgage-related securities traded, but not yet settled.

(2) For securities classified as available-for-sale, we calculate average balances based on their unpaid principal balance plus their associated deferred fees and costs (e.g., premiums and discounts), but exclude the effects of other-than-temporary impairments on the unpaid principal balances of impaired securities. For securities in the Retained portfolio classified as trading, we calculate average balances excluding their mark-to-fair-value

adjustments. For securities in the Cash and investments portfolio classified as trading during 2004 and 2003, we calculated average balances based on their fair values.

- (3) May not sum due to rounding.
- (4) Average rates for securities classified as available-for-sale are calculated on the historical cost basis, which is not affected by the change in fair value that is reflected in the Accumulated other comprehensive income, or AOCI, component of Stockholders' equity.
- (5) Certain amounts for 2004 and 2003 have been revised to conform with the 2005 presentation.
- (6) Non-accrual loans are included in average balances.
- (7) Loan fees included in mortgage loan interest income were \$371 million, \$223 million and \$120 million for the years ended December 31, 2005, 2004 and 2003, respectively.
- (8) A change in estimate resulted in a net pre-tax reduction in Net interest income of \$(166) million in the first quarter of 2005. Of this amount, \$(92) million relates to Mortgage interest income and \$(74) million relates to mortgage-related securities interest income. See "Net Interest Income — 2005 versus 2004."
- (9) Average rates calculated on a fully taxable-equivalent basis were 4.90 percent, 4.86 percent and 5.37 percent for the years ended December 31, 2005, 2004 and 2003, respectively, based upon related income of \$29,966 million, \$28,688 million and \$29,246 million, respectively.
- (10) For 2005, investments consist of Cash and cash equivalents and the Non-mortgage-related securities subtotal of Cash and Investments as reported on our consolidated balance sheets. 2004 and 2003 also include Mortgage-related securities held in the Cash and Investments portfolio.
- (11) Includes current portion of long-term debt. See "NOTE 8: DEBT SECURITIES AND SUBORDINATED BORROWINGS" to our consolidated financial statements for a reconciliation of Senior debt, due within one year on our consolidated balance sheets.
- (12) Includes amortization of deferred balances related to certain cash flow hedges and the accrual of periodic cash settlements of all derivatives in qualifying hedge accounting relationships. See "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — Derivatives" to our consolidated financial statements for more information.
- (13) The determination of Net interest income/yield (fully taxable-equivalent basis), which reflects fully taxable-equivalent adjustments to interest income, involves the conversion of tax-exempt sources of interest income to the equivalent amounts of interest income that would be necessary to derive the same net return if the investments had been subject to income taxes using our statutory tax rate of 35 percent.
- (14) Combined rate/volume changes are allocated to the individual rate and volume change based on their relative size.

Table 8 summarizes components of our Net interest income.

**Table 8 — Net Interest Income**

	Year Ended December 31,		
	2005	2004	2003
	(in millions)		
Contractual amounts of Net interest income	\$ 8,877	\$11,746	\$12,990
Deferred item amortization expense, net: <sup>(1)</sup>			
Asset-related amortization expense, net	(1,003)	(1,408)	(1,422)
Debt-related amortization expense, net	(1,446)	(1,301)	(979)
Total deferred item amortization expense, net	(2,449)	(2,709)	(2,401)
Income (expense) related to derivatives: <sup>(2)</sup>			
Amortization of deferred balances in AOCI, net	(1,966)	(1,814)	(1,482)
Accrual of periodic settlements of derivatives	908	1,914	391
Total income (expense) related to derivatives	(1,058)	100	(1,091)
Net interest income	5,370	9,137	9,498
Fully taxable-equivalent adjustment	339	267	227
Net interest income (fully taxable-equivalent basis)	<u>\$ 5,709</u>	<u>\$ 9,404</u>	<u>\$ 9,725</u>

(1) Amortization relates to premiums, discounts, deferred fees and other basis adjustments to the carrying value of our financial instruments and the reclassification of previously deferred balances from AOCI for certain derivatives in cash flow hedge relationships related to individual debt issuances and mortgage purchase transactions.

(2) Includes amortization of deferred balances related to certain cash flow hedges and the accrual of periodic cash settlements of all derivatives in qualifying hedge accounting relationships. See "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — Derivatives" to our consolidated financial statements for more information.

#### *2005 versus 2004*

Net interest income and net interest yield on a fully taxable-equivalent basis both decreased in 2005 due to narrowing spreads on fixed-rate assets and a greater proportion of variable-rate assets purchased in 2005. Net interest yield declined 47 basis points to 76 basis points for 2005 from 123 basis points for 2004, on a fully taxable-equivalent basis. This compression of the net interest yield and the decline in Net interest income reflected the impact of a flattening yield curve driven by increases in short-term interest rates. Because the repricing of our variable-rate assets lagged the increase in the cost of our short-term debt, the impact of the rising short-term rates on our short-term debt was only partially offset by the impact of rising rates on our variable-rate assets. Also, the decline in Net interest income for 2005 reflected the change in the asset mix, as the composition of our Retained portfolio shifted to a greater percentage of lower-yielding, variable-rate assets, and higher interest expense on derivatives in qualifying hedge accounting relationships. Another factor in the decline in Net interest income for 2005 was the result of our decision to cease the PC market-making and support activities conducted through our Securities Sales and Trading Group, or SS&TG, business unit and our external Money Manager program during the fourth quarter of 2004. This result is reflected in the \$28.6 billion, or 35 percent, decline in the average balance of our Investments portfolio. These negative factors were partially offset by a \$20.9 billion, or 3 percent, increase in the average balance of our Retained portfolio.

Interest income related to our Retained portfolio increased by \$1,254 million for 2005, as compared to 2004, as a result of the increase in the average balance of the portfolio as well as the rising rate environment. These positive factors were partially offset by the shift in the composition of the portfolio to lower-yielding, variable-rate non-agency securities. Interest income for the Retained portfolio in the first quarter of 2005 also includes the effect of enhancements to certain models



used to estimate prepayment speeds on mortgage-related securities and our approach for estimating uncollectible interest on single-family mortgages greater than 90 days delinquent. We implemented these enhancements as changes in estimates, resulting in a net decrease in interest income of \$(166) million (pre-tax) during the first quarter of 2005.

Interest income related to our Investments portfolio declined by \$943 million during 2005, as compared to 2004 as the average balance of this portfolio declined. By the end of 2004, we divested the trading portfolios related to our SS&TG business unit and our external Money Manager program in the Investments portfolio. This divestiture reduced the interest expense for funding the Investments portfolio as well as the hedging costs associated with it, which were reflected in Gains (losses) on investment activity. Our investments in mortgage-related securities held by our SS&TG business unit and external Money Manager program were generally hedged by entering into forward sales of mortgage-related securities. To determine the fair value of these positions, the held investment was valued at the current market, or spot price, while the forward sale commitments were valued at the discounted sales price, or forward price. For 2004 and 2003, the spot-forward difference between the trading securities and the related forward sale commitments resulted in a loss of \$1,101 million and \$981 million, respectively, in Gains (losses) on investment activity that was offset by Net interest income on the held position.

Interest income related to Securities purchased under agreements to resell and Federal funds sold increased by \$413 million for 2005, as compared to 2004, due to the increase in short-term interest rates discussed above, which more than offset the 16 percent decline in the related average balance of such securities.

Total interest expense on debt securities increased by \$3,490 million for 2005, compared to 2004. Interest expense on short-term debt increased by \$3,194 million for 2005, as compared to 2004, due to the increase in short-term interest rates during 2005. Interest expense related to long-term debt increased by \$296 million for 2005, as compared with 2004, as the increase in rates more than offset the decrease in the average balance of long-term debt.

Interest expense related to amounts due on pass through payments to PC investors decreased by \$157 million for 2005, as compared to 2004, as liquidation rates on outstanding guaranteed PCs and Structured Securities declined to 24 percent for 2005, as compared to 29 percent for 2004, driving the year-over-year decline in the average balance of Due to PC investors.

Income (expense) related to derivatives in qualifying hedge accounting relationships decreased \$1,158 million to an expense of \$1,058 million during 2005, as compared to income of \$100 million during 2004, primarily as a result of the increased interest expense associated with the accrual of periodic settlements related to our receive-fixed swaps and foreign-currency swaps resulting from increases in LIBOR. Also contributing to this change was our decision in 2004 to discontinue hedge accounting treatment for a significant amount of our pay-fixed interest-rate swaps and receive-fixed interest-rate swaps. The net impact of this decision was that the net interest expense related to these interest-rate swaps was no longer a component of Net interest income in 2005 but rather a component of Derivative gains (losses).

#### *2004 versus 2003*

Net interest income on a fully taxable-equivalent basis decreased by \$321 million in 2004, as compared with 2003. Net interest yield on a fully taxable-equivalent basis decreased by 6 basis points to 123 basis points in 2004 from 129 basis points in 2003, as the decline in yields on interest-earning assets exceeded the benefit of lower debt funding costs. The yield on interest-earning assets declined in 2004 due to the Retained portfolio's acquisition of relatively lower-yielding assets and the liquidation of higher-coupon securities, partially offset by an improvement in the yield on our Securities purchased under agreements to resell and Federal funds sold as short-term interest rates increased during 2004. The yield on interest-bearing liabilities declined in 2004 due to the maturity and repurchase of higher cost long-term debt and the issuance of new long-term debt at lower rates, coupled with a decrease in interest expense related to amounts due to PC investors. This decline in yield was partially offset by higher short-term debt yields in 2004.

During 2004, interest income on mortgage loans and mortgage-related securities declined by \$835 million, or 3 percent. We earned lower interest income on these investments during 2004 compared to 2003 because we increased purchases of lower-coupon non-agency mortgage-related securities (such as variable-rate securities that tend to earn lower initial yields than fixed-rate securities), coupled with the continued liquidation of relatively higher-coupon assets during 2004. The decline in our Retained portfolio yields during 2004 more than offset the additional interest income related to 7 percent growth in the average unpaid principal balance of our Retained portfolio. We also earned lower interest income related to our Investments portfolio as well as our Securities purchased under agreements to resell and Federal funds sold during 2004 as compared to 2003. The average balance of these portfolios declined by 14 percent and 39 percent, respectively, during 2004 as we ceased the PC market-making and support activities conducted through our SS&TG business unit and our external Money Manager program during the fourth quarter of 2004. The decline in these average balances more than offset a 28 basis point increase in the yield we earned on our Securities purchased under agreements to resell and Federal funds sold during 2004 as compared to 2003, due to a change in the asset mix and increases in short-term interest rates during 2004.

During the first quarter of 2004, we implemented enhancements to certain assumptions and calculations in the amortization process for deferred fees recorded as basis adjustments on assets in our Retained portfolio. The effect on Net interest income of these enhancements, which were treated as changes in estimates, was the recognition of \$86 million of additional amortization expense during the first quarter of 2004.

During 2004, total interest expense on debt securities increased by \$990 million. Interest expense related to long-term debt increased by \$867 million, or 4 percent, during 2004 as the average balance of long-term debt increased by approximately \$53 billion, or 11 percent, compared to 2003. This increase more than offset the benefit from the maturity and repurchase of higher-rate long-term debt and the issuance of new long-term debt at lower rates. Interest expense related to short-term debt increased by \$123 million, or 4 percent, in 2004 as average short-term interest rates were higher in 2004 than 2003, partially offset by a 10 percent decline in the average balance of short-term debt.

Income (expense) related to derivatives improved to income of \$100 million during 2004 from expense of \$(1,091) million in 2003 primarily as a result of moving certain pay-fixed swaps out of hedge accounting relationships. In 2004, we discontinued hedge accounting treatment for pay-fixed swaps with a notional balance of approximately \$108 billion, moving them from cash flow hedge designation to no hedge designation. This movement had a significant impact on Net interest income during 2004 because the net interest expense on these swaps is no longer reported as a component of Net interest income in periods following the move, but as a component of Derivative gains (losses). We also voluntarily discontinued hedge accounting treatment for a significant amount of our receive-fixed interest-rate swaps effective November 1, 2004, resulting in receive-fixed interest-rate swaps with a notional balance of approximately \$50 billion being moved from the fair value hedge designation to no hedge designation.

Interest expense related to amounts due to PC investors decreased by \$933 million as liquidation rates on outstanding PCs and Structured Securities declined to 29 percent in 2004 from 63 percent in 2003.

## Non-Interest Income (Loss)

### Management and Guarantee Income

Table 9 provides summary information about Management and guarantee income. The total management and guarantee rate consists of the contractual management and guarantee fee rate, and the effects of the amortization of certain pre-2003 deferred fees, including credit fees and buy-down fees. Management and guarantee income is the primary component of the revenue we earn from our credit guarantee activities. Other guarantee-related revenue is deferred and recognized over time as a component of Income on Guarantee obligation.

**Table 9 — Management and Guarantee Income<sup>(1)</sup>**

	Year Ended December 31,					
	2005		2004		2003	
	Amount	Rate	Amount	Rate	Amount	Rate
	(dollars in millions, rate in basis points)					
Contractual management and guarantee fees . . . . .	\$1,431	15.7	\$1,303	16.5	\$1,229	17.3
Amortization of credit and buy-down fees included in Other liabilities <sup>(2)</sup> . . . . .	19	0.2	79	1.0	424	6.0
Total management and guarantee income . . . . .	<u>\$1,450</u>	<u>15.9</u>	<u>\$1,382</u>	<u>17.5</u>	<u>\$1,653</u>	<u>23.3</u>
Unamortized balance of credit and buy-down fees included in Other liabilities, at period end <sup>(3)</sup> . . . . .	\$ 186		\$ 323		\$ 465	

(1) Excludes amounts related to PCs we held, which are reported in Net interest income.

(2) Credit and buy-down fees are amortized over the estimated lives of the underlying securities using the retrospective effective interest method. This method of amortization results in periodic adjustments when the effective interest rate changes due to differences between actual and estimated prepayments and changes in estimated future prepayments. Catch-up adjustments are made to the unamortized balances of the deferred items to reflect the application of the updated effective yield as if it had been in effect since acquisition.

(3) Previous periods' balances have been revised to conform with the 2005 presentation.

### 2005 vs. 2004

Management and guarantee income increased in 2005 as compared to 2004 primarily driven by a 15 percent increase in the average outstanding PCs balance, partially offset by lower amortization of deferred fees. The total management and guarantee fee rate was lower for 2005 at 15.9 basis points as compared to 17.5 basis points for 2004. The contractual management and guarantee fee rate recognized in 2005 decreased to 15.7 basis points from 16.5 basis points in 2004 reflecting lower fee rates on new business and the liquidation of existing business with relatively higher fee rates. The lower fee rates on new business were the result of competitive pricing pressures, an increase in buy-down activity, where lenders pay a portion of their guarantee fee up-front resulting in a lower contractual guarantee fee rate over the life of the related PCs, and continued use of market adjusted pricing through which guarantee fees are adjusted upward or downward to compensate for the strength or weakness of our PC prices relative to competing securities. It is important to note that the increase in buy-downs generates up-front fees that, beginning in 2003, are deferred and recognized over time as a component of Income on Guarantee obligation.

Management and guarantee income includes amortization of pre-2003 deferred credit fees and buy-down fees on our PCs. The unamortized balance of deferred fees related to outstanding PCs was approximately \$186 million, \$323 million and \$465 million at December 31, 2005, 2004 and 2003, respectively, and will ultimately be reduced to zero over time. The portion of the management and guarantee fee rate related to the amortization of deferred fees was 0.2 basis points and 1.0 basis point for 2005 and 2004, respectively. The decrease was primarily driven by higher average interest rates for 2005 compared to 2004, resulting in longer estimated lives of the loans underlying our PCs and a decrease in the pace of amortization. In addition, during the first quarter of 2005, we improved our approach for estimating the expected weighted average lives of mortgages underlying our PCs with related deferred credit fees, which in turn are used to calculate the recognition of deferred fees based on the effective interest method. This change in estimate reduced amortization income for the first quarter 2005 by \$17 million. The decline in the unamortized balance of credit and buy-down fees between 2005 and 2004 relates primarily to the correction of an error in the calculation of the amortization of this balance in prior periods that reduced the balance by \$103 million with a corresponding increase recorded in Other income in 2005.

#### *2004 vs. 2003*

Management and guarantee income decreased in 2004 as compared to 2003. This decrease was primarily driven by an 81 percent decrease in amortization of pre-2003 deferred fees, the effect of a change in our approach to amortizing deferred fees implemented in the first quarter of 2003, which is discussed below, and the decline in the balance of deferred fees contributed to this decrease. The total management and guarantee income rate declined to 17.5 basis points in 2004 from 23.3 basis points in 2003. The management and guarantee rate related to the amortization of deferred fees decreased from 6.0 basis points in 2003 to 1.0 basis point in 2004. The primary drivers of the decrease in amortization of deferred fees in 2004 were higher interest rates in 2004 resulting in longer estimated lives of the loans underlying our PCs and a reduction in the unamortized balances of deferred fees being amortized through Management and guarantee income.

In the first quarter of 2003, improvements to our amortization approach with respect to deferred fees resulted in the recognition of \$110 million (*i.e.*, 1.5 basis points) of additional amortization income in Management and guarantee income. The decrease in amortization of deferred fees in 2004 as compared with 2003 also resulted from higher mortgage interest rates in 2004 compared to 2003 and the associated impact on prepayment speeds used in our amortization models, which increased the expected weighted average lives of outstanding PCs and slowed the pace of amortization.

The contractual management and guarantee fee rate in 2004 decreased to 16.5 basis points compared with 17.3 basis points in 2003. The portfolio turnover we experienced in 2004 reduced our contractual guarantee fee rates because newly issued PCs tended to have lower contractual guarantee fee rates than previously outstanding PCs that were liquidated during 2004. This rate decline was partly driven by the impact of market adjusted pricing on new business purchases. Also, the contractual guarantee fee rate for 2004 declined because a greater proportion of our overall credit guarantee compensation was received in the form of upfront fees paid to us by seller/servicers.

#### **Gains (Losses) on Guarantee Asset**

The change in fair value of the Guarantee asset reflects:

- reductions related to the portion of cash received that is considered a return of our recorded investment in the Guarantee asset; and
- changes in the fair value of expected future cash inflows.

*Factors Affecting the Fair Value of the Guarantee Asset.* Two principal factors affect the fair value of the Guarantee asset. First, with the passage of time, actual expected cash flows are realized when received, resulting in a reduction in the value of the Guarantee asset. Cash flows received, which are recorded as Management and guarantee income, represent in part a reduction of our investment in the Guarantee asset. As shown on “Table 10 — Attribution of Change — Gains (Losses) on Guarantee Asset,” cash flows received on the Guarantee asset are allocated between interest income (imputed income on the asset based on the discount rate used in the calculation of the fair value of the Guarantee asset) and return of investment (the portion of actual cash flows that represents a reduction of the Guarantee asset receivable).

Second, the fair value of the Guarantee asset is also affected by changes in the fair value of future expected cash flows. The value of expected cash flows is driven by changes in the expected interest rates and related discount rates that affect the estimated life of the mortgages underlying the outstanding PCs and Structured Securities and other economic factors that influence the amount and timing of the future cash flows. Changes in the estimated lives of the underlying mortgages affect the value of the Guarantee asset because our right to receive guarantee fees ceases when borrowers prepay the underlying mortgages. See “Table 24 — Changes in Guarantee Asset” for additional information about the Guarantee asset.

**Table 10 — Attribution of Change — Gains (Losses) on Guarantee Asset<sup>(1)</sup>**

	Year Ended December 31,		
	2005	2004	2003
	(in millions)		
Total cash flows received <sup>(2)</sup>	\$ (1,270)	\$ (1,086)	\$ (891)
Portion of cash flows received related to imputed interest income	371	257	244
Return of investment in Guarantee asset	(899)	(829)	(647)
Change in fair value of future cash flows	(138)	(306)	(814)
Change in estimate <sup>(3)</sup>	(27)	—	—
Gains (losses) on Guarantee asset	<u>\$ (1,064)</u>	<u>\$ (1,135)</u>	<u>\$ (1,461)</u>

(1) Represents the change in fair value of the Guarantee asset related to PCs held by third parties that have previously been sold pursuant to SFAS 140 or PCs issued through our Guarantor Swap program, where we primarily exchange mortgage loans for PCs.

(2) Represents guarantee fees received related to PCs and Structured Securities held by third parties for which a recognized Guarantee asset exists.

(3) Represents a change in estimate resulting from enhancing our approach for determining the fair value of the Guarantee asset. See “NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES” to our consolidated financial statements for further information.

Losses on the Guarantee asset decreased \$71 million, or 6 percent, in 2005 as compared with 2004. The decrease in the change in fair value of future cash flows during 2005 reflects, in part, the new valuation approach implemented for 2005, which uses more market-based information to determine the fair value of the Guarantee asset. Our new valuation approach effectively equates the majority of the fair value of the Guarantee asset with the current, or “spot,” market values quoted by third-party dealers as if the cash flows were structured in excess-servicing interest-only securities and uses other market inputs for valuing the remaining portion. Accordingly, changes in the fair value of the Guarantee asset, which are recorded in current period earnings through Gains (losses) on Guarantee asset, will reflect the volatility associated with these market-based inputs. See “NOTE 2: TRANSFERS OF SECURITIZED INTERESTS IN MORTGAGE-RELATED ASSETS” to our consolidated financial statements for more information about this new approach.

The decrease in the change in the fair value of future cash flows during 2004 was primarily due to a smaller overall decline in mortgage interest rates in 2004 compared to 2003, which affected actual and expected prepayments. Return of investment for each year was consistent with the growth of the outstanding PCs and Structured Securities, as shown in “Table 46 — Total Mortgage Portfolio and Total Guaranteed PCs and Structured Securities Issued Based on Unpaid Principal Balances.”

### Income on Guarantee Obligation

Table 11 summarizes our income on Guarantee obligation.

**Table 11 — Income on Guarantee Obligation**

	Year Ended December 31,		
	2005	2004	2003
	(dollars in millions)		
Amortization income related to:			
Credit and buy-down fees received in FIN 45 transactions <sup>(1)</sup>	\$ 197	\$ 128	\$ 57
Other components of recognized Guarantee obligation	723	604	868
Income on Guarantee obligation	<u>\$ 920</u>	<u>\$ 732</u>	<u>\$ 925</u>
Components of the Guarantee obligation, at period end:			
Unamortized balance that is attributable to credit and buy-down fees received in FIN 45 transactions <sup>(1)</sup>	\$1,167	\$ 940	\$ 612
Unamortized balance that is attributable to the other components of the Guarantee obligation	4,374	3,125	2,292
Guarantee obligation	<u>\$5,541</u>	<u>\$4,065</u>	<u>\$2,904</u>
Liquidation rate for outstanding PCs and Structured Securities <sup>(2)</sup>	24%	29%	63%

(1) Related to upfront cash payments in the form of credit fees and buy-down payments that are received from counterparties to guarantee transactions that are accounted for pursuant to FIN 45 (e.g., Guarantor Swaps).

(2) Related to outstanding PCs and Structured Securities (including other PCs and Structured Securities held in our Cash and investments portfolio during 2004 and 2003).

In 2005, Income on Guarantee obligation increased as the balance of the Guarantee obligation increased during the year, offsetting the impact of lower PC and Structured Security liquidation rates. The amortization of the Guarantee obligation is reduced by lower liquidation rates because the rate of amortization is based on changes in the unpaid principal balance of the underlying mortgage loans. Amortization of credit fees and buy-downs increased in 2005 and 2004 as deferred balances increased.

In 2004, our Guarantee obligation increased, but our Income on Guarantee obligation decreased as the 2004 full-year liquidation rate for our outstanding PCs and Structured Securities was significantly lower than 2003 resulting in comparatively lower amortization.



## Derivative Overview

Table 12 shows the notional amount for each of our hedge accounting classifications and the corresponding impact of those positions on our consolidated financial statements. The application and effectiveness of our hedge accounting strategies can materially affect stockholders' equity and the timing of our recognition of earnings because those strategies determine the accounting for the derivatives involved.

**Table 12 — Summary of the Effect of Derivatives on Selected Consolidated Financial Statement Captions**

Description	Consolidated Balance Sheets					
	December 31, 2005			December 31, 2004		
	Notional Amount	Fair Value (Pre-Tax) <sup>(1)</sup>	AOCI (Net of Taxes) <sup>(2)</sup>	Notional Amount	Fair Value (Pre-Tax) <sup>(1)</sup>	AOCI (Net of Taxes) <sup>(2)</sup>
			(in millions)			
Fair value hedges-open	\$115,146	\$ 3,402	\$ —	\$113,101	\$12,317	\$ —
Cash flow hedges-open	668	(26)	4	21,214	228	(25)
No hedge designation <sup>(3)</sup>	567,558	3,131	—	622,463	2,486	—
Subtotal	683,372	6,507	4	756,778	15,031	(25)
Balance related to closed cash flow hedges	—	—	(6,291)	—	—	(7,899)
Total	<u>\$683,372</u>	<u>\$ 6,507</u>	<u>\$ (6,287)</u>	<u>\$756,778</u>	<u>\$15,031</u>	<u>\$ (7,924)</u>

Description	Consolidated Statements of Income for the Years Ended December 31,					
	2005		2004		2003	
	Derivative Gains (Losses)	Hedge Accounting Gains (Losses) <sup>(4)</sup>	Derivative Gains (Losses)	Hedge Accounting Gains (Losses) <sup>(4)</sup>	Derivative Gains (Losses)	Hedge Accounting Gains (Losses) <sup>(4)</sup>
			(in millions)			
Fair value hedges-open <sup>(5)</sup>	\$ —	\$ 22	\$ —	\$742	\$—	\$697
Cash flow hedges-open <sup>(5)(6)</sup>	(25)	—	2	1	29	(53)
No hedge designation <sup>(3)</sup>	(1,332)	—	(4,477)	—	10	—
Total	<u>\$(1,357)</u>	<u>\$ 22</u>	<u>\$(4,475)</u>	<u>\$743</u>	<u>\$39</u>	<u>\$644</u>

(1) The fair values of derivatives (netted by counterparty) are presented as Derivative assets, at fair value, and Derivative liabilities, at fair value, on our consolidated balance sheets.

(2) Derivatives that meet specific criteria may be accounted for as cash flow hedges. Changes in the fair value of the effective portion of these open derivatives contracts are recorded in AOCI, net of taxes. Net deferred gains and losses on closed cash flow hedges (*i.e.*, where the derivative is either terminated or redesignated) are also included in AOCI, net of taxes, until the related forecasted transaction is determined to be probable of not occurring or affects earnings.

(3) For most derivatives not qualifying as an accounting hedge, fair value gains and losses are reported as Derivative gains (losses) on our consolidated statements of income. For forward purchase and sale commitments of securities classified as trading (with notional balances of approximately \$— billion, \$— billion and \$78 billion at December 31, 2005, 2004 and 2003, respectively), fair value gains and losses are reported as Gains (losses) on investment activity on our consolidated statements of income and therefore, those fair value gains and losses are not included above.

(4) Hedge accounting gains (losses) arise when the fair value change of a derivative does not exactly offset the fair value change of the hedged item attributable to the hedged risk. For further information, see "Hedge Accounting Gains (Losses)" below and "NOTE 12: DERIVATIVES" to our consolidated financial statements.

(5) For all derivatives in qualifying hedge accounting relationships, the accrual of periodic cash settlements is recorded in Net interest income on our consolidated statements of income and therefore, those amounts are not included above. For derivatives not in qualifying hedge accounting relationships, the accrual of periodic cash settlements is recorded in Derivative gains (losses) on our consolidated statements of income.

(6) Derivative gains (losses) in each period include gains or losses reclassified from AOCI, net of taxes, as a result of the termination of cash flow hedge designations because we determined that the related forecasted transaction is probable of not occurring.

As Table 12 shows, the majority of our derivatives were not designated in hedge accounting relationships at December 31, 2005 and 2004. Derivatives that are not in qualifying hedge accounting relationships generally increase the volatility of reported Non-interest income (loss) because the fair value gains and losses on the derivatives are recognized in earnings without the offsetting recognition in earnings for the change in value of the economically hedged exposures.

A receive-fixed swap results in our receipt of a fixed interest-rate payment from our counterparty in exchange for a variable-rate payment to our counterparty. Conversely, a pay-fixed swap requires us to make a fixed interest-rate payment to our counterparty in exchange for a variable-rate payment from our counterparty. Call and put swaptions are options to enter into receive- and pay-fixed swaps, respectively. We use swaptions and other option-based derivatives to adjust the contractual funding of our debt in response to changes in the expected lives of mortgage-related assets in the Retained portfolio. Generally, receive-fixed swaps increase in value and pay-fixed swaps decrease in value when interest rates decrease (with the opposite being true when interest rates increase). The fair values of purchased call and put swaptions are sensitive to changes in interest rates. Swaption values are also driven by the market's expectation of potential changes in future interest rates (referred to as "implied volatility"). Swaptions generally become more valuable as implied volatility increases and less valuable as implied volatility decreases. Recognized losses on these purchased options in any given period are limited to the premium paid to purchase the option plus any unrealized gains previously recorded.

Effective at the beginning of the second quarter of 2004, we determined that substantially all pay-fixed interest-rate swaps and other derivatives that previously had been in cash flow hedge accounting relationships no longer met hedge accounting requirements. Consequently, we discontinued hedge accounting treatment for these relationships at that time



resulting in a move of pay-fixed swaps with a notional balance of approximately \$108 billion from the cash flow hedge designation to no hedge designation. We also voluntarily discontinued hedge accounting treatment for a significant amount of our receive-fixed interest-rate swaps effective November 1, 2004, resulting in a move of receive-fixed swaps with a notional balance of approximately \$50 billion from fair value hedge designation to no hedge designation. Effective at the beginning of the second quarter of 2005, we voluntarily discontinued hedge accounting treatment for all new forward purchase commitments and the majority of our new commitments to forward sell mortgage-related securities. In addition, effective March 31, 2006, we voluntarily discontinued hedge accounting treatment for all derivatives, with the exception of certain commitments to forward sell mortgage-related securities and one foreign-currency hedge strategy. We believe that our voluntary discontinuation of hedge accounting treatment for these derivatives assists us in addressing the operational complexity and related control remediation efforts that would otherwise be needed to ensure ongoing compliance with the requirements for obtaining and maintaining hedge accounting treatment. We may consider implementing new hedge accounting strategies in the future.

### Derivative Gains (Losses)

Derivative gains (losses) are affected by the change in the fair value of and the accrual of periodic settlements of all derivatives not in hedge accounting relationships. We experienced significant income volatility due to changes in the fair values of our derivatives and changes in the composition of our portfolio of derivatives not in hedge accounting relationships, particularly due to the discontinuation of hedge accounting treatment described above. Table 13 provides a summary of the period-end notional amounts and the gains and losses related to swaptions, swaps and other derivatives that we used to manage interest-rate risk, but were not accounted for in hedge accounting relationships.

**Table 13 — Derivatives Not in Hedge Accounting Relationships**

	Year Ended December 31,					
	2005		2004		2003	
	Notional	Derivative Gains (Losses)	Notional	Derivative Gains (Losses)	Notional	Derivative Gains (Losses)
	(in billions)					
Call swaptions	\$146.6	\$(0.4)	\$189.9	\$ 0.4	\$216.9	\$(0.6)
Put swaptions	34.7	0.2	25.2	(1.4)	123.1	(0.3)
Receive-fixed swaps	81.2	(1.5)	25.6	(0.4)	13.8	(0.2)
Pay-fixed swaps	181.6	0.6	95.0	(0.8)	47.1	2.8
Other <sup>(1)(2)</sup>	123.5	0.1	286.8	(0.6)	395.4	(0.7)
Subtotal	567.6	(1.0)	622.5	(2.8)	796.3	1.0
Accrual of periodic settlements <sup>(3)</sup>		(0.4)		(1.7)		(1.0)
Total	<u>\$567.6</u>	<u>\$(1.4)</u>	<u>\$622.5</u>	<u>\$(4.5)</u>	<u>\$796.3</u>	<u>\$ —</u>

(1) Other consists of basis swaps, certain option-based contracts, futures, foreign-currency swaps, interest-rate caps, commitments, derivatives held as part of our external Money Manager program (in 2003) and other derivatives not accounted for in hedge accounting relationships, including credit derivatives, swap guarantee derivatives and a prepayment management agreement.

(2) Derivative gains (losses) in each period include gains or losses reclassified from AOCI, net of taxes, as a result of the termination of cash flow hedge designations because we determined that the related forecasted transactions are probable of not occurring.

(3) Composed of receive-fixed swaps of \$0.4 billion and \$0.1 billion and pay-fixed swaps of \$(0.8) billion and \$(1.8) billion for the years ended December 31, 2005 and 2004, respectively.

During 2005, long-term and short-term interest rates generally rose, with short-term interest rates increasing more significantly than long-term interest rates. These interest-rate movements caused our pay-fixed swaps, which are primarily long-term, to increase in fair value and our receive-fixed swaps, which are primarily short-term, to decrease in fair value. The accrual of periodic settlements declined during 2005 compared to 2004 because interest accruals related to our pay-fixed and receive-fixed swaps not in qualifying hedge accounting relationships largely offset one another during 2005, but only did so for the later part of 2004, following the discontinuation of hedge accounting discussed above.

During 2004, we experienced net losses on our call and put swaption positions as the fair values of these positions were driven down by changes in swap rates and the decline in implied volatilities of interest rates (*i.e.*, the market's expectation of potential changes in future interest rates). During 2004, a large portion of our pay-fixed swaps not in hedge accounting relationships were forward-starting. Generally, spot and forward rates move in tandem. However, in the fourth quarter of 2004 forward rates declined, ending the year lower than the prior year-end, whereas spot rates increased, ending the year at roughly the same level as the prior year-end. The net loss on our pay-fixed portfolio for 2004 was caused by the overall decline in forward rates.

The movement of the pay-fixed and receive-fixed swaps to no hedge designation at different dates during 2004 was the primary cause of the increase in the accrual of periodic settlements recorded in Derivative gains (losses) as compared to 2003. Had these pay-fixed and receive-fixed swaps remained in hedge accounting relationships, the related accrual of periodic settlements would have instead been reported as a component of Net interest income (loss). The increase in the

notional balance of our pay-fixed swaps not in hedge accounting relationships contributed to a \$0.4 billion increase in the net expense associated with the accrual of periodic settlements in the second quarter of 2004 as compared to the first quarter of 2004. This expense continued to be high in the third and fourth quarters of 2004, but began to be partially offset by the accrual of periodic settlements related to the receive-fixed swaps, which were moved to no hedge designation during the fourth quarter of 2004.

Derivative gains (losses) fluctuated significantly during 2003 due to the decrease in interest rates during the first half of 2003 compared to an increase in interest rates during the third quarter of 2003. As interest rates increased during the third quarter of 2003, our call swaptions declined in value and we incurred losses on commitments to purchase or sell mortgages and mortgage-related securities. These losses were partially offset by gains on pay-fixed swaps.

### Hedge Accounting Gains (Losses)

Hedge accounting gains (losses) will vary from period to period based on the notional amount of derivatives accounted for in hedge accounting relationships and the amount of any hedge ineffectiveness, which is the extent to which differences in the characteristics or terms of the derivative and the hedged item result in fair value or cash flow changes that are not exactly offset. Our net hedge ineffectiveness gains in 2005 related to derivatives used to manage interest-rate risk associated with our debt securities, along with other derivatives in other fair value hedge accounting relationships. Net hedge ineffectiveness gains in 2004 and 2003 related primarily to our fair value hedge accounting relationships where the derivative is valued using forward rates while the hedged debt is valued using spot rates. As discussed in “Derivative Overview” above, a substantial portion of our derivatives in fair value hedge accounting relationships were reclassified to no hedge designation during 2004.

### Gains (Losses) on Investment Activity

Table 14 summarizes the components of Gains (losses) on investment activity.

**Table 14 — Gains (Losses) on Investment Activity**

	Year Ended December 31,		
	2005	2004	2003
	(in millions)		
Gains (losses) on trading securities	\$(289)	\$(1,071)	\$(1,606)
Gains (losses) on PC residuals, at fair value	(95)	58	(144)
Gains (losses) on sale of mortgage loans <sup>(1)</sup>	92	209	725
Gains (losses) on sale of available-for-sale securities	546	584	826
Security impairments:			
Mortgage-related interest-only security impairments	(71)	(66)	(524)
Other security impairments	(300)	(60)	(212)
Total security impairments	(371)	(126)	(736)
Lower-of-cost-or-market adjustments	(10)	(2)	(179)
Total gains (losses) on investment activity	<u>\$(127)</u>	<u>\$ (348)</u>	<u>\$(1,114)</u>

(1) Represents mortgage loans sold in connection with securitization transactions.

#### *Gains (losses) on trading securities*

The fair value of trading securities in our Retained portfolio declined in 2005 as medium- and long-term interest rates increased during the year. Prior to 2005, our trading positions related primarily to our SS&TG business unit and external Money Manager program, both of which ceased operations in the fourth quarter of 2004. The trading activities of our SS&TG business unit resulted in spot-forward differences, or trading losses, that totaled \$1,101 million and \$981 million in 2004 and 2003, respectively, which were offset by net interest income on the held positions. Absent these spot-forward differences, our trading gains (losses) netted to a \$30 million gain in 2004 and a \$625 million loss in 2003. These gains and losses were primarily caused by changes in the prevailing medium- and long-term market interest rates (*i.e.*, 10-year swap rate). In 2004, trading losses were adversely impacted by prepayments on mortgage-related securities that we held in the trading portfolios of our SS&TG business unit and external Money Manager program. In 2003, our trading securities portfolio experienced losses as a result of prepayments that reduced the fair value of these securities during the first half of 2003. In addition, during the second half of 2003, the portfolio experienced losses as rising interest rates decreased the value of these investments.

#### *Gains (losses) on PC residuals, at fair value*

Gains (losses) on PC residuals that we classify as trading securities relate to certain PCs and Structured Securities we hold in our Retained portfolio and represent the net fair value of the future cash inflows and cash outflows related to our guarantee of these securities. The fair value of PC residuals is affected by several factors including: (a) changes in interest rates, which affect the expected lives of the related PCs and Structured Securities; (b) default experience and loss severity trends related to our guarantee and (c) third party information with respect to fair value. In 2005, losses on PC residuals

were also affected by changes in the approach we use to estimate the fair values of our guarantee-related assets and liabilities, which resulted in net pre-tax losses of \$(78) million in the first quarter of 2005. In addition, PC residual losses in 2005 were affected by the impact of Hurricane Katrina, which increased the estimated future credit costs considered in the valuation of the Guarantee obligation component of the PC residuals. In 2004, expected default costs declined due to continued house price appreciation, generating gains, partially offset by declines in mortgage interest rates that reduced the expected life of the Guarantee asset, generating losses. We recorded losses in 2003, primarily driven by reductions in mortgage interest rates.

#### *Gains (losses) on sale of mortgage loans*

Gains and losses on the sale of mortgage loans are primarily determined based on the volume of mortgage loan sales and interest rate movements from the time the loans are purchased until the time they are sold in any given period. Net gains on sales of mortgage loans have declined since 2003 primarily due to the decline in the volume of loan sales as our guarantee activities have trended toward a higher proportion of Guarantor Swap transactions as opposed to sales of mortgage loans from our Retained portfolio. Net gains on the sales of mortgage loans from our Retained portfolio decreased in 2005 and 2004 from 2003 levels as the proceeds from such sales have declined to approximately \$24 billion in 2005 from \$31 billion in 2004 and \$84 billion in 2003 reflecting the decline in volume.

#### *Gains (losses) on sale of available-for-sale securities*

Proceeds from the sale of available-for-sale securities totaled \$95 billion, \$86 billion and \$144 billion during 2005, 2004 and 2003, respectively, and we recognized net gains during each year. Prior to 2005, we generated a large volume of these sales through our SS&TG business unit and external Money Manager program, which ceased operations during the fourth quarter of 2004. During 2005, our sales of available-for-sale securities were primarily from the Retained portfolio reflecting structuring activity designed to improve returns and to enhance liquidity by broadening the investor base for our mortgage-related securities.

#### *Total security impairments*

Total security impairments for 2005 were \$371 million. Of that amount, approximately \$185 million relates to impairments of certain commercial mortgage-backed securities, or CMBS, which involved cash flows from mixed pools (*i.e.*, mortgage loan pools containing both multifamily residential loans and non-residential commercial loans). In December 2005, HUD determined that such mixed-pool investments are not authorized under our charter. OFHEO concurred with HUD's determination and subsequently directed us to provide a written plan for the divestiture of these assets, which we have done. Accordingly, we determined that we no longer had the ability or intent to hold these investments and, pursuant to relevant accounting guidance, recognized impairments on affected CMBS investments with an unrealized loss at December 31, 2005. Accounting guidance does not permit the recognition of unrealized gains on other affected CMBS until such securities are sold. As such, we anticipate that the sale of the related assets in 2006 would result in a net gain, absent significant changes in market prices. Also included within the \$371 million in total security impairments in 2005 were \$71 million of impairments of mortgage-related interest-only securities, primarily related to the decline in mortgage interest rates experienced in the second quarter of 2005, and \$115 million of remaining security impairments, mainly associated with an adverse change in estimated cash flows on securities in an unrealized loss position.

Impairments in 2004 and 2003 included impairments on manufactured housing securities totaling \$44 million and \$208 million, respectively, as a result of the comparatively low credit quality of these securities. In 2003, we also recorded impairments on mortgage-related interest-only securities totaling \$524 million primarily driven by declines in mortgage interest rates during the first half of the year.

#### *Lower-of-cost-or-market adjustments*

We value mortgage loans classified as held-for-sale at the lower-of-cost-or-market with resulting valuation adjustments, if any, reflected in this caption. Increases in mortgage interest rates during 2005, particularly in the first, third and fourth quarters, resulted in higher lower-of-cost-or-market adjustments than recorded in 2004. The sharp decline in mortgage interest rates in the second quarter of 2003 resulted in an increase in mortgage loans purchased as the market experienced heavy refinancing activity. A sharp increase in mortgage interest rates during the third quarter of 2003 reduced the value of our held-for-sale mortgage loan portfolio, resulting in lower-of-cost-or-market valuation adjustments that totaled \$(178) million in the third quarter of 2003.

#### **Gains (Losses) on Debt Retirement**

During 2005, we recognized a pre-tax gain of \$206 million on debt repurchases of \$11.7 billion. During 2004 and 2003, we recognized pre-tax losses of \$(327) million and \$(1,775) million, respectively, on debt repurchases of \$14.5 billion and \$27.3 billion, respectively. We repurchase our outstanding debt securities on a regular basis to help preserve the liquidity of

our debt securities and to manage our mix of assets and liabilities. For example, in early 2005, we executed a tender offer for certain debt securities with expired European call options because the price of those securities had declined relative to other debt securities. In 2005, we also recorded gains on repurchases of debt originally issued in response to investor requests. See “LIQUIDITY AND CAPITAL RESOURCES” for further discussion of our debt management activities. Our most significant debt repurchases occurred in the second quarter of 2003, resulting in pre-tax losses of \$(1,266) million, when we repurchased an aggregate of \$17.1 billion of U.S. dollar and Euro-denominated debt securities, most of which followed the announcement of changes in our senior management. We executed these particular repurchases to support the liquidity and price performance of these securities. In all periods, Gains (losses) on debt retirement include previously deferred amounts related to cash flow hedges associated with the repurchased debt securities.

## Resecuritization Fees

Table 15 summarizes the components of our single-class and multi-class structured resecuritization activities.

**Table 15 — Total Resecuritization Fees and Activity**

	Year Ended December 31,		
	2005	2004	2003
	(in millions)		
Resecuritization fees <sup>(1)</sup> :			
Multi-class .....	\$ 119	\$ 149	\$ 338
Single-class .....	6	10	14
Total resecuritization fees .....	<u>\$ 125</u>	<u>\$ 159</u>	<u>\$ 352</u>

(1) Represents the portion of resecuritization fee income that we recognize as Resecuritization fees, which relate to resecuritization classes held by third parties.

Investor demand for multi-class structured cash flows tends to increase in periods characterized by a steep yield curve and declining interest rates. Beginning in the second half of 2005, a flattening of the yield curve accompanied by rising mortgage interest rates slowed investor demand for our multi-class Structured Securities, particularly REMICs. Conversely, during 2004 and 2003, investor demand for our multi-class Structured Securities remained high largely due to the comparatively steep yield curve during these periods.

During 2005, partly in response to competitive market conditions, we began to issue select REMIC products (*e.g.*, Reference REMIC<sup>SM</sup> securities, Whole Loan REMIC and alternative collateral deals) and Giant PCs without charging up-front transaction fees, which we previously charged under our normal practice.

## Other Income

Other income totaled \$24 million, \$230 million and \$493 million for 2005, 2004 and 2003, respectively. Absent fluctuations related to certain prior period accounting errors in 2005, 2004 and 2003 (discussed in more detail below), Other income would have been \$104 million, \$172 million and \$279 million in 2005, 2004 and 2003, respectively. Other income declined in 2005 and 2004, primarily due to a decline in the use of Loan Prospector®, our automated loan-underwriting tool, as the proportion of loans underwritten using alternate underwriting tools prior to purchase has increased.

In the process of reviewing our accounting policies and practices during 2005, 2004 and 2003, we identified certain errors not material to our financial statements that related to income in previously reported periods. During 2005, 2004 and 2003, we identified approximately \$80 million of expense, net (\$52 million after-tax), \$58 million of income, net (\$38 million after-tax) and \$214 million of income, net (\$139 million after-tax) of such errors, which were recorded in the first quarter of each respective year. During 2005, our largest correction related to an error associated with the accrual of interest income for certain mortgage-related securities during 2001 to 2004, which reduced Other income in 2005 by approximately \$210 million (\$137 million after-tax). In addition, we corrected errors related to the ending balance of pre-2003 deferred credit and buy-down fees at December 31, 2004 that increased Other income in 2005 by \$103 million (\$67 million after-tax) as well as other errors that increased Other income in 2005 by \$27 million (\$18 million after-tax).

## Non-Interest Expense

Table 16 summarizes the components of Non-interest expenses.

**Table 16 — Non-Interest Expense**

	Year Ended December 31,		
	2005	2004	2003
	(in millions)		
Administrative expenses:			
Salaries and employee benefits	\$ 805	\$ 758	\$ 624
Professional services	386	588	311
Occupancy expense	58	60	52
Other administrative expenses	286	144	194
Total administrative expenses	1,535	1,550	1,181
Provision for credit losses	251	143	(5)
REO operations (income) expense	40	(3)	7
Housing tax credit partnerships	320	281	200
Minority interests in earnings of consolidated subsidiaries	96	129	157
Other expenses:			
Reserve for legal settlements	339	—	75
Realized losses on certain guarantees	234	33	60
Amortization of credit enhancements	99	86	134
Selected affordable housing transaction fees	—	41	124
Loan Prospector®-related expenses	51	56	99
OFHEO civil money penalty	—	—	125
Other	48	55	79
Total other expenses	771	271	696
Total Non-interest expenses	\$3,013	\$2,371	\$2,236

### Administrative Expenses

Salaries and employee benefits increased during each of the past three years primarily because we hired additional employees in support of our financial reporting and infrastructure-related activities. In addition, we continued to experience increases in employee incentive compensation costs, such as employee stock compensation, special incentive awards and annual employee bonuses, in an effort to recruit new talent and retain existing employees. The cessation of our SS&TG business unit and external Money Manager program activities during the fourth quarter of 2004 and related employee terminations partially offset other increases in Salaries and employee benefits during 2005. Furthermore, Salary and employee benefits in 2004 included an \$18 million charge for employee severance and related costs associated with the cessation of SS&TG and external Money Manager activities.

Professional services expense fluctuated with our ongoing financial reporting and internal control and remediation activities. Professional services expense declined during 2005 compared to 2004, in part because we were able to replace consultants with employees, increasing our Salaries and employee benefits expense as a consequence.

Other administrative expenses are presented net of certain expenses that we defer related to capitalized software development activities. The net effect of these capitalized software costs, including the write-off of previously capitalized amounts, was an increase (reduction) to Other administrative expenses totaling \$29 million, \$(94) million and \$(42) million in 2005, 2004 and 2003, respectively. In addition, Other administrative expenses increased in 2005 compared to 2004 as a result of higher OFHEO regulatory assessments associated with its oversight responsibilities and charitable contributions, particularly associated with Hurricane Katrina.

### Provision for Credit Losses

The Provision for credit losses may be expense or income, depending on whether the loan loss reserves balance needs to be increased or decreased based on the inherent losses associated with our portfolio at any time. The Provision for credit losses was \$251 million and \$143 million in 2005 and 2004, respectively, compared to a benefit of \$5 million in 2003.

The Provision for credit losses increased during 2005 primarily because Hurricane Katrina heavily damaged properties underlying some of the mortgage loans we hold in the Retained portfolio or that underlie our guaranteed PCs and Structured Securities. The 2005 provision also includes increases related to the single-family portfolio as we anticipate an increase in the severity of losses on a per-property basis driven, in part, by the expectation of low or slower home price appreciation in certain areas and increased incurred losses as delinquencies occur for loans that are expected to experience higher default rates based on their year of origination. The Provision for credit losses increased in 2004 due to increases in the estimated incurred losses in the single-family portfolio at December 31, 2004 compared to December 31, 2003. However, a decrease in the estimated incurred losses for the multifamily mortgage portfolio, driven primarily by an increase in the estimated fair value of multifamily properties in certain areas, partially offset the increase resulting from the single-family portfolio.



## **Housing Tax Credit Partnerships**

Operating losses of our housing tax credit partnerships, which are recorded as a component of Non-interest expense, have increased over the last three years as our investments in these partnerships have increased. The increased investment in Housing tax credit partnerships have generated related tax benefits, which consist of tax credits and the tax deductibility of the operating losses. See “Income Tax Expense” for a description of the impact of these investments on our income tax expense.

## **Other Expenses**

### *Reserve for legal settlements*

On April 20, 2006, we announced that we reached an agreement in principle to settle the securities class action and stockholder derivative lawsuits that relate to our restatement. The \$339 million expense recorded in 2005 for Reserves for legal settlements includes this settlement, net of expected insurance proceeds. This expense is in addition to the \$75 million expense we recorded in 2003 for a loss contingency reserve related to legal proceedings arising from the restatement. See “NOTE 13: LEGAL CONTINGENCIES” to our consolidated financial statements for more information.

### *Realized losses on certain guarantees*

The increase in Realized losses on certain guarantees during 2005 resulted primarily from the application of our new approach for determining the initial fair values of our guarantee-related assets and liabilities that employs more direct market-based information. Such losses arise in connection with our Guarantor Swap transactions and in 2005 were partly driven by our efforts to meet the affordable housing goals and subgoals established by HUD. When determining the fees we will charge customers with respect to providing our credit guarantee, we consider all of the mortgage loans we expect to guarantee. However, the recognition of realized losses on certain guarantees or the deferral of guarantee income is determined based upon the specific loan pools formed that underlie our PCs and Structured Securities. Our new approach for valuing our guarantee-related assets and liabilities is discussed in “NOTE 2: TRANSFERS OF SECURITIZED INTERESTS IN MORTGAGE-RELATED ASSETS” to our consolidated financial statements.

### *Amortization of credit enhancements*

Amortization of our credit enhancement asset accelerates when the related PC or Structured Security liquidates. Total Guaranteed PCs and Structured Securities Issued liquidated at roughly the same pace in 2005 and 2004, resulting in relatively flat amortization expense during these years. These securities liquidated at a much faster pace in 2003 compared to 2004 and 2005 because mortgage interest rates declined during the first half of 2003, resulting in relatively higher amortization expense.

### *Other expenses*

Other expenses in 2003 included a \$125 million civil money penalty we paid in connection with the OFHEO consent order. We entered into certain multifamily affordable transactions during 2003 that contained a number of contractual incentives, including the payment of fees totaling \$124 million in the third and fourth quarters of 2003 and \$41 million in the first quarter of 2004. We did not enter into similar transactions during 2005.

## **Income Tax Expense**

For 2005, 2004 and 2003, our effective tax rates were 14 percent, 21 percent and 31 percent, respectively. The decrease in the effective tax rate over the past three years is primarily due to the decline in pre-tax income and year-over-year increases in tax credits related to our investments in housing tax credit partnerships and interest earned on tax-exempt securities. Tax benefits associated with our investments in housing tax credit partnerships reduced Income tax expense by \$476 million, \$378 million and \$302 million for 2005, 2004 and 2003, respectively. We expect tax credits resulting from our investments in housing tax credit partnerships to grow in the future. However, our ability to use all of the tax credits generated by existing or future investments in housing tax credit partnerships to reduce our federal income tax liability may be limited, depending on the amount of our future federal income tax liability, which cannot be predicted with certainty.

Our effective tax rate for 2004 benefited from a \$94 million reduction to our tax reserves as a result of a closing agreement we entered into with the Internal Revenue Service relating to the tax treatment of dividends paid on step-down preferred stock issued by our two REIT subsidiaries. In 2003, we recorded a non-tax deductible \$125 million OFHEO civil money penalty and a \$75 million loss contingency reserve described above in “Other expenses,” which increased our effective tax rate.

## CONSOLIDATED BALANCE SHEETS ANALYSIS

The following discussion of our consolidated balance sheets should be read in conjunction with our consolidated financial statements, including the accompanying notes. Also see “CRITICAL ACCOUNTING POLICIES AND ESTIMATES” for more information concerning our significant accounting policies.

### Retained Portfolio

Table 17 provides detail regarding the mortgage loans and mortgage-related securities that comprised our Retained portfolio.

**Table 17 — Characteristics of Mortgage Loans and Mortgage-Related Securities in the Retained Portfolio**

	December 31,					
	2005			2004		
	Fixed Rate	Variable Rate <sup>(1)</sup>	Total	Fixed Rate <sup>(2)</sup>	Variable Rate <sup>(1)(2)</sup>	Total <sup>(2)</sup>
	(in millions)					
Mortgage loans	\$ 56,458	\$ 5,023	\$ 61,481	\$ 56,530	\$ 4,830	\$ 61,360
Guaranteed PCs and Structured Securities: <sup>(3)</sup>						
Single-family	299,188	61,745	360,933	304,555	51,737	356,292
Multifamily	247	144	391	261	145	406
Total Guaranteed PCs and Structured Securities	299,435	61,889	361,324	304,816	51,882	356,698
Non-Freddie Mac mortgage-related securities:						
Agency mortgage-related securities: <sup>(4)</sup>						
Fannie Mae:						
Single-family	28,818	13,180	41,998	41,828	14,504	56,332
Multifamily	1,294	41	1,335	1,589	83	1,672
Ginnie Mae:						
Single-family	1,045	218	1,263	1,599	81	1,680
Multifamily	30	—	30	31	—	31
Total agency mortgage-related securities	31,187	13,439	44,626	45,047	14,668	59,715
Non-agency mortgage-related securities: <sup>(5)</sup>						
Single-family	5,795	180,632	186,427	8,243	115,168	123,411
Commercial mortgage-backed securities	35,860	7,627	43,487	36,791	4,393	41,184
Mortgage revenue bonds <sup>(6)</sup>	11,171	150	11,321	8,945	132	9,077
Manufactured housing <sup>(7)</sup>	1,183	168	1,351	1,289	202	1,491
Total non-agency mortgage-related securities	54,009	188,577	242,586	55,268	119,895	175,163
Total unpaid principal balance of Retained portfolio <sup>(8)</sup>	\$441,089	\$268,928	710,017	\$461,661	\$191,275	652,936
Premiums, discounts, deferred fees and other basis adjustments			2,440			4,039
Net unrealized gains (losses) on mortgage-related securities, pre-tax			(3,551)			6,762
Participation Certificate residuals, at fair value			597			845
Reserve for losses on mortgage loans held-for-investment			(119)			(114)
Total Retained portfolio per consolidated balance sheets			\$709,384			\$664,468

(1) Variable-rate mortgages include mortgages with a current contractual coupon that is scheduled to change prior to contractual maturity, ARMs, and mortgage-related securities backed by ARMs with 1-, 3-, 5-, 7- and 10-year initial fixed-rate periods. Mortgage loans also include mortgages with balloon/reset provisions.

(2) Amounts for 2004 have been revised to conform with the 2005 presentation.

(3) We guarantee the payment of principal and interest on our Guaranteed PCs and Structured Securities and are subject to the credit risk associated with the underlying mortgage loan collateral.

(4) Agency mortgage-related securities are generally not separately rated by credit rating agencies, but are viewed as having a level of credit quality at least equivalent to non-agency mortgage securities rated AAA or equivalent.

(5) Credit rating of most non-agency mortgage-related securities is designated by at least two nationally recognized credit rating agencies.

(6) Consists of obligations of states and political subdivisions. Approximately 66 percent and 72 percent were AAA rated at December 31, 2005 and 2004, respectively.

(7) At December 31, 2005 and 2004, 51 percent and 43 percent, respectively, of mortgage-related securities backed by manufactured housing were rated BBB— or above. For the same dates, 75 percent and 96 percent, respectively, of these securities were supported by third-party credit enhancements (e.g., bond insurance) and other credit enhancements (e.g., deal structure through subordination). Approximately 33 percent were AAA rated at December 31, 2005 and 2004.

(8) Approximately 98 percent and 97 percent were AAA rated at December 31, 2005 and 2004, respectively.

The aggregate carrying value of the loans and securities held in our Retained portfolio increased 7 percent during 2005 while their aggregate unpaid principal balance increased by 9 percent. The aggregate unpaid principal balance of the loans and securities held in our Retained portfolio excludes premiums, discounts, deferred fees and other basis adjustments, the reserve for losses on mortgage loans held-for-investment, and unrealized gains or losses on mortgage-related securities and PC residuals. The non-agency mortgage-related securities portion of the Retained portfolio grew during 2005 in both unpaid principal balance and as a percentage of the total Retained portfolio. This growth was a result of the attractive option-adjusted spreads on, and increased supply of, non-agency mortgage-related securities, particularly variable-rate products, and fewer attractive investment opportunities in agency fixed-rate products. During 2005, strong demand from other investors, combined with fewer mortgage loan originations, generally resulted in unattractive mortgage-to-debt option-adjusted spreads on agency fixed-rate products. Net unrealized gains (losses) on mortgage-related securities, pre-tax was a

loss at December 31, 2005 compared to a gain at December 31, 2004. This change was primarily attributable to rising interest rates.

Table 18 provides additional detail regarding the fair value of mortgage-related securities in the Retained portfolio.

**Table 18 — Fair Value of Available-For-Sale and Trading Mortgage-Related Securities in the Retained Portfolio**

	December 31,		
	2005	2004 (in millions)	2003
Available-for-sale securities:			
Mortgage-related securities issued by:			
Freddie Mac .....	\$351,447	\$352,102	\$384,426
Fannie Mae .....	43,306	59,519	76,844
Ginnie Mae .....	1,115	1,762	2,918
Other .....	231,356	168,058	109,409
Obligations of states and political subdivisions .....	11,241	9,020	7,729
Total available-for-sale mortgage-related securities .....	<u>638,465</u>	<u>590,461</u>	<u>581,326</u>
Trading securities:			
Mortgage-related securities issued by:			
Freddie Mac .....	8,156	11,398	17,590
Fannie Mae .....	534	385	586
Ginnie Mae .....	204	59	24
Total trading mortgage-related securities .....	<u>8,894</u>	<u>11,842</u>	<u>18,200</u>
Total fair value of available-for-sale and trading mortgage-related securities .....	<u>\$647,359</u>	<u>\$602,303</u>	<u>\$599,526</u>

#### Issuers Greater than 10 Percent of Stockholders' Equity

At December 31, 2005, we held Fannie Mae securities in our Retained portfolio with a fair value of \$43.8 billion that represented 161 percent of Total stockholders' equity. No other individual issuer at the individual trust level exceeded 10 percent of Total stockholders' equity at December 31, 2005.

#### Cash and Investments

Table 19 provides additional detail regarding the non-mortgage-related securities that comprised our Cash and investments portfolio.

**Table 19 — Cash and Investments**

	December 31,					
	2005			2004		
	Fair Value	Average Maturity (Months)	% of Portfolio A Rated or Better <sup>(1)</sup>	Fair Value	Average Maturity (Months)	% of Portfolio A Rated or Better <sup>(1)</sup>
	(dollars in millions)					
Cash and cash equivalents .....	\$10,468	<3	N/A	\$35,253	<3	N/A
Investments:						
Non-mortgage-related securities:						
Asset-backed securities <sup>(2)</sup> .....	30,578	N/A	100.0%	21,733	N/A	100.0%
Obligations of states and political subdivisions .....	5,823	282	100.0%	8,097	303	99.7%
Commercial paper .....	5,764	<3	100.0%	—	—	—
Total non-mortgage-related securities .....	<u>42,165</u>		100.0%	<u>29,830</u>		99.9%
Federal funds sold and Eurodollars .....	9,909	<3	N/A	18,647	<3	N/A
Securities purchased under agreements to resell .....	5,250	<3	N/A	13,550	<3	N/A
Subtotal .....	<u>15,159</u>			<u>32,197</u>		
Total investments .....	<u>57,324</u>			<u>62,027</u>		
Total Cash and investments per consolidated balance sheets .....	<u>\$67,792</u>			<u>\$97,280</u>		

(1) Credit ratings for most securities are designated by at least two nationally recognized credit rating agencies.

(2) Consists primarily of securities that can be prepaid prior to their contractual maturity without penalty.

The balance of our Cash and investments portfolio at December 31, 2005 decreased by approximately 30 percent from December 31, 2004. The balance at December 31, 2004 included funds from the liquidation of the portfolios of our SS&TG business unit and external Money Manager program. The decrease in 2005 was also driven by our use of Cash and cash equivalents to return swap collateral to our derivative counterparties, as the fair market value of derivative instruments covered by counterparty collateral arrangements at December 31, 2005 decreased as compared to December 31, 2004. See "RISK MANAGEMENT — Interest-Rate Risk and Other Market Risks — *Derivative-Related Risks* — Derivative Counterparty Credit Risk" for further discussion of these arrangements.

Table 20 provides additional detail regarding the fair value of securities in the Cash and investments portfolio.

**Table 20 — Fair Value of Securities in the Cash and Investments Portfolio<sup>(1)</sup>**

	December 31,		
	2005	2004	2003
	(in millions)		
Available-for-sale securities:			
Non-mortgage-related securities:			
Asset-backed securities	\$30,578	\$21,733	\$16,596
Corporate debt securities	—	—	4,924
Obligations of states and political subdivisions	5,823	8,097	9,494
Commercial paper	5,764	—	150
Preferred stock	—	—	64
Total available-for-sale non-mortgage-related securities	<u>42,165</u>	<u>29,830</u>	<u>31,228</u>
Trading securities:			
Mortgage-related securities issued by:			
Freddie Mac	—	—	17,266
Fannie Mae	—	—	15,052
Ginnie Mae	—	—	490
Other	—	—	9
Total trading mortgage-related securities	<u>—</u>	<u>—</u>	<u>32,817</u>
Non-mortgage-related securities:			
Asset-backed securities	—	—	52
Debt securities issued by the U.S. Treasury and other U.S. government corporations and agencies	—	—	479
Commercial paper	—	—	341
Corporate debt securities	—	—	437
Debt securities issued by foreign governments	—	—	5
Total trading non-mortgage-related securities	<u>—</u>	<u>—</u>	<u>1,314</u>
Total mortgage-related and non-mortgage-related securities	<u>\$42,165</u>	<u>\$29,830</u>	<u>\$65,359</u>

(1) The reduction of trading securities within the Cash and investments portfolio in 2004 was attributable to the liquidation in the fourth quarter of 2004 of securities purchased through our SS&TG business unit and external Money Manager program.

During 2004, we adjusted the investment strategy for the Cash and investments portfolio and as a result, this portfolio did not hold corporate debt securities or preferred stock at December 31, 2005 and 2004, respectively.

## Derivative Assets and Liabilities, at Fair Value

Table 21 summarizes the notional or contractual amounts and related fair value of our total derivative portfolio by product type.

**Table 21 — Total Derivative Portfolio**

	December 31,			
	2005		2004	
	Notional or Contractual Amount <sup>(1)</sup>	Fair Value <sup>(2)</sup>	Notional or Contractual Amount <sup>(1)</sup>	Fair Value <sup>(2)</sup>
	(in millions)			
Interest-rate swaps:				
Pay-fixed	\$181,562	\$ (991)	\$ 95,043	\$(2,879)
Receive-fixed	159,212	756	83,602	2,394
Basis (floating to floating)	234	—	94	1
Total interest-rate swaps	<u>341,008</u>	<u>(235)</u>	<u>178,739</u>	<u>(484)</u>
Option-based:				
Call swaptions	146,615	3,453	189,945	4,988
Put swaptions	34,675	1,200	25,175	267
Other option-based derivatives <sup>(3)</sup>	11,814	(7)	9,084	(3)
Total option-based	<u>193,104</u>	<u>4,646</u>	<u>224,204</u>	<u>5,252</u>
Futures <sup>(4)</sup>	86,252	19	129,110	(33)
Foreign-currency swaps	37,850	2,124	56,850	10,303
Interest-rate caps	45	—	9,897	5
Subtotal	<u>658,259</u>	<u>6,554</u>	<u>598,800</u>	<u>15,043</u>
Commitments	21,961	(44)	32,952	(9)
Credit derivatives	2,414	(1)	10,926	(2)
Swap guarantee derivatives	738	(2)	408	(1)
Prepayment management agreement	—	—	113,692	—
Total derivative portfolio	<u>\$683,372</u>	<u>\$6,507</u>	<u>\$756,778</u>	<u>\$15,031</u>

(1) Notional or contractual amounts are used to calculate the periodic amounts to be received and paid and generally do not represent actual amounts to be exchanged or directly reflect our exposure to institutional credit risk. Notional or contractual amounts are not recorded as assets or liabilities on our consolidated balance sheets.

(2) The fair value by derivative type presented on this table is shown prior to netting by counterparty. The fair value of derivatives presented on the consolidated balance sheets, however, is netted by counterparty, and is reported in the Derivative assets, at fair value and Derivative liabilities, at fair value captions. The fair values for futures are directly derived from quoted market prices. Fair values of other derivatives are derived primarily from valuation models using market data inputs.

(3) Primarily represents written options, including guarantees of stated final maturity of issued Structured Securities and written call options on PCs we issued (see “NOTE 4: FINANCIAL GUARANTEES” to our consolidated financial statements for more information).

(4) Includes Treasury futures notional amounts of \$— million and \$2,001 million at December 31, 2005 and 2004, respectively.

The carrying value of our derivative assets and liabilities on our consolidated balance sheets is equal to their fair value, which is affected by changes in market conditions such as the level and expected volatility of interest rates. The composition of our derivative portfolio will change from period to period as a result of derivative purchases, terminations prior to contractual maturity and expiration of the derivatives at their contractual maturity. We record changes in fair values of our derivatives in current income or, to the extent our accounting hedge relationships are effective, we may defer those changes in AOCI or offset them by basis adjustments to the related hedged item. As a result, the increases or decreases in fair value by derivative categories will not correspond directly to Derivative gains (losses) or Hedge accounting gains (losses) on our consolidated statements of income.

The fair value of the total derivative portfolio declined in 2005 due to a decline in the fair value of foreign-currency swaps used primarily to hedge Euro-denominated debt as the U.S. dollar strengthened relative to the Euro during the year. The notional balance of our total derivative portfolio declined by \$73.4 billion during 2005 as a result of the termination of our prepayment management agreement at December 31, 2005 and a change in the composition of our derivative portfolio. The composition of our derivative portfolio changed with an increase in the notional balance of interest-rate swaps, offset by decreases in the notional balance of call swaptions, futures and foreign-currency swaps. Several factors contributed to this change in derivative composition. The asset mix in the Retained portfolio has moved toward a greater proportion of non-agency, variable-rate mortgage-related securities, which generally require less interest-rate protection than fixed-rate products. Also, the gradual increase in market interest rates and the flattening of the yield curve in 2005 has reduced the interest-rate risk of our existing fixed-rate investments, thereby reducing our need for call swaptions to manage the related risk. In addition, during 2005 and 2004, we sought to offset the prepayment risk in the Retained portfolio by increasing the amount of our callable debt outstanding.

The notional balance of our interest-rate swaps increased in the aggregate during 2005. Due to the flattening of the yield curve and generally higher interest rates in 2005, we entered into pay-fixed swaps with relatively short maturities to offset our yield curve exposure. The notional balance of receive-fixed swaps increased primarily as a result of economic hedging



activities related to our callable debt securities outstanding. Callable debt gives us the option to redeem the debt security on one or more specified call dates or at anytime on or after a specified call date. We employ receive-fixed swaps to protect against a decline in interest rates until the specified call date and in between specified call dates. As a result of changes in the composition of our debt securities issued, we also reduced the notional balance of our call swaptions during 2005. The notional balance of our futures declined in 2005 primarily because we reduced our position in Eurodollar future contracts held for risk-management purposes in response to movements in short-term rates. The notional balance of our foreign-currency swaps declined due to maturities of such swaps throughout 2005 that were not replaced by new contracts.

Table 22 summarizes the changes in derivative fair values.

**Table 22 — Changes in Derivative Fair Values**

	December 31,	
	2005	2004
	(in millions)	
Beginning balance, at January 1 — Net asset (liability) .....	\$15,031	\$15,823
Net change in:		
Futures .....	52	(214)
Commitments .....	(35)	221
Credit derivatives .....	1	(7)
Swap guarantee derivatives .....	(1)	(1)
Other derivatives: <sup>(1)</sup>		
Changes in fair value .....	(8,486)	(627)
Fair value of new contracts entered into during the period <sup>(2)</sup> .....	2,522	1,733
Contracts realized or otherwise settled during the period .....	(2,577)	(1,897)
Ending balance, at December 31 — Net asset (liability) .....	<u>\$ 6,507</u>	<u>\$15,031</u>

(1) Includes fair value changes for over-the-counter, or OTC, interest-rate swaps, option-based derivatives, foreign-currency swaps and interest-rate caps.

(2) Consists primarily of cash premiums paid or received on options and the initial value of interest-rate swaps after we have exercised related swaptions.

Table 23 shows the fair value for each derivative type and the maturity profile of our derivative positions. The fair value of a longer-term derivative generally will vary more over time than a comparable derivative with a shorter term. A positive fair value in Table 23 for each derivative type is the estimated amount, prior to netting by counterparty, that we would be entitled to receive if we terminated the derivatives of that type. A negative fair value for a derivative type is the estimated amount, prior to netting by counterparty, that we would owe if we terminated the derivatives of that type. See Table 35 under “RISK MANAGEMENT — Interest-Rate Risk and Other Market Risks” for additional information regarding derivative counterparty credit exposure. Table 23 also provides the weighted-average fixed rate of our pay-fixed and receive-fixed swaps.

**Table 23 — Derivative Fair Values and Maturities**

	December 31, 2005				
	Total Fair Value	Fair Value <sup>(1)</sup>			
		Less than 1 Year	1 to 3 Years	Greater than 3 and up to 5 Years	In Excess of 5 Years
		(dollars in millions)			
Interest-rate swaps:					
Pay-fixed:					
Swaps	\$ 882	\$ 23	\$ 551	\$ 376	\$ (68)
Weighted-average fixed rate		4.02%	4.25%	4.56%	4.94%
Forward-starting swaps <sup>(2)</sup>	(1,873)	—	—	—	(1,873)
Weighted-average fixed rate		—	—	—	6.05%
Total pay-fixed	(991)	23	551	376	(1,941)
Receive-fixed:					
Swaps	756	(147)	(344)	395	852
Weighted-average fixed rate		3.95%	4.22%	4.69%	5.07%
Total receive-fixed	756	(147)	(344)	395	852
Total interest-rate swaps	(235)	(124)	207	771	(1,089)
Option-based:					
Call swaptions	3,453	86	877	406	2,084
Put swaptions	1,200	7	—	124	1,069
Other option-based derivatives	(7)	—	—	—	(7)
Total option-based	4,646	93	877	530	3,146
Futures	19	19	—	—	—
Foreign-currency swaps	2,124	297	144	1,178	505
Commitments	(44)	(44)	—	—	—
Swap guarantee derivatives	(2)	—	—	—	(2)
Subtotal	6,508	\$ 241	\$ 1,228	\$ 2,479	\$ 2,560
Credit derivative	(1)				
Total	\$ 6,507				

(1) Fair value is categorized based on the years from December 31, 2005 until the contractual maturity of the derivative.

(2) Represents interest-rate swap agreements scheduled to begin on a future date.

### Guarantee Asset

Table 24 summarizes the changes in our Guarantee asset balance.

**Table 24 — Changes in Guarantee Asset**

	December 31,	
	2005	2004
	(in millions)	
Beginning balance, at January 1	\$4,516	\$3,686
Additions, net of repurchases	1,631	1,965
Gains (losses) on Guarantee asset <sup>(1)</sup>	(1,064)	(1,135)
Ending balance, at December 31	\$5,083	\$4,516

(1) Individual guarantee assets are marked to fair value based on the related PCs or Structured Securities. Consequently, the fair value of some guarantee assets increases, while the fair value of other guarantee assets decreases.

In 2005 and 2004, the primary drivers affecting the net increase in our Guarantee asset balance were our business volumes and changes in mortgage interest rates. Additions, net of repurchases declined from 2004 primarily because net repurchases of PCs and Structured Securities into the Retained portfolio increased by approximately 28 percent in 2005 as compared to 2004 (based on unpaid principal balances).

## Total Debt Securities, Net

Table 25 reconciles the par value of our debt securities to the amounts shown on our consolidated balance sheets.

**Table 25 — Reconciliation of the Par Value of Total Debt Securities to the Consolidated Balance Sheets**

	December 31,	
	2005	2004
	(in millions)	
Total debt securities:		
Par value <sup>(1)</sup>	\$780,382	\$749,219
Unamortized balance of discounts and premiums <sup>(2)</sup>	(39,338)	(33,899)
Foreign-currency-related and hedging-related basis adjustments <sup>(3)</sup>	7,748	16,377
Total debt securities, net per consolidated balance sheets	<u>\$748,792</u>	<u>\$731,697</u>

(1) Includes securities sold under agreements to repurchase and Federal funds purchased and swap collateral obligations.

(2) Primarily represents unamortized discounts on zero-coupon debt securities. Also, includes accrued interest payable on swap collateral obligations.

(3) Primarily represents the mark-to-market of foreign-currency debt that is in hedge accounting relationships. Balance will fluctuate due to a number of factors, primarily the U.S. dollar to Euro exchange rate.

Total debt securities, net increased by approximately \$17.1 billion during 2005 while the par value of outstanding debt securities increased by \$31.2 billion as a result of our net issuance of Medium-term Notes, partially offset by reductions in swap collateral obligations. The increase in par value was offset by increases in the unamortized balance of net discounts, and a decline in foreign-currency-related and hedging-related basis adjustments. During 2005, the par value of our callable Medium-term Notes increased by \$26.3 billion, resulting from issuances of \$88.8 billion offset by calls, maturities and repurchases. In 2005, we issued more callable fixed-rate debt as part of our effort to reduce the liquidity risk of short-term debt at a time when relative funding costs across our credit curve were more attractive. Our foreign-currency-related and hedging-related basis adjustments declined during 2005 primarily due to fluctuations in foreign-currency exchange rates. See “LIQUIDITY AND CAPITAL RESOURCES” for further discussion of our debt management activities.

Table 26 summarizes our Senior debt, due within one year.

**Table 26 — Senior Debt, Due Within One Year**

	2005				
	December 31,		Average Outstanding During the Year		Maximum Balance, Net Outstanding at Any Month End
	Balance, Net <sup>(1)</sup>	Weighted Average Effective Rate <sup>(2)</sup>	Balance, Net <sup>(3)</sup>	Weighted Average Effective Rate <sup>(4)</sup>	
	(dollars in millions)				
Reference Bills® securities and discount notes	\$181,468	4.00%	\$181,878	3.11%	\$194,578
Medium-term Notes	2,032	4.17	850	3.35	2,032
Securities sold under agreements to repurchase and Federal funds purchased	450	4.26	267	3.08	1,000
Swap collateral obligations	8,768	4.30	10,374	3.14	13,533
Hedging-related basis adjustments	(5)	N/A			
Short-term debt securities	192,713	4.02			
Current portion of long-term debt	95,819	3.42			
Senior debt, due within one year	<u>\$288,532</u>	3.82			

	2004				
	December 31,		Average Outstanding During the Year		Maximum Balance, Net Outstanding at Any Month End
	Balance, Net <sup>(1)</sup>	Weighted Average Effective Rate <sup>(2)</sup>	Balance, Net <sup>(3)</sup>	Weighted Average Effective Rate <sup>(4)</sup>	
	(dollars in millions)				
Reference Bills® securities and discount notes	\$180,198	2.04%	\$184,834	1.40%	\$212,715
Medium-term Notes	162	2.51	4,289	1.31	5,320
Securities sold under agreements to repurchase and Federal funds purchased	—	—	801	1.37	3,046
Swap collateral obligations	16,279	2.24	13,549	1.36	16,279
Short-term debt securities	196,639	2.05			
Current portion of long-term debt	85,664	3.33			
Senior debt, due within one year	<u>\$282,303</u>	2.44			

	2003				
	December 31,		Average Outstanding During the Year		Maximum Balance, Net Outstanding at Any Month End
	Balance, Net <sup>(1)</sup>	Weighted Average Effective Rate <sup>(2)</sup>	Balance, Net <sup>(3)</sup>	Weighted Average Effective Rate <sup>(4)</sup>	
			(dollars in millions)		
Reference Bills® securities and discount notes .....	\$188,309	1.12%	\$207,374	1.21%	\$264,370
Medium-term Notes .....	5,300	1.18	1,243	1.32	5,300
Securities sold under agreements to repurchase and Federal funds purchased .....	1,611	0.96	2,283	0.94	8,296
Swap collateral obligations .....	16,082	1.02	11,694	1.13	16,082
Securities sold, not yet purchased .....	733	N/A			
Short-term debt securities .....	212,035	1.11			
Current portion of long-term debt .....	83,227	3.61			
Senior debt, due within one year .....	<u>\$295,262</u>	1.81			

(1) Represents par value, net of associated discounts or premiums. Swap collateral obligations include the related accrued interest payable.

(2) Represents the weighted average effective rate at the end of the period, which includes the amortization of discounts or premiums and issuance costs, but excludes the amortization of foreign-currency-related and hedging-related basis adjustments.

(3) Includes unamortized discounts or premiums and issuance costs. Issuance costs are reported in the Other assets caption on our consolidated balance sheets.

(4) Represents the approximate weighted average effective rate during the period, which includes the amortization of discounts or premiums and issuance costs, but excludes the amortization of foreign-currency-related and hedging-related basis adjustments.

## Guarantee Obligation

Table 27 summarizes the changes in the Guarantee obligation balance.

**Table 27 — Changes in the Guarantee Obligation**

	December 31,	
	2005	2004
	(in millions)	
Beginning balance, at January 1 .....	\$4,065	\$2,904
Transfer-out to the loan loss reserve <sup>(1)</sup> .....	(10)	(13)
Additions, net of repurchases:		
Fair value of newly-issued guarantee obligations <sup>(2)</sup> .....	1,629	1,174
Deferred gains on newly-executed guarantees <sup>(3)</sup> .....	777	732
Amortization income related to:		
Credit and buy-down fees received <sup>(4)</sup> .....	(197)	(128)
Initial fair value of contractual guarantee fees .....	(723)	(604)
Income on Guarantee obligation .....	(920)	(732)
Ending balance, at December 31 .....	<u>\$5,541</u>	<u>\$4,065</u>
Components of the Guarantee obligation, at period end:		
Unamortized balance that is attributable to credit and buy-down fees received in FIN 45 transactions <sup>(4)</sup> .....	\$1,167	\$ 940
Unamortized balance that is attributable to the other components of the Guarantee obligation .....	4,374	3,125
Ending Guarantee obligation .....	<u>\$5,541</u>	<u>\$4,065</u>

(1) Represents portions of the Guarantee obligation recognized upon the sale of PCs or Structured Securities that correspond to incurred credit losses reclassified to Reserve for guarantee losses on Participation Certificates at initial recognition of a Guarantee obligation.

(2) Includes the fair value of the Guarantee obligation that was recognized in connection with transfers of PCs and Structured Securities that qualified as sales, as well as the fair value of the Guarantee obligation recognized that related to PCs and Structured Securities issued in Guarantor Swaps and other similar transactions subject to FIN 45. The amount is presented net of reductions attributable to purchases of PCs and Structured Securities.

(3) Represents the excess of recognized consideration received on guarantee transactions that are accounted for pursuant to the requirements of FIN 45 over the recognized fair value of the corresponding Guarantee obligation. Consideration received includes the contractual right to receive guarantee fees, various credit enhancements for which we are the named beneficiary and upfront cash payments that relate to credit and buy-down fees.

(4) Relates to upfront cash payments in the form of credit fees and buy-down payments that are received from counterparties to guarantee transactions that are accounted for pursuant to FIN 45 (e.g., Guarantor Swaps).

In 2005, the Guarantee obligation increased due to business volume, the application of a new approach for estimating the initial fair value of the Guarantee obligation and generally increasing mortgage interest rates during the year resulting in lower liquidation rates on outstanding PCs and Structured Securities and lower rates of amortization. In addition, in 2004, the Guarantee obligation increased due to business volume. See “NOTE 2: TRANSFERS OF SECURITIZED INTERESTS IN MORTGAGE-RELATED ASSETS” for a discussion of our approach for estimating the initial fair value of the Guarantee obligation.

## Total Stockholders’ Equity

The balance of Total stockholders’ equity as presented on our consolidated balance sheets declined in 2005 primarily as a result of an increase in net unrealized losses on available-for-sale securities, which are a component of the AOCI balance, partially offset by an increase in Retained earnings. The driver of the increase in Retained earnings was net income earned in 2005, partially offset by preferred and common stock dividends declared during 2005. Common stock dividends were higher in 2005 due to increases in quarterly dividends declared by our board of directors in March and December of 2005.

The balance of AOCI at December 31, 2005 was a loss of approximately \$8.8 billion, net of tax, compared to a loss of \$3.6 billion, net of tax, at December 31, 2004. This decline in the AOCI balance was primarily the result of changes in the mark-to-fair value of our available-for-sale securities. Our available-for-sale securities are primarily funded with debt securities which are recorded at amortized cost. As interest rates rose during 2005, the balance of AOCI related to available-for-sale securities shifted to a net unrealized loss position from a net unrealized gain position at December 31, 2004. The balance of AOCI associated with our available-for-sale securities was a loss of approximately \$2.5 billion, net of tax, at December 31, 2005 compared to a gain of \$4.3 billion, net of tax, at December 31, 2004. The decline in the AOCI balance associated with our available-for-sale securities was partially offset by the recognition of deferred losses in AOCI related to derivatives in cash flow hedge accounting relationships. The balance of net deferred losses in AOCI related to derivatives in cash flow hedge relationships was a loss of \$6.3 billion, net of tax, at December 31, 2005 compared to a loss of \$7.9 billion, net of tax, at December 31, 2004.

At December 31, 2005, \$668 million notional amount of derivative contracts was designated in cash flow hedge relationships, consisting of \$534 million notional amount of foreign-currency swaps and \$134 million notional amount of commitments. For derivatives that receive cash flow hedge accounting treatment, the effective portion of the change in fair value of the derivative asset or derivative liability is presented in the stockholders' equity section of our consolidated balance sheets in AOCI, net of taxes. The effective portion of the derivative generally offsets, on a cumulative basis, the cumulative change in the present value of the hedged cash flows.

At December 31, 2005, the net cumulative change in the fair value of all derivatives designated in cash flow hedge relationships for which the forecasted transactions had not yet affected earnings since SFAS 133 was implemented on January 1, 2001 (net of amounts previously reclassified to earnings through December 31, 2005) or that were still open was a loss of approximately \$6.3 billion on an after-tax basis. This amount related almost entirely to net deferred losses on closed cash flow hedge relationships, which involve derivatives that have been terminated or are no longer designated in cash flow hedge relationships. The majority of the closed cash flow hedges related to the hedging of the variability of cash flows from forecasted issuances of debt. Fluctuations in prevailing market interest rates have no impact on the deferred portion of AOCI, net of taxes, relating to losses on closed cash flow hedges. Therefore, the deferred losses related to closed cash flow hedges will be recognized as a reduction of earnings as the originally hedged forecasted transactions affect earnings, unless it becomes probable that the forecasted transaction will not occur. If it is probable that the forecasted transaction will not occur, then the entire deferred amount associated with the forecasted transaction will be reclassified into earnings immediately.

Of the \$6.3 billion net unrealized loss included in AOCI, net of taxes, with respect to cash flow hedge relationships at December 31, 2005, approximately \$5.9 billion relates to hedges associated with the forecasted issuances of non-callable debt securities with maturities or interest payment frequencies of approximately one month to one year. Such debt issuances are forecasted over the next 28 years; however, over 90 percent of the deferred losses relates to such issuances over the next 10 years. Over the next 10 years, the forecasted debt issuances associated with these hedges range from approximately \$24 billion to \$105 billion in any one quarter, with an average of \$74 billion per quarter.

Table 28 presents the scheduled amortization of the net deferred losses in AOCI at December 31, 2005, related to closed cash flow hedges based on a number of hypothetical assumptions that may differ from our expectations of future events or from actual future events. It is likely that actual amortization in any given future period will differ from the scheduled amortization presented in Table 28, perhaps materially, as we make decisions or changes in market conditions occur that differ from these assumptions. For example, the scheduled amortization for cash flow hedges related to future debt issuances is based on the assumption that we will not repurchase the related debt and that no other factors affecting debt issuance probabilities will change. In addition, for forward purchase commitments in closed cash flow hedge relationships, the scheduled amortization assumes no changes in prepayment activities or other factors affecting the timing of reclassifications.



**Table 28 — Scheduled Amortization of Net Deferred Losses in AOCI to Income Related to Closed Cash Flow Hedge Relationships**

Period of Scheduled Amortization to Income	December 31, 2005	
	Amount (Pre-tax)	Amount (After-tax)
	(in millions)	
2006 .....	\$ (1,969)	\$ (1,280)
2007 .....	(1,462)	(950)
2008 .....	(1,329)	(864)
2009 .....	(1,105)	(718)
2010 .....	(912)	(593)
2011 to 2015 .....	(2,156)	(1,401)
Thereafter .....	(746)	(485)
Net deferred losses in AOCI related to closed cash flow hedge relationships .....	(9,679)	(6,291)
Net deferred gains in AOCI related to open cash flow hedge relationships .....	7	4
Total AOCI related to cash flow hedge relationships .....	<u>\$ (9,672)</u>	<u>\$ (6,287)</u>

### CONSOLIDATED FAIR VALUE BALANCE SHEETS ANALYSIS

Our consolidated fair value balance sheets include the estimated fair values of financial instruments recorded in our consolidated balance sheets prepared in accordance with GAAP, as well as off-balance sheet financial instruments that represent our assets or liabilities that are not recorded in our GAAP consolidated balance sheets. These off-balance sheet items predominantly consist of: (a) the unrecognized Guarantee asset and Guarantee obligation associated with our PCs issued through our Guarantor Swap program prior to the implementation of FIN 45, (b) commitments to purchase multifamily and single-family mortgage loans that will be classified as held-for-investment in our GAAP consolidated financial statements and (c) certain credit enhancements on manufactured housing asset-backed securities. See “OFF-BALANCE SHEET ARRANGEMENTS” and “CRITICAL ACCOUNTING POLICIES AND ESTIMATES” as well as “NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES” and “NOTE 16: FAIR VALUE DISCLOSURES” to our consolidated financial statements for more information on fair values.

In conjunction with the preparation of our consolidated fair value balance sheets, we use a number of financial models. See “RISK MANAGEMENT — Operational Risks” and “RISK MANAGEMENT — Interest-Rate Risk and Other Market Risks” for information concerning the risks associated with these models.

#### Key Components of Changes in Fair Value of Net Assets

Changes in the fair value of net assets from period to period result from returns (measured on a fair value basis) and capital transactions and are attributable to changes in a number of key components:

##### *Core spread income*

Core spread income on the Retained portfolio is a fair value estimate of the net current period accrual of income from the spread between mortgage-related investments and debt, calculated on an option-adjusted basis. An option-adjusted spread, or OAS, is an estimate of the yield spread between a given security and a benchmark (LIBOR, agency or Treasury) yield curve, after consideration of variability in the security’s cash flows across different potential future interest rate scenarios resulting from any options embedded in the security, such as prepayment options.

##### *Changes in mortgage-to-debt OAS*

The fair value of our net assets can be significantly affected from period to period by changes in the net OAS between the mortgage and agency debt sectors. The fair value impact of changes in OAS for a given period represents an estimate of the net unrealized increase or decrease in fair value of net assets arising from net fluctuations in OAS during that period between our mortgage asset holdings and our outstanding debt securities. We do not attempt to hedge or actively manage the impact of changes in mortgage-to-debt OAS because we generally hold a substantial portion of our mortgage assets for the long term and we do not believe that periodic increases or decreases in the fair value of net assets arising from fluctuations in OAS will significantly affect the long-term value of the Retained portfolio. Our estimate of the effect of changes in OAS excludes the impact of other market risk factors, primarily duration and convexity risk, yield curve risk, volatility risk and basis risk, the majority of which we actively manage, or economically hedge, to keep interest-rate risk exposure within prescribed limits. The estimated impacts of these other market risk factors are subsumed within the “Return on risk positions” component discussed below.

##### *Return on risk positions*

Return on risk positions represents the estimated net increase or decrease in the fair value of net assets resulting from net exposures related to the market risks we actively manage. The types of market risks to which we are exposed as a result of our Retained portfolio activities include duration and convexity risks, yield curve risk, volatility risk and basis risk. We

actively manage, or hedge, the majority of these risks to keep interest-rate risk exposures within prescribed limits. We do not, however, hedge all interest-rate risk that exists at the time a mortgage is purchased or that arises over its life. Therefore, in the normal course of business, we consistently have a limited net exposure to these risks, which will result in a net increase or decrease in fair value for a given period. See “RISK MANAGEMENT — Interest-Rate Risk and Other Market Risks” for more information.

#### *Core guarantee fees, net*

Core guarantee fees, net represents the annual income of the credit guarantee portfolio, based on current portfolio characteristics and market conditions. This estimate considers both contractual guarantee fees collected over the life of the credit guarantee portfolio and credit-related delivery fees collected up-front when pools are formed, and associated costs and obligations which include default and capital costs.

#### *Change in the fair value of the guarantee portfolio*

Change in the fair value of the guarantee portfolio represents the estimated impact on the fair value of the credit guarantee business of additions to the portfolio (net difference between the fair values of the Guarantee asset and Guarantee obligation recorded when pools are formed) plus the effect of changes in interest rates and other market factors (*e.g.*, impact of the passage of time on cash flow discounting and changes in projections of the future credit outlook) on the fair value of the existing credit guarantee portfolio. In 2005, we changed our method for estimating the fair values of the Guarantee asset and Guarantee obligation. See “NOTE 2: TRANSFERS OF SECURITIZED INTERESTS IN MORTGAGE-RELATED ASSETS” to our consolidated financial statements for additional information.

We generally do not hedge changes in the fair value of our existing credit guarantee portfolio, with two exceptions discussed below. While periodic changes in the fair value of the guarantee portfolio may have a significant impact on the fair value of net assets, we believe that changes in the fair value of our existing guarantee portfolio are not the best indication of long-term fair value expectations because such changes do not reflect our expectation that, over time, replacement business will largely replenish guarantee fee income lost because of prepayments.

We hedge interest-rate exposure related to net buy-ups (up-front payments made by us that increase the guarantee fee that we will receive over the life of the pool) and float (expected gains or losses resulting from our mortgage security program remittance cycles). However, these value changes are excluded from our estimate of the change in fair value of the guarantee portfolio, so that it reflects only the impact of changes in interest rates and other market factors on the unhedged portion of the projected cash flows from the credit guarantee business. The value changes associated with net buy-ups and float are considered in return on risk positions (defined above) because they relate to hedged positions.

#### *Fee income*

Fee income includes miscellaneous fees, such as resecuritization fees, fees generated by our automated underwriting service and delivery fees on some mortgage purchases.

### **Discussion of Fair Value Results**

We believe fair value measures provide an important view of our business economics and risks because fair value takes a consistent approach to the representation of substantially all financial assets and liabilities, rather than an approach that combines historical cost and fair value measurements, as is the case with our GAAP-based consolidated financial statements. We use estimates of fair value on a routine basis to make decisions about our business activities. In addition, we use fair value derived performance measures to establish corporate objectives and as a factor in determining management compensation. Our consolidated fair value balance sheets are an important component of our risk management processes, as we use estimates of the changes in fair value to calculate our PMVS and duration gap measures.

#### *Discussion of the estimated impact of mortgage-to-debt OAS on fair value results*

We believe disclosing the impact of changes in mortgage-to-debt OAS on the fair value of net assets is helpful to understanding our current period fair value results in the context of our long-term fair value return expectation. Our long-term expectation is to generate returns, before capital transactions, over time on the average fair value of net assets attributable to common stockholders in the low- to mid-teens. In discussing this long-term expectation, we qualify it by noting that period-to-period returns may fluctuate substantially due to market conditions. These market conditions include changes in interest rates and other market factors that affect certain components of our fair value changes, including those which we do not attempt to hedge or actively manage — specifically, the change in mortgage-to-debt OAS with respect to our Retained portfolio and the change in the fair value of the single-family guarantee portfolio.

Our estimate of the periodic increases or decreases in the fair value of net assets associated with fluctuations in option-adjusted spreads provides insight into a component of our fair value results that we do not believe will significantly affect the

long-term fair value of the Retained portfolio. This belief is based on our expectation that differences between the prepayments forecasted by our models and the actual prepayments we will experience are not likely to be significant.

During the year ended December 31, 2005, the fair value of net assets attributable to common stockholders, before capital transactions, increased by \$1.0 billion. We estimate that this \$1.0 billion is net of a decrease of approximately \$1.3 billion due to the net widening of mortgage-to-debt OAS.

#### *How we estimate the impact of mortgage-to-debt OAS on fair value results*

The method we have chosen to estimate the OAS impact is to fully revalue the fair value of identified financial instruments for a given period using the OAS level from the end of the previous period and subtract the revalued amount from the estimated fair value of those instruments. We make this calculation as of the end of each month and sum these monthly results into quarterly and annual estimates. To achieve consistency month-to-month, we use the smaller unpaid principal balance for a given instrument between months so that we are measuring the OAS impact on constant positions, with newly acquired positions excluded entirely during the month of acquisition.

For certain financial instruments in the Retained portfolio that affect our total change in fair value of net assets, we did not estimate the impact of changes in OAS on fair value. We did not estimate the impact of changes in OAS for single-family and multifamily whole loans because we do not have a reliable methodology for estimating OAS impacts on these loans at this time. We did not estimate the impact of changes in OAS for certain other instruments, including mortgage revenue bonds, other securities and LIBOR-based derivatives, because an OAS measured in relation to LIBOR is not relevant for these instruments. The Retained portfolio instruments for which we did not estimate an impact of the changes in OAS represent approximately 17 percent of our total Retained portfolio. The funding instruments (including preferred stock) for which we did not estimate an impact of the changes in OAS represent approximately 9 percent of our total debt and preferred stock securities. The majority of this 9 percent was short-term debt instruments with maturities less than thirty days.

The impact of changes in OAS on fair value should be understood as an estimate rather than a precise measurement. To estimate the impact of OAS, we use models that involve the forecast of interest rates, prepayment behavior and other inputs. We also make assumptions about a variety of factors, including macroeconomic and security-specific data, interest-rate paths, cash flows and prepayment rates. We use these models and assumptions in running our business, and we rely on many of the models in producing our financial statements and measuring, managing and reporting interest-rate and other market risks. The use of different estimation methods or the application of different assumptions could result in a materially different estimate.

#### *Understanding our estimate of the impact of mortgage-to-debt OAS on fair value results*

A number of important qualifications apply to our disclosed estimates. The estimated impact of the change in option-adjusted spreads on the fair value of our net assets in any given period does not depend on other components of the change in fair value. Although the net fair value of our financial instruments will generally move toward their par values as the instruments approach maturity, investors should not expect that the effect of past changes in OAS will necessarily reverse through future changes in OAS. To the extent that actual prepayment or interest rate distributions differ from the forecasts contemplated in our models, changes in values reflected in mortgage-to-debt OAS may not be recovered in fair value returns at a later date.

When the OAS on a given asset widens, the fair value of that asset will typically decline, all other things being equal. However, we believe such OAS widening has the effect of increasing the likelihood that, in future periods, we will recognize income at a higher spread on this existing asset. The reverse is true when the OAS on a given asset tightens — current period fair values for that asset typically increase due to the tightening in OAS, while future income recognized on the asset is more likely to be earned at a reduced spread. Although a widening of OAS is generally accompanied by lower current period fair values, it can also provide us with greater opportunity to purchase new assets for our Retained portfolio at the wider mortgage-to-debt OAS. (Again, the reverse can be true when OAS tightens.)

For these reasons, our estimate of the impact of the change in OAS provides information regarding one component of the change in fair value for the particular period being evaluated, but results for a single period should not be used to extrapolate long-term fair value returns. We believe the potential fair value return of our business over the long term depends primarily on our ability to add new assets at attractive mortgage-to-debt OAS and to effectively manage over time the risks associated with these assets, as well as those of our existing portfolio to ensure that we realize anticipated returns on our business. In other words, to capture the fair value returns we expect, we have to apply accurate estimates of future

prepayment rates and other performance characteristics at the time we purchase assets, and then manage successfully the range of market risks associated with a debt-funded mortgage portfolio over the life of these assets.

## **LIQUIDITY AND CAPITAL RESOURCES**

### **Liquidity**

Our business activities require that we maintain adequate liquidity to make payments upon the maturity or repurchase of our debt securities, purchase mortgage loans, mortgage-related securities and other investments, make payments of principal and interest on our debt securities and on our guaranteed PCs and Structured Securities, make net payments on derivative instruments, fund our general operations and pay dividends on our preferred and common stock.

We fund our cash requirements primarily by issuing short-term and long-term debt. Other sources of cash include:

- receipts of principal and interest payments on securities we hold or mortgage loans we have securitized and sold;
- sales of securities we hold;
- borrowings against mortgage-related securities and other investment securities we hold;
- other cash flows from operating activities, including guarantee activities; and
- issuances of common and preferred stock.

We measure our cash position on a daily basis, netting uses of cash with sources of cash. We manage the net cash position over a rolling forecasted 90-day period, with the goal of providing the amount of debt funding needed to cover expected net cash outflows without adversely affecting our overall funding levels. We maintain alternative sources of liquidity to allow normal operations for 90 days without relying upon issuance of unsecured debt and comply with industry practices of sound liquidity management. We conduct our daily liquidity management activities in accordance with our October 2000 Liquidity Management and Contingency Planning commitment, incorporated into our agreement with OFHEO in September 2005. See “RISK MANAGEMENT AND DISCLOSURE COMMITMENTS” for further information.

The Federal Reserve Board has revised its payments system risk policy, effective beginning in July 2006, to restrict or eliminate daylight overdrafts by GSEs in connection with their use of the Fedwire system. The revised policy also includes a requirement that the GSEs fully fund their accounts in the system to the extent necessary to cover payments on their debt and mortgage-related securities each day, before the Federal Reserve Banks, acting as fiscal agents for the GSEs, will initiate such payments. We are taking actions to fully fund our account as necessary and we believe that these revisions to the Federal Reserve’s policies will not have a material adverse effect on our liquidity.

To fund our business activities, we depend substantially on the continuing willingness of investors to purchase our debt securities. Any change in applicable legislative or regulatory exemptions, including those described in “REGULATION AND SUPERVISION” could adversely affect our access to some debt investors, thereby potentially increasing our debt funding costs. However, because of our financial performance and our regular and significant participation as an issuer in the capital markets, our sources of liquidity have remained adequate to meet our needs and we anticipate that they will continue to be so.

Under our charter, the Secretary of the Treasury has discretionary authority to purchase our obligations up to a maximum of \$2.25 billion principal balance outstanding at any one time. However, we do not rely on this authority as a source of liquidity to meet our obligations.

Depending on market conditions and the mix of derivatives we employ in connection with our ongoing risk management activities, our derivative portfolio can be either a net source or a net use of cash. For example, depending on the prevailing interest-rate environment, interest-rate swap agreements could cause us either to make interest payments to counterparties or to receive interest payments from counterparties. Purchased options require us to pay a premium while written options allow us to receive a premium.

We are required to pledge collateral to third parties in connection with secured financing and daily trade activities. In accordance with contracts that we voluntarily entered into with certain derivative counterparties, we post collateral to those counterparties for derivatives in a net loss position, after netting by counterparty, above agreed-upon posting thresholds. See “NOTE 5: RETAINED PORTFOLIO AND CASH AND INVESTMENTS PORTFOLIO” to our consolidated financial statements for information about assets we pledge as collateral.

We are involved in various legal proceedings, including those discussed in “NOTE 13: LEGAL CONTINGENCIES” to our consolidated financial statements, which may result in a use of cash.

### ***Debt Securities***

We fund our operating cash needs and finance our purchases of mortgage loans, mortgage-related securities and non-mortgage-related securities held in our Retained portfolio and Cash and investments portfolio primarily through the issuance of short-term and long-term debt. Table 29 below summarizes the par value of the debt securities we issued (based



on settlement dates) during 2005 and 2004. We seek to maintain a variety of consistent, active funding programs that promote high-quality coverage by market makers and reach a broad group of institutional and retail investors. By diversifying our investor base and the types of debt securities we offer, we believe we enhance our ability to maintain continuous access to the debt markets under a variety of conditions.

**Table 29 — Debt Security Issuances by Product, at Par Value<sup>(1)</sup>**

	Year Ended December 31,	
	2005	2004
	(in millions)	
Short-term debt:		
Reference Bills® securities and discount notes	\$826,253	\$793,462
Medium-term Notes — Callable	1,745	145
Medium-term Notes — Non-callable	360	46
Total short-term debt	828,358	793,653
Long-term debt:		
Medium-term Notes — Callable <sup>(2)</sup>	87,047	144,431
Medium-term Notes — Non-callable	33,624	6,428
U.S. dollar Reference Notes® securities — Non-callable <sup>(3)</sup>	48,146	40,000
€Reference Notes® securities — Non-callable	—	8,680
Total long-term debt	168,817	199,539
Total debt securities issued	<u>\$997,175</u>	<u>\$993,192</u>

(1) Excludes securities sold under agreements to repurchase and Federal funds purchased, swap collateral obligations and securities sold, not yet purchased.

(2) Includes \$— million and \$717 million of Medium-term Notes issued for the years ended December 31, 2005 and 2004, respectively, which were accounted for as debt exchanges.

(3) Includes \$3,396 million and \$— million of Reference Notes® securities issued for the years ended December 31, 2005 and 2004, respectively, which were accounted for as debt exchanges.

**Short-Term Debt.** We fund our operating cash needs primarily by issuing Reference Bills® securities and other discount notes, which are short-term instruments with maturities of one year or less that are sold on a discounted basis, paying only principal at maturity. Our Reference Bills® securities program consists of large issues of short-term debt that we auction to dealers on a regular schedule. We issue discount notes with maturities ranging from one day to one year in response to investor demand and our cash needs. Short-term debt also includes certain Medium-term Notes that have original maturities of one year or less.

**Long-Term Debt.** We issue long-term debt primarily through our Medium-term Notes program and our Reference Notes® securities program.

**Medium-term Notes.** We issue a variety of fixed- and variable-rate Medium-term Notes, including callable and non-callable fixed-rate securities, zero coupon securities and variable-rate securities, with various maturities ranging up to 30 years. Medium-term Notes with original maturities of one year or less are classified as short-term debt. Medium-term Notes typically contain call provisions, effective as early as three months or as late as 10 years after the securities are issued.

**Reference Notes® Securities.** Through our Reference Notes® securities program, we sell large issues of long-term debt that provide investors worldwide with a high-quality, liquid investment vehicle. Reference Notes® securities are regularly issued, non-callable fixed-rate securities, which we currently issue with original maturities ranging from two through ten years. We primarily issue securities denominated in U.S. dollars. We have also issued €Reference Notes® securities denominated in Euros but did not issue any such securities in 2005. We hedge our exposure to changes in foreign-currency exchange rates by entering into swap transactions that convert foreign-denominated obligations to U.S. dollar-denominated obligations. See “RISK MANAGEMENT — Interest-Rate Risk and Other Market Risks — Sources of Interest-Rate Risk and Other Market Risks” for more information.

The investor base for our debt is predominantly institutional. However, we also conduct weekly offerings of FreddieNotes® securities, a Medium-term Notes program designed to meet the investment needs of retail investors.

**Subordinated Debt.** We did not issue any Freddie SUBS® during 2005, 2004 or 2003. In accordance with our risk management and disclosure commitments with OFHEO (described in “RISK MANAGEMENT AND DISCLOSURE COMMITMENTS”), we issued Freddie SUBS® with a principal amount of approximately \$1.25 billion in June 2006. Our ability to issue additional subordinated debt may be limited until we return to regular financial reporting. See “RISK MANAGEMENT AND DISCLOSURE COMMITMENTS” and “NOTE 10: REGULATORY CAPITAL” to our consolidated financial statements for additional information.

**Debt Repurchase Activities.** In order to manage our mix of assets and liabilities, we regularly conduct repurchases of outstanding debt securities. Our repurchase activities support the liquidity and predictability of the market for our long-term



debt securities. When our debt securities become seasoned or European call options on our debt securities expire, they may become less liquid, which could cause their price to decline. By periodically repurchasing debt securities, we help preserve the liquidity of our debt securities and improve their price performance, which helps to reduce our funding costs over the long-term. Our repurchase activities also help us manage the funding mismatch, or duration gap, created by declines in interest rates. When interest rates decline, the expected lives of the mortgage-related securities held in our Retained portfolio decrease, reducing the need for long-term debt. We use a number of different means to shorten the effective weighted average lives of our outstanding debt securities and thereby manage the duration gap, including retiring long-term debt through repurchases or calls; issuing additional short-term debt; or using derivative instruments, such as entering into receive-fixed interest-rate swaps or terminating or assigning pay-fixed interest-rate swaps. From time to time, we may also enter into transactions in which we exchange newly issued debt securities for similar outstanding debt securities held by investors. These transactions are not accounted for as repurchases, but rather as debt exchanges.

Table 30 provides the par value of debt securities we repurchased, called and exchanged (based on settlement dates) during 2005 and 2004.

**Table 30 — Debt Security Repurchases, Calls and Exchanges**

	Year Ended December 31,	
	2005	2004
	(in millions)	
Repurchases of outstanding U.S. dollar Reference Notes® securities and €Reference Notes® securities .....	\$ —	\$ 9,007
Repurchases of outstanding Medium-term Notes .....	11,663	5,530
Calls of callable Medium-term Notes .....	36,236	119,987
Exchanges of U.S. dollar Reference Notes® securities and Medium-term Notes .....	3,043	717

**Credit Ratings.** Our ability to access the capital markets and other sources of funding, as well as our cost of funds, are highly dependent upon our credit ratings. Table 31 indicates our credit ratings at June 1, 2006.

**Table 31 — Freddie Mac Credit Ratings**

	Rating Agency		
	Standard & Poor's	Moody's	Fitch
Senior long-term debt <sup>(1)</sup> .....	AAA	Aaa	AAA
Short-term debt <sup>(2)</sup> .....	A-1+	Prime-1	F-1+
Subordinated debt .....	AA-	Aa2	AA-Watch Negative
Preferred stock .....	AA-	Aa3	AA-Watch Negative

(1) Includes Medium-term Notes, U.S. dollar Reference Notes® securities and €Reference Notes® securities.

(2) Includes Reference Bills® securities and discount notes.

In addition to the ratings described in Table 31, Standard & Poor's, or S&P, provides a "Risk-To-The-Government" rating that measures our ability to meet our debt obligations and the value of our franchise in the absence of any implied government support. Our "Risk-To-The-Government" rating was AA- at June 1, 2006. Moody's also provides a "Bank Financial Strength" rating that represents Moody's opinion of our intrinsic safety and soundness and, as such, excludes certain external credit risks and credit support elements. Ratings under this measure range from A, the highest, to E. Our "Bank Financial Strength" rating was A- at June 1, 2006.

### ***Equity Securities***

During 2005 and 2004, we did not issue, redeem or repurchase any equity securities, other than reissuances of previously issued treasury stock to employees and non-employee directors under our stock compensation plans. With the release of our 2005 financial results in May, we have moved forward with the repurchase of common stock and we expect to issue the authorized preferred stock depending on market conditions and other factors. See "Capital Resources — *Capital Transactions*" below for further information.

### ***Cash and Investments Portfolio***

We maintain a cash and investments portfolio that is important to our financial management and our ability to provide liquidity and stability to the mortgage market. At December 31, 2005, the investments in this portfolio consisted of liquid non-mortgage-related securities that we could sell or finance to provide us with an additional source of liquidity to fund our business operations. We also use the portfolio to help manage recurring cash flows and meet our other cash management needs. In addition, we use the portfolio to hold capital on a temporary basis until we can deploy it into Retained portfolio investments or credit guarantee opportunities. We may also sell or finance the securities in this portfolio to maintain capital reserves to meet mortgage funding needs, provide diverse sources of liquidity, or help manage the interest-rate risk inherent in mortgage-related assets.

The non-mortgage-related securities in the Cash and investments portfolio consist principally of asset-backed securities and other marketable assets that can be readily converted to cash. For additional information on our Cash and investments

portfolio, see “CONSOLIDATED BALANCE SHEETS ANALYSIS — Cash and Investments.” The non-mortgage-related investments in this portfolio may expose us to institutional credit risk and the risk that the investments could decline in value due to market-driven events such as credit downgrades or changes in interest rates and other market conditions. See “RISK MANAGEMENT — Credit Risks — *Institutional Credit Risk*” for more information.

### **Contractual Obligations**

Table 32 provides aggregated information about the listed categories of our contractual obligations. These contractual obligations affect our short- and long-term liquidity and capital resource needs. Table 32 includes information about undiscounted future cash payments due under these contractual obligations, aggregated by type of contractual obligation, including the contractual maturity profile of our debt securities and other liabilities reported on our consolidated balance sheets and our operating leases at December 31, 2005. The timing of actual future payments may differ from those presented in this table due to a number of factors, including discretionary debt repurchases. Our contractual obligations include other purchase obligations that are enforceable and legally binding. For purposes of this table, purchase obligations are included through the termination date specified in the respective agreements, even if the contract is renewable. Many of our purchase agreements for goods or services include clauses that would allow us to cancel the agreement prior to the expiration of the contract within a specified notice period; however, this table includes such obligations without regard to such termination clauses (unless we have provided the counterparty with actual notice of our intention to terminate the agreement).

Table 32 excludes our Guarantee obligation, which represents our obligation to stand ready to perform under our guarantees of the payment of principal and interest of PCs and Structured Securities, as the amount and timing of payments under these arrangements are generally contingent upon the occurrence of future events. See “NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES” to our consolidated financial statements for additional information about our Guarantee obligation.

We maintain a tax-qualified, funded defined benefit pension plan, or Pension Plan, covering substantially all of our employees. We generally contribute to our Pension Plan an amount equal to at least the minimum required contribution, if any, but no more than the maximum amount deductible for Federal income tax purposes each year. See “NOTE 15: EMPLOYEE BENEFITS” to our consolidated financial statements for additional information about contributions to the Pension Plan.

With the exception of purchase commitments that are accounted for as derivatives, derivative transactions that may require cash settlement in future periods are not reflected on Table 32. See “Table 23 — Derivative Fair Values and Maturities,” which describes the fair value for each derivative type and the maturity profile of the positions.

Dividend payments on preferred stock we issue are not reflected on Table 32, since all classes of preferred stock are non-cumulative. See “NOTE 9: STOCKHOLDERS’ EQUITY” to our consolidated financial statements for additional information. Dividend payments on cumulative preferred stock issued by our two consolidated REIT subsidiaries are not reflected on Table 32 since the timing of these payments is dependent upon declaration by the boards of the REITs. See “NOTE 18: MINORITY INTERESTS” to our consolidated financial statements for additional information.

On April 20, 2006, we reached an agreement in principle to settle the securities class action lawsuits and the shareholder derivative lawsuits related to our restatement. The settlement of these actions includes a cash payment of \$410 million, including the application of expected net insurance proceeds, and is not included in Table 32 since this was not a contractual obligation at December 31, 2005. See “NOTE 13: LEGAL CONTINGENCIES” for additional information.

**Table 32 — Specified Contractual Obligations by Year (at December 31, 2005)**

	Total	2006	2007	2008	2009	2010	Thereafter
	(in millions)						
Long-term debt securities <sup>(1)</sup>	\$585,804	\$ 95,596	\$106,696	\$72,125	\$47,348	\$52,249	\$211,790
Short-term debt securities <sup>(1)</sup>	194,578	194,578	—	—	—	—	—
Other liabilities reflected on our consolidated balance sheets:							
Due to Participation Certificate investors	10,607	10,607	—	—	—	—	—
Accrued interest payable <sup>(2)</sup>	7,611	7,611	—	—	—	—	—
Other contractual liabilities <sup>(3)(4)</sup>	3,931	2,179	1,006	425	126	63	132
Purchase obligations:							
Purchase commitments <sup>(5)</sup>	13,095	13,095	—	—	—	—	—
Other purchase obligations	408	209	91	47	20	14	27
Operating lease obligations	101	17	14	11	10	10	39
Total specified contractual obligations	<u>\$816,135</u>	<u>\$323,892</u>	<u>\$107,807</u>	<u>\$72,608</u>	<u>\$47,504</u>	<u>\$52,336</u>	<u>\$211,988</u>

- (1) Represents par value. Callable debt is included in this table at its contractual maturity. For additional information about our debt securities, see “NOTE 8: DEBT SECURITIES AND SUBORDINATED BORROWINGS” to our consolidated financial statements.
- (2) Accrued interest payable primarily represents the accrual of interest on our short-term and long-term debt securities, as well as the accrual of periodic cash settlements of all derivatives, netted by counterparty.
- (3) Other contractual liabilities primarily represent future cash payments due under our contractual obligations to make delayed equity contributions to low-income housing tax credit partnerships that are unconditional and legally binding.
- (4) Accrued obligations related to our defined benefit plans, defined contribution plans and executive deferred compensation plan are included in the Total and 2006 columns. However, the timing of payments due under these obligations is uncertain. See “NOTE 15: EMPLOYEE BENEFITS” to our consolidated financial statements for additional information.
- (5) Purchase commitments represent our obligations to purchase mortgage loans and mortgage-related securities from third parties. The majority of purchase commitments included in this caption are accounted for as derivatives in accordance with SFAS 133.

## Capital Resources

Our objective in managing capital is to preserve our safety and soundness, while maintaining sufficient capital to take advantage of new business opportunities and support our mission at attractive long-term returns.

### Capital Transactions

During 2005 and 2004, we added approximately \$1.0 billion and \$2.0 billion, respectively, to Core capital primarily from Net income of \$2.1 billion and \$2.9 billion, respectively, offset by the payment of common and preferred stock dividends totalling \$1.3 billion and \$1.0 billion, respectively. See “NOTE 10: REGULATORY CAPITAL” to our consolidated financial statements for additional information.

Our board of directors approved a dividend per common share of \$0.47 for the fourth quarter of 2005, an increase of 34 percent over the previous quarterly dividends in 2005. The dividend per common share was \$0.35 for the first three quarters in 2005, an increase of 17 percent over the \$0.30 per common share quarterly dividend paid each quarter during 2004. We paid a quarterly dividend per common share of \$0.26 in 2003. Our board of directors will determine the amount of dividends, if any, declared and paid in any quarter after considering our capital position and earnings and growth prospects, among other factors.

In addition, as described in “MARKET FOR THE COMPANY’S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES,” on October 5, 2005, our board of directors authorized us to repurchase up to \$2.0 billion of outstanding shares of common stock and issue up to \$2.0 billion of non-cumulative, perpetual preferred stock. With the release of our 2005 financial results in May, we moved forward with the repurchase of common stock and we expect to issue the authorized preferred stock depending on market conditions and other factors.

Subject to being consistently well capitalized relative to our regulatory requirements and risks and having sufficient capital to support our business and mission, we will consider returning excess capital to our stockholders in future periods. The amount of capital available to distribute to our stockholders is affected primarily by our capital position and earnings and growth prospects, among other factors. In addition, as long as OFHEO’s capital monitoring framework remains in place, certain capital transactions, including the repurchase of any shares of common stock, require prior written OFHEO approval.

For a summary of our preferred stock outstanding at December 31, 2005 and information on redemption dates for our preferred stock issuances, see “NOTE 9: STOCKHOLDERS’ EQUITY” to our consolidated financial statements.

We periodically reissue treasury stock to employees and non-employee directors as part of our stock-based compensation plans. See “NOTE 11: STOCK-BASED COMPENSATION” to our consolidated financial statements for a description of these plans.

### ***Capital Adequacy***

We regularly assess the adequacy of our capital to ensure that we hold capital sufficient to comply with our minimum, critical and risk-based regulatory capital requirements.

We evaluate ongoing compliance with minimum and critical capital requirements under changing market conditions through regular assessments of the impact of these conditions on the level of our minimum capital surplus. We measure the effects of changes in key market drivers, including the level of interest rates, the slope of the yield curve and changes in implied market volatilities. Our assessment process is designed to ensure that we maintain a significant minimum capital surplus across a wide range of market scenarios. We monitor the level and variability of our capital surplus relative to the 30 percent mandatory target surplus established under the capital monitoring framework mandated by OFHEO. We believe that our actual surplus would exceed the mandatory target surplus across a wide range of market scenarios. We also evaluate ongoing compliance with the risk-based capital requirement through regular intra-quarter analysis of the sensitivity of our risk-based capital surpluses to changes in interest rates and house prices, among other factors.

At December 31, 2005, we exceeded each of our capital requirements, including the 30 percent mandatory target surplus. See “NOTE 10: REGULATORY CAPITAL” to our consolidated financial statements for further information regarding our regulatory capital requirements and OFHEO’s capital monitoring framework.

## **RISK MANAGEMENT**

Our business is exposed to operational risks, interest-rate and other market risks, and credit risks. We are also exposed to other risks, such as those described in “RISK FACTORS,” including reputation risk and risks related to implementing our business strategies. We manage risk through a framework that recognizes primary risk ownership and management by our business units, oversight by our executive management committees and divisions responsible for independent risk oversight functions, and oversight by our board of directors and its committees.

Executive management committees and other internal advisory groups monitor performance against our risk management strategies and established risk limits; identify and assess potential issues; and provide oversight regarding changes in business processes and activities. Within the business units, risk management personnel identify, monitor and report risks. Independent oversight of risk management is provided by our Enterprise Risk Oversight, Corporate Compliance and Internal Audit divisions, in addition to the oversight provided by the board of directors and its committees. Together, these groups assess the adequacy and effectiveness of the risk management functions across the company.

While we believe that both our day-to-day and long-term management of interest-rate and other market risks and credit risks is satisfactory, weaknesses exist in our overall risk governance framework. We are focused on strengthening our capacity in four important areas: risk governance, risk identification, risk measurement and assessment, and related education and communication. Our risk management framework is being reviewed under a new leadership team in our Enterprise Risk Oversight division to address these issues and to establish clear lines of authority, clarify roles and responsibilities, and to improve the overall effectiveness of the risk oversight function. We recently created an executive management enterprise risk committee to provide an enterprise-wide view of risk. Our board of directors also assigned primary responsibility for oversight of enterprise risk management to the newly re-chartered Governance, Nominating and Risk Oversight Committee of the board of directors.

### **Operational Risks**

Operational risks are inherent in all of our business activities and can become apparent in various ways, including accounting or operational errors, business interruptions, fraud, failures of the technology used to support our business activities, and other operational challenges from failed or inadequate internal controls. We face a number of significant operational risks, including material weaknesses and other significant deficiencies in our internal control over financial reporting. These operational risks may expose us to financial loss, may delay or interfere with our ability to return to and sustain timely financial reporting, or may result in other adverse consequences.

We endeavor to mitigate our operational risks related to properly executing and recording transactions through comprehensive processes that include approval authorities, data quality standards and control procedures within business processes. A cross-divisional committee oversees new products and transaction types.

Our business processes are highly dependent on our use of technology and business and financial models. As described below, we are making significant investments to build new financial reporting and operational systems and to move to more effective and efficient business processing systems. See “*Internal Control Over Financial Reporting*” for more information concerning internal control deficiencies related to our systems. In recent years, we have strengthened our processes to validate model assumptions, code, theory, and the system applications that utilize our models. We are currently improving our model oversight processes and enhancing our staffing both within the business areas and in our risk oversight functions.



We currently outsource certain key functions to external parties, including processing functions for trade capture, market risk management analytics, asset valuation, and mortgage loan underwriting. We mitigate the risk from outsourcing by engaging in active vendor management, including establishing detailed vendor requirements, reviewing business continuity plans, monitoring quality assurance processes and engaging third party reviews of our vendors. In addition, we use a process of delegated underwriting for the single-family mortgages we purchase or securitize. In this process, we provide originators with a series of mortgage underwriting guidelines and they represent and warrant to us that the mortgages sold to us meet these guidelines. See “Credit Risks — *Mortgage Credit Risk* — Mortgage Credit Risk Management Strategies — *Underwriting Requirements and Quality Control Standards*” and “*Institutional Credit Risk* — Mortgage Seller/Serviceers” for information about how we mitigate the risks associated with delegated underwriting.

We are making significant investments to build new financial reporting systems and to move to more effective and efficient business processing systems. During the transition period, however, we are more reliant on end-user computing systems than is desirable and are challenged to deliver integrated production systems. Certain of these end-user computing systems increase the risk of errors in some of our core operational processes and increase our reliance on monitoring controls, which is an area where we have a material weakness in our internal control over financial reporting. They may also limit our capacity for change. In the near term, we are mitigating this risk by improving our documentation and controls over these systems and placing key end-user systems under the same technology controls as our production applications. We also face challenges in the areas of system security, change management and information technology application and general controls. See “*Internal Control over Financial Reporting*” for more information concerning internal control issues related to our systems, both financial and non-financial reporting.

We are also exposed to the risk that our business processes could be adversely affected by inadequate staffing, which strains existing resources and increases the risk that an error or fraud will not be detected. This risk is of particular concern for us because of high turnover rates, critical vacancies and recent changes in our senior management. We have filled some important vacancies such as General Counsel, General Auditor, Principal Accounting Officer, and Senior Vice President, Enterprise Operational Risk. Our President and Chief Operating Officer has assumed the responsibilities of the Chief Financial Officer while we conduct a search to fill that position. Recently, high employee turnover rates have contributed to increased operational risk. While we have made progress in our efforts to build a strong management team by filling several senior positions, we need to continue to recruit additional qualified people into leadership positions across the organization in order to achieve our objectives in regard to remediation of our internal control deficiencies.

In addition to the particular risks and challenges we are facing, we face ongoing risks that are similar to those of other large financial institutions. For example, we are exposed to the risk that a catastrophic event, such as a terrorist event or natural disaster, could result in a significant business disruption and an inability to process transactions through normal business processes. To mitigate this risk, we maintain and test business continuity plans and have established backup facilities for critical business processes and systems away from, although in the same metropolitan area as, our main offices. In 2005, we began an effort to establish out-of-region capabilities for clearing and treasury services. However, it is not clear that these measures will be sufficient to respond to the full range of catastrophic events that might occur.

### ***Internal Control over Financial Reporting***

Since the revision and restatement of our financial results for 2000 through 2002, we have had to face many challenging and complex accounting and financial reporting issues, including ongoing controls remediation and systems re-engineering and development. We fell behind in our periodic reporting for the years ended December 31, 2002, 2003, 2004 and 2005, and we have not yet returned to quarterly reporting. Improving internal control over financial reporting and mitigating the risks presented by material weaknesses and other control deficiencies in our financial reporting processes continue to be top corporate priorities. Many of the material weaknesses and other control deficiencies identified in prior years persisted throughout 2005 and continue to present challenges for us in 2006. In addition, we determined that some previously identified deficiencies were more serious than originally assessed. We also identified additional control deficiencies in 2005. While we believe we have made progress in the remediation of certain material weaknesses and other control deficiencies that have been identified, these will continue to pose significant risks to our financial reporting process until fully remediated. For example, in the course of completing our financial reporting processes for 2005, we discovered a number of internal control issues that resulted in adjustments to our interim 2005 financial results.

The material weaknesses that affected us throughout 2005 and at the end of the year included:

- Integration among our systems, business units and external service providers — Integration issues among our systems and processes related to our operational and financial accounting systems, business units and external service providers, which collectively increase the risk of error in our financial reporting due to: (a) the potential failure to correctly pass information between systems and processes; (b) incompatibility of data between systems; (c) incompatible systems; or (d) a lack of clarity in process ownership. To compensate for this weakness, we have



implemented compensating controls, including the performance of significant data validation and financial analytics, which contributed to our delayed financial reporting timeline.

- Information technology general controls as they relate to change management — Our controls over managing changes related to the introduction of program and data changes and our controls related to production data and applications need improvement. Weaknesses in these controls include lack of consistent standards and inadequate testing of changes prior to deployment.
- Information technology general controls as they relate to security administration, management and technology — Our controls over information systems security administration and management functions need to improve in the following areas: (a) development of and adherence to procedures and guidelines; (b) segregation of duties; (c) logging and monitoring user access rights; and (d) periodic review of the appropriateness of access rights. Weaknesses in these controls could allow unauthorized users to enter, delete or change data in these systems, as well as increase the possibility that entries could be duplicated or omitted inadvertently.
- Monitoring controls within financial operations and reporting functions — Monitoring controls are those controls that are designed to evaluate how other controls are working, such as the performance of financial analytics and the completion of account reconciliations. Despite the progress made in the identification, documentation, and enhancement of monitoring controls during 2005, there were several instances where these controls did not identify issues that ultimately led to accounting adjustments.
- Staffing adequacy — While we have made progress in our efforts to build a strong management team by filling several senior positions, we need to continue to recruit additional qualified people into leadership positions across the organization in order to achieve our objectives with regard to the remediation of weaknesses and deficiencies within our internal control infrastructure and our return to timely financial reporting. We have recently experienced high employee turnover rates, which strain existing resources and contribute to increased operational risk. We are also assessing our standards of performance and how we enforce those standards to create a more effective culture of accountability.
- Management risk and control self-assessment process — Our process to identify deficiencies in key financial reporting controls, prior to testing, does not provide reliable information on our risk and control environment.

In addition to these material weaknesses, a number of significant deficiencies in our internal control were apparent that, although not determined to be material at this time, still present risks of error in our financial reporting. For example, we place reliance on end-user computing solutions with both insufficient documentation and change controls. This control deficiency was considered a material weakness at December 31, 2004. We believe that our remediation efforts have reduced the severity of this deficiency, however, it continues to pose significant risk to our financial reporting processes and requires us to allocate significant resources to continue progress toward full remediation and to provide that this deficiency does not become material again.

Other significant deficiencies include areas that need improvement: the governance over our risk management processes, where we need to strengthen the resources engaged in this oversight role and our ability to aggregate risks across our organization; our new product implementation process; and the governance of and processes related to our valuation of our guarantee-related assets and liabilities. We also need to strengthen our procedures for monitoring instances where we make simplifying assumptions in the application of our accounting policies in our financial reporting, and we need to reduce our reliance on such assumptions. The excessive use of such assumptions increases the risk that differences, when compared to a stricter application of our accounting policies, could become consequential over time and result in errors that are not detected (*e.g.*, if the underlying transaction volume increases). Furthermore, we are examining the cause of certain data quality issues associated with information provided to us by seller/servicers related to mortgage loans underlying our PCs and Structured Securities and the use of that data within our operational transaction systems and financial reporting systems.

As we continue the remediation activities noted below, we may identify additional material weaknesses, significant deficiencies or other operational issues in our internal controls or conclude that significant deficiencies we have already identified should be regarded as material weaknesses, either individually or in the aggregate.

During 2005, we implemented an internal control testing and evaluation program designed to evaluate the significant components of our internal control over financial reporting and to identify whether deficiencies exist within our internal control environment. Upon discovering the need for several adjustments to our 2005 interim financial results in the course of our financial reporting processes for 2005, we began a more comprehensive review of our internal control environment. This review includes an assessment of the design and effectiveness of our internal control environment, an initiative to improve information technology general controls, and remedial actions needed to address any issues identified in the course of these reviews.

This review is expected to continue throughout 2006 and contemplates the implementation of several planned system enhancements to our accounting, financial reporting and operational infrastructure later in the year. This review will enable us to further evaluate the risk severity of our existing deficiencies and may identify new material weaknesses or other deficiencies. We believe that this process will provide consistency in evaluations and verification of the appropriateness and completeness of our remediation activities. After a control deficiency is identified, the responsible business area is required to establish a remediation plan to address it. Upon achieving milestones in our remediation plans, we will test the results. To provide for financial reporting at the end of 2006, we will conduct an assessment of the existing material weaknesses and deficiencies and remediation activities. We will regularly monitor and report on our remediation progress to senior management, our board of directors, OFHEO and our internal and external auditors.

In order to devote the resources needed to complete the review effectively and return to timely reporting as soon as possible, we have decided to delay our interim financial reporting for 2006. We have also decided to limit the number of initiatives we plan to undertake in 2006 and defer lower priority systems initiatives until we have progressed further with our internal controls. It is our objective to return to quarterly reporting with our release of full-year 2006 financial results. After we resume regular quarterly reporting, we will begin the process of registering our common stock with the SEC.

Our review of the internal control environment and our ongoing control remediation activities are intended to provide a basis for our reliance on our internal control over financial reporting. Our ability to rely on internal controls is essential to our return to timely reporting, because it will alleviate the need to perform substantive procedures to compensate for our material weaknesses and other control deficiencies.

The material weaknesses and significant deficiencies in our internal control over financial reporting adversely affect our ability to record, process, summarize and report financial data in a timely manner. Based on the continued existence of material weaknesses at December 31, 2005, our Chief Executive Officer and President and Chief Operating Officer have concluded that our internal control over financial reporting was not effective at December 31, 2005. In order to compensate for the material weaknesses and other deficiencies in our internal controls, we continue to perform extensive verification and validation procedures to provide reasonable assurance that our consolidated financial statements are prepared in accordance with GAAP. Therefore, in view of the alternative procedures we performed, we believe that these weaknesses do not prevent us from preparing and issuing our consolidated financial statements in accordance with GAAP.

Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that the information required to be disclosed by a company in its financial reports is accumulated and communicated to its senior management team as appropriate to allow timely decisions regarding required disclosure. Full evaluation of our disclosure controls and procedures has been delayed pending our completion of the design and implementation of these controls and procedures and the testing program for evaluating their effectiveness.

### **Interest-Rate Risk and Other Market Risks**

Our interest-rate risk management objective is to serve our housing mission by protecting shareholder value in all interest-rate environments. Our disciplined approach to interest-rate risk management is essential to maintaining a strong and durable capital base and uninterrupted access to debt and equity capital markets.

#### ***Sources of Interest-Rate Risk and Other Market Risks***

Our Retained portfolio activities expose us to interest-rate risk and other market risks arising primarily from the uncertainty as to when borrowers will pay the outstanding principal balance of mortgage loans and mortgage-related securities held in the Retained portfolio, known as prepayment risk, and the resulting potential mismatch in the timing of our receipt of cash flows on our assets versus the timing of our obligation to make payments on our liabilities. For the vast majority of our mortgage-related investments, the mortgage borrower has the option to make unscheduled payments of additional principal or to completely pay off a mortgage loan at any time before its scheduled maturity date (without having to pay a prepayment penalty) or to hold the mortgage loan to its stated maturity.

Our credit guarantee activities also expose us to interest-rate risk because changes in interest rates can cause fluctuations in the fair value of our existing credit guarantee portfolio. We generally do not hedge these changes in fair value except for interest-rate exposure related to net buy-ups and float. Float, which arises from timing differences between when the borrower pays us and when we reduce the PC balance, can lead to significant interest expense if the interest rate paid to a PC investor is higher than the reinvestment rate we earn on payments received from mortgage borrowers.

The types of interest-rate risk and other market risks to which we are exposed are described below.

**Duration Risk and Convexity Risk.** Duration is a measure of a financial instrument's price sensitivity to changes in interest rates. Convexity is a measure of how much a financial instrument's duration changes as interest rates change. Our convexity risk primarily results from prepayment risk. We actively manage duration risk and convexity risk through asset selection and structuring (that is, by identifying or structuring mortgage-related securities with attractive prepayment and

other characteristics), by issuing a broad range of both callable and non-callable debt instruments and by using interest-rate derivatives. Managing the impact of duration risk and convexity risk is the principal focus of our daily market risk management activities. These risks are encompassed in our PMVS and duration gap risk measures, discussed in greater detail below. We use prepayment models to determine the estimated duration and convexity of mortgage assets for our PMVS and duration gap measures. Expected results can be affected by differences between prepayments forecasted by the models and actual prepayments.

**Yield Curve Risk.** Yield curve risk is the risk that non-parallel shifts in the yield curve (such as a flattening or steepening) will adversely affect shareholder value. Because changes in the shape, or slope, of the yield curve often arise due to changes in the market's expectation of future interest rates at different points along the yield curve, we evaluate our exposure to yield curve risk by examining potential reshaping scenarios at various points along the yield curve. Our yield curve risk under a specified yield curve scenario is reflected in our PMVS-Yield Curve, or PMVS-YC, disclosure.

**Volatility Risk.** Volatility risk is the risk that changes in the market's expectation of the magnitude of future variations in interest rates will adversely affect shareholder value. The market's expectation about the future volatility of interest rates, or implied volatility, is a key determinant of the value of an interest-rate option. Since mortgage assets generally include the borrower's option to prepay a loan without penalty, changes in implied volatility affect the value of mortgage assets. We manage volatility risk through asset selection and by maintaining a consistently high percentage of option-embedded liabilities relative to our mortgage assets. We monitor volatility risk by measuring exposure levels on a daily basis and we maintain internal limits on the amount of volatility risk exposure that is acceptable to us.

**Basis Risk.** Basis risk is the risk that interest rates in different market sectors will not move in tandem and will adversely affect shareholder value. This risk arises principally because we generally hedge mortgage-related investments with debt securities. We do not actively manage the basis risk arising from funding Retained portfolio investments with our debt securities, also referred to as mortgage-to-debt option-adjusted spread risk. See "CONSOLIDATED FAIR VALUE BALANCE SHEETS ANALYSIS — Key Components of Changes in Fair Value of Net Assets — *Changes in mortgage-to-debt OAS*" for additional information.

**Foreign-Currency Risk.** Foreign-currency risk is the risk that fluctuations in currency exchange rates (e.g., foreign currencies to the U.S. dollar) will adversely affect shareholder value. We are exposed to foreign currency risk because we have debt denominated in currencies other than the U.S. dollar, our functional currency. We mitigate foreign-currency risk by entering into swap transactions that effectively convert foreign-denominated obligations into U.S. dollar denominated obligations.

#### ***Portfolio Market Value Sensitivity and Measurement of Interest-Rate Risk***

We employ a risk management strategy that seeks to substantially match the duration characteristics of our assets and liabilities. To accomplish this, we employ an integrated strategy encompassing asset selection and structuring and asset and liability management.

The prepayment option held by mortgage borrowers drives the market value profile of our mortgage assets such that the combined market value of our mortgage assets and non-callable debt will decline if interest rates move significantly in either direction. We mitigate much of our exposure to changes in interest rates by funding a significant portion of our mortgage portfolio with callable debt. When interest rates change, our option to redeem this debt offsets a large portion of the fair value change driven by the mortgage prepayment option. Currently, approximately 60 percent of our fixed-rate mortgage assets are funded and economically hedged with callable debt. However, because the mortgage prepayment option is not fully hedged by callable debt, the combined market value of our mortgage assets and debt will be affected by changes in interest rates.

To further reduce our exposure to changes in interest rates, we hedge a significant portion of the remaining prepayment risk with option-based derivatives. These derivatives primarily consist of call swaptions, which tend to increase in value as interest rates decline, and put swaptions, which tend to increase in value as interest rates increase. With the addition of these option-based derivatives, the market value of stockholders' equity becomes relatively stable over a wide range of interest rates because a greater portion of our prepayment risk has been hedged. The market value of stockholders' equity is further stabilized by our ongoing portfolio rebalancing primarily involving interest-rate swaps. Generally, receive-fixed swaps increase in value as interest rates decline and pay-fixed swaps increase in value as interest rates increase. Although some unhedged exposure to changes in interest rates remains, these exposures are generally well understood, subject to established limits, monitored and controlled through our disciplined risk management process.

We measure our exposure to key interest-rate risks every day against both internal management limits and limits set by our board of directors. Throughout 2005, our interest-rate risk remained low and well below management and board limits.

**PMVS and Duration Gap.** Our primary interest-rate risk measures are PMVS and duration gap. PMVS is measured in two ways, one measuring the estimated sensitivity of our portfolio market value (as defined below) to parallel moves in interest rates (PMVS-L) and the other to nonparallel movements (PMVS-YC). PMVS-L and PMVS-YC are based on the assumption of instantaneous yield curve shifts; therefore neither measure includes the effect on fair value of any rebalancing actions that we would typically take to reduce our risk exposure.

Our PMVS and duration gap estimates are determined using models that involve our best judgment of interest-rate and prepayment assumptions. In addition, in the case of PMVS, daily calculations are based on an estimate of the fair value of our net assets attributable to common stockholders. Accordingly, while we believe that PMVS and duration gap are useful risk management tools, they should be understood as estimates rather than as precise measurements.

While PMVS and duration gap estimate the exposure of the fair value of net assets attributable to common stockholders (measured as fair value of total net assets less the fair value of preferred stock) to changes in interest rates, they do not capture the potential impact of certain other market risks, such as changes in volatility, basis, prepayment model, mortgage-to-debt option-adjusted spreads and foreign-currency risk. The impact of these other market risks can be significant. See “*Sources of Interest-Rate Risk and Other Market Risks*” and “*CONSOLIDATED FAIR VALUE BALANCE SHEETS ANALYSIS — Key Components of Changes in Fair Value of Net Assets — Changes in mortgage-to-debt OAS*” for further information.

- PMVS-L shows the estimated loss in pre-tax portfolio market value, expressed as a percentage of our after-tax fair value of net assets attributable to common stockholders, from an immediate adverse 50 basis point parallel shift in the level of LIBOR rates (that is, when the yield at each point on the LIBOR yield curve increases or decreases by 50 basis points). We believe the use of an immediate 50 basis point shift in the LIBOR yield curve is a conservative estimate of interest-rate risk.
- PMVS-YC shows the estimated loss in pre-tax portfolio market value, expressed as a percentage of our after-tax fair value of net assets attributable to common stockholders, from an immediate adverse 25 basis point change in the slope (up and down) of the LIBOR yield curve. The 25 basis point change in slope for the PMVS-YC measure is obtained by shifting the two-year and ten-year LIBOR rates by an equal amount (12.5 basis points), but in opposite directions. LIBOR rate shifts between the two-year and ten-year points are interpolated.
- Duration gap estimates the net sensitivity of the fair value of our financial instruments to movements in interest rates. Duration gap is presented in units expressed as months. A duration gap of zero implies that the change in value of assets from an instantaneous rate move will be accompanied by an equal and offsetting move in the value of debt and derivatives thus leaving the net fair value of equity unchanged. However, because duration does not capture convexity exposure (the amount by which duration itself changes as rates move), actual changes in fair value from interest-rate changes may differ from those implied by duration gap alone. For that reason, we believe duration gap is most useful when used in conjunction with PMVS.

In measuring the expected loss in portfolio market value, which is the numerator in the fraction used to calculate the PMVS percentages, we estimate the sensitivity to changes in interest rates of the fair value of all interest-earning assets and interest-bearing liabilities and derivatives on a pre-tax basis. When we calculate the expected loss in portfolio market value and duration gap, we also take into account the cash flows related to certain credit guarantee-related items, including net buy-ups and expected gains or losses due to net interest from float. In calculating the expected loss in portfolio market value and duration gap, we do not consider the sensitivity to interest-rate changes of the following assets and liabilities:

- *Credit guarantee portfolio.* Except for the guarantee-related items mentioned above (*i.e.*, net buy-ups and float), the sensitivity of the fair value of the credit guarantee portfolio to changes in interest rates is not included in calculating the expected loss in portfolio market value or duration gap because we believe the expected benefits from replacement business provide an adequate hedge against interest-rate changes.
- *Other assets with minimal interest-rate sensitivity.* Other assets, primarily including non-financial instruments such as fixed assets and REO, are not included in the calculation of the expected loss in portfolio market value or duration gap because of the minimal impact they would have on both PMVS and duration gap.

The fair value of the credit guarantee portfolio and certain other assets with minimal interest-rate risk sensitivity is included in the estimate of the after-tax fair value of net assets attributable to common stockholders, which is the denominator of the fraction used to calculate the PMVS-L and PMVS-YC percentages.

**PMVS Results.** Table 33 provides estimated point-in-time PMVS-L and PMVS-YC results at December 31, 2005 and 2004. Table 33 also provides year-end PMVS-L estimates assuming an immediate 100 basis point shift in the LIBOR yield curve. Because we do not hedge all prepayment option risk, the duration of our mortgage assets changes more rapidly as changes in interest rates increase. Accordingly, as shown in Table 33, the PMVS-L results based on a 100 basis point shift



in the LIBOR curve are disproportionately higher than the PMVS-L results based on a 50 basis point shift in the LIBOR curve.

**Table 33 — Portfolio Market Value Sensitivity Assuming Shifts of the LIBOR Yield Curve**

	Portfolio Market Value Sensitivity			Potential Pre-Tax Loss in Portfolio Market Value (in millions)		
	PMVS-YC	PMVS-L		PMVS-YC	PMVS-L	
	25 bp	50 bp	100 bp	25 bp	50 bp	100 bp
At:						
December 31, 2005 .....	—%	1%	3%	\$ 26	\$236	\$ 798
December 31, 2004 .....	—%	3%	8%	\$ 25	\$725	\$2,083

Derivatives have enabled us to keep our interest-rate risk exposure at consistently low levels in a wide range of interest-rate environments. By keeping PMVS-L and PMVS-YC low, we have been able to reduce the exposure of the fair value of our stockholders' equity to adverse changes in interest rates.

Table 34 shows that the low PMVS-L risk levels for the periods presented would generally have been higher if we had not used derivatives to manage our interest-rate risk exposure.

**Table 34 — Derivative Impact on PMVS**

	Before Derivatives	After Derivatives	Effect of Derivatives
<b>At December 31, 2005</b>			
PMVS-L (50bp) .....	2%	1%	(1)%
PMVS-YC (25bp) .....	—%	—%	—%
<b>At December 31, 2004</b>			
PMVS-L (50bp) .....	7%	3%	(4)%
PMVS-YC (25bp) .....	1%	—%	(1)%

*Duration Gap Results.* Our estimated average duration gap for the months of December 2005 and 2004 was zero months and negative one month, respectively.

The disclosure in our Monthly Volume Summary reports, which are available on our website at [www.FreddieMac.com](http://www.FreddieMac.com), reflects the average of the daily PMVS-L, PMVS-YC and Duration Gap estimates for a given reporting period (a month, quarter or year).

#### *Use of Derivatives and Interest-Rate Risk Management*

**Use of Derivatives.** We use derivatives primarily to:

- hedge forecasted issuances of debt and synthetically create callable and non-callable funding;
- regularly adjust or rebalance our funding mix in order to more closely match changes in the interest-rate characteristics of our mortgage assets; and
- hedge foreign-currency exposure (discussed above in “*Sources of Interest-Rate Risk and Other Market Risks — Foreign-Currency Risk.*”)

*Hedge Forecasted Debt Issuances and Create Synthetic Funding.* We typically commit to purchase mortgage investments on an opportunistic basis for a future settlement, typically ranging from two weeks to three months after the date of the commitment. To facilitate larger and more predictable debt issuances that contribute to lower funding costs, we use interest-rate derivatives to economically hedge the interest-rate risk exposure from the time we commit to purchase a mortgage to the time the related debt is issued. We also use derivatives to synthetically create the substantive economic equivalent of various debt funding structures. For example, the combination of a series of short-term debt issuances over a defined longer-term period and a pay-fixed swap with the same maturity as the last issuance is the substantive economic equivalent of a long-term fixed-rate debt instrument of comparable maturity. Similarly, the combination of non-callable debt and a swaption, or option to enter into a receive-fixed swap, with the same maturity as the non-callable debt, is the substantive economic equivalent of callable debt. These derivatives strategies increase our funding flexibility and allow us to better match asset and liability cash flows, often reducing the overall funding costs.

*Adjust Funding Mix.* We generally use interest-rate swaps to mitigate contractual funding mismatches between our assets and liabilities. We also use swaptions and other option-based derivatives to adjust the contractual funding of our debt in response to changes in the expected lives of mortgage-related assets in the Retained portfolio. As market conditions dictate, we take rebalancing actions to keep our interest-rate risk exposure within management-set limits. In a declining interest-rate environment, we typically enter into receive-fixed swaps or purchase Treasury-based derivatives to shorten the duration of our funding to offset the declining duration of our mortgage assets. In a rising interest-rate environment, we typically enter into pay-fixed swaps or sell Treasury-based derivatives in order to lengthen the duration of our funding to offset the increasing duration of our mortgage assets.



**Types of Derivatives.** The derivatives we use are common in the financial markets. We principally use the following types of derivatives:

- LIBOR-based interest-rate swaps;
- LIBOR- and Treasury-based exchange-traded futures;
- LIBOR- and Treasury-based options (including swaptions); and
- Foreign-currency swaps.

In addition to swaps, futures and options, our derivative positions include the following:

**Forward Purchase and Sale Commitments.** We routinely enter into forward purchase and sale commitments for mortgage loans and mortgage-related securities. Most of these commitments are derivatives subject to the requirements of SFAS 133.

**Swap Guarantee Derivatives.** We guarantee the payment of principal and interest on (a) multifamily mortgage loans that are originated and held by state and municipal housing finance agencies to support tax-exempt multifamily housing revenue bonds, (b) tax-exempt multifamily housing revenue bonds that support pass-through certificates issued by third parties and (c) Freddie Mac pass-through certificates which are backed by tax-exempt multifamily housing revenue bonds and related taxable bonds and/or loans. In connection with these guarantees, we have also guaranteed the sponsor's or the borrower's performance as a counterparty on any related interest-rate swaps used to mitigate interest-rate risk. Guarantees of these interest-rate swaps entered into after June 30, 2003 are treated as derivatives in accordance with SFAS 149 and are reported as swap guarantee derivatives.

**Prepayment Management Agreement.** Beginning in 2002, we required that certain mortgage pools delivered to us between 2001 and 2003, which we considered to pose an elevated risk of prepayment, be covered by a prepayment management agreement to partially compensate us for the adverse financial impacts caused by disproportionately higher mortgage prepayments. We also offered an incentive through an adjusted guarantee fee level on certain mortgage deliveries when the prepayment experience of the mortgage pools was within defined ranges. Effective December 31, 2005, we agreed to an early termination of this prepayment management agreement.

**Credit Derivatives.** See "Credit Risks — *Mortgage Credit Risk* — Mortgage Credit Risk Management Strategies" for more information.

### ***Derivative-Related Risks***

Our use of derivatives exposes us to derivative market liquidity risk and counterparty credit risk.

**Derivative Market Liquidity Risk.** Derivative market liquidity risk is the risk that we may not be able to enter into or exit out of derivative transactions at a reasonable cost. A lack of sufficient capacity or liquidity in the derivatives market could limit our risk management activities, increasing our exposure to interest-rate risk. To help maintain continuous access to derivative markets, we use a variety of products and transact with many different derivative counterparties. In addition to OTC derivatives, we also use exchange-traded derivatives, asset securitization activities, callable debt and short-term debt to rebalance our portfolio.

We limit our duration and convexity exposure to each counterparty. At December 31, 2005, the largest single uncollateralized exposure of our 25 approved OTC counterparties listed in "Table 35 — Derivative Counterparty Credit Exposure" was related to a AAA-rated counterparty, constituting \$93 million, or 49 percent, of the total uncollateralized exposure of our OTC interest-rate swaps, option-based derivatives and foreign-currency swaps.

**Derivative Counterparty Credit Risk.** Counterparty credit risk arises from the possibility that the derivative counterparty will not be able to meet its contractual obligations. Exchange-traded derivatives, such as futures contracts, do not measurably increase our counterparty credit risk because changes in the value of open exchange-traded contracts are settled daily through a financial clearinghouse established by each exchange. OTC derivatives, however, expose us to counterparty credit risk because transactions are executed and settled between us and the counterparty. When an OTC derivative has a market value above zero at a given date (*i.e.*, it is an asset reported as Derivative assets, at fair value on the consolidated balance sheets), then the counterparty could potentially be obligated to deliver cash, securities or a combination of both having that market value to satisfy its obligation to us under the derivative.

We actively manage our exposure to counterparty credit risk using several tools, including:

- review of external rating analyses;
- strict standards for approving new derivative counterparties;
- ongoing monitoring of our positions with each counterparty by type of derivative;

- master netting agreements and collateral agreements; and
- stress-testing to evaluate potential exposure under possible adverse market scenarios.

On an ongoing basis, we review the credit fundamentals of all of our derivative counterparties to confirm that they continue to meet our internal standards. We assign internal ratings, credit, capital and trading limits to each counterparty based on quantitative and qualitative analysis, which we update and monitor on a regular basis. We conduct additional reviews when market conditions dictate or events affecting an individual counterparty occur.

*Derivative Counterparties.* Our use of OTC interest-rate swaps, option-based derivatives and foreign-currency swaps is subject to rigorous internal credit and legal reviews. Our derivative counterparties carry external credit ratings among the highest available from major rating agencies. All of these counterparties are major financial institutions and are experienced participants in the OTC derivatives market.

*Master Netting and Collateral Agreements.* We use master netting and collateral agreements to reduce our credit risk exposure to our active OTC derivative counterparties for interest-rate swaps, option-based derivatives and foreign-currency swaps. See “NOTE 17: CONCENTRATION OF CREDIT AND OTHER RISKS” to our consolidated financial statements for additional information.

Table 35 summarizes our exposure to counterparty credit risk in our derivatives, which represents the net positive fair value of derivative contracts and related accrued interest after netting by counterparty as applicable (*i.e.*, net amounts due to us under derivative contracts). This table is useful in understanding the credit risk related to our derivative portfolio.

**Table 35 — Derivative Counterparty Credit Exposure**

December 31, 2005						
Rating <sup>(1)</sup>	Number of Counterparties <sup>(2)</sup>	Notional Amount	Total Exposure at Fair Value <sup>(3)</sup>	Exposure, Net of Collateral <sup>(4)</sup>	Weighted Average Contractual Maturity (in years)	Collateral Posting Threshold
				(dollars in millions)		
AAA .....	2	\$ 3,102	\$ 93	\$ 93	2.7	Mutually agreed upon
AA .....	7	148,135	619	16	4.3	\$10 million or less
AA- .....	8	156,058	2,499	73	5.8	\$10 million or less
A+ .....	5	227,842	5,297	2	5.8	\$1 million or less
A .....	2	24,879	364	5	4.0	\$1 million or less
A- .....	1	210	3	1	6.0	\$1 million or less
Subtotal <sup>(5)</sup> .....	25	560,226	8,875	190	5.3	
Other derivatives <sup>(6)</sup> .....		98,033	—	—		
Commitments .....		21,961	35	35		
Credit derivative .....		2,414	—	—		
Swap guarantee derivatives....		738	—	—		
Total derivatives .....		<u>\$683,372</u>	<u>\$8,910</u>	<u>\$225</u>		
December 31, 2004						
Rating <sup>(1)</sup>	Number of Counterparties <sup>(2)</sup>	Notional Amount	Total Exposure at Fair Value <sup>(3)</sup>	Exposure, Net of Collateral <sup>(4)</sup>	Weighted Average Contractual Maturity (in years)	Collateral Posting Threshold
				(dollars in millions)		
AAA .....	2	\$ 3,041	\$ 498	\$498	2.5	Mutually agreed upon
AA+ .....	1	597	399	32	23.9	\$10 million or less
AA .....	5	110,692	3,096	25	4.4	\$10 million or less
AA- .....	7	135,041	5,199	36	5.2	\$10 million or less
A+ .....	6	153,867	6,505	—	5.1	\$1 million or less
A .....	3	56,530	1,478	8	5.1	\$1 million or less
A- .....	1	210	11	2	7.0	\$1 million or less
Subtotal <sup>(5)</sup> .....	25	459,978	17,186	601	5.0	
Other derivatives <sup>(6)</sup> .....		138,822	—	—		
Prepayment management agreement .....		113,692	—	—		
Commitments .....		32,952	40	40		
Credit derivatives .....		10,926	—	—		
Swap guarantee derivatives....		408	—	—		
Total derivatives .....		<u>\$756,778</u>	<u>\$17,226</u>	<u>\$641</u>		

(1) We use the lower of S&P and Moody's ratings to manage collateral requirements. In this table, the rating of the legal entity is stated in terms of the S&P equivalent.

(2) Based on legal entities. Affiliated legal entities are reported separately.

(3) For each counterparty, this amount includes derivatives with a net positive fair value (recorded as Derivative assets, at fair value) including the related accrued interest receivable/payable (net) (recorded in Accounts and other receivables, net and Accrued interest payable).

(4) Total Exposure at Fair Value less collateral held as determined at the counterparty level.

(5) Consists of OTC derivative agreements for interest-rate swaps, option-based derivatives, excluding written options, foreign-currency swaps and purchased interest-rate caps. Written options do not present counterparty credit exposure, because we receive a one-time up-front premium in exchange for giving the holder the right to execute a contract under specified terms, which generally puts us in a liability position.

(6) Consists primarily of exchange-traded contracts.

Over time, our exposure to individual counterparties for OTC interest-rate swaps, option-based derivatives and foreign-currency swaps varies depending on changes in fair values which are affected by changes in period-end interest rates, the implied volatility of interest rates, foreign-currency exchange rates and the amount of derivatives held. Our uncollateralized exposure to counterparties for these derivatives, after applying netting agreements and collateral, decreased to \$190 million at December 31, 2005 from \$601 million at December 31, 2004. This decrease was due to a significant decrease in uncollateralized exposure to AAA-rated counterparties, which typically are not required to post collateral given their low risk profile.

At December 31, 2005, the uncollateralized exposure to non-AAA-rated counterparties was due to uncollateralized exposure below the applicable counterparty posting threshold as well as market movements during the time period between when a derivative was marked to fair value and the date we received the related collateral.

As indicated in Table 35, approximately 98 percent of our counterparty credit exposure for OTC interest-rate swaps, option-based derivatives and foreign-currency swaps was collateralized at December 31, 2005. In the event that all of our

counterparties for these derivatives were to have defaulted simultaneously on December 31, 2005, our maximum loss for accounting purposes would have been approximately \$190 million. Our economic loss, as measured by our potential additional uncollateralized exposure, may be higher than the uncollateralized exposure of our derivatives if we were not able to replace the defaulted derivatives in a timely fashion. We monitor the risk that our uncollateralized exposure to each of our OTC counterparties for interest-rate swaps, option-based derivatives and foreign-currency swaps will increase under certain adverse market conditions by performing daily market stress tests. These tests evaluate the potential additional uncollateralized exposure we would have to each of these derivative counterparties assuming changes in the level and implied volatility of interest rates and changes in foreign-currency exchange rates over a brief time period.

To date, we have not incurred any credit losses on OTC derivative counterparties or set aside specific reserves for institutional credit risk exposure. We do not believe such reserves are necessary, given our counterparty credit risk management policies and collateral requirements.

*OTC Forward Purchase and Sale Commitments Treated as Derivatives.* Since the typical maturity for our OTC commitments is less than one year, we do not require master netting and collateral agreements for the counterparties of these commitments. However, we monitor the credit fundamentals of our OTC commitments counterparties on an ongoing basis to ensure that they continue to meet our internal risk-management standards. As indicated in Table 35, the exposure to OTC commitments counterparties of \$35 million and \$40 million at December 31, 2005 and 2004, respectively, was uncollateralized.

## **Credit Risks**

Our credit guarantee portfolio is subject primarily to two types of credit risk — mortgage credit risk and institutional credit risk. Mortgage credit risk is the risk that a borrower will fail to make timely payments on a mortgage or security we own or guarantee. Institutional credit risk is the risk that a counterparty that has entered into a business contract or arrangement with us will fail to meet its obligations. See “Table 46 — Total Mortgage Portfolio and Total Guaranteed PCs and Structured Securities Issued Based on Unpaid Principal Balances” for more information on the composition of our Total mortgage portfolio.

### ***Mortgage Credit Risk***

**Mortgage Credit Risk Management Strategies.** Mortgage credit risk is primarily influenced by the credit profile of the borrower on the mortgage, the features of the mortgage itself, the type of property securing the mortgage and by the general economy, especially the movement of house prices. To manage our mortgage credit risk, we focus on three key areas: underwriting requirements and quality control standards; portfolio diversification; and portfolio management activities, including loss mitigation, and the use of credit enhancements and credit risk transfers. While we have historically focused on obtaining credit enhancements at the time of mortgage purchase, we are continuing to expand our capabilities in this area to allow more active and ongoing credit portfolio rebalancing and risk transfers.

***Underwriting Requirements and Quality Control Standards.*** All mortgages that we purchase or guarantee have an inherent risk of default. We seek to manage the underlying risk in a given mortgage we securitize or purchase for our Retained portfolio by adequately pricing for the risk we assume using our underwriting and quality control processes. We use a process of delegated underwriting for the single-family mortgages we purchase or securitize. In this process, we provide originators with a series of mortgage underwriting guidelines and they represent and warrant to us that the mortgages sold to us meet these guidelines. We subsequently review a sample of these loans and, if we determine that any loan is not in compliance with our underwriting standards, we may require the seller/servicer to repurchase that mortgage or make us whole in the event of a default. We provide originators with written standards and/or automated underwriting software tools, such as Loan Prospector® and other quantitative credit risk management tools that are designed to evaluate single-family mortgages and monitor the related mortgage credit risk for loans we may purchase. Loan Prospector® generates a credit risk classification by evaluating information on significant indicators of mortgage default risk, such as loan-to-value ratios, credit scores and other mortgage and borrower characteristics. These statistically-based risk assessment tools increase our ability to distinguish among single-family loans based on their expected risk, return and importance to our mission. We may allow seller/servicers to underwrite mortgages for sale to us using other automated underwriting systems and agreed-upon underwriting standards that differ from our normal standards.

The percentage of our single-family mortgage purchase volume evaluated using Loan Prospector® prior to purchase has declined over the last three years. As part of our post-purchase quality control review process, we use Loan Prospector® to evaluate the credit quality of virtually all single-family mortgages that were not evaluated by Loan Prospector® prior to purchase. Loan Prospector® risk classifications influence both the price we charge to guarantee loans and the loans we review in quality control.

We have been expanding the share of mortgages we purchase that were underwritten and originated using alternative automated underwriting systems, which could increase our credit risk. We regularly monitor the performance of mortgages purchased using these systems and if they underperform mortgages originated using Loan Prospector we may seek additional compensation for guaranteeing such mortgages in the future.

For multifamily mortgage loans, unless the mortgage loans have significant credit enhancements, we use an intensive pre-purchase underwriting process for the mortgages we purchase. Our underwriting process includes assessments of the local market, the borrower, the property manager, the property's historical and projected financial performance and the property's physical condition, which may include a physical inspection of the property. In addition to our own inspections, we rely on third-party appraisals and environmental and engineering reports.

**Credit Enhancements.** Our charter requires that single-family mortgages with loan-to-value ratios above 80 percent at the time of purchase must be covered by one or more of the following: (a) primary mortgage insurance; (b) a seller's agreement to repurchase or replace any mortgage in default (for such period and under such circumstances as we may require); or (c) retention by the seller of at least a ten percent participation interest in the mortgages. In addition, for some mortgage loans, we elect to share the default risk by transferring a portion of that risk to various third parties through a variety of other credit enhancements. In many cases, the lender's or third party's risk is limited to a specific level of losses at the time the credit enhancement becomes effective. At December 31, 2005 and 2004, credit-enhanced single-family mortgages and mortgage-related securities represented approximately 17 percent and 19 percent of the \$1,395 billion and \$1,267 billion, respectively, unpaid principal balance of the Total mortgage portfolio, excluding non-Freddie Mac mortgage-related securities and that portion of issued Structured Securities that is backed by Ginnie Mae Certificates. We exclude non-Freddie Mac mortgage-related securities because they expose us primarily to institutional credit risk. We exclude that portion of Structured Securities backed by Ginnie Mae Certificates because the incremental credit risk to which we are exposed is considered de minimis. See "CONSOLIDATED BALANCE SHEETS ANALYSIS — Table 17 — Characteristics of Mortgage Loans and Mortgage-Related Securities in the Retained Portfolio" for additional information about our non-Freddie Mac mortgage-related securities. Our ability and desire to expand the portion of our Total mortgage portfolio with credit enhancements will depend on our evaluation of the credit quality of new business purchase opportunities, the risk profile of our portfolio and the future availability of effective credit enhancements at prices that permit an attractive return. While the use of credit enhancements reduces our exposure to mortgage credit risk, it increases our exposure to institutional credit risk.

Primary mortgage insurance is the most prevalent type of credit enhancement protecting our Total mortgage portfolio and is typically provided on a loan-level basis for certain single-family mortgages. Primary mortgage insurance transfers varying portions of the credit risk associated with a mortgage to a third-party insurer. The amount of insurance we obtain on any mortgage depends on our requirements, which depend on our assessment of risk. We may from time to time agree with the insurer to reduce the amount of coverage that is in excess of our charter's minimum requirement and may also furnish certain services to the insurer in exchange for fees paid by the insurer. As is the case with credit enhancement agreements generally, these agreements often improve the overall value of purchased mortgages and thus may allow us to offer lower guarantee fees to sellers.

After primary mortgage insurance, the most prevalent type of credit enhancement that we use is pool insurance. With pool insurance, a mortgage insurer provides insurance on a pool of loans up to a stated aggregate loss limit. In addition to a pool-level loss coverage limit, some pool insurance contracts may have limits on coverage at the loan level. For pool insurance contracts that expire before the completion of the contractual term of the mortgage loan, we seek to ensure that the contracts cover the period of time during which we believe the mortgage loans are most likely to default.

Other forms of credit enhancements on single-family mortgage loans include indemnification agreements (under which we may require a lender to reimburse us for credit losses realized on mortgages), government guarantees, collateral (including cash or high-quality marketable securities) pledged by a lender and subordinated security structures.

For multifamily mortgages, we occasionally use credit enhancements to mitigate risk. The types of credit enhancements used for multifamily mortgage loans include recourse, third-party guarantees or letters of credit, cash escrows, subordinated participations in mortgage loans or structured pools, and cross-default and cross-collateralization provisions. Cross-default and cross-collateralization provisions typically work in tandem. With a cross-default provision, if the loan on a property goes into default, we have the right to declare specified other mortgage loans of the same borrower or certain of its affiliates to be in default and to foreclose those other mortgages. In cases where the borrower agrees to cross-collateralization, we have the additional right to apply excess proceeds from the foreclosure of one mortgage to amounts owed to us by the same borrower or its specified affiliates relating to other multifamily mortgage loans we own. For information about our maximum coverage in regards to these credit enhancements, see "NOTE 4: FINANCIAL GUARANTEES" to our consolidated financial statements. We also receive similar credit enhancements for multifamily PC Guarantor Swaps; for tax-exempt multifamily



housing revenue bonds that support pass-through certificates issued by third parties for which we provide our guarantee of the payment of principal and interest; for Freddie Mac pass-through certificates that are backed by tax-exempt multifamily housing revenue bonds and related taxable bonds and/or loans; and for multifamily mortgage loans that are originated and held by the state and municipal agencies to support tax-exempt multifamily housing revenue bonds for which we provide our guarantee of the payment of principal and interest.

**Portfolio Diversification.** A key characteristic of our credit risk portfolio is diversification along a number of critical risk dimensions. We continually monitor a variety of mortgage loan characteristics such as product mix, loan-to-value ratios and geographic concentration, which may affect the default experience on our overall mortgage portfolio. As part of our risk management practices, we have adopted a set of limits on our purchases and holdings of certain types of loans that are deemed to have higher risks, including interest-only loans, Option ARMs, loans with high loan-to-value ratios, and mortgages originated with limited or no underwriting documentation.

Table 36 provides the distribution of our Total mortgage portfolio.

**Table 36 — Total Mortgage Portfolio Distribution<sup>(1)(2)</sup>**

	December 31,	
	2005	2004
	(dollars in millions)	
<b>Balances related to:</b>		
Guaranteed PCs and Structured Securities:		
Single-family .....	\$1,294,521	\$1,173,847
Multifamily .....	14,503	15,546
Structured Securities backed by non-Freddie Mac mortgage-related securities .....	26,500	19,575
Mortgage loans in the Retained Portfolio:		
Single-Family .....	20,396	23,389
Multifamily .....	41,085	37,971
Total Unpaid Principal Balance .....	<u>\$1,397,005</u>	<u>\$1,270,328</u>
<b>Product Distribution</b>		
<i>Single-family</i>		
30-year fixed .....	59%	56%
15-year fixed .....	23	28
ARMS/Variable-rate .....	8	8
Option ARMS <sup>(3)</sup> .....	1	—
Interest only <sup>(4)</sup> .....	2	—
Balloon/Resets .....	2	3
Other <sup>(5)</sup> .....	1	1
Total single-family .....	<u>96</u>	<u>96</u>
<i>Multifamily</i> .....	<u>4</u>	<u>4</u>
<b>Total</b> .....	<u>100%</u>	<u>100%</u>

(1) Based on unpaid principal balances.

(2) Excludes non-Freddie Mac mortgage-related securities other than those that underlie Structured Securities.

(3) Represents loans that may expose the borrower to future increases in the loan obligation in excess of increases that result solely from contractual interest-rate adjustments. Includes mortgage loans we purchased that underlie the guaranteed portion of whole-loan REMICs and that portion of alternative collateral deals that are backed by negative amortization loans.

(4) Represents loans where the borrower pays only interest for a period of time before the loan begins to amortize.

(5) Represents alternative collateral deals that include Structured Securities backed by non-agency securities, which were backed by FHA/VA and subprime mortgage loans primarily, and Structured Securities backed by Ginnie Mae securities.

Product mix affects the credit risk profile of our Total mortgage portfolio. In general, 15-year fixed-rate mortgages exhibit the lowest default rate among the types of mortgage loans we securitize and purchase, due to the accelerated rate of principal amortization on these mortgages and the credit profiles of borrowers who seek and qualify for them. The next lowest rate of default is associated with 30-year fixed-rate mortgages. Balloon/reset mortgages and ARMs typically default at a higher rate than fixed-rate mortgages, although default rates for different types of ARMs may vary. While ARMs are typically originated with interest rates that are initially lower than those available for fixed-rate mortgages, their interest rates also change over time based on changes in an index or reference interest rate. As a result, the borrower's payments may rise or fall, within limits, as interest rates change. As payment amounts increase, the risk of default also increases. In the low interest rate environment experienced during 2005, 2004 and 2003, this trend was reversed with ARMs exhibiting lower default rates than fixed-rate mortgages.

During 2005 and 2004, there was a rapid proliferation of alternative product types designed to address a variety of borrower needs, including issues of affordability and lack of income documentation. While each of these products has been on the market for some time, their prevalence increased in 2005 and 2004. We expect each of these products to default more often than traditional products and we consider this when determining our guarantee fee. Our purchases of interest-only and Option ARM mortgage products increased in 2005, representing approximately 11 percent of our Total mortgage portfolio purchases as compared to 2 percent in 2004, and we expect this trend to continue in 2006. Despite this recent

increase in purchases, these products represent a small percentage of the unpaid principal balance of our Total mortgage portfolio. At December 31, 2005 and 2004, interest-only and option ARMs collectively represented approximately 3 percent and less than 1 percent, respectively, of the unpaid principal balance of the Total mortgage portfolio. We will continue to monitor the growth of these products in our portfolio and, if appropriate, may seek credit enhancements to further manage the incremental risk.

We also hold securities issued by third parties where the underlying collateral may include interest-only and Option ARM mortgage products. We generally mitigate credit risk inherent in these securities through a guarantee from the third party issuer or the underlying structure of the security. For additional information about the credit quality and credit risk management of non-Freddie Mac securities we hold see “*Institutional Credit Risk — Non-Freddie Mac Mortgage-Related Securities*” and “MD&A — CONSOLIDATED BALANCE SHEETS ANALYSIS — Retained Portfolio.”

The subprime segment of the mortgage market primarily serves borrowers with lower quality credit payment histories. Our participation in this market helps reduce barriers to homeownership for these borrowers by increasing the availability of mortgage credit and reducing the costs of homeownership. We participate in the subprime market segment primarily in two ways. First, our Retained portfolio makes investments in non-Freddie Mac mortgage-related securities that were originated in this market segment. Substantially all of these securities were rated “AAA” by one or more rating agencies at the time of purchase. Second, we guarantee securities backed by subprime mortgages, which comprise a portion of the “alternative collateral deals” we purchase. These securities have previously been credit enhanced and at the time of our purchase most were “shadow rated” at least “BBB” (based on the S&P rating scale) by at least one nationally recognized credit rating agency which assessed the credit risks of the securities without regard to the benefits of our guarantee. At December 31, 2005 and 2004, we guaranteed \$2.3 billion and \$4.5 billion of securities backed by subprime mortgages which constituted less than one percent of our Total mortgage portfolio, respectively. In addition to the non-Freddie Mac mortgage-related securities discussed above, we make investments through our Retained portfolio in some of the Structured Securities we issue with underlying collateral that is subprime.

The distribution of the single-family loans underlying our Total mortgage portfolio by original and estimated current loan-to-value ratio, credit scores, loan purpose, property type and occupancy type is shown in Table 37.

**Table 37 — Characteristics of Single-Family Total Mortgage Portfolio<sup>(1)</sup>**

Original Loan-to-Value, or LTV, Ratio Range <sup>(2)</sup>	Purchases During the Year Ended December 31,			Ending Balance December 31,		
	2005	2004	2003	2005	2004	2003
Less than 60% . . . . .	21%	23%	29%	25%	26%	26%
Above 60% to 70% . . . . .	16	16	19	17	17	17
Above 70% to 80% . . . . .	50	46	40	44	42	41
Above 80% to 90% . . . . .	7	8	7	8	9	9
Above 90% to 95% . . . . .	4	6	4	5	5	6
Above 95% . . . . .	2	1	1	1	1	1
Total . . . . .	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>
Weighted average original loan-to-value ratio . . . . .	71%	71%	68%	70%	70%	70%
<b>Estimated Current LTV Ratio Range<sup>(3)</sup></b>						
Less than 60% . . . . .				57%	53%	44%
Above 60% to 70% . . . . .				17	19	20
Above 70% to 80% . . . . .				18	18	23
Above 80% to 90% . . . . .				6	7	9
Above 90% to 95% . . . . .				1	2	3
Above 95% . . . . .				1	1	1
Total . . . . .				<u>100%</u>	<u>100%</u>	<u>100%</u>
Weighted average estimated current LTV ratio . . . . .				55%	57%	61%
<b>Credit Score<sup>(4)</sup></b>						
740 and above . . . . .	44%	41%	49%	45%	44%	44%
700 to 739 . . . . .	23	24	23	23	23	23
660 to 699 . . . . .	19	20	17	18	18	17
620 to 659 . . . . .	10	11	8	9	9	9
Less than 620 . . . . .	4	4	3	4	4	4
Not Available . . . . .	—	—	—	1	2	3
Total . . . . .	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>
Weighted average credit score . . . . .	722	719	729	725	723	723
<b>Loan Purpose</b>						
Purchase . . . . .	44%	40%	19%	32%	28%	25%
Cash-out refinance . . . . .	35	27	26	29	27	26
Other refinance . . . . .	21	33	55	39	45	49
Total . . . . .	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>
<b>Property Type</b>						
1 unit . . . . .	97%	97%	98%	97%	97%	97%
2-4 units . . . . .	3	3	2	3	3	3
Total . . . . .	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>
<b>Occupancy Type</b>						
Primary residence . . . . .	91%	92%	95%	93%	94%	94%
Second/vacation home . . . . .	5	4	3	4	3	3
Investment . . . . .	4	4	2	3	3	3
Total . . . . .	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>

(1) Purchases and ending balances are based on the unpaid principal balance of the single-family mortgage portfolio (excluding non-Freddie Mac mortgage-related securities, alternative collateral deals that are not backed by prime mortgage loans and that portion of Structured Securities that is backed by Ginnie Mae Certificates). Such purchases totaled \$396 billion, \$360 billion and \$701 billion at December 31, 2005, 2004 and 2003, respectively. Such ending balances totaled \$1,333 billion, \$1,203 billion and \$1,151 billion at December 31, 2005, 2004 and 2003, respectively.

(2) Our charter requires that mortgage loans purchased with loan-to-value ratios above 80 percent be covered by mortgage insurance or other credit enhancements.

(3) Current market values are estimated by adjusting the value of the property at origination based on changes in the market value of house prices since origination. Estimated current LTV excludes alternative collateral deals and Option ARMs. Estimated current LTV ratio range is not applicable to purchases made during the year.

(4) Credit score data are as of mortgage loan origination.

**Loan-to-Value Ratios.** Our principal safeguard against credit losses for mortgage loans in our single-family, non-credit-enhanced portfolio is provided by the borrowers' equity in the underlying properties. Mortgage loans with higher loan-to-value ratios (and therefore lower levels of borrower equity) at the time of purchase are also protected by credit enhancements, since our charter requires that loans with loan-to-value ratios above 80 percent at the time of purchase be covered by mortgage insurance or certain other credit protections.

The likelihood of single-family mortgage default depends not only on the initial credit quality of the loan, but also on events that occur after origination. Accordingly, we monitor changes in house prices across the country and the impact of these house price changes on the underlying loan-to-value ratio of mortgages in our portfolio. House prices have risen significantly over the last 10 years, and have grown very dramatically over the last four years. This house price appreciation

has increased the values of properties underlying the mortgages in our portfolio. We monitor regional geographic markets for changes in these trends, particularly with respect to new loans originated in regional markets that have had significant house price appreciation, and may seek to reinsure a portion of this risk should we determine that the possibility of such changes warrants action. Historical experience has shown that defaults are less likely to occur on mortgages with lower estimated current loan-to-value ratios. Furthermore, in the event of a default, increases in house prices generally reduce the total amount of loss, thereby mitigating credit losses.

**Credit Score.** Credit scores are a useful measure for assessing the credit quality of a borrower. Credit scores are numbers reported by credit repositories, based on statistical models, that summarize an individual's credit record and predict the likelihood that a borrower will repay future obligations as expected. FICO® scores, developed by Fair, Isaac and Co., Inc., are the most commonly used credit scores today. FICO scores are ranked on a scale of approximately 300 to 850 points. Statistically, consumers with higher credit scores are more likely to repay their debts as expected than those with lower scores. The weighted average credit score for the Total mortgage portfolio (based on the credit score at origination) remained high at 725 at December 31, 2005 and 723 at both December 31, 2004 and 2003, indicating borrowers with strong credit quality.

**Loan Purpose.** Mortgage loan purpose indicates how the borrower intends to use the funds from a mortgage loan. The three general categories are: purchase, cash-out refinance, or other refinance. In a purchase transaction, funds are used to acquire a property. In a cash-out refinance transaction, in addition to paying off an existing first mortgage lien, the borrower obtains additional funds that may be used for other purposes, including paying off subordinate mortgage liens and providing unrestricted cash proceeds to the borrower. In other refinance transactions, the funds are used to pay off an existing first mortgage lien and may be used in limited amounts for certain specified purposes; such refinances are generally referred to as "no cash-out" or "rate and term" refinances. Other refinance transactions also include refinance mortgages for which the delivery data provided was not sufficient for us to determine whether the mortgage was a cash-out or a no cash-out refinance transaction. Given similar loan characteristics (e.g., loan-to-value ratios), purchase transactions have the lowest likelihood of default followed by no-cash out refinances and then cash out refinances. As a practical matter, however, no-cash out refinances tend to have lower loan-to-value ratios and borrowers with higher credit scores than purchase transactions and as such, have better overall performance than purchase transactions.

**Property Type.** Single-family mortgage loans are defined as mortgages secured by housing with up to four living units. Mortgages on one-unit properties tend to have lower credit risk than mortgages on multiple-unit properties.

**Occupancy Type.** Borrowers may purchase a home as a primary residence, second/vacation home or investment property that is typically a rental property. Mortgage loans on properties occupied by the borrower as a primary or secondary residence tend to have a lower credit risk than mortgages on investment properties.

**Geographic Concentration.** Since our business involves purchasing mortgages from every geographic region in the U.S., we maintain a geographically diverse mortgage portfolio. This diversification generally mitigates credit risks arising from changing local economic conditions. See "NOTE 17: CONCENTRATION OF CREDIT AND OTHER RISKS" to our consolidated financial statements for more information concerning the distribution of our Total mortgage portfolio by geographic region. Our Total mortgage portfolio's geographic distribution was relatively stable from 2003 to 2005, and remains broadly diversified across these regions.

**Loss Mitigation Activities.** Within our Total mortgage portfolio, we expect and price for some mortgage loans to become non-performing due to changes in general economic conditions, changes in the financial status of individual borrowers or other factors. Table 38 summarizes our non-performing assets. The increase in our non-performing assets from 2001 through 2003 was primarily driven by higher delinquencies associated with our alternative collateral deals. While these delinquencies result in higher levels of non-performing assets, we have limited loss exposure due to the credit enhancements associated with these securities. The increase in our troubled debt restructurings from 2004 to 2005 was primarily related to multifamily loans impacted by Hurricane Katrina. At December 31, 2005, troubled debt restructurings as shown in Table 38 included multifamily loans affected by Hurricane Katrina with unpaid principal balances totaling approximately \$210 million.

**Table 38 — Non-Performing Assets**

	December 31,				
	2005	2004	2003	2002	2001
	(in millions)				
Troubled debt restructurings <sup>(1)</sup>	\$2,605	\$2,297	\$ 2,370	\$2,164	\$1,617
Serious delinquencies <sup>(2)</sup>	6,438	6,318	7,470	6,830	5,070
Non-accrual loans <sup>(3)</sup>	1	27	21	47	44
Subtotal <sup>(4)</sup>	9,044	8,642	9,861	9,041	6,731
REO, net <sup>(5)</sup>	629	741	795	594	447
Total	<u>\$9,673</u>	<u>\$9,383</u>	<u>\$10,656</u>	<u>\$9,635</u>	<u>\$7,178</u>

- (1) Includes previously delinquent loans whose terms have been modified. Some of these loans may be performing as a result of the modified terms. Troubled debt restructurings are considered part of our impaired loan population. Figures presented are based on unpaid principal balances of mortgage loans. See “NOTE 6: LOAN LOSS RESERVES” to the consolidated financial statements for additional information on impaired loans.
- (2) Includes single-family loans 90 days or more delinquent. For multifamily loans, the population includes all loans 60 days or more delinquent, but less than 90 days delinquent. Also included within this population are multifamily loans greater than 90 days past due but where principal and interest are being paid to us under the terms of a credit enhancement agreement. Also includes seriously delinquent loans in alternative collateral deals, which totaled \$1,449 million, \$2,234 million, \$2,793 million, \$2,290 million and \$1,052 million at December 31, 2005, 2004, 2003, 2002 and 2001, respectively. For more information about delinquency rates, see “NOTE 6: LOAN LOSS RESERVES — Table 6.3 — Delinquency Performance” to the consolidated financial statements.
- (3) Non-accrual mortgage loans are loans for which interest income is recognized only on a cash basis and only includes multifamily loans that are 90 days or more delinquent. No single-family mortgage loans are classified as non-accrual.
- (4) For the year ended December 31, 2005, \$481 million was included in net interest income and management and guarantee income related to these mortgage loans (excluding interest income related to alternative collateral deals). The amount of forgone net interest income and additional management and guarantee income that we would have recorded had these loans been current is \$140 million for the year ended December 31, 2005.
- (5) For more information about REO balances, see “NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES” and “NOTE 7: REAL ESTATE OWNED” to the consolidated financial statements.

Loss mitigation activities are a key component of our strategy for managing and resolving troubled assets and lowering credit losses. Our loss mitigation strategy emphasizes early intervention in delinquent mortgages and alternatives to foreclosure. Other single-family loss mitigation activities include providing our single-family servicers with default management tools designed to help them manage non-performing loans more effectively. Foreclosure alternatives are intended to reduce the number of delinquent mortgages that proceed to foreclosure and, ultimately, mitigate our total credit losses by eliminating a portion of the costs related to foreclosed properties. Repayment plans, the most common type of foreclosure alternative, mitigate our credit losses because they assist borrowers in returning to compliance with the original terms of their mortgages. Loan modifications, the second most common type of foreclosure alternative, involve changing the terms of a mortgage and therefore are a more favorable alternative to the borrower during a declining interest-rate environment. Forbearance agreements, the third most common type of foreclosure alternative, provide a temporary suspension of the foreclosure process to allow additional time for the borrower to return to compliance with the original terms of the borrower’s mortgage or to implement another foreclosure alternative. The total number of loans with foreclosure alternatives was approximately 60,000, 48,300 and 46,900 for the years ended December 31, 2005, 2004 and 2003, respectively. The increase in foreclosure alternatives in 2005 was primarily driven by forbearance agreements related to single-family loans affected by Hurricane Katrina.

We require multifamily servicers to closely manage mortgage loans they have sold us in order to mitigate potential losses. Generally, on an annual basis, for loans over \$1 million, servicers must submit an assessment of the mortgaged property to us based on the servicer’s analysis of financial and other information about the property and, except for certain higher performing loans, an inspection of the property. We evaluate these assessments internally and may direct the servicer to take specific actions to reduce the likelihood of delinquency or default. If a loan defaults despite this intervention, we may offer a foreclosure alternative to the borrower. For example, we may modify the terms of a multifamily mortgage loan, which gives the borrower an opportunity to bring the loan current and allows the borrower to retain ownership of the property. Since multifamily seller/servicers are an important part of our loss mitigation process, we rate their performance regularly and conduct on-site reviews of their servicing operations to confirm compliance with our standards.

**Other Credit Risk Management Activities.** We purchase a broad range of mortgage products with differing degrees of default risk. To compensate us for unusual levels of risk in some mortgage products we may charge incremental fees above a base guarantee fee calculated based on credit risk factors such as the mortgage product type, loan purpose, loan-to-value ratio, and other loan or borrower attributes. In addition, we occasionally use financial incentives and credit derivatives, as described below, in situations where we believe they will benefit our credit risk management strategy. These arrangements are intended to reduce our credit-related expenses and to help us manage purchase quality, thereby improving our overall returns.

In some cases, we provide financial incentives in the form of lump sum payments to selected seller/servicers if they deliver a specified volume or percentage of mortgage loans meeting specified credit risk standards over a defined period of



time. These financial incentives may also take the form of a fee payable to us by the seller if the mortgages delivered to us do not meet certain credit standards.

We have also entered into risk-sharing agreements. Under these agreements, default losses on specific mortgage loans delivered by sellers are compared to default losses on reference pools of mortgage loans with similar characteristics. Based upon the results of that comparison, we remit or receive payments based upon the default performance of the specified mortgage loans. These agreements are accounted for as credit derivatives rather than financial guarantees, in part, because we may make payments to the seller/servicer under these agreements (depending upon actual default experience over the lives of the mortgages). The total notional amount of mortgage loans subject to these agreements was approximately \$2.4 billion and \$10.9 billion at December 31, 2005 and 2004, respectively. These risk-sharing agreements are derivatives classified as no hedge designation, with changes in fair value recorded as Derivative gains (losses) on the consolidated statements of income. The fair value of these risk-sharing agreements is recorded in Derivative assets, at fair value and Derivative liabilities, at fair value on the consolidated balance sheets, with net amounts of \$(1) million and \$(2) million at December 31, 2005 and 2004, respectively.

Although these arrangements are part of our overall credit risk management strategy, we have not treated them as credit enhancements for purposes of describing our Total mortgage portfolio characteristics because the financial incentive and credit derivative agreements may result in us making payments to the seller/servicer.

**Credit Performance.** Credit losses are a useful indicator of credit risk management activities; however, they must ultimately be considered relative to the revenue received for assuming the underlying credit risk. Several key statistics associated with potential and actual credit losses are detailed in the tables below.

**Delinquencies.** Table 39 presents delinquency information for the single-family loans underlying our Total mortgage portfolio.

**Table 39 — Single-Family — Delinquency Rates — By Region<sup>(1)(2)(3)</sup>**

	December 31,		
	2005	2004	2003
Northeast .....	0.22%	0.24%	0.28%
Southeast .....	0.38	0.31	0.32
North central .....	0.30	0.27	0.27
Southwest .....	0.64	0.26	0.28
West .....	0.11	0.15	0.19
Total non-credit-enhanced — all regions .....	0.30	0.24	0.27
Total credit-enhanced — all regions .....	2.46	2.75	2.96
Total credit-enhanced and non-credit-enhanced — all regions .....	0.69%	0.73%	0.86%

(1) Based on mortgage loans in the Retained portfolio and Total Guaranteed PCs and Structured Securities Issued, excluding that portion of Structured Securities that is backed by Ginnie Mae Certificates.

(2) Based on the number of mortgages 90 days or more delinquent or in foreclosure. Excludes delinquencies in alternative collateral deals.

(3) Region Designation: West (AK, AZ, CA, GU, HI, ID, MT, NV, OR, UT, WA); Northeast (CT, DE, DC, MA, ME, MD, NH, NJ, NY, PA, RI, VT, VA, WV); North central (IL, IN, IA, MI, MN, ND, OH, SD, WI); Southeast (AL, FL, GA, KY, MS, NC, PR, SC, TN, VI); Southwest (AR, CO, KS, LA, MO, NE, NM, OK, TX, WY). Beginning in 2005, Puerto Rico and Virgin Islands were reclassified from Northeast to Southeast.

While overall single-family delinquencies have declined over the past three years as a result of generally strong economic conditions and continued house price appreciation in the United States, non-credit enhanced delinquencies increased in 2005, with some regional variation, primarily due to Hurricane Katrina. See “Table 6.3 — Delinquency Performance” in “NOTE 6: LOAN LOSS RESERVES” to the consolidated financial statements for detailed delinquency performance information.

Our multifamily delinquency rate remained very low at zero percent, 0.06 percent and 0.05 percent at the end of 2005, 2004 and 2003, respectively. Hurricane Katrina has not affected our reported multifamily delinquency rate because the contractual terms of certain affected mortgage loans, with unpaid principal balances totaling \$210 million at December 31, 2005, were modified. Multifamily delinquencies may include mortgage loans where the borrowers are not paying as agreed, but principal and interest are being paid to us under the terms of a credit enhancement agreement.

**Table 40 — Single-Family Mortgages By Year of Origination — Percentage of Mortgage Portfolio and Non-Credit-Enhanced Delinquency Rates**

Year of Origination	December 31,					
	2005		2004		2003	
	Percent of Single-Family Balance <sup>(1)</sup>	Non-Credit-Enhanced Delinquency Rate <sup>(2)</sup>	Percent of Single-Family Balance <sup>(1)</sup>	Non-Credit-Enhanced Delinquency Rate <sup>(2)</sup>	Percent of Single-Family Balance <sup>(1)</sup>	Non-Credit-Enhanced Delinquency Rate <sup>(2)</sup>
Pre-1998 .....	3%	0.75%	4%	0.67%	7%	0.69%
1998 .....	2	0.56	3	0.49	4	0.45
1999 .....	1	0.89	2	0.78	3	0.73
2000 .....	—	2.09	1	1.94	1	1.78
2001 .....	4	0.75	6	0.59	10	0.48
2002 .....	11	0.38	16	0.26	24	0.18
2003 .....	34	0.17	44	0.06	51	0.01
2004 .....	21	0.21	24	0.03	—	—
2005 .....	24	0.08	—	—	—	—
At December 31 .....	<u>100%</u>	<u>0.30%</u>	<u>100%</u>	<u>0.24%</u>	<u>100%</u>	<u>0.27%</u>

(1) Based on unpaid principal balances of the single-family mortgage portfolio (excluding non-Freddie Mac mortgage-related securities, alternative collateral deals and that portion of Structured Securities that is backed by Ginnie Mae Certificates).

(2) Based on mortgages 90 days or more delinquent or in foreclosure.

Our single-family portfolio was affected by heavy refinance volumes in recent years. At December 31, 2005, 79 percent of our single-family mortgage portfolio consisted of mortgage loans originated in 2005, 2004 or 2003. Mortgage loans originated in 2002 and earlier, which represent approximately 21 percent of our single-family mortgage portfolio, have delinquency rates that are generally higher than the overall portfolio delinquency rate due to the natural aging of the loans and, in some instances, the weaker credit quality of these loans. For example, mortgage loans originated in 2000 were generally for purchase transactions, which typically involve more risk because they tend to have relatively higher loan-to-value ratios and borrowers with lower credit scores, resulting in weaker credit quality, than loans originated in refinancing transactions. As a result, we have experienced higher than average early defaults and delinquency rates on these mortgage loans originated in 2000, but they represent less than one percent of the single-family Total mortgage portfolio.

**Credit Loss Performance.** Table 41 provides detail on our credit loss performance, including REO activity, charge-offs and credit losses. The decrease in REO operations income of \$43 million in 2005 compared to 2004 was primarily attributable to a reduction in recoveries.

**Table 41 — Credit Loss Performance**

	Year Ended December 31,		
	2005	2004	2003
	(dollars in millions)		
<b>REO</b>			
REO balances:			
Single-family	\$ 611	\$ 740	\$ 758
Multifamily	18	1	37
Total	<u>\$ 629</u>	<u>\$ 741</u>	<u>\$ 795</u>
REO activity (number of properties): <sup>(1)</sup>			
Beginning property inventory, at January 1	9,604	9,170	7,222
Properties acquired	15,861	18,489	17,750
Properties disposed	(17,395)	(18,055)	(15,802)
Ending property inventory, at December 31	<u>8,070</u>	<u>9,604</u>	<u>9,170</u>
Average holding period (in days) <sup>(2)</sup>	186	177	174
REO operations income (expense):			
Single-family	\$ (40)	\$ (1)	\$ (4)
Multifamily	—	4	(3)
Total	<u>\$ (40)</u>	<u>\$ 3</u>	<u>\$ (7)</u>
<b>CHARGE-OFFS</b>			
<b>Single-family:</b>			
Foreclosure alternatives, gross	\$ (44)	\$ (47)	\$ (40)
Recoveries <sup>(3)</sup>	23	21	17
Foreclosure alternatives, net	(21)	(26)	(23)
REO acquisitions, gross	(242)	(253)	(176)
Recoveries <sup>(3)</sup>	162	139	127
REO acquisitions, net	(80)	(114)	(49)
Single-family totals:			
Charge-offs, gross	(286)	(300)	(216)
Recoveries <sup>(3)</sup>	185	160	144
Single-family charge-offs, net	<u>(101)</u>	<u>(140)</u>	<u>(72)</u>
<b>Multifamily:</b>			
Charge-offs, gross	(8)	—	(8)
Recoveries <sup>(3)</sup>	—	—	1
Multifamily charge-offs, net	<u>(8)</u>	<u>—</u>	<u>(7)</u>
<b>Total Charge-offs:</b>			
Charge-offs, gross	(294)	(300)	(224)
<b>Recoveries:</b>			
Related to primary mortgage insurance	119	85	94
Not related to primary mortgage insurance	66	75	51
Total recoveries <sup>(3)</sup>	185	160	145
Charge-offs, net	<u>\$ (109)</u>	<u>\$ (140)</u>	<u>\$ (79)</u>
<b>CREDIT GAINS (LOSSES)<sup>(4)</sup></b>			
Single-family	\$ (141)	\$ (141)	\$ (76)
Multifamily	(8)	4	(10)
Total	<u>\$ (149)</u>	<u>\$ (137)</u>	<u>\$ (86)</u>
In basis points: <sup>(5)</sup>			
Single-family	(1.1)	(1.1)	(0.7)
Multifamily	—	—	(0.1)
Total	<u>(1.1)</u>	<u>(1.1)</u>	<u>(0.8)</u>

(1) Includes single-family and multifamily REO properties.

(2) Represents weighted average holding period for single-family and multifamily properties based on number of REO properties disposed.

(3) Includes recoveries of charge-offs primarily resulting from foreclosure alternatives and REO acquisitions on loans where a share of default risk has been assumed by mortgage insurers, servicers, or other third parties through credit enhancements. Recoveries of charge-offs through credit enhancements are limited in some instances to amounts less than the full amount of the loss.

(4) Equal to REO operations income (expense) plus Charge-offs, net.

(5) Calculated as credit gains (losses) divided by the average Total mortgage portfolio, excluding non-Freddie Mac mortgage-related securities and that portion of Structured Securities that is backed by Ginnie Mae Certificates.

Table 42 and Table 43 provide detail by region for two credit performance statistics, REO activity and charge-offs. Regional REO acquisition and charge-off trends generally follow a pattern that is similar to, but lags, that of regional delinquency trends.

**Table 42 — REO Activity By Region<sup>(1)</sup>**

	Year Ended December 31,		
	2005	2004	2003
	(number of properties)		
<b>REO Inventory</b>			
Beginning property inventory, at January 1 .....	9,604	9,170	7,222
Properties acquired by region:			
Northeast.....	1,306	1,500	1,600
Southeast.....	4,504	5,499	5,378
North central .....	5,790	5,787	4,643
Southwest .....	3,412	3,926	3,503
West.....	849	1,777	2,626
Total properties acquired.....	15,861	18,489	17,750
Properties disposed by region:			
Northeast.....	(1,384)	(1,562)	(1,674)
Southeast.....	(5,221)	(5,596)	(4,476)
North central .....	(5,715)	(5,111)	(3,908)
Southwest .....	(3,820)	(3,605)	(3,018)
West.....	(1,255)	(2,181)	(2,726)
Total properties disposed.....	(17,395)	(18,055)	(15,802)
Ending property inventory, at December 31 .....	8,070	9,604	9,170

(1) See "Table 39 — Single-Family — Delinquency Rates-By Region" for a description of these regions.

**Table 43 — Single-Family Charge-offs and Recoveries By Region<sup>(1) (2)</sup>**

	Year Ended December 31,								
	2005			2004			2003		
	Charge-offs, gross	Recoveries	Charge-offs, net	Charge-offs, gross	Recoveries	Charge-offs, net	Charge-offs, gross	Recoveries	Charge-offs, net
	(in millions)								
Northeast .....	\$ 21	\$ (10)	\$ 11	\$ 24	\$ (10)	\$ 14	\$ 21	\$ (10)	\$ 11
Southeast .....	76	(54)	22	84	(49)	35	62	(44)	18
North central .....	102	(66)	36	92	(49)	43	54	(35)	19
Southwest .....	68	(44)	24	66	(35)	31	43	(32)	11
West .....	19	(11)	8	34	(17)	17	36	(23)	13
Total .....	<u>\$286</u>	<u>\$(185)</u>	<u>\$101</u>	<u>\$300</u>	<u>\$(160)</u>	<u>\$140</u>	<u>\$216</u>	<u>\$(144)</u>	<u>\$72</u>

(1) See "Table 39 — Single-Family — Delinquency Rates-By Region" for a description of these regions.

(2) Includes recoveries of charge-offs primarily resulting from foreclosure alternatives and REO acquisitions on loans where a share of default risk has been assumed by mortgage insurers, servicers, or other third parties through credit enhancements. Recoveries of charge-offs through credit enhancements are limited in some instances to amounts less than the full amount of the loss.

Table 44 summarizes our loan loss reserves activity.

**Table 44 — Loan Loss Reserves Activity**

	Year Ended December 31,				
	2005	2004	2003	2002	2001
	(dollars in millions)				
<b>Total loan loss reserves<sup>(1)</sup>:</b>					
Beginning balance	\$ 264	\$ 299	\$ 265	\$ 224	\$ 229
Provision for credit losses	251	143	(5)	122	33
Charge-offs, gross	(294)	(300)	(224)	(171)	(129)
Recoveries <sup>(2)</sup>	185	160	145	99	101
Charge-offs, net	(109)	(140)	(79)	(72)	(28)
Adjustment for change in accounting <sup>(3)</sup>	—	—	110	—	—
Transfers-out during the period <sup>(4)</sup>	(11)	(20)	(11)	(9)	(10)
Other transfers, net, during the period <sup>(5)</sup>	19	(18)	19	—	—
Ending balance	<u>\$ 414</u>	<u>\$ 264</u>	<u>\$ 299</u>	<u>\$ 265</u>	<u>\$ 224</u>
Charge-offs, net to Total mortgage portfolio <sup>(6)</sup>	0.8bp	1.1bp	0.7bp	0.7bp	0.3bp
Coverage ratio (reserves to charge-offs, net)	3.8	1.9	3.8	3.7	8.0

(1) Includes Reserves for loans held-for-investment in the Retained portfolio and Reserves for guarantee losses on Participation Certificates. See “NOTE 6: LOAN LOSS RESERVES” to the consolidated financial statements for more details.

(2) Includes recoveries of charge-offs primarily resulting from foreclosure alternatives and REO acquisitions on loans where a share of default risk has been assumed by mortgage insurers, servicers or third parties through credit enhancements. Recoveries of charge-offs through credit enhancements are limited in some instances to amounts less than the full amount of the loss.

(3) On January 1, 2003, \$110 million of recognized Guarantee obligation attributable to estimated incurred losses on outstanding PCs or Structured Securities was reclassified to Reserve for guarantee losses on Participation Certificates.

(4) Represents the reclassification of the reserve amount attributable to uncollectible interest on outstanding PCs and Structured Securities, which is included as an offset to the related receivable balance within Accounts and other receivables, net on the consolidated balance sheets.

(5) Represents the portion of the Guarantee obligation recognized upon the sale of PCs or Structured Securities that correspond to incurred credit losses reclassified to Reserve for guarantee losses on Participation Certificates upon initial recognition of a Guarantee obligation. In addition, the amount includes an increase (reduction) of loan loss reserves of \$9 million and \$(31) million in 2005 and 2004, respectively, related to prior period adjustments for which the related income was recorded in Other income.

(6) Calculated using the average Total mortgage portfolio, excluding non-Freddie Mac mortgage-related securities and that portion of Structured Securities that is backed by Ginnie Mae Certificates.

We maintain two loan loss reserves — Reserve for losses on mortgage loans held-for-investment and Reserve for guarantee losses on Participation Certificates — at levels we deem adequate to absorb probable incurred losses on mortgage loans held-for-investment in the Retained portfolio and certain mortgages underlying PCs held by third parties. In certain circumstances, incurred losses related to PCs we hold in the Retained portfolio are captured as part of mark-to-market adjustments that are recognized in connection with PC residuals, which represent the portion of the fair value of the PCs related to the Guarantee asset and Guarantee obligation. See “CRITICAL ACCOUNTING POLICIES AND ESTIMATES — Credit Losses” and “NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES” to the consolidated financial statements for further information.

As shown in “Table 44 — Loan Loss Reserves Activity,” total loan loss reserves increased in 2005. The increase in loan loss reserves in 2005 is primarily related to our estimate of our incurred losses as a result of Hurricane Katrina. The 2005 provision also includes additions related to the single-family portfolio as we anticipate an increase in the severity of losses on a per-property basis driven, in part, by the expectation of low or slower home price appreciation in certain areas and increased incurred losses as delinquencies occur for loans that are experiencing higher default rates based on their year of origination.

**Credit Risk Sensitivity.** Our credit risk sensitivity analysis assesses the assumed increase in the present value of expected single-family mortgage portfolio losses over ten years as the result of an estimated immediate five percent decline in house prices nationwide, followed by a return to more normal growth in house prices based on historical experience. We use an internally developed Monte Carlo simulation-based model to generate our credit risk sensitivity analyses. The Monte Carlo model uses a simulation program to generate numerous potential interest-rate paths that, in conjunction with a prepayment model, are used to estimate mortgage cash flows along each path. In the credit rate sensitivity analysis, we adjust the house-price assumption used in the base case to estimate the level and sensitivity of potential credit costs resulting from a sudden decline in house prices.



The credit risk sensitivity results at December 31, 2005 and 2004 are shown in Table 45. Credit risk sensitivity results at the end of each quarter in 2005 and the fourth quarter of 2004 are presented in “RISK MANAGEMENT AND DISCLOSURE COMMITMENTS.”

**Table 45 — Credit Risk Sensitivity — Estimated Increase in Net Present Value, or NPV, of Credit Losses<sup>(1)</sup>**

	Before Receipt of Credit Enhancements <sup>(2)</sup>		After Receipt of Credit Enhancements <sup>(3)</sup>	
	NPV	NPV Ratio <sup>(4)</sup>	NPV	NPV Ratio <sup>(4)</sup>
	(dollars in millions, except ratios)			
At:				
December 31, 2005 .....	\$873	6.5bps	\$564	4.2bps
December 31, 2004 .....	\$794	6.5bps	\$463	3.8bps

(1) Based on single-family Total mortgage portfolio, excluding non-Freddie Mac mortgage-related securities and that portion of Structured Securities that is backed by Ginnie Mae Certificates.

(2) Assumes that none of the credit enhancements currently covering our single-family mortgages has any mitigating impact on our credit losses.

(3) Assumes we collect amounts due from credit enhancement providers after giving effect to certain assumptions about counterparty default rates.

(4) Calculated as the ratio of net present value of increase in credit losses to the single-family Total mortgage portfolio, excluding non-Freddie Mac mortgage-related securities and that portion of Structured Securities that is backed by Ginnie Mae Certificates.

### ***Institutional Credit Risk***

Our primary institutional credit risk exposure, other than counterparty credit risk exposure relating to derivatives, arises from agreements with the following entities: mortgage loan insurers; mortgage seller/servicers; issuers, guarantors or third party providers of credit enhancements on non-Freddie Mac mortgage-related securities held in our Retained portfolio; mortgage investors and originators; and issuers, guarantors and insurers of investments held in our Cash and investments portfolio. See “Interest-Rate Risk and Other Market Risks — *Derivative-Related Risks* — Derivative Counterparty Credit Risk” for information concerning counterparty credit risk exposure relating to derivatives.

**Mortgage Loan Insurers.** We bear institutional credit risk relating to the potential insolvency or non-performance of mortgage insurers that insure mortgages we purchase or guarantee. We manage this risk by establishing eligibility standards for mortgage insurers and by regularly monitoring our exposure to individual mortgage insurers. We also monitor the mortgage insurers’ credit ratings, as provided by nationally recognized credit rating agencies and we periodically review the methods used by the credit rating agencies. We also perform periodic on-site reviews of mortgage insurers to confirm compliance with our eligibility requirements and to evaluate their management and control practices. In addition, state insurance authorities regulate mortgage insurers. Substantially all mortgage insurers providing primary mortgage insurance and pool insurance coverage on single-family mortgages we purchased during 2005 were rated “AA” or better by S&P. At December 31, 2005, there were seven mortgage insurers (the largest being Mortgage Guarantee Insurance Corporation) that each provided more than seven percent of our Total mortgage insurance coverage (including primary mortgage insurance and pool insurance) and together accounted for approximately 99 percent of our overall coverage.

**Mortgage Seller/Servicers.** We are exposed to institutional credit risk arising from the insolvency of or non-performance by our mortgage seller/servicers, including performance of their repurchase obligations arising from the representations and warranties made to us for loans they underwrote and sold to us. The servicing fee charged by mortgage servicers varies by mortgage product. We generally require our single-family servicers to retain a minimum percentage fee for mortgages serviced on our behalf, typically 0.25 percent of the unpaid principal balance of the mortgage loans. However, on an exception basis, we allow a lower or no minimum servicing amount. The credit risk associated with servicing fees relates to whether we could transfer the servicing to an alternate servicer without a loss in the event the current servicer is unable to fulfill its responsibilities.

In order to manage the credit risk associated with our mortgage seller/servicers, we require them to meet minimum financial capacity standards, insurance and other eligibility requirements. We institute remedial actions against seller/servicers that fail to comply with our standards. These actions may include transferring mortgage servicing to other qualified servicers or terminating our relationship with the seller/servicer. We conduct periodic operational reviews of our single-family mortgage seller/servicers to help us better understand their control environment and its impact on the quality of loans sold to us. We use this information to determine the terms of business we conduct with a particular seller/servicer.

We manage the credit risk associated with our multifamily seller/servicers by establishing eligibility requirements for participation in our multifamily programs. These seller/servicers must also meet our standards for originating and servicing multifamily loans. We conduct regular quality control reviews of our multifamily mortgage seller/servicers to determine whether they remain in compliance with our standards.

**Non-Freddie Mac Mortgage-Related Securities.** Investments for our Retained portfolio expose us to institutional credit risk on non-Freddie Mac mortgage-related securities to the extent that servicers, issuers, guarantors, or third parties

providing credit enhancements become insolvent or do not perform. See “Table 17 — Characteristics of Mortgage Loans and Mortgage-Related Securities in the Retained Portfolio” for more information concerning our Retained portfolio.

Our non-Freddie Mac mortgage-related securities portfolio consists of both agency and non-agency mortgage securities. Agency mortgage-related securities, which are securities issued or guaranteed by Fannie Mae or Ginnie Mae, present minimal institutional credit risk due to the high credit quality of Fannie Mae and Ginnie Mae. Agency mortgage-related securities are generally not separately rated by credit rating agencies, but are viewed as having a level of credit quality at least equivalent to non-agency mortgage securities rated AAA (based on the S&P rating scale or an equivalent rating from other nationally recognized credit rating agencies). At December 31, 2005, we held approximately \$45 billion of agency securities, representing approximately 3 percent of our Total mortgage portfolio.

Non-agency mortgage-related securities expose us to institutional credit risk if the nature of the credit enhancement relies on a third party to cover potential losses. However, most of our non-agency mortgage-related securities rely primarily on subordinated tranches to provide credit loss protection and therefore expose us to limited counterparty risk. In those instances where we desire further protection, we may choose to mitigate our exposure with bond insurance or by purchasing additional subordination. Bond insurance exposes us to the risks related to the bond insurer’s ability to satisfy claims. At December 31, 2005, substantially all of the bond insurers providing coverage for non-agency mortgage-related securities held by us were rated AAA or equivalent by at least one nationally recognized credit rating agency. At December 31, 2005, we held approximately \$243 billion of non-agency mortgage-related securities. Of this amount, 97.8 percent were rated AAA or equivalent.

We manage institutional credit risk on non-Freddie Mac mortgage-related securities by only purchasing securities that meet our investment guidelines and performing ongoing analysis to evaluate the creditworthiness of the issuers and servicers of these securities and the bond insurers that guarantee them. To assess the creditworthiness of these entities, we may perform additional analysis, including on-site visits, verification of loan documentation, review of underwriting or servicing processes and similar due diligence measures. In addition, we regularly evaluate our investments to determine if any impairment in fair value requires an impairment loss recognition in earnings, warrants divestiture or requires a combination of both.

**Mortgage Investors and Originators.** We are exposed to pre-settlement risk through the purchase, sale and financing of mortgage loans and mortgage-related securities with mortgage investors and originators. The probability of such a default is generally remote over the short time horizon between the trade and settlement date. We manage this risk by evaluating the creditworthiness of our counterparties and monitoring and managing our exposures. In some instances, we may require these counterparties to post collateral.

**Cash and Investments Portfolio.** Institutional credit risk also arises from the potential insolvency or non-performance of issuers or guarantors of investments held in our Cash and investments portfolio. Instruments in this portfolio are investment grade at the time of purchase and primarily short-term in nature, thereby substantially mitigating institutional credit risk in this portfolio. We regularly evaluate these investments to determine if any impairment in fair value requires an impairment loss recognition in earnings, warrants divestiture or requires a combination of both.

## OFF-BALANCE SHEET ARRANGEMENTS

### Off-Balance Sheet Transactions

Financial instruments created through our business transactions may be recorded on our consolidated balance sheets at their fair value or on a cost basis, or not recorded, as appropriate. A transaction's contractual or notional amount usually does not equal the related fair value or carrying amount. See "CRITICAL ACCOUNTING POLICIES AND ESTIMATES — Issuances and Transfers of PCs and Structured Securities" for more discussion of off-balance sheet arrangements.

### *Guarantee of PCs and Structured Securities*

As discussed in "BUSINESS — Credit Guarantee Activities," we participate in the secondary mortgage market in part by issuing PCs and Structured Securities to third party investors. We guarantee the payment of principal and interest on issued PCs or Structured Securities. In these transactions, mortgage-related assets that back PCs and Structured Securities held by third parties are not reflected as our assets, unless we retained an interest in PCs that back Structured Securities that were issued as part of a sale transaction.

We assume the mortgage credit risk on the mortgages underlying PCs and Structured Securities by guaranteeing the payment of principal and interest to holders of these securities. We manage this risk carefully, sharing the risk in some cases with third parties through the use of primary loan-level mortgage insurance, pool insurance and other credit enhancements. "NOTE 4: FINANCIAL GUARANTEES" to the consolidated financial statements provides information about our guarantees, including details related to credit protections and maximum coverages that we obtain through credit enhancements in our credit guarantee activities. Also, see "RISK MANAGEMENT — Credit Risks" for more information.

Most of our credit guarantee activity occurs through the Guarantor Swap program in the form of mortgage swap transactions. In a mortgage swap transaction, a mortgage lender delivers mortgages to us in exchange for PCs that represent undivided interests in those same mortgages. We receive various forms of consideration in exchange for providing our guarantee on issued PCs, including (i) the contractual right to receive a management and guarantee fee, (ii) delivery or credit fees for higher-risk mortgages and (iii) other forms of credit enhancements received from counterparties or mortgage loan insurers.

Most of the remaining credit guarantee activity occurs through our Cash Window or our MultiLender Swap program. Single-family mortgage loans we purchase for cash through the Cash Window are typically either retained by us in our Retained portfolio or pooled together with other single-family mortgage loans we purchase in connection with PC swap-based transactions in our MultiLender Program executed with various lenders. We may issue such PCs to these lenders in exchange for the mortgage loans we purchase from them or, to the extent these loans are pooled with loans purchased for cash, we may sell them to third parties for cash consideration through an auction.

In addition to the issuance and transfer of PCs to third parties, we also sell PCs from our Retained portfolio in resecutitized form. More specifically, we issue single- and multi-class Structured Securities that are backed by securities held in our Retained portfolio and subsequently transfer such Structured Securities to third parties in exchange for cash, or for PCs and other mortgage-related securities delivered to us by third party dealers who sell such Structured Securities to mortgage security investors. We generally earn resecutitization fees in connection with the creation of Structured Securities and can earn an ongoing management and guarantee fee for certain issued Structured Securities. Our principal exposure on Structured Securities relates only to that portion of resecutitized assets that is represented by non-Freddie Mac mortgage-related securities. Our outstanding PCs and Structured Securities also include securities issued by third parties that we guarantee. See "NOTE 4: FINANCIAL GUARANTEES" for more information about these guarantees. For information about our purchase and securitization activity, see "PORTFOLIO BALANCES AND ACTIVITIES."

The accounting policies and fair value estimation methodologies we apply to our credit guarantee activities significantly affect the volatility of our reported earnings through the initial recognition of the fair value of the Guarantee asset and Guarantee obligation in connection with sales of PCs and Structured Securities, the recognition of subsequent gains or losses from the change in fair value of the Guarantee asset and PC residuals generated from such sales and the repurchase and sale of PCs into and out of our Retained portfolio. See "CONSOLIDATED RESULTS OF OPERATIONS — Non-Interest Income (Loss)" for an analysis of management and guarantee income and other affected consolidated statements of income captions related to our credit guarantee activities. See "CONSOLIDATED BALANCE SHEETS ANALYSIS" for discussion of our Guarantee asset and Guarantee obligation. The accounting for our securitization transactions (including gains and losses on transfers of PCs and Structured Securities that are accounted for as sales and periodic cash flows on transfers of securitized interests and corresponding retained interests) and the significant assumptions used to determine the gains or losses from such transfers that are accounted for as sales are discussed in "NOTE 2: TRANSFERS OF SECURITIZED INTERESTS IN MORTGAGE-RELATED ASSETS" to the consolidated financial statements.

## **Other**

We extend other guarantees and provide indemnification to counterparties for breaches of standard representations and warranties in contracts entered into in the normal course of business based on an assessment that the risk of loss would be remote. See “NOTE 4: FINANCIAL GUARANTEES” to the consolidated financial statements for additional information.

We are a party to numerous entities that are considered to be variable interest entities in accordance with FASB Interpretation No. 46 (Revised December 2003), “Consolidation of Variable Interest Entities”, or FIN 46(R). These variable interest entities include low-income multifamily housing tax credit partnerships, certain Structured Securities trusts (T-Series transactions or alternative collateral deals), and certain asset-backed investment entities. See “NOTE 3: VARIABLE INTEREST ENTITIES” to the consolidated financial statements for additional information related to our significant variable interests in these VIEs.

As part of our credit guarantee business, we routinely enter into forward purchase and sale commitments for mortgage loans and mortgage-related securities. A portion of these commitments are accounted for as derivatives, with their fair value reported as either Derivative assets, at fair value or Derivative liabilities, at fair value on the consolidated balance sheets. See “RISK MANAGEMENT — Interest-Rate Risk and Other Market Risks” for further information. Certain non-derivative commitments are related to commitments arising from mortgage swap transactions and commitments to purchase certain multifamily mortgage loans that will be classified as held-for-investment. These non-derivative commitments totaled \$178.8 billion and \$182.9 billion at December 31, 2005 and 2004, respectively. Such commitments were not accounted for as derivatives and were not recorded on our consolidated balance sheets.

## **CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

Certain of our accounting policies, as well as estimates we make, are critical to the presentation of our financial condition and results of operations since they are particularly sensitive to our judgment and are highly complex in nature. Some of these policies and estimates relate to matters that are inherently uncertain. Actual results could differ from our estimates and it is possible that such differences could have a material impact on our consolidated financial statements. The accounting policies discussed in this section are particularly critical to understanding our consolidated financial statements. For additional information about these and other accounting policies, including recently issued accounting pronouncements, see “NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES” to our consolidated financial statements. We have discussed each of these critical accounting policies and the significant related estimates with the Audit Committee of the board of directors.

### **Fair Value Measurement**

The measurement of fair value is fundamental to the presentation of our financial condition and results of operations in our consolidated financial statements. Fair value is defined as the amount at which an asset or liability could be exchanged between willing parties, other than in a forced or liquidation sale. We record many of our financial instruments at fair value in our consolidated balance sheets, with changes in these fair values recognized as gains and losses in our consolidated statements of income or deferred, net of tax, in AOCI. We also disclose fair value-based consolidated balance sheets, which present our financial assets and liabilities at fair value (including instruments such as debt, which are presented at amortized cost in our consolidated financial statements). Our consolidated fair value balance sheets satisfy our disclosure requirements under SFAS No. 107, “Disclosures about Fair Value of Financial Instruments,” or SFAS 107, and are a tool to communicate our financial position and results on a fair value basis. See “CONSOLIDATED FAIR VALUE BALANCE SHEETS ANALYSIS” and “NOTE 16: FAIR VALUE DISCLOSURES” to our consolidated financial statements for more information.

Fair value affects our earnings in a variety of ways. For certain financial instruments that are carried at fair value (such as securities and PC residuals classified as trading, derivatives in fair value hedge accounting relationships, derivatives with no hedge designation and the Guarantee asset), changes in fair value are recognized in current period earnings. These changes are classified in several captions on our consolidated statements of income, including Gains (losses) on investment activity, Derivative gains (losses) and Gains (losses) on Guarantee asset. For certain other financial instruments that are carried at fair value (such as securities and PC residuals classified as available-for-sale and derivatives in cash flow hedge relationships), changes in fair value are generally deferred, net of tax, in AOCI, a component of Stockholders’ equity. The deferred gains and losses in AOCI, initially measured at fair value, are recognized in earnings over time, including through amortization, sale of securities from the available-for-sale category or impairment recognition. In addition, impairments of mortgage loans classified as held-for-sale are recognized in earnings through lower-of-cost-or-market valuation adjustments. Finally, certain other amounts (such as the Guarantee obligation) are initially measured at fair value, but are not remeasured at fair value on a periodic basis. These amounts affect earnings over time through the amortization of these



amounts into income and extinguishment when we purchase the related PCs and Structured Securities into the Retained portfolio.

The estimation of fair values reflects our judgments regarding appropriate valuation methods and assumptions. The selection of a method to estimate fair value for each type of financial instrument depends on both the reliability and availability of relevant market data. The amount of judgment involved in estimating the fair value of a financial instrument is affected by a number of factors, such as the type of instrument, the liquidity of the markets for the instrument and the contractual characteristics of the instrument.

Even for instruments with a high degree of price transparency, fair value estimation involves our application of significant, ongoing judgment. These judgments include:

- evaluation of the expected reliability of the estimate;
- reliability, timeliness and cost of alternative valuation methodologies;
- selection of third-party market data sources;
- selection of proxy instruments, as necessary; and
- adjustments to market-derived data to reflect differences in instruments' contractual terms.

We periodically evaluate our methodologies and may change them to improve our fair value estimates, to accommodate market developments or to compensate for changes in data availability or other operational constraints.

For financial instruments with active markets and readily available market prices, we estimate fair values based on independent price quotations obtained from third parties, including pricing services, dealer marks or direct market observations, where available. We seek to use third-party pricing where possible. Independent price quotations obtained from third-party pricing services are valuations estimated by an independent service provider using market information. Dealer marks are prices that are obtained from third-party dealers that generally make markets in the relevant products and are an indication of the price at which the dealer would consider transacting in normal market conditions. Market observable prices are prices that are retrieved from sources in which market trades are executed, such as electronic trading platforms.

Certain instruments are less actively traded and, therefore, are not always able to be reliably valued based on prices obtained from third parties. If quoted prices or market data are not available, fair value is based on internal valuation models using market data inputs or internally developed assumptions, where appropriate. Model-based valuations with significant market inputs are estimated using one or more models such as: interest rate models, prepayment models, option-adjusted spread models and/or credit models. These models use market inputs such as interest rate curves, market volatilities and pricing spreads, which can be validated using external sources such as third party pricing services, dealer marks and market observable transactions. Model-based valuations without market inputs are required for products with limited price discovery and are estimated using one or more of the models indicated or are based on our judgment and assumptions. The use of different pricing models and assumptions could produce materially different estimates of fair values.

The fair values for approximately 99 percent of our mortgage-related securities are based on prices obtained from third parties or are determined using models with significant market inputs. The fair values for the remainder of our mortgage-related securities are obtained from internal models with few or no market inputs. The fair values for our non-mortgage-related securities are based on prices obtained from third parties, unless their interest rates frequently reset, in which case the carrying value is presumed to be a reasonable approximation of fair value. As few of the derivative contracts we use are listed on exchanges, the majority of our derivative positions are valued using internally developed models that use market inputs. Approximately 68 percent of the gross fair value of our derivatives portfolio relates to interest-rate and foreign-currency swaps that do not have embedded options. These derivatives are valued using a discounted cash flow model that projects future cash flows and discounts them at the spot rate related to each cash flow. The remaining 32 percent of our derivatives portfolio is valued based on prices obtained from third parties or using models with significant market inputs. The fair values for all of our debt securities are based on prices obtained from third parties or are determined using models with significant market inputs.

Some of our financial instruments are not traded in active markets. Examples include the Guarantee asset, Guarantee obligation and PC residuals. In 2005, our approach for valuing these items incorporated more third-party market-based information in their valuations. Our valuation methodologies and the recent improvements are discussed in "NOTE 2: TRANSFERS OF SECURITIZED INTERESTS IN MORTGAGE-RELATED ASSETS" to our consolidated financial statements.

As described above, the estimation of fair value requires judgment and we may have reasonably chosen different methodologies or assumptions in the current period. The use of different pricing methodologies and assumptions could have produced materially different estimates of fair value in the periods currently presented. However, we believe the fair values we estimated are reasonable based on internal reviews of significant pricing models and methodologies as well as



verification of financial instrument pricing with third-party broker/dealers or pricing services. Furthermore, our estimates of fair value are likely to change in future periods to reflect changes in market factors such as interest rates and related volatility, credit performance, expectations about prepayment behavior and other factors. Our estimates of fair value for individual instruments may change by material amounts, depending on market developments. See “RISK MANAGEMENT — Interest-Rate Risk and Other Market Risks” for discussion of market risks and our interest-rate sensitivity measures, PMVS and duration gap.

### **Issuances and Transfers of PCs and Structured Securities**

As is further discussed in “BUSINESS,” we issue PCs and Structured Securities to third parties in several different ways. In general, we account for such transfers as sales of financial assets or as financial guarantee transactions.

We evaluate whether transfers of PCs or Structured Securities qualify as sales based upon the requirements of SFAS No. 140, “Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities” and, prior to April 1, 2001, SFAS No. 125, “Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,” which we collectively refer to as SFAS 125/140. In this regard, we account for a transfer as a sale to the extent we conclude that (i) assets that underlie the transferred PCs or Structured Securities are legally beyond our reach and the reach of our creditors even in the event that we were to become financially insolvent, (ii) a third-party buyer can freely pledge or exchange the PCs or Structured Securities that were transferred to it and (iii) we did not maintain effective control over transferred PCs or Structured Securities through either (a) an arrangement that both entitles and obligates us to repurchase or redeem transferred PCs or Structured Securities before their maturity or (b) the ability to unilaterally cause the holder of a transferred PC or Structured Security to return specific assets (*i.e.*, other than through a clean up call).

If a transfer of PCs or Structured Securities qualifies as a sale, we recognize a gain or loss on the sale immediately in earnings based upon the difference in value between cash received, the recognized carrying value of interests sold and the fair value of liabilities incurred upon sale. In this case, our guarantee of the payment of principal and interest on PCs and Structured Securities results in the recognition of a Guarantee asset and Guarantee obligation on our consolidated balance sheets.

If we determine that a transfer of PCs or Structured Securities does not qualify as a sale, we account for such transfer as a secured borrowing or as a financial guarantee transaction pursuant to the provisions of FASB Interpretation No. 45, “Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others”, or FIN 45. Many of the transfers of PCs and Structured Securities that are made to third parties do not qualify as sales or secured borrowings, but are accounted for as financial guarantee transactions pursuant to the provisions of FIN 45. For such transactions, at the inception of an executed guarantee, we recognize a Guarantee obligation that is initially measured to be the greater of (a) fair value or (b) the contingent liability amount required to be recognized at inception of the guarantee by SFAS No. 5, “Accounting For Contingencies,” or SFAS 5. We also recognize the fair value of any consideration received on such transactions. Positive differences between the fair value of consideration expected and received, and Guarantee obligations incurred, are deferred as a component of recognized Guarantee obligations, while negative differences between such amounts are recognized immediately in earnings as a component of Other expense.

With respect to all transfers of PCs and Structured Securities to third parties, the measurement of the Guarantee asset, Guarantee obligation and credit enhancement-related assets involves our best estimate with respect to key assumptions, including expected credit losses and the exposure to credit losses that could be greater than expected credit losses, prepayment rates, forward yield curves and discount rates. We believe that the assumptions we made in this regard are comparable to those used by other market participants. The use of different pricing models and assumptions could produce materially different results. See “NOTE 2: TRANSFERS OF SECURITIZED INTERESTS IN MORTGAGE-RELATED ASSETS” to our consolidated financial statements for further discussion of the approach we use to determine the fair values of the Guarantee asset and Guarantee obligation.

### **Derivative Instruments and Hedging Activities**

The determination of whether a derivative qualifies for hedge accounting requires significant judgment and has a significant impact on how such instruments are accounted for in our consolidated financial statements. As described more fully in “CONSOLIDATED RESULTS OF OPERATIONS — Derivative Gains (Losses),” we discontinued substantially all of our cash flow hedge accounting relationships effective as of April 2, 2004, because they no longer met the hedge effectiveness requirements of SFAS 133, as amended by SFAS No. 138, “Accounting for Certain Derivative Instruments and Certain Hedging Activities” and SFAS No. 149, “Amendment of Statement 133 on Derivative Instruments and Hedging Activities,” which we collectively refer to as SFAS 133. In addition, we voluntarily discontinued a significant portion of our fair value hedging relationships effective November 1, 2004. Accordingly, the portion of our derivatives portfolio that was designated in hedge accounting relationships was significantly reduced by the end of 2004. Effective at the

beginning of the second quarter of 2005, we voluntarily discontinued hedge accounting treatment for all new forward purchase commitments and the majority of our new commitments to forward sell mortgage-related securities. On March 31, 2006, we voluntarily discontinued hedge accounting treatment for all derivatives, with the exception of certain commitments to forward sell mortgage-related securities and one foreign-currency hedge strategy, in an effort to simplify our operations.

Our total derivative portfolio is an effective component of our interest-rate risk management activities. We recognize all derivatives, whether designated in hedging relationships or not, at fair value as either assets or liabilities on our consolidated balance sheets. Derivatives that are expected to be highly effective in reducing the risk associated with the exposure being hedged may be designated for accounting purposes as a hedge of:

- the cash flows of a variable-rate instrument or a forecasted transaction, or a “cash flow hedge;”
- the changes in fair value of a fixed-rate instrument, or a “fair value hedge;” or
- foreign-currency fair value or cash flow, or a “foreign-currency hedge.”

We report the change in fair value of derivatives that are not in hedge accounting relationships in our consolidated statements of income in the period in which the change in value occurs. We record the change in fair value of derivatives that are in cash flow hedge accounting relationships, to the extent these relationships are effective, as a separate component of AOCI and reclassify this amount into earnings when the hedged item or forecasted transaction affects earnings. We record the change in fair value of derivatives in fair value hedge accounting relationships each period in earnings along with the change in fair value of the hedged item attributable to the hedged risk.

The determination of whether a derivative qualifies for hedge accounting requires judgment about the application of SFAS 133. SFAS 133 requires contemporaneous documentation of our hedge relationships, including identification of the hedged item, the hedging instrument, the nature of the hedged risk and the method used to assess the effectiveness of the hedge relationship. Throughout 2005, we have used a comparison of the critical terms of the hedging instrument to those of the hedged item to assess the effectiveness of hedges. If our documentation and assessments are not adequate, the derivative does not qualify for hedge accounting.

Derivatives designated as cash flow hedges generally hedged interest-rate risk related to forecasted issuances of debt. For these hedging relationships to qualify for hedge accounting both at inception and over the life of the derivative, we must estimate the probable future level of certain types of debt issuances. These estimates are based on our expectation of future funding needs and the future mix of funding sources. Our expectations about future funding are based upon projected growth and historical activity. If these estimates had been lower, a smaller notional amount of derivatives would have been eligible for designation as cash flow hedges and potentially material amounts that were deferred and reported in AOCI would have been reported in Derivative gains (losses) in the consolidated statements of income in the period they occurred. If estimated future fundings do not occur, or are probable of not occurring, potentially material amounts that were deferred and reported in AOCI would be immediately recognized in Derivative gains (losses) in the consolidated statements of income. We believe that the forecasted issuances of debt previously hedged in cash flow hedging relationships are sufficiently likely to occur so that we may continue recording previously deferred amounts in AOCI.

For a more detailed description of our use of derivatives and summaries of derivative positions, see “CONSOLIDATED RESULTS OF OPERATIONS — Derivative Overview” and “NOTE 12: DERIVATIVES” to the consolidated financial statements.

### **Credit Losses**

We maintain a Reserve for losses on mortgage loans held-for-investment to provide for credit losses incurred related to those mortgage loans. At December 31, 2005 and 2004, the Reserve for losses on mortgage loans held-for-investment was \$119 million and \$114 million, respectively. We also maintain a Reserve for guarantee losses on Participation Certificates to provide for losses incurred on mortgages underlying PCs or Structured Securities held by third parties. At December 31, 2005 and 2004, the Reserve for guarantee losses on Participation Certificates was \$295 million and \$150 million, respectively. The Reserve for losses on mortgage loans held-for-investment and the Reserve for guarantee losses on Participation Certificates are collectively referred to as the loan loss reserves. Increases in loan loss reserves are reflected in earnings as a component of the Provision for credit losses. Loan loss reserves decrease when charge-offs of such balances (net of recoveries) occur or when we record realized losses.

The process for determining the level of loan loss reserves is subject to numerous estimates and assumptions that require judgment. We regularly evaluate the underlying estimates and assumptions we use when determining the loan loss reserves and update these assumptions to reflect our own historical experience and our current view of overall economic conditions and other relevant factors. Changes in one or more of these underlying estimates and assumptions could have a material

impact on the loan loss reserves and the provision for credit losses. Key estimates and assumptions that could have an impact on loan loss reserves include:

- loss severity trends;
- default experience;
- expected proceeds from credit enhancements;
- evaluation of collateral; and
- identification of relevant macroeconomic factors and assessment of their applications.

Our use of estimates and assumptions is based on all available information and our knowledge and experience in the single-family and multifamily loan markets. We exercise a significant amount of judgment in selecting these factors and, had we made different determinations in the selection of these factors, a materially different level of loan loss reserves could have resulted. However, we believe the level of loan loss reserves is reasonable based on internal reviews of the factors and methodologies used.

### **Interest Income Recognition and Impairment Recognition on Investments in Securities**

For most of our mortgage-related and non-mortgage-related investments, we recognize interest income using the effective interest method in accordance with SFAS No. 91, "Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases." Deferred items, including premiums, discounts and other basis adjustments, such as changes in commitment-period fair value, are amortized into interest income over the estimated lives of the securities using the retrospective effective interest method. Under this method, we recalculate the constant effective yield based on changes in estimated prepayments. Catch-up adjustments to the unamortized balance of premiums, discounts and other deferred items that result from applying the updated effective yield as if it had been in effect since acquisition are recognized through interest income.

For certain other investments in mortgage-related securities classified as available-for-sale, interest income is recognized using the prospective effective interest method in accordance with EITF 99-20. Under this method, changes in the effective yield due to changes in estimated lives are recognized as adjustments to interest income in future periods. We specifically apply such guidance to beneficial interests (including undivided interests which are similar to beneficial interests) in securitized financial assets that:

- can contractually be prepaid or otherwise settled in such a way that we may not recover substantially all of our recorded investment (such as interest-only securities); or
- were not of high credit quality at the date that we acquired them.

We use actual prepayment experience and estimates of future prepayments to determine the constant yield needed to apply the effective interest method of income recognition. In estimating future prepayments and cash flows, we aggregate securities by similar characteristics of their underlying collateral such as origination date, coupon, and product. For securities with structured cash flow payments, such as Structured Securities, we also consider the characteristics of other security classes within the same transaction structure when estimating future prepayments and cash flows.

Determination of the effective yield requires significant judgment in estimating expected prepayment behavior, which is inherently uncertain. Estimates of future prepayments are derived from market sources and our internal prepayment models. Judgment is involved in making initial determinations about prepayment expectations and in changing those expectations over time in response to changes in market conditions, such as interest rates and other macroeconomic factors. The effects of future changes in market conditions may be material. We believe that the above assumptions are comparable to those used by other market participants. However, the use of different assumptions in our prepayment models could have resulted in materially different income recognition results.

We recognize impairment losses on available-for-sale securities when we have concluded that a decrease in the fair value of a security is not temporary. For securities accounted for under EITF 99-20, an impairment loss is recognized when there is both a decline in fair value below the carrying amount and an adverse change in expected cash flows. Determination of whether an adverse change has occurred involves judgment about expected prepayments and credit events. We review securities not accounted for under EITF 99-20 for potential impairment whenever the security's fair value is less than its amortized cost. This review considers a number of factors, including the severity of the decline in fair value, credit ratings and the length of time the investment has been in an unrealized loss position. We recognize impairment when quantitative and qualitative factors indicate that we may not recover the unrealized loss. One of the factors we consider is our intent and ability to hold the investment until a point in time at which recovery can be reasonably expected to occur. We apply significant judgment in determining whether impairment loss recognition is appropriate. We believe our judgments are reasonable, however, different judgments could have resulted in materially different impairment loss recognition. See

“NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES” to the consolidated financial statements for more information on interest income and impairment recognition on securities.

**Accounting Changes and Recently Issued Accounting Pronouncements**

See “NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES” to the consolidated financial statements for more information concerning our accounting policies, changes to those policies, and recently issued accounting pronouncements that we have not yet adopted and that will likely affect our consolidated financial statements.

## PORTFOLIO BALANCES AND ACTIVITIES

### Total Mortgage Portfolio

Our Total mortgage portfolio includes the unpaid principal balances of mortgages and mortgage-related securities held in our Retained portfolio and the unpaid principal balances of guaranteed PCs and Structured Securities held by third parties. Guaranteed PCs and Structured Securities held by third parties are considered outstanding and are not included on our consolidated balance sheets.

Table 46 provides information about our Total mortgage portfolio at December 31, 2005 and 2004.

**Table 46 — Total Mortgage Portfolio and Total Guaranteed PCs and Structured Securities Issued Based on Unpaid Principal Balances<sup>(1)</sup>**

	December 31,			
	2005		2004	
	Amounts (dollars in millions)	% of Total Mortgage Portfolio	Amounts (dollars in millions)	% of Total Mortgage Portfolio
Outstanding Guaranteed PCs and Structured Securities <sup>(2)</sup> .....	\$ 974,200	58%	\$ 852,270	56%
Retained portfolio:				
PCs and Structured Securities .....	361,324	21	356,698	24
Non-Freddie Mac mortgage-related securities .....	287,212	17	234,878	16
Mortgage loans .....	61,481	4	61,360	4
Total Retained portfolio <sup>(3)</sup> .....	710,017	42	652,936	44
Total mortgage portfolio .....	<u>\$1,684,217</u>	<u>100%</u>	<u>\$1,505,206</u>	<u>100%</u>

(1) Excludes mortgage loans and mortgage-related securities traded, but not yet settled.

(2) Represents Guaranteed PCs and Structured Securities held by third parties.

(3) The Retained portfolio presented in this table differs from the Retained portfolio presented in our consolidated balance sheets because the amounts presented in our consolidated balance sheets include valuation adjustments and deferred balances. See “Table 17 — Characteristics of Mortgage Loans and Mortgage-Related Securities in the Retained Portfolio” for a reconciliation of the Retained portfolio amounts shown in this table to the amounts shown under such caption on our consolidated balance sheets.

See “Table 49 — Guaranteed PCs and Structured Securities Issued and Outstanding” for more information concerning outstanding guaranteed PCs and Structured Securities. Also see “Table 17 — Characteristics of Mortgage Loans and Mortgage-Related Securities in the Retained Portfolio” for more information concerning the non-Freddie Mac mortgage-related securities in our Retained portfolio.

Table 47 presents the distribution of unsecuritized whole mortgage loans held in our Retained portfolio.

**Table 47 — Mortgage Loans Held in the Retained Portfolio<sup>(1)</sup>**

	December 31,	
	2005	2004
	(in millions)	
<b>Single-family:</b>		
Conventional		
Fixed-rate .....	\$18,532	\$21,409
Variable-rate .....	903	990
Total conventional .....	19,435	22,399
FHA/VA — Fixed-rate .....	255	344
Rural Housing Service, or RHS, and other federally guaranteed loans .....	706	646
Total single-family .....	20,396	23,389
<b>Multifamily:</b>		
Conventional		
Fixed-rate .....	36,961	34,127
Variable-rate .....	4,121	3,841
Total conventional .....	41,082	37,968
RHS .....	3	3
Total multifamily .....	41,085	37,971
<b>Total mortgages .....</b>	<u>\$61,481</u>	<u>\$61,360</u>

(1) Based on unpaid principal balances. Excludes mortgage loans traded, but not yet settled.



Table 48 summarizes purchases into our Total mortgage portfolio.

**Table 48 — Total Mortgage Portfolio Purchase Detail<sup>(1)</sup>**

	Year Ended December 31,			
	2005		2004	
	Amounts	% of Purchase Amounts	Amounts	% of Purchase Amounts
	(dollars in millions)			
<b>New business purchases<sup>(2)</sup></b>				
Single-family mortgage purchases				
Conventional:				
30-year fixed-rate <sup>(3)(4)</sup>	\$272,702	67%	\$220,867	59%
15-year fixed-rate <sup>(4)</sup>	40,963	10	72,754	19
ARMs/Variable-Rate <sup>(4)(5)</sup>	35,677	9	50,187	14
Interest Only <sup>(4)(6)</sup>	26,516	7	818	—
Option ARMs <sup>(7)</sup>	3,918	1	—	—
Balloon/Resets <sup>(8)</sup>	1,720	—	9,658	3
FHA/VA <sup>(9)</sup>	—	—	319	—
RHS and other federally guaranteed loans	177	—	209	—
<b>Total single-family</b>	<b>381,673</b>	<b>94</b>	<b>354,812</b>	<b>95</b>
Multifamily:				
Conventional	11,172	3	12,712	3
<b>Total multifamily</b>	<b>11,172</b>	<b>3</b>	<b>12,712</b>	<b>3</b>
<b>Total mortgage purchases</b>	<b>392,845</b>	<b>97</b>	<b>367,524</b>	<b>98</b>
<b>Non-Freddie Mac mortgage-related securities purchased for Structured Securities:</b>				
Alternative collateral deals backed by:				
Option ARMs	14,331	3	5,653	2
Ginnie Mae Certificates	37	—	85	—
Other <sup>(10)(11)</sup>	—	—	1,552	—
<b>Total Non-Freddie Mac mortgage-related securities purchased for Structured Securities</b>	<b>14,368</b>	<b>3</b>	<b>7,290</b>	<b>2</b>
<b>Total single-family and multifamily mortgage purchases and total non-Freddie Mac mortgage-related securities purchased for Structured Securities</b>	<b>\$407,213</b>	<b>100%</b>	<b>\$374,814</b>	<b>100%</b>
<b>Non-Freddie Mac Mortgage-Related Securities Purchased into the Retained Portfolio:</b>				
Agency Securities:				
Fannie Mae:				
Single-Family:				
Fixed-Rate	\$ 2,854		\$ 756	
Variable-Rate	3,368		3,282	
<b>Total Fannie Mae</b>	<b>6,222</b>		<b>4,038</b>	
Ginnie Mae:				
Single-Family:				
Fixed-Rate	64		—	
<b>Total Ginnie Mae</b>	<b>64</b>		<b>—</b>	
<b>Total agency mortgage-related securities</b>	<b>6,286</b>		<b>4,038</b>	
Non-Agency Securities:				
Single-family and other mortgage-related securities				
Single-family:				
Fixed-Rate	2,478		1,294	
Variable-Rate	148,276		101,620	
<b>Total single-family and other mortgage-related securities</b>	<b>150,754</b>		<b>102,914</b>	
CMBS:				
Fixed-Rate	11,291		8,841	
Variable-Rate	3,549		2,037	
<b>Total CMBS</b>	<b>14,840</b>		<b>10,878</b>	
Mortgage Revenue Bonds:				
Single-family:				
Fixed-Rate	2,374		1,499	
Variable-Rate	27		—	
Multifamily:				
Fixed-Rate	418		414	
Variable-Rate	21		31	
<b>Total mortgage revenue bonds</b>	<b>2,840</b>		<b>1,944</b>	
<b>Total non-agency mortgage-related securities</b>	<b>168,434</b>		<b>115,736</b>	
<b>Total non-Freddie Mac mortgage-related securities purchased into the Retained portfolio</b>	<b>174,720</b>		<b>119,774</b>	
<b>Total new business purchases</b>	<b>\$581,933</b>		<b>\$494,588</b>	
Mortgage purchases with credit enhancements	17%		19%	
Mortgage liquidations <sup>(12)</sup>	\$384,674		\$401,029	
Mortgage liquidations rate	26%		28%	
Freddie Mac securities repurchased into the Retained portfolio:				
Single-family:				
Fixed-Rate	\$106,682		\$ 72,147	
Variable-Rate	29,805		23,942	
Multifamily:				
Variable-Rate	—		146	
<b>Total Freddie Mac securities repurchased into the Retained portfolio</b>	<b>\$136,487</b>		<b>\$ 96,235</b>	

(1) Based on unpaid principal balances. Excludes mortgage loans and mortgage-related securities traded but not yet settled.

(2) 2004 data includes certain mortgage-related securities that have been transferred from the Investments caption to the Retained portfolio caption on the consolidated balance sheets.

(3) Includes 20 year fixed-rate mortgages.

(4) Subsequent to the issuance of our Information Statement dated June 14, 2005, we reclassified select captions to agree with current period classifications.

(5) Includes ARMs with 1-, 3-, 5-, 7- and 10-year initial fixed-rate periods.

(6) Represents loans where the borrower pays interest only for a period of time before the borrower begins making principal payments.

- (7) Includes mortgage loans we purchased that underlie whole-loan REMICs. Excludes \$83 million of mortgage loan purchases that collateralize the unguaranteed portion of whole-loan REMICs.
- (8) Mortgages whose terms require lump sum principal payments on contractually determined future dates unless the borrower qualifies for and elects an extension of the maturity date at an adjusted interest rate.
- (9) Excludes FHA/VA loans that may be collateral for alternative collateral deals.
- (10) Includes Structured Securities backed by non-agency securities, which were backed by a mixture of prime, FHA/VA and subprime mortgage loans.
- (11) 2004 data represents \$1,462 million of fixed-rate and \$90 million of variable-rate non-Freddie Mac single-family mortgage-related securities.
- (12) Excludes the effect of sales of non-Freddie Mac mortgage-related securities.

## Guaranteed PCs and Structured Securities

Guaranteed PCs and Structured Securities Issued represent the unpaid principal balances of the mortgage-related securities we issue or otherwise guarantee. Table 49 presents the distribution of underlying mortgage assets for total PCs and Structured Securities issued and outstanding.

**Table 49 — Guaranteed PCs and Structured Securities Issued and Outstanding**

	December 31,			
	2005		2004	
	Total Issued PCs and Structured Securities <sup>(1)</sup>	Outstanding PCs and Structured Securities <sup>(2)</sup>	Total Issued PCs and Structured Securities <sup>(1)</sup>	Outstanding PCs and Structured Securities <sup>(2)</sup>
	(in millions)			
PCs and Structured Securities				
Single-family:				
Conventional:				
30-year fixed-rate <sup>(3)</sup>	\$ 810,897	\$614,112	\$ 689,945	\$509,923
15-year fixed-rate	321,176	220,225	347,135	224,627
ARMs/Variable-rate	131,294	88,898	102,273	59,234
Option ARMs <sup>(4)</sup>	3,830	414	—	—
Balloons/Resets	26,321	24,973	32,966	31,075
FHA/VA <sup>(5)</sup>	849	823	1,350	1,340
RHS and other federally guaranteed loans	154	154	178	178
<i>Total single-family</i>	<u>1,294,521</u>	<u>949,599</u>	<u>1,173,847</u>	<u>826,377</u>
Multifamily:				
Conventional:				
Fixed-rate	10,149	9,902	10,787	10,526
Variable-rate	4,354	4,210	4,759	4,614
<i>Total multifamily</i>	<u>14,503</u>	<u>14,112</u>	<u>15,546</u>	<u>15,140</u>
Structured Securities backed by Non-Freddie Mac mortgage-related securities:				
Ginnie Mae Certificates <sup>(6)</sup>	2,021	1,900	3,015	2,628
Other <sup>(7)</sup>	24,479	8,589	16,560	8,125
<i>Total Structured Securities</i>	<u>26,500</u>	<u>10,489</u>	<u>19,575</u>	<u>10,753</u>
<b>Total</b>	<u><u>\$1,335,524</u></u>	<u><u>\$974,200</u></u>	<u><u>\$1,208,968</u></u>	<u><u>\$852,270</u></u>

(1) Based on unpaid principal balances. Excludes mortgage loans and mortgage-related securities traded, but not yet settled.

(2) Represents PCs and Structured Securities held by third parties.

(3) Includes 20-year fixed-rate mortgages.

(4) Excludes \$82 million of Structured Securities issued by non-consolidated, special-purpose entities established by us that are not guaranteed by us.

(5) Excludes FHA and VA loans that may be collateral for alternative collateral deals.

(6) Ginnie Mae Certificates which underlie the Structured Securities are backed by FHA/VA loans.

(7) Alternative collateral deals include Structured Securities backed by non-agency securities, which are backed by a mixture of prime, FHA/VA and subprime mortgage loans. Outstanding alternative collateral deals include \$1,520 million and \$1,587 million of fixed-rate, \$3,472 million and \$1,165 million of ARMs/variable-rate, \$3,566 million and \$5,286 million of FHA/VA, \$12 million and \$17 million of the Rural Housing Service and other federally guaranteed loans and \$19 million and \$70 million of second mortgages, which are mortgage loans that are subordinate to a superior mortgage lien on the property, at December 31, 2005 and 2004, respectively.

Table 50 provides further detail regarding both issued and outstanding Guaranteed PCs and Structured Securities.

**Table 50 — Single-Class and Multi-Class PCs and Other Structured Securities Based on Unpaid Principal Balances<sup>(1)</sup>**

<u>December 31, 2005</u>	<u>PCs and Structured Securities in Retained Portfolio</u>	<u>PCs and Structured Securities Outstanding (held by third parties) (in millions)</u>	<u>Total Guaranteed PCs and Structured Securities Issued</u>
PCs and Structured Securities:			
Single-class <sup>(2)</sup>	\$202,970	\$529,901	\$ 732,871
Multi-class <sup>(3)(4)(5)</sup>	158,354	437,668	596,022
Other <sup>(6)</sup>	—	6,631	6,631
Total PCs and Structured Securities <sup>(7)</sup>	<u>\$361,324</u>	<u>\$974,200</u>	<u>\$1,335,524</u>
<u>December 31, 2004</u>			
PCs and Structured Securities: <sup>(8)</sup>			
Single-class <sup>(2)</sup>	\$219,154	\$454,973	\$ 674,127
Multi-class <sup>(3)(5)</sup>	137,544	390,516	528,060
Other <sup>(6)</sup>	—	6,781	6,781
Total PCs and Structured Securities <sup>(7)</sup>	<u>\$356,698</u>	<u>\$852,270</u>	<u>\$1,208,968</u>

(1) Excludes Freddie Mac mortgage-related securities traded, but not yet settled.

(2) Includes PCs not backing Structured Securities and single-class Structured Securities backed by PCs and Ginnie Mae Certificates.

(3) Includes that portion of multi-class Structured Securities that are backed by PCs and non-agency mortgage-related securities. Also includes multi-class Structured Securities backed by Ginnie Mae Certificates.

(4) Excludes \$82 million of Structured Securities issued by non-consolidated, special-purpose entities established by us that are not guaranteed by us.

(5) Principal-only strips backed by Freddie Mac mortgage-related Securities held in the Retained portfolio are classified as multi-class for the purpose of this table.

(6) See "NOTE 4: FINANCIAL GUARANTEES," for a discussion of our guarantees of principal and interest related to these securities.

(7) PCs and Structured Securities Issued exclude \$961,777 million and \$723,429 million at December 31, 2005 and 2004, respectively, of Structured Securities backed by resecutitized PCs and other previously issued Structured Securities. These excluded Structured Securities, which do not increase our credit related exposure, consist of single-class Structured Securities backed by PCs, REMICs, and principal-only strips. The notional balances of interest-only strips (including excess interest-only strips) totaled \$132,883 million and \$105,703 million at December 31, 2005 and 2004, respectively, and are excluded because this table is based on unpaid principal balances. Also excluded are modifiable and combinable REMIC tranches and interest and principal classes, which collectively totaled \$1,495,501 million and \$1,097,336 million at December 31, 2005 and 2004, respectively, where the holder has the option to exchange the security tranches for other pre-defined security tranches.

(8) Subsequent to our Information Statement dated June 14, 2005, we reclassified PCs and Structured Securities in the Retained portfolio from Single-class to Multi-class and Total Guaranteed PCs and Structured Securities Issued from Single-class and Other to Multi-class to conform to the current period classifications.

Table 51 provides settlement detail for the mortgage-related securities that we issued during the past two years.

**Table 51 — Security Settlement Detail for Total Guaranteed PCs and Structured Securities Issued<sup>(1)</sup>**

	Year Ended December 31,	
	2005	2004
	(in millions)	
Total Guaranteed PCs and Structured Securities Issuance Detail:		
Single-family:		
Conventional: <sup>(2)</sup>		
30-year fixed-rate	\$272,910	\$220,137
15-year fixed-rate	41,037	72,358
ARMs/Variable-Rate	35,666	50,226
Interest Only	26,487	818
Option ARMs	3,918	—
Balloon/Resets	1,817	9,737
FHA/VA	—	319
RHS and other federally guaranteed loans	10	48
<i>Total single-family</i>	<u>381,845</u>	<u>353,643</u>
Multifamily:		
Conventional	1,654	4,175
<i>Total multifamily</i>	<u>1,654</u>	<u>4,175</u>
Non-Freddie Mac mortgage-related securities purchased for Structured Securities:		
Alternative collateral deals backed by:		
Option ARMs	14,331	5,653
Ginnie Mae Certificates	37	85
Other	—	1,552
<i>Total Non-Freddie Mac mortgage-related securities purchased for Structured Securities</i>	<u>14,368</u>	<u>7,290</u>
Total Guaranteed PCs and Structured Securities Issued	<u>\$397,867</u>	<u>\$365,108</u>

(1) Based on unpaid principal balances. Excludes Freddie Mac mortgage-related securities traded, but not yet settled.

(2) The single-family product detail in this table does not agree to similar detail in “Table 48 — Total Mortgage Portfolio Purchase Detail” due to timing differences associated with mortgage loan purchases into the Retained portfolio and sales from the Retained portfolio. Specifically, we report mortgage loans in Table 48 when we purchase them into the Retained portfolio whereas we report mortgage loans in Table 51 when we sell them from the Retained portfolio to create PCs and Structured Securities.

Our new business purchases consist of mortgage loans and non-Freddie Mac mortgage-related securities that are purchased for our Retained portfolio and serve as collateral for our issued PCs and Structured Securities. We generate a significant portion of our mortgage purchase volume through several key mortgage lenders that have entered into unique business arrangements with us. See “BUSINESS — Credit Guarantee Activities” for information about these relationships and consequent risks. During 2005 and 2004, we increased purchases of adjustable-rate (*i.e.*, ARMs/Variable-Rate and Option ARMs) and interest-only mortgage products and non-Freddie Mac mortgage-related securities because these products generally offered more attractive option-adjusted spreads than fixed-rate products.

## QUARTERLY SELECTED FINANCIAL DATA

In our opinion, financial data for each quarter and full-year 2005 and 2004 reflects all adjustments, consisting of normal recurring adjustments, necessary for fair presentation of the results of operations for such periods. See “NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — Estimates” and “— Changes in Accounting Principles” for more information concerning some of these adjustments.

	2005				
	1Q	2Q	3Q	4Q	Full-Year
	(in millions, except share-related amounts)				
Net interest income	\$1,501	\$1,269	\$1,363	\$1,237	\$ 5,370
Non-interest income (loss)	(292)	(278)	423	346	199
Non-interest expense	(940)	(583)	(729)	(761)	(3,013)
Income tax benefit (expense)	16	(68)	(177)	(138)	(367)
Net income before cumulative effect of change in accounting principle	285	340	880	684	2,189
Cumulative effect of change in accounting principle, net of taxes	(59)	—	—	—	(59)
Net income	<u>\$ 226</u>	<u>\$ 340</u>	<u>\$ 880</u>	<u>\$ 684</u>	<u>\$ 2,130</u>
Earnings per common share before cumulative effect of change in accounting principle:					
Basic <sup>(1)</sup>	\$ 0.34	\$ 0.41	\$ 1.19	\$ 0.90	\$ 2.84
Diluted <sup>(1)</sup>	\$ 0.33	\$ 0.41	\$ 1.19	\$ 0.90	\$ 2.83
Earnings per common share after cumulative effect of change in accounting principle:					
Basic <sup>(1)</sup>	\$ 0.25	\$ 0.41	\$ 1.19	\$ 0.90	\$ 2.76
Diluted <sup>(1)</sup>	\$ 0.25	\$ 0.41	\$ 1.19	\$ 0.90	\$ 2.75

	2004				
	1Q	2Q	3Q	4Q	Full-Year
	(in millions, except share-related amounts)				
Net interest income	\$2,126	\$2,625	\$ 2,321	\$2,065	\$ 9,137
Non-interest income (loss)	(26)	1,532	(3,691)	(854)	(3,039)
Non-interest expense	(503)	(548)	(603)	(717)	(2,371)
Income tax (expense) benefit	(285)	(855)	467	(117)	(790)
Net income (loss)	<u>\$1,312</u>	<u>\$2,754</u>	<u>\$ (1,506)</u>	<u>\$ 377</u>	<u>\$ 2,937</u>
Earnings (loss) per common share:					
Basic <sup>(1)</sup>	\$ 1.83	\$ 3.92	\$ (2.26)	\$ 0.47	\$ 3.96
Diluted <sup>(1)</sup>	\$ 1.82	\$ 3.91	\$ (2.26)	\$ 0.47	\$ 3.94

(1) Earnings (loss) per share is computed independently for each of the quarters presented. Due to the use of weighted-average common shares outstanding when calculating earnings (loss) per share, the sum of the four quarters may not equal the full-year amount. Earnings (loss) per share amounts may not recalculate using the amounts in this table due to rounding.



## RISK MANAGEMENT AND DISCLOSURE COMMITMENTS

In October 2000, we announced our voluntary adoption of a series of commitments designed to enhance market discipline, liquidity and capital. In September 2005, we entered into a written agreement with OFHEO that updated these commitments and set forth a process for implementing them. The letters between the company and OFHEO dated September 1, 2005 constituting the written agreement are available on the Investor Relations page of our website at [www.freddiemac.com/investors/reports.html#commit](http://www.freddiemac.com/investors/reports.html#commit). As noted in these letters, disclosures may be affected by situations where current financial statements are not available. Our commitments at December 31, 2005 follow:

Description	Status
<p>1. <i>Periodic Issuance of Subordinated Debt:</i></p> <ul style="list-style-type: none"> <li>• We will issue Freddie SUBS® for public secondary market trading that are rated by no less than two nationally recognized statistical rating organizations.</li> <li>• Freddie SUBS® will be issued in an amount such that the sum of Total capital (core capital plus general allowance for losses) and the outstanding balance of “Qualifying subordinated debt” will equal or exceed the sum of 0.45 percent of outstanding PCs and Structured Securities we guaranteed and 4 percent of total on-balance sheet assets. Each quarter we will submit to OFHEO calculations of the quantity of qualifying Freddie SUBS® and Total capital as part of our quarterly capital report.</li> <li>• Every six months, beginning January 1, 2006, we will submit to OFHEO a subordinated debt management plan that includes any issuance plans for the six months following the date of the plan.</li> </ul>	<ul style="list-style-type: none"> <li>• We did not issue any Freddie SUBS® during 2005, 2004 or 2003. We issued approximately \$1.25 billion of Freddie SUBS® in June 2006. Our ability to issue additional subordinated debt may be limited until we return to regular financial reporting. During 2001 and 2002, we completed a total of four offerings of Freddie SUBS® that provided approximately \$5.5 billion in net proceeds.</li> <li>• At December 31, 2005, we had \$5.5 billion in qualifying Freddie SUBS® outstanding and Total capital, for the purpose of this calculation, in the amount of \$36.4 billion, resulting in a surplus of \$5.2 billion.</li> <li>• We have submitted our semi-annual subordinated debt management plan to OFHEO.</li> <li>• We expect to issue additional subordinated debt in a principal amount in excess of \$1 billion from time to time during the remainder of 2006, subject to market conditions and other factors.</li> </ul>
<p>2. <i>Liquidity Management and Contingency Planning:</i></p> <ul style="list-style-type: none"> <li>• We will maintain a contingency plan providing for at least three months’ liquidity without relying upon the issuance of unsecured debt. We will also periodically test the contingency plan in consultation with OFHEO.</li> </ul>	<ul style="list-style-type: none"> <li>• We have in place a liquidity contingency plan, upon which we report to OFHEO on a monthly basis. During the second quarter of 2006, we also began our periodic testing.</li> </ul>
<p>3. <i>Interest-Rate Risk Disclosures:</i></p> <ul style="list-style-type: none"> <li>• We will provide public disclosure of our duration gap, PMVS-L and PMVS-YC interest-rate risk sensitivity results on a monthly basis. See “RISK MANAGEMENT — Interest-Rate Risk and Other Market Risks — <i>Portfolio Market Value Sensitivity and Measurement of Interest-Rate Risk</i>” for a description of these metrics.</li> </ul>	<ul style="list-style-type: none"> <li>• For the twelve months ended December 31, 2005, our duration gap averaged zero months, PMVS-L averaged one percent and PMVS-YC averaged zero percent. Our 2005 monthly average duration gap, PMVS results and related disclosures are provided in our Monthly Volume Summary which is available on our website, <a href="http://www.FreddieMac.com/investors/volsum">www.FreddieMac.com/investors/volsum</a>.</li> </ul>

Description	Status																																								
<p>4. <i>Credit Risk Disclosures:</i></p> <ul style="list-style-type: none"><li>We will make quarterly assessments of the impact on expected credit losses from an immediate 5 percent decline in single-family home prices for the entire U.S. We will disclose the impact in present value terms and measure our losses both before and after receipt of private mortgage insurance claims and other credit enhancements.</li></ul>	<ul style="list-style-type: none"><li>Our quarterly credit risk sensitivity estimates are as follows:</li></ul> <table><tr><th></th><th colspan="2">Before Receipt of Credit Enhancements<sup>(1)</sup></th><th colspan="2">After Receipt of Credit Enhancements<sup>(2)</sup></th></tr><tr><th></th><th>Net Present Value, or NPV<sup>(3)</sup> (dollars in millions)</th><th>NPV Ratio<sup>(4)</sup></th><th>Net Present Value, or NPV<sup>(3)</sup> (dollars in millions)</th><th>NPV Ratio<sup>(4)</sup></th></tr><tr><td>As of:</td><td></td><td></td><td></td><td></td></tr><tr><td>12/31/05</td><td>\$873</td><td>6.5 bps</td><td>\$564</td><td>4.2 bps</td></tr><tr><td>09/30/05</td><td>844</td><td>6.6</td><td>516</td><td>4.0</td></tr><tr><td>06/30/05</td><td>787</td><td>6.3</td><td>471</td><td>3.7</td></tr><tr><td>03/31/05<sup>(5)</sup></td><td>814</td><td>6.6</td><td>505</td><td>4.1</td></tr><tr><td>12/31/04</td><td>794</td><td>6.5</td><td>463</td><td>3.8</td></tr></table> <p>(1) Assumes that none of the credit enhancements currently covering our mortgage loans has any mitigating impact on our credit losses.</p> <p>(2) Assumes we collect amounts due from credit enhancement providers after giving effect to certain assumptions about counterparty default rates.</p> <p>(3) Based on single-family Total mortgage portfolio, excluding Structured Securities backed by Ginnie Mac Certificates.</p> <p>(4) Calculated as the ratio of net present value of increase in credit losses to the single-family Total mortgage portfolio, defined above.</p> <p>(5) Beginning with period ended March 31, 2005, results included in this table are based on the model enhancements implemented on January 1, 2005. Results from March 31, 2005 using the previous model were \$756 million or 6.2 bps before receipt of credit enhancements and \$447 million or 3.6 bps after receipt of credit enhancements.</p>		Before Receipt of Credit Enhancements <sup>(1)</sup>		After Receipt of Credit Enhancements <sup>(2)</sup>			Net Present Value, or NPV <sup>(3)</sup> (dollars in millions)	NPV Ratio <sup>(4)</sup>	Net Present Value, or NPV <sup>(3)</sup> (dollars in millions)	NPV Ratio <sup>(4)</sup>	As of:					12/31/05	\$873	6.5 bps	\$564	4.2 bps	09/30/05	844	6.6	516	4.0	06/30/05	787	6.3	471	3.7	03/31/05 <sup>(5)</sup>	814	6.6	505	4.1	12/31/04	794	6.5	463	3.8
	Before Receipt of Credit Enhancements <sup>(1)</sup>		After Receipt of Credit Enhancements <sup>(2)</sup>																																						
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12/31/04	794	6.5	463	3.8																																					
<p>5. <i>Public Disclosure of Risk Rating:</i></p> <ul style="list-style-type: none"><li>We will seek to obtain a rating, that will be continuously monitored by at least one nationally recognized statistical rating organization, assessing “risk-to-the-government” or independent financial strength.</li></ul>	<ul style="list-style-type: none"><li>At June 1, 2006, our “risk-to-the-government” rating from Standard &amp; Poor’s, or S&amp;P, was “AA–” and Moody’s Bank Financial Strength Rating for us was “A–”.</li></ul>																																								

**CONSOLIDATED FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

## REPORT OF INDEPENDENT AUDITORS

To the Board of Directors and Stockholders of Freddie Mac:

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income, of cash flows, and of stockholders' equity present fairly, in all material respects, the financial position of Freddie Mac, a stockholder-owned government-sponsored enterprise (the "company"), and its subsidiaries at December 31, 2005 and 2004, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2005, in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America. 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, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

We have also audited in accordance with auditing standards generally accepted in the United States of America the supplemental consolidated fair value balance sheets of the company as of December 31, 2005 and 2004. As described in "NOTE 16: FAIR VALUE DISCLOSURES," the supplemental consolidated fair value balance sheets have been prepared by management to present relevant financial information that is not provided by the historical-cost consolidated balance sheets and is not intended to be a presentation in conformity with generally accepted accounting principles. In addition, the supplemental consolidated fair value balance sheets do not purport to present the net realizable, liquidation, or market value of the company as a whole. Furthermore, amounts ultimately realized by the company from the disposal of assets or amounts required to settle obligations may vary significantly from the fair values presented. In our opinion, the supplemental consolidated fair value balance sheets referred to above present fairly, in all material respects, the information set forth therein as described in "NOTE 16: FAIR VALUE DISCLOSURES."

As discussed in "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES," the company changed its method of accounting for interest expense related to callable debt instruments as of January 1, 2005, and its method for determining gains and losses on sales of certain guaranteed securities as of October 1, 2005.

The signature of PricewaterhouseCoopers LLP is written in a cursive, handwritten style.

McLean, Virginia  
June 28, 2006

**FREDDIE MAC**  
**CONSOLIDATED STATEMENTS OF INCOME**

	Year Ended December 31,		
	2005	2004	2003
	(dollars in millions, except share-related amounts)		
<i>Interest income</i>			
Mortgage loans	\$ 4,037	\$ 4,007	\$ 4,251
Mortgage-related securities in the Retained portfolio	29,684	28,460	29,051
Cash and investments	2,606	3,136	3,796
Total interest income	36,327	35,603	37,098
<i>Interest expense</i>			
Short-term debt	(6,102)	(2,908)	(2,785)
Long-term debt	(23,246)	(22,950)	(22,083)
Total interest expense on debt securities	(29,348)	(25,858)	(24,868)
Due to Participation Certificate investors	(551)	(708)	(1,641)
Total interest expense	(29,899)	(26,566)	(26,509)
Income (expense) related to derivatives	(1,058)	100	(1,091)
<i>Net interest income</i>	5,370	9,137	9,498
<i>Non-interest income (loss)</i>			
Management and guarantee income (includes interest on Guarantee asset of \$371, \$257 and \$244)	1,450	1,382	1,653
Gains (losses) on Guarantee asset	(1,064)	(1,135)	(1,461)
Income on Guarantee obligation	920	732	925
Derivative gains (losses)	(1,357)	(4,475)	39
Hedge accounting gains (losses)	22	743	644
Gains (losses) on investment activity	(127)	(348)	(1,114)
Gains (losses) on debt retirement	206	(327)	(1,775)
Resecuritization fees	125	159	352
Other income	24	230	493
<i>Non-interest income (loss)</i>	199	(3,039)	(244)
<i>Non-interest expense</i>			
Salaries and employee benefits	(805)	(758)	(624)
Professional services	(386)	(588)	(311)
Occupancy expense	(58)	(60)	(52)
Other administrative expenses	(286)	(144)	(194)
Total administrative expenses	(1,535)	(1,550)	(1,181)
Provision for credit losses	(251)	(143)	5
REO operations income (expense)	(40)	3	(7)
Housing tax credit partnerships	(320)	(281)	(200)
Minority interests in earnings of consolidated subsidiaries	(96)	(129)	(157)
Other expenses	(771)	(271)	(696)
<i>Non-interest expense</i>	(3,013)	(2,371)	(2,236)
Income before income tax expense and cumulative effect of change in accounting principle	2,556	3,727	7,018
Income tax expense	(367)	(790)	(2,202)
Net income before cumulative effect of change in accounting principle	2,189	2,937	4,816
Cumulative effect of change in accounting principle, net of taxes of \$32	(59)	—	—
<i>Net income</i>	\$ 2,130	\$ 2,937	\$ 4,816
Preferred stock dividends	(223)	(210)	(216)
<i>Net income available to common stockholders</i>	\$ 1,907	\$ 2,727	\$ 4,600
Basic earnings per common share:			
Earnings before cumulative effect of change in accounting principle	\$ 2.84	\$ 3.96	\$ 6.69
Cumulative effect of change in accounting principle, net of taxes	\$ (0.09)	\$ —	\$ —
Basic earnings per common share	\$ 2.76	\$ 3.96	\$ 6.69
Diluted earnings per common share:			
Earnings before cumulative effect of change in accounting principle	\$ 2.83	\$ 3.94	\$ 6.68
Cumulative effect of change in accounting principle, net of taxes	\$ (0.08)	\$ —	\$ —
Diluted earnings per common share	\$ 2.75	\$ 3.94	\$ 6.68
Weighted average common shares outstanding (in thousands)			
Basic	691,582	689,282	687,094
Diluted	693,511	691,521	688,675
Dividends per common share	\$ 1.52	\$ 1.20	\$ 1.04

*The accompanying notes are an integral part of these financial statements.*



**FREDDIE MAC  
CONSOLIDATED BALANCE SHEETS**

	December 31,	
	2005	2004
	(in millions, except share-related amounts)	
<b>Assets</b>		
<i>Retained portfolio</i>		
Mortgage loans:		
Held-for-investment, at amortized cost	\$ 60,009	\$ 58,852
Reserve for losses on mortgage loans held-for-investment	(119)	(114)
Held-for-sale, at lower-of-cost-or-market	1,538	2,582
Mortgage loans, net of reserve	61,428	61,320
Mortgage-related securities:		
Available-for-sale, at fair value (includes \$168 and \$194, respectively, pledged as collateral that may be repledged)	638,465	590,461
Trading, at fair value	8,894	11,842
Participation Certificate residuals, at fair value	597	845
Total mortgage-related securities	647,956	603,148
<i>Retained portfolio</i>	709,384	664,468
<i>Cash and investments</i>		
Cash and cash equivalents	10,468	35,253
Investments:		
Non-mortgage-related securities:		
Available-for-sale, at fair value	42,165	29,830
Securities purchased under agreements to resell and Federal funds sold	15,159	32,197
<i>Cash and investments</i>	67,792	97,280
Accounts and other receivables, net	6,373	7,286
Derivative assets, at fair value	7,097	15,257
Guarantee asset, at fair value	5,083	4,516
Real estate owned, net	629	741
Other assets	9,864	5,736
<i>Total assets</i>	\$806,222	\$795,284
<b>Liabilities and stockholders' equity</b>		
<i>Debt securities, net</i>		
Senior debt:		
Due within one year	\$288,532	\$282,303
Due after one year	454,627	443,772
Subordinated debt, due after one year	5,633	5,622
<i>Total debt securities, net</i>	748,792	731,697
Due to Participation Certificate investors	10,607	13,654
Accrued interest payable	7,611	7,329
Guarantee obligation	5,541	4,065
Derivative liabilities, at fair value	590	226
Reserve for guarantee losses on Participation Certificates	295	150
Other liabilities	4,646	5,238
<i>Total liabilities</i>	778,082	762,359
Commitments and contingencies (Notes 1, 3, 4, 13 and 14)		
<i>Minority interests in consolidated subsidiaries</i>	949	1,509
<i>Stockholders' equity</i>		
Preferred stock, at redemption value	4,609	4,609
Common stock, \$0.21 par value, 726,000,000 shares authorized, 725,882,280 shares issued and 692,717,422 shares and 690,606,185 shares outstanding, respectively	152	152
Additional paid-in capital	924	873
Retained earnings	31,559	30,728
Accumulated other comprehensive income (loss) (AOCI), net of taxes, related to:		
Available-for-sale securities	(2,485)	4,339
Cash flow hedge relationships	(6,287)	(7,924)
Minimum pension liability	(1)	(8)
Total accumulated other comprehensive income (loss), net of taxes	(8,773)	(3,593)
Treasury stock, at cost, 33,164,858 shares and 35,276,095 shares, respectively	(1,280)	(1,353)
<i>Total stockholders' equity</i>	27,191	31,416
<i>Total liabilities and stockholders' equity</i>	\$806,222	\$795,284

*The accompanying notes are an integral part of these financial statements.*

**FREDDIE MAC**  
**CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY**

	Year Ended December 31,					
	2005		2004		2003	
	Shares	Amount	Shares	Amount	Shares	Amount
			(in millions)			
<i>Preferred stock, at redemption value</i>						
Balance, beginning of year	92	\$ 4,609	92	\$ 4,609	92	\$ 4,609
<i>Preferred stock, end of year</i>	<u>92</u>	<u>4,609</u>	<u>92</u>	<u>4,609</u>	<u>92</u>	<u>4,609</u>
<i>Common stock, par value</i>						
Balance, beginning of year	726	152	726	152	726	152
<i>Common stock, end of year</i>	<u>726</u>	<u>152</u>	<u>726</u>	<u>152</u>	<u>726</u>	<u>152</u>
<i>Additional paid-in capital</i>						
Balance, beginning of year		873		814		744
Stock-based compensation, before tax effect of \$24, \$20 and \$23, respectively		67		56		64
Income tax benefit from employee stock option exercises		6		20		16
Common stock issuances		(13)		(17)		(10)
REIT preferred stock purchase		(9)		—		—
<i>Additional paid-in capital, end of year</i>		<u>924</u>		<u>873</u>		<u>814</u>
<i>Retained earnings</i>						
Balance, beginning of year		30,728		28,837		24,955
Net income		2,130		2,937		4,816
Preferred stock dividends declared		(223)		(210)		(216)
Common stock dividends declared		(1,076)		(836)		(718)
<i>Retained earnings, end of year</i>		<u>31,559</u>		<u>30,728</u>		<u>28,837</u>
<i>AOCI, net of taxes</i>						
Balance, beginning of year		(3,593)		(1,498)		2,340
Changes in unrealized gains (losses) related to available-for-sale securities, net of reclassification adjustments		(6,824)		(2,010)		(5,868)
Changes in unrealized gains (losses) related to cash flow hedge relationships, net of reclassification adjustments		1,637		(87)		2,040
Change in minimum pension liability		7		2		(10)
<i>AOCI, net of taxes, end of year</i>		<u>(8,773)</u>		<u>(3,593)</u>		<u>(1,498)</u>
<i>Treasury stock, at cost</i>						
Balance, beginning of year	35	(1,353)	37	(1,427)	39	(1,470)
Common stock issuances	(2)	73	(2)	74	(2)	43
<i>Treasury stock, end of year</i>	<u>33</u>	<u>(1,280)</u>	<u>35</u>	<u>(1,353)</u>	<u>37</u>	<u>(1,427)</u>
<i>Total stockholders' equity</i>		<u>\$27,191</u>		<u>\$31,416</u>		<u>\$31,487</u>
<i>Comprehensive income (loss)</i>						
Net income		\$ 2,130		\$ 2,937		\$ 4,816
Changes in AOCI, net of taxes, net of reclassification adjustments		(5,180)		(2,095)		(3,838)
<i>Total comprehensive income (loss)</i>		<u>\$ (3,050)</u>		<u>\$ 842</u>		<u>\$ 978</u>

*The accompanying notes are an integral part of these financial statements.*

**FREDDIE MAC**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

	Year Ended December 31,		
	2005	2004	2003
	(in millions)		
<b>Cash flows from operating activities</b>			
Net income	\$ 2,130	\$ 2,937	\$ 4,816
Adjustments to reconcile net income to net cash provided by operating activities:			
Cumulative effect of change in accounting principle, net	59	—	—
Hedge accounting gains	(22)	(743)	(644)
Unrealized losses (gains) on derivatives not in hedge accounting relationships, net	1,014	2,758	(1,079)
Asset related amortization — premiums, discounts and hedging basis adjustments	791	1,302	968
Debt related amortization — premiums and discounts on certain debt securities and hedging basis adjustments	9,129	5,748	5,027
Net discounts paid on retirements of debt	(5,207)	(3,085)	(3,326)
(Gains) losses on debt retirement	(206)	327	1,775
Provision for credit losses	260	143	(5)
Housing tax credit partnership losses	320	281	200
Losses on investment activity	343	738	2,625
(Decrease) increase in deferred income taxes	(1,452)	(346)	737
Purchases of held-for-sale mortgages	(26,763)	(31,698)	(82,074)
Sales of held-for-sale mortgages	23,662	30,965	84,329
Repayments of held-for-sale mortgages	118	162	390
Net proceeds of trading securities	2,598	38,672	8,935
Change in accounts and other receivables, net	661	1,870	3,902
Change in amounts due to Participation Certificate investors, net	(3,077)	529	(22,369)
Change in accrued interest payable	282	(235)	275
Change in income taxes payable	607	773	(1,074)
Change in Guarantee asset	(567)	(830)	(1,362)
Change in Guarantee obligation	1,413	1,173	1,606
Change in Participation Certificate residuals, at fair value	112	(170)	(389)
Other, net	(66)	37	7
<i>Net cash provided by operating activities</i>	<u>6,139</u>	<u>51,308</u>	<u>3,270</u>
<b>Cash flows from investing activities</b>			
Purchases of available-for-sale securities	(414,063)	(276,573)	(446,036)
Proceeds from sales of available-for-sale securities	94,961	85,583	143,513
Proceeds from maturities of available-for-sale securities	249,857	176,432	240,041
Purchases of held-for-investment mortgages	(12,980)	(12,525)	(15,567)
Repayments of held-for-investment mortgages	12,051	11,511	15,283
Proceeds from sales of REO	1,380	1,552	1,327
Net decrease (increase) in securities purchased under agreements to resell and Federal funds sold	17,038	(11,615)	2,461
Repurchase of REIT preferred stock	(142)	—	—
Derivative premiums and terminations, net	932	(193)	3,333
Investments in housing tax credit partnerships	(127)	(69)	(32)
<i>Net cash used for investing activities</i>	<u>(51,093)</u>	<u>(25,897)</u>	<u>(55,677)</u>
<b>Cash flows from financing activities</b>			
Proceeds from issuance of short-term debt	857,361	826,020	900,073
Repayments of short-term debt	(862,176)	(841,638)	(881,860)
Proceeds from issuance of long-term debt	153,504	187,779	258,267
Repayments of long-term debt	(125,959)	(183,541)	(210,121)
Repayments of minority interest in consolidated subsidiaries	(436)	(405)	(376)
Proceeds from issuance of common stock	60	57	33
Payment of cash dividends on preferred stock and common stock	(1,299)	(1,046)	(934)
Repayments of housing tax credit partnerships notes payable	(940)	(498)	(349)
Increase (decrease) in cash overdraft	54	(28)	24
<i>Net cash provided by (used for) financing activities</i>	<u>20,169</u>	<u>(13,300)</u>	<u>64,757</u>
Net (decrease) increase in cash and cash equivalents	(24,785)	12,111	12,350
Cash and cash equivalents at beginning of year	35,253	23,142	10,792
<i>Cash and cash equivalents at end of year</i>	<u>\$ 10,468</u>	<u>\$ 35,253</u>	<u>\$ 23,142</u>
<b>Supplemental cash flow information</b>			
Cash (received) paid for:			
Interest	\$ 26,797	\$ 23,902	\$ 25,918
Derivative interest carry, net	(590)	325	578
Income taxes	1,212	363	2,538
Loans in acceleration held in the retained portfolio	1,372	1,716	2,003
Non-cash investing and financing activities:			
Securitized and retained available-for-sale securities of held-for-sale mortgages	175	272	1,681
Transfers from mortgage loans to REO	1,312	1,546	1,570
Investments in housing tax credit partnerships financed by notes payable	1,095	1,184	702
Transfers from held-for-sale mortgages to held-for-investment mortgages	291	198	179

*The accompanying notes are an integral part of these financial statements.*

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

We are a stockholder-owned, government-sponsored enterprise, or GSE, established by Congress in 1970 to provide a continuous flow of funds for residential mortgages. Our obligations are ours alone and are not insured or guaranteed by the U.S., or any other agency or instrumentality of the U.S. We play a fundamental role in the American housing finance system, linking the domestic mortgage market and the global capital markets. Our participation in the secondary mortgage market includes providing our credit guarantee for residential mortgages originated by mortgage lenders and investing in mortgage loans and mortgage-related securities that we hold in our Retained portfolio. Through our credit guarantee activities, we securitize mortgage loans by issuing Mortgage Participation Certificates, or PCs, to third-party investors. We also resecuritize mortgage-related securities that are issued by us or the Government National Mortgage Association, or Ginnie Mae, as well as non-agency entities. Resecuritized mortgage-related securities are referred to as Structured Securities. We also guarantee multifamily mortgage loans that support housing revenue bonds issued by third parties and we guarantee other mortgage loans held by third parties. Securitized mortgage-related assets that back PCs and Structured Securities that are held by third parties are not reflected as our assets. In return for providing our guarantee on issued PCs and Structured Securities, we may earn a management and guarantee fee that is paid to us over the life of the related PCs and Structured Securities. Our obligation to guarantee the payment of principal and interest on issued PCs and Structured Securities usually results in the recognition of a Guarantee asset and Guarantee obligation.

Our financial reporting and accounting policies conform to U.S. generally accepted accounting principles, or GAAP. Certain amounts in prior periods have been reclassified to conform to the current presentation.

#### Estimates

The preparation of financial statements requires us to make estimates and assumptions that affect (a) the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and (b) the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Our estimates and judgments include the following: the estimation of fair value for financial instruments (See “NOTE 16: FAIR VALUE DISCLOSURES” for a discussion of our fair value estimates); determining the expected future cash flows (including the timing and amounts of prepayments) of mortgage-related assets in the Retained portfolio for the purpose of amortizing deferred amounts and assessing when securities are other-than-temporarily impaired; assessing the reserves for credit losses on mortgage loans and guarantee losses on PCs; assessing our legal and tax contingencies; estimating the expected timing and amounts of future issuances of non-callable debt; and determining other matters that affect the reported amounts and disclosure of contingencies in the financial statements.

Net income for 2005 was reduced by approximately \$206 million (after tax), or \$0.30 per diluted common share, related to the implementation of enhancements to our approach for certain valuations, the estimation of reserves for uncollectible interest and models used to estimate prepayment behavior of mortgage assets that were recorded as changes in accounting estimates.

Effective January 1, 2005, we implemented several enhancements to the valuation approach that we use to estimate the fair value of our guarantee-related assets and liabilities. With respect to our guarantee-related assets, these enhancements include the use of third-party quotes on assets that have similar characteristics. We have also worked with third parties to create and value hypothetical credit structures based on the collateral underlying our PCs, and used those values in determining the fair values of our guarantee-related liabilities. The change in valuation approach for our guarantee-related assets and liabilities primarily affected our Guarantee asset and Participation Certificate residuals, which are both carried at fair value, and reduced Net income by approximately \$68 million (after-tax). This valuation change also affected the amortization of deferred credit fees resulting in a \$17 million reduction in Net income. Additional information about the valuation methods used for our guarantee-related assets and liabilities is discussed in “NOTE 2: TRANSFERS OF SECURITIZED INTERESTS IN MORTGAGE-RELATED ASSETS.”

We also changed our estimate of reserves for uncollectible interest on single-family mortgage loans we hold that are greater than 90 days delinquent. Our new estimation approach establishes reserves for all accrued but uncollected interest on all single-family loans that are greater than 90 days delinquent. Prior to this change, we accrued interest on all single-family loans and established reserves for all accrued interest we deemed uncollectible using internal statistically based models. This change resulted in a \$77 million (after-tax) reduction in Net income for 2005.

Also, effective January 1, 2005, we implemented refinements to our prepayment model that is used to evaluate prepayment behavior for assets in our Retained portfolio. As a result, prepayment speeds used in our amortization model

generally increased, reflecting better estimates of the effects of recent market conditions on expected prepayments. This change resulted in a \$44 million (after-tax) reduction in Net income for 2005.

Net income for 2004 was decreased by approximately \$56 million (after tax), or \$0.08 per diluted common share, as the result of a change in estimate related to enhancements to certain assumptions and calculations in the amortization process for deferred fees recorded as basis adjustments on assets in our Retained portfolio.

Net income for 2003 was increased by approximately \$92 million (after tax), or \$0.13 per diluted common share, as a result of changes in accounting estimates related to: (a) the amortization of certain deferred fees recorded as basis adjustments on assets in our Retained portfolio, which increased net income by \$20 million, and (b) improvements to our approach for estimating the expected weighted-average lives of mortgages with related deferred fees, including credit fees and buy-down fees, which increased net income by \$72 million.

Table 1.1 shows the pre-tax impact of the changes in estimates on our consolidated statement of income:

**Table 1.1 — Summary of Change in Estimates (Pre-Tax)**

	Year ended December 31,		
	2005	2004	2003
	(in millions)		
Interest income .....	\$(166)	\$(86)	\$ 31
Non-interest income (loss)			
Management and guarantee income .....	(17)	—	110
Gains (losses) on Guarantee asset .....	(27)	—	—
Gains (losses) on investment activity .....	(78)	—	—
Other income .....	(27)	—	—
Total non-interest income (loss) .....	(149)	—	110
Total pre-tax impact of changes in estimates .....	<u>\$(315)</u>	<u>\$(86)</u>	<u>\$141</u>

### Changes in Accounting Principles

Effective January 1, 2005, we changed our method of accounting for interest expense related to callable debt instruments to recognize interest expense using an effective interest method over the contractual life of the debt. For periods prior to 2005, we amortized premiums, discounts, deferred issuance costs and other basis adjustments in interest expense using an effective interest method over the estimated life of the debt. We implemented this change in accounting method to facilitate improved financial reporting, particularly to promote the comparability of our financial reporting with that of our primary competitor. The change in accounting method also reduces the operational complexity associated with determining the estimated life of callable debt. The cumulative effect of this change was a \$59 million (after-tax) reduction in net income for 2005.

Table 1.2 summarizes the pro forma net income and related basic and diluted earnings per common share, had the amortization of premiums, discounts, deferred issuance costs and other basis adjustments related to callable debt based on the contractual maturity been in effect for the years ended December 31, 2004 and 2003.

**Table 1.2 — Pro Forma Information — Change in Accounting for Interest Expense Related to Callable Debt**

	Year Ended December 31,	
	2004	2003
	(in millions, except share-related amounts)	
As reported:		
Net income .....	\$2,937	\$4,816
Basic earnings per common share .....	\$ 3.96	\$ 6.69
Diluted earnings per common share .....	\$ 3.94	\$ 6.68
Pro forma:		
Net income .....	\$2,910	\$4,746
Basic earnings per common share .....	\$ 3.92	\$ 6.59
Diluted earnings per common share .....	\$ 3.90	\$ 6.58

Beginning October 1, 2005, we changed our method for determining gains and losses upon the re-sale of PCs and Structured Securities related to deferred items recognized in connection with our guarantee of those securities. This change in accounting principle was facilitated by system changes that now allow us to apply and track these deferred items relative to the specific portions of the purchased PCs and Structured Securities, thus improving our financial reporting. Due to the unavailability of certain historical data, we did not have the ability to calculate the cumulative effect of the change nor were we able to determine the pro forma effects of applying the new method retroactively. See “NOTE 2: TRANSFERS OF SECURITIZED INTERESTS IN MORTGAGE-RELATED ASSETS” for additional information.



## **Consolidation and Equity Method of Accounting**

The consolidated financial statements include our accounts and those of our subsidiaries. All material intercompany transactions have been eliminated in consolidation. For each entity with which we are involved, we determine whether the entity should be considered our subsidiary and included in our consolidated financial statements. We consolidate (a) all Variable Interest Entities, or VIEs, in which we are the primary beneficiary and (b) entities that are not VIEs in which we hold more than 50 percent of the voting rights and have the ability to exercise control over the entity.

For each entity in which we are involved, we determine if the entity is a VIE. A VIE is an entity (a) that has a total equity investment at risk that is not sufficient to finance its activities without additional subordinated financial support from other entities or (b) where the group of equity holders does not have the ability to make significant decisions about the entity's activities, or the obligation to absorb the entity's expected losses or the right to receive the entity's expected residual returns, or both. We consolidate entities that are VIEs when we are the primary beneficiary. We are considered the primary beneficiary and must consolidate a VIE when we absorb a majority of expected losses or expected residual returns, or both. In addition to the VIEs that are consolidated, we have significant variable interest in certain other VIEs that are not consolidated because we are not the primary beneficiary. See "NOTE 3: VARIABLE INTEREST ENTITIES" for more information.

We consolidate entities that are not VIEs when we hold more than 50 percent of the voting rights and have the ability to exercise control over the entity. Accordingly, we consolidate our two majority-owned Real Estate Investment Trusts, or REITs, Home Ownership Funding Corporation and Home Ownership Funding Corporation II. The equity and net earnings attributable to the minority shareholder interests in our consolidated subsidiaries are reported separately in the consolidated balance sheets as Minority interests in consolidated subsidiaries and in the consolidated statements of income as Minority interests in earnings of consolidated subsidiaries.

We use the equity method of accounting for VIEs when we are not the primary beneficiary and for entities that are not VIEs over which we have the ability to exercise significant influence, but not control. Under the equity method of accounting, we report our recorded investment as part of Other assets on the consolidated balance sheets and recognize our share of the entity's net income or losses in the consolidated statements of income, with an offset to the recorded investment on the consolidated balance sheets. Losses are recognized up to the amount of investment recorded.

We regularly invest as a limited partner in qualified low-income housing tax credit, or LIHTC, partnerships that are eligible for federal tax credits. Most of these are VIEs. We are the primary beneficiary and consolidate certain of these partnerships as described further in "NOTE 3: VARIABLE INTEREST ENTITIES." Our recorded investment in those partnerships that are not consolidated is accounted for under the equity method and is reported as part of Other assets on the consolidated balance sheets. Our share of partnership income or loss is reported in the consolidated statements of income as Non-interest expense — Housing tax credit partnerships. Our obligations to make delayed equity contributions that are unconditional and legally binding are recorded at their present value in Other liabilities on the consolidated balance sheets. To the extent our cost basis in qualified LIHTC partnerships differs from the book basis reflected at the partnership level, the difference is amortized over the life of the tax credits and included in our share of earnings (losses) from housing tax credit partnerships. We periodically review these investments for impairment and adjust them to fair value when a decline in market value below the recorded investment is deemed to be other than temporary. Impairment losses are included in our consolidated statements of income as part of Non-interest expense — Housing tax credit partnerships.

## **Cash and Cash Equivalents and Statements of Cash Flows**

Highly liquid investment securities that have an original maturity of three months or less and are used for cash management purposes are accounted for as cash equivalents. Cash collateral we obtained from counterparties to derivative contracts where we are in a net unrealized gain position is recorded as Cash and cash equivalents. The vast majority of the cash and cash equivalents balance is interest-bearing in nature.

In the consolidated statements of cash flows, cash flows related to the acquisition and termination of derivatives other than forward commitments are generally classified in investing activities, without regard to whether the derivatives are designated as a hedge of another item. Cash flows from commitments accounted for as derivatives that result in the acquisition or sale of mortgage securities or mortgage loans are classified in either: (a) operating activities for trading securities or mortgage loans classified as held-for-sale, or (b) investing activities for available-for-sale securities or mortgage loans classified as held-for-investment. Cash flows related to mortgage loans classified as held-for-sale are classified in operating activities until the loans have been securitized and retained as available-for-sale PCs, at which time the cash flows are classified as investing activities. Cash flows related to guarantee fees, including buy-up and buy-down payments, are classified as operating activities, along with the cash flows related to the collection and distribution of payments on the mortgage loans underlying PCs. Buy-up and buy-down payments are discussed further below in "Swap-Based Issuances of PCs and Structured Securities." There were less than \$1 million, \$428 million and \$322 million of non-cash net transfers to

the available-for-sale classification from the trading classification related to resecuritization transactions during 2005, 2004 and 2003, respectively.

### **Transfers of PCs and Structured Securities that Qualify as Sales**

Upon completion of a transfer of a financial asset that qualifies as a sale under SFAS No. 140, “Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities” (“SFAS 140”), we de-recognize all assets sold and recognize all assets obtained and liabilities incurred. In this regard, we recognize the fair value of our obligation to guarantee the payment of principal and interest of PCs and Structured Securities transferred in sale transactions. The portion of such obligation that relates to our non-contingent obligation to stand ready to perform under our guarantee is recognized as a Guarantee obligation, while the portion of the obligation that relates to estimated incurred losses on securitized assets is recognized for consolidated balance sheet purposes as Reserve for guarantee losses on Participation Certificates. The resulting gain (loss) on sale of transferred PCs and Structured Securities is reflected in our consolidated statements of income as a component of Gains (losses) on investment activity.

In recording a sales transaction, we also continue to carry on our consolidated balance sheets any retained interests in securitized financial assets. Such retained interests include our right to receive management and guarantee fees on PCs or Structured Securities, which is classified on our consolidated balance sheets as a Guarantee asset. The carrying amount of all such retained interests is determined by allocating the previous carrying amount of the transferred assets between assets sold and the retained interests based upon their relative fair values at the date of transfer. Other retained interests include PCs or Structured Securities that are not transferred to third parties upon the completion of a securitization or resecuritization transaction.

### **Swap-Based Issuances of PCs and Structured Securities**

In addition to issuing PCs and Structured Securities through cash-based sales transactions, we issue such securities through various swap-based exchanges. In the case of PC-based swaps, we issue such securities to third parties through Guarantor and MultiLender Swap transactions. Guarantor Swaps represent transactions in which financial institutions transfer mortgage loans to us in exchange for PCs we issue that are backed by such mortgage loans. MultiLender Swaps are similar to Guarantor Swaps, except that formed pools include loans that are contributed by more than one other party or by us. In Guarantor and MultiLender Swaps, as in sales transactions, in return for providing our guarantee, we earn a guarantee fee that is paid to us over the life of an issued PC. It is also common for buy-up or buy-down payments to be exchanged between our counterparties and us upon the issuance of a PC. Buy-Ups are upfront payments made by us that increase the guarantee fee we will receive over the life of the PC. Buy-Downs are upfront payments that are made to us that decrease (*i.e.*, partially prepay) the guarantee fee we will receive over the life of the PC. We also may receive upfront, cash-based payments as additional compensation for our guarantee of mortgage loans, referred to as Credit Fees, and as additional consideration received on such exchanges, we may receive various types of seller-provided credit enhancements related to the underlying mortgage loans. We also issue and transfer Structured Securities to third parties in exchange for PCs and non-Freddie Mac mortgage-related securities.

We recognize the fair value of our contractual right to receive guarantee fees as a Guarantee asset at the inception of an executed guarantee. Additionally, we recognize a Guarantee obligation at the greater of (a) fair value or (b) the contingent liability amount required by SFAS No. 5, “Accounting For Contingencies,” or SFAS 5, to be recognized at inception of an executed guarantee. Similar to transfers of PCs and Structured Securities that qualify as sales, that portion of our estimated guarantee liability that relates to our non-contingent obligation to stand ready to perform under a PC guarantee is recognized as Guarantee obligation, while that portion of such estimated guarantee liability that relates to our contingent obligation to make payments under our guarantee is recognized for consolidated balance sheet purposes as Reserve for guarantee losses on Participation Certificates. Further, credit enhancements received in connection with Guarantor Swaps and other similar exchange transactions of PCs are measured at fair value and recognized as follows: (a) pool insurance is recognized as an Other asset; (b) recourse and/or indemnifications that are provided by counterparties to Guarantor Swap transactions are recognized as Other assets; and (c) primary mortgage insurance is recognized at inception as a component of the recognized Guarantee obligation.

Because Guarantee asset, Guarantee obligation and credit enhancement-related assets that are recognized at the inception of an executed Guarantor Swap are valued independently of each other, net differences between such recognized assets and liabilities may exist at inception. Net positive differences between such amounts are deferred on our consolidated balance sheet as a component of Guarantee obligation and are hereinafter referred to as “Deferred Guarantee Income”. Net negative differences between Guarantee asset, Guarantee obligation and credit enhancement-related assets that are recognized at the inception of executed financial guarantees are expensed immediately to earnings as a component of Non-interest expense — Other expenses. Additionally, cash payments that are made or received in connection with Buy-Ups

and Buy-Downs are recognized as adjustments of recognized Deferred Guarantee Income. Likewise, Credit Fees that we receive at inception are also recognized as adjustments of recognized Deferred Guarantee Income.

With regard to PCs that we issue through our MultiLender Swap Program, we account for a portion of such transactions in the same manner as transfers described above that are accounted for as sales. The remaining portion of such PC issuances are accounted for in a manner consistent with the accounting for PCs issued through the Guarantor Swap program.

Concerning Structured Securities that we issue to third parties in exchange for PCs and non-Freddie Mac mortgage-related securities, we do not recognize any incremental Guarantee asset or Guarantee obligation on such transactions. Rather, we defer and amortize into income on a straight-line basis that portion of the transaction fee that we receive on such transactions that relates to the estimated fair value of our future administrative responsibilities for issued Structured Securities. In cases where we retain portions of Structured Securities issued in such transactions, a portion of the received transaction fee is deferred as a carrying value adjustment of retained Structured Securities. The balance of transaction fees received, which relates to compensation earned in connection with structuring-related services rendered by us to third parties, is recognized immediately in earnings as Non-interest income — Resecuritization fees.

### **Purchases of PCs or Structured Securities**

The purchase of a PC or Structured Security prompts the extinguishment of the corresponding, recognized Guarantee obligation. Likewise, and where applicable, the purchase of such securities also prompts the extinguishment of the related unamortized balance of Deferred Guarantee Income.

We de-recognize an extinguished Guarantee obligation against earnings as a component of Gains (losses) on investment activity. Correspondingly, the recognized Guarantee asset is reclassified on our consolidated balance sheets as a component of Participation Certificate residuals, at fair value, or PC Residuals.

The unamortized balance of Deferred Guarantee Income is extinguished as a basis adjustment to the recognized value of purchased PCs. Like purchase discounts, such basis adjustments are subsequently amortized into earnings as Interest income pursuant to the requirements of SFAS No. 91, “Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases,” or SFAS 91, using the effective interest method.

### **Subsequent Measurement of Recognized Guarantee-Related Assets and Liabilities**

#### *Deferred Guarantee Income*

Deferred Guarantee Income is amortized into earnings at a rate that is commensurate with the observed decline in the unpaid principal balance of securitized mortgage loans. Periodic amortization of recognized Deferred Guarantee Income is reflected in earnings as a component of Income on Guarantee obligation.

#### *Recognized Guarantee Asset*

We generally account for a Guarantee asset like a debt instrument classified as trading under SFAS 115. As such, all changes in the fair value of recognized Guarantee asset are reflected in earnings as a component of Gains (losses) on Guarantee asset. All guarantee-related compensation that is received over the life of the loan in cash is reflected in earnings as a component of Management and guarantee income.

#### *Recognized Guarantee Obligation*

We subsequently amortize the recognized Guarantee obligation into earnings in proportion to the rate of the unpaid principal balance decline of securitized mortgage loans. Periodic amortization of a recognized Guarantee obligation is reflected in earnings as a component of Income on Guarantee obligation. The subsequent measurement of our contingent obligation to make guarantee payments is further discussed below in “Reserves for Losses on Mortgage Loans Held-for-Investment and Losses on PCs”.

#### *Recognized Credit Enhancements*

Credit enhancements that are separately recognized as Other assets are amortized into earnings as Non-interest expense. Such assets are amortized over related contract terms at the greater of results calculated by amortizing recognized credit enhancements (a) in proportion to the rate of unpaid principal balance decline of covered mortgage loans or (b) on a straight-line basis over a credit enhancement’s contract term, whichever is shorter. Recurring insurance premiums are recorded at the amount paid and amortized over their contractual life and, if provided quarterly, then the amortization period is three months.

#### *PC Residuals*

PC residuals relate to certain PCs or Structured Securities held by us as investments and represent the fair value of the expected future cash flows associated with the guarantee contracts (including cash flows related to Management and guarantee fees and our Guarantee obligation) that are inherent within such securities.

We recognize a PC residual in connection with PCs or Structured Securities held by us that (a) were previously transferred to third parties as part of transactions that were accounted for either as sales or in a manner described above for Guarantor Swap transactions (such that a Guarantee asset and Guarantee obligation was previously established for held PCs or Structured Securities), (b) were formed from mortgage loans purchased through our Cash Window (“Cash Window Purchases”) and that were never transferred to third parties, (c) were purchased by us from third parties in contemplation of the related issuance of such PCs through the Guarantor Swap program or (d) relate to Buy-Ups paid in connection with purchased PCs that had not previously been included as part of a transfer that was accounted for as a sale or as part of a guarantee transaction that was accounted for like Guarantor Swaps as described above.

Like a recognized Guarantee asset, a PC residual is accounted for like a debt security and is classified as either available-for-sale or trading under SFAS 115. PC residuals relating to PCs or Structured Securities that were transferred to third parties and for which a Guarantee asset and Guarantee obligation was recognized are accounted for like debt securities that are classified as trading. PC residuals relating to PCs held in portfolio that were formed from Cash Window Purchases and that were never transferred to third parties are generally accounted for like debt securities that are classified as available-for-sale.

All changes in the fair value of PC residuals that are designated as trading are reflected in earnings as a component of Gains (losses) on investment activity. All changes in the fair value of PC residuals that are accounted for as available-for-sale are reflected as a component of Accumulated other comprehensive income (loss), net of taxes, or AOCI, a component of Stockholders’ equity. All cash received over the life of the underlying loans with respect to the Guarantee asset component of the PC residuals is reflected in earnings as a component of Net interest income.

#### **Due to Participation Certificate Investors**

Timing differences between our receipt of scheduled and unscheduled principal and interest payments from seller/servicers on mortgages underlying PCs and the subsequent pass through of those payments on PCs owned by third-party investors result in the liability Due to Participation Certificate investors. In those cases, the PC balance is not reduced for payments of principal received from seller/servicers in a given month until the first day of the next month and we do not release the cash received (principal and interest) to the PC investor until the fifteenth day of that next month. We generally invest the principal and interest amounts we receive in short-term investments from the time the cash is received until the time we pay the PC investor. Interest income resulting from investment of principal and interest payments from seller/servicers is reported in interest income.

For unscheduled principal prepayments, these timing differences result in an expense accrual upon prepayment of the underlying mortgage. This is because the related PCs continue to bear interest due to the PC investor at the PC coupon rate from the date of prepayment until the date the PC security balance is reduced, while generally no interest is received from the mortgage on that prepayment amount during that period. The expense recognized upon prepayment is reported in Interest expense — Due to Participation Certificate investors. We report PC coupon interest amounts relating to our investment in PCs consistent with the accounting practices generally applied by third party investors in PCs. Accordingly, the PC coupon interest on prepayments of a mortgage pending remittance on PCs held by us is reported as both Interest Income — Mortgage-related securities in the Retained portfolio and Interest expense — Due to Participation Certificate investors. Scheduled and unscheduled principal payments received by us that relate to our investment in PCs are reported as a reduction to our investment in PCs on the consolidated balance sheets.

#### **Mortgage Loans**

Mortgage loans that we may sell are classified as held-for-sale. If we decide to retain a loan, the loan is transferred to the held-for-investment portfolio. Loans transferred to the held-for-investment portfolio are transferred at lower of cost or market. Lower-of-cost-or-market valuation adjustments relating to these loans are treated as basis adjustments and are subsequently amortized into interest income over the period held. We recognize interest on mortgage loans on an accrual basis, except when we believe the collection of principal or interest is doubtful.

Held-for-sale mortgages are reported at lower-of-cost-or-market, on a portfolio basis, with losses reported in Gains (losses) on investment activity. Premiums and discounts on loans classified as held-for-sale are not amortized during the period that such loans are classified as held-for-sale. For a description of how we determine the fair value of our held-for-sale mortgage loans, see “NOTE 16: FAIR VALUE DISCLOSURES.”

Mortgage loans that we have the ability and intent to hold for the foreseeable future or to maturity are classified as held-for-investment. These mortgage loans are reported at their outstanding principal balances, net of deferred fees (including premiums and discounts). These deferred items are amortized into interest income over the estimated lives of the mortgages using the effective interest method. We use actual prepayment experience and estimates of future prepayments to



determine the constant yield needed to apply the effective interest method. For purposes of estimating future prepayments, the mortgages are aggregated by similar characteristics such as origination date, coupon and maturity.

### **Reserves for Losses on Mortgage Loans Held-for-Investment and Losses on PCs**

We maintain a Reserve for losses on mortgage loans held-for-investment to provide for credit losses inherent in that portfolio. We also maintain a Reserve for guarantee losses on Participation Certificates or Structured Securities held by third parties. The Reserve for losses on mortgage loans held-for-investment and Reserve for guarantee losses on Participation Certificates are collectively referred to as “loan loss reserves.” Increases in loan loss reserves are reflected in earnings as a component of the Provision for credit losses. Decreases in loan loss reserves are reflected through either (a) charging-off such balances (net of recoveries) when realized losses are recorded or (b) a reduction in the Provision for credit losses.

Loan loss reserves are also recorded upon the sale of PCs and Structured Securities for which losses were incurred on the underlying mortgage loans while we held such securities. We recognize incurred losses as a component of Gains (losses) on investment activity through, where applicable: (a) the subsequent measurement of corresponding PC residuals that are classified as trading; (b) the recognition of impairment-related losses on such securities (*i.e.*, to the extent that such securities do not have recognized PC residual balances associated with them that are classified as trading); or (c) as a component of gain (loss) on sale of such securities. Upon the sale of such PCs or Structured Securities, incurred losses are classified on the consolidated balance sheets as Reserve for guarantee losses on Participation Certificates.

*Single-family loan portfolio* — We estimate credit losses on homogeneous pools of single-family loans using statistically-based models that evaluate a variety of factors. The homogeneous pools of single-family mortgage loans are determined based on common underlying characteristics, including year of origination, loan-to-value ratio and geographic region. In determining the loan loss reserves for impaired single-family loans at the balance sheet date, we determine the point within the range of probable losses that represents the best estimate of losses. The factors used to estimate losses include the year of loan origination, geographic location, actual and estimated amounts for loss severity trends for similar loans, default experience, proceeds from credit enhancements, pre-foreclosure real estate taxes and insurance, and estimated costs should the underlying property ultimately be foreclosed upon and sold.

We frequently validate and update the models and factors to capture changes in actual loss experience, as well as changes in underwriting practices and in our loss mitigation strategies. We also consider macroeconomic and other factors including regional housing trends, applicable home price indices, unemployment and employment dislocation trends, consumer credit statistics, recent changes in credit underwriting practices, the extent of third party insurance, and other measurable factors that influence the quality of the portfolio at the balance sheet date. Favorable trends in these macroeconomic and other factors produce a reserve requirement toward the lower end of the range, while adverse trends in these factors produce a reserve requirement toward the higher end of the range. We then adjust the level of loan loss reserves to the level required based on our best assessment of these factors.

*Multifamily loan portfolio* — We estimate credit losses on the multifamily loan portfolio based on all available evidence, including adequacy of third-party credit enhancements, evaluation of the repayment prospects, and fair value of collateral underlying the individual loans. The review of the repayment prospects and value of collateral underlying individual loans is based on property-specific and market-level risk characteristics including apartment vacancy rates, apartment rental rates, and property sales information. Loans individually evaluated for impairment include loans that become 60 days past due for principal and interest, certain loans with observable collateral deficiencies and loans whose contractual terms were modified due to credit concerns. When loan loss reserves for individual loans are established, consideration is given to all available evidence, such as present value of discounted expected future cash flows, fair value of collateral, and credit enhancements.

### **Non-performing Loans**

Non-performing loans consist of (a) loans that were previously delinquent whose terms have been modified and, therefore, are now considered part of our impaired loan population (“troubled debt restructurings”), (b) serious delinquencies and (c) nonaccrual loans. Serious delinquencies are those single-family loans that are 90 days or more past due or in foreclosure, and multifamily loans that are more than 60 days but less than 90 days past due. This category also includes multifamily loans that are 90 days or more past due but where principal and interest are being paid to us under the terms of a credit enhancement agreement. Non-performing loans generally accrue interest in accordance with their contractual terms unless they are in nonaccrual status. Nonaccrual loans are loans where interest income is recognized on a cash basis, and only include multifamily loans 90 days or more past due. For nonaccrual loans, any existing accruals are reversed against interest income unless they are both well secured and in the process of collection. For single-family loans greater than 90 days delinquent, interest income is accrued; however, we establish reserves for all accrued but uncollected interest on all single-family loans we hold that are greater than 90 days delinquent. Prior to 2005, we established a reserve for



all single-family accrued interest we deemed uncollectible using internal statistically based models, which estimated accrued but uncollectible interest. We report this reserve as a reduction to the accrued loan interest balance in Accounts and other receivables, net.

Impaired loans include single-family loans, both performing and non-performing, that are troubled debt restructurings. Multifamily impaired loans are defined as performing and non-performing troubled debt restructurings, loans 60 days or more past due (except for certain credit-enhanced loans) and certain mortgage loans with real estate collateral values less than the outstanding unpaid principal balances. See “Table 6.2 — Impaired Loans” in “NOTE 6: LOAN LOSS RESERVES” for further discussion.

We have the option to purchase mortgage loans out of PC pools under certain circumstances, such as to resolve an existing or impending delinquency or default. Our general practice is to purchase the mortgage loans out of pools after the loans are 120 days delinquent. These loans are recorded on our consolidated balance sheets at fair value.

### **Charge-Offs**

The loan loss reserves are reduced for charge-offs when a loss is specifically identified and is virtually certain of occurring. For both single-family and multifamily mortgages where the original terms of the mortgage loan agreement are modified for economic or legal reasons related to the borrower’s financial difficulties, losses are recorded at the time of modification and the loans are subsequently accounted for as troubled debt restructurings. For mortgages that are foreclosed upon and thus transferred to Real estate owned, net, or REO, or are involved in a pre-foreclosure sale, losses at the time of transfer or pre-foreclosure sale are charged-off against Reserve for losses on mortgage loans held-for-investment. For transfers to REO, losses arise when the carrying basis of the loan (including accrued interest) exceeds the fair value of the foreclosed property (after deduction for estimated selling costs and consideration of third-party insurance or other credit enhancements). REO gains arise and are recognized immediately in earnings when the fair market value of the acquired asset (after deduction for estimated disposition costs) exceeds the carrying value of the mortgage (including accrued interest). REO gains and losses subsequent to foreclosure are included in REO operations income (expense).

### **Investments in Securities**

Investments in securities consist primarily of mortgage-related securities. We classify securities as “available-for-sale” or “trading.” We currently do not classify any securities as “held-to-maturity” although we may elect to do so in the future. Securities classified as available-for-sale and trading are reported at fair value with changes in fair value included in AOCI and Gains (losses) on investment activity, respectively. See “NOTE 16: FAIR VALUE DISCLOSURES” for more information on how we determine the fair value of securities.

We record forward purchases and sales of securities that are specifically exempt from the requirements of “Accounting for Derivative Instruments and Hedging Activities,” or SFAS 133, on a trade date basis. Securities underlying forward purchases and sales contracts that are not exempt from the requirements of SFAS 133 are recorded on the contractual settlement date with a corresponding commitment recorded on the trade date.

We often retain Structured Securities created through securitizations of mortgage-related securities held by us. The new Structured Securities we acquire in these transactions are classified as available-for-sale or trading based upon the predominant classification of the mortgage-related security collateral we contributed.

For most of our investments in securities, interest income is recognized using the retrospective effective interest method. Deferred items, including premiums, discounts and other basis adjustments, are amortized into interest income over the estimated lives of the securities. We use actual prepayment experience and estimates of future prepayments to determine the constant yield needed to apply the effective interest method. We recalculate the constant effective yield based on changes in estimated prepayments as a result of changes in interest rates and other factors. When the constant effective yield changes, an adjustment to interest income is made for the amount of amortization that would have been recorded if the new effective yield had been applied since the mortgage assets were acquired.

For certain securities investments, interest income is recognized using the prospective effective interest method. We specifically apply this accounting to beneficial interests in securitized financial assets that (a) can contractually be prepaid or otherwise settled in such a way that we may not recover substantially all of our recorded investment (such as interest-only strips) or (b) are not of high credit quality at the acquisition date. We recognize as interest income (over the life of these securities) the excess of all estimated cash flows attributable to these interests over their principal amount using the effective yield method. We update our estimates of expected cash flows periodically and recognize changes in calculated effective yield on a prospective basis.

We periodically review securities for potential impairment. We consider a number of factors, including whether the fair value of a security is less than its amortized cost, the severity of the decline in fair value, credit ratings and the length of time the investment has been in an unrealized loss position. We also recognize impairment when qualitative factors indicate that

we may not recover the unrealized loss. When evaluating these factors, we consider our intent and ability to hold the investment until a point in time at which recovery of the unrealized loss can be reasonably expected to occur. Impairment losses on manufactured housing securities exclude the effects of separate financial guarantee contracts that are not embedded in the securities since the benefits of such contracts are not recognized until claims become probable of recovery under the contracts. When a security is deemed to be impaired, the cost basis of the security is written down to fair value, with the loss recorded to Gains (losses) on investment activity. Based on the new cost basis, the adjusted deferred amounts related to the impaired security are amortized over the security's remaining life in a prospective manner consistent with the amount and timing of the future estimated cash flows. The security cost basis is not changed for subsequent recoveries in fair value. For certain securities meeting the criteria of (a) and (b) in the preceding paragraph, other-than-temporary impairment is defined as occurring whenever there is an adverse change in estimated cash flows coupled with a decline in fair value below the amortized cost basis.

Gains and losses on the sale of securities are included in Gains (losses) on investment activity, including those gains (losses) reclassified into earnings from AOCI. We use the specific identification method for determining the cost of a security in computing the gain or loss.

### **Repurchase and Resale Agreements**

We enter into repurchase and resale agreements primarily as an investor or to finance our security positions. Such transactions are accounted for as purchases and sales when the transferor relinquishes control over transferred securities and as secured financings when the transferor does not relinquish control. Our policy is to take possession of securities purchased under agreements to resell and reverse dollar roll transactions.

### **Debt Securities Issued**

Debt securities that we issue are classified as either Due within one year or Due after one year based on their remaining contractual maturity. The classification of interest expense on debt securities as either short-term or long-term is based on the original contractual maturity of the debt security. Deferred items, including premiums, discounts, issuance costs and hedging-related basis adjustments, are amortized and reported through interest expense using the effective interest method over the contractual life of the related indebtedness. The balance of deferred items remaining when debt is extinguished prior to its contractual maturity is reflected in earnings in the period of extinguishment as a component of Gains (losses) on debt retirement. Prior to 2005, for callable debt, deferred items were amortized over the period during which the related indebtedness was expected to be outstanding and changes in the expected life were reflected prospectively as an adjustment to the effective yield on the debt. Amortization of hedging-related basis adjustments is initiated upon the termination of the related hedge relationship. Amortization of premiums, discounts and issuance costs begins at the time of debt issuance. Premiums, discounts and hedging-related basis adjustments are reported as a component of Debt securities, net. Issuance costs are reported as a component of Other assets. Debt securities denominated in a foreign currency are translated into U.S. dollars using foreign exchange spot rates at the balance sheet dates and any translation gains or losses are reported in Non-interest income (loss) — Other income.

Contemporaneous transfers of cash between us and a creditor in connection with the issuance of a new debt obligation and satisfaction of an existing debt obligation are accounted for as extinguishments, with recognition of any gains or losses in earnings if the debt instruments have substantially different terms. If the debt instruments do not have substantially different terms, the transaction is accounted for as an exchange rather than an extinguishment.

### **Derivatives**

Generally, derivatives are financial instruments with little or no initial net investment in comparison to their notional amount and whose value is based upon an underlying asset, index, reference rate or other variable. They may be privately negotiated contractual agreements that can be customized to meet specific needs, including certain commitments to purchase and sell mortgage loans, mortgage-related securities or debt securities, or they may be standardized contracts executed through organized exchanges. All derivatives are reported at their fair value on the consolidated balance sheets. The fair value of derivatives is generally reported net by counterparty, provided that a legally enforceable master netting agreement exists. Derivatives in a net unrealized gain position are reported as Derivative assets, at fair value. Similarly, derivatives in a net unrealized loss position are reported as Derivative liabilities, at fair value.

Currently, the majority of our derivatives are not designated in hedge accounting relationships. For those derivatives not designated as an accounting hedge, fair value gains and losses are reported as Derivative gains (losses) in the consolidated statements of income. For purchase and sale commitments of securities classified as trading, fair value gains and losses are reported as Gains (losses) on investment activity in the consolidated statements of income.

Subject to certain qualifying conditions, we may designate a derivative as either a hedge of the cash flows of a variable-rate instrument or forecasted transaction, referred to as a cash flow hedge; a hedge of the fair value of a fixed-rate

instrument, referred to as a fair value hedge; or a foreign-currency fair value or cash flow hedge, referred to as a foreign-currency hedge. In order to be designated as an accounting hedge, the derivative must be expected to be highly effective in offsetting the changes in cash flows or fair value of the hedged item resulting from the hedged risk. In addition, the documentation of the hedging designation must include identification of the hedged item, the hedging instrument, the risk exposure and corresponding risk management objective, how effectiveness will be assessed and how ineffectiveness will be measured.

For a derivative qualifying as a cash flow hedge, we report changes in the fair value of these instruments in AOCI to the extent the hedge is effective. The remaining ineffective portion is reported as Hedge accounting gains (losses). In general, we recognize the associated amounts reported in AOCI as Net interest income during the period or periods in which the hedged item affects earnings. Amounts reported in AOCI related to changes in the fair value of commitments to purchase or sell securities that are designated as cash flow hedges are recognized as basis adjustments to the assets held which are amortized in earnings as interest income using the effective interest method and, for assets sold, as Gains (losses) on investment activity.

If the hedged item in a cash flow hedge is the forecasted issuance of debt and the occurrence of the forecasted transaction becomes probable of not occurring, the amount in AOCI is reclassified to earnings immediately. If we expect at any time that continued reporting of a net loss in AOCI would lead to recognizing a net loss on the combination of a hedging instrument and the hedged transaction (and related asset acquired or liability incurred) in one or more future periods, the loss is reclassified immediately into earnings for the amount that is not expected to be recovered.

For a derivative qualifying as a fair value hedge, we report changes in the fair value of the derivative as Hedge accounting gains (losses) along with the changes in the fair value of the hedged item attributable to the risk being hedged. Any difference between these two amounts results in ineffectiveness recognized in the income statement. When the hedge is terminated or redesignated, the fair value adjustment to the carrying amount of the hedged asset or liability is amortized to earnings as a component of the hedged item's interest income or expense over the remaining life of the hedged item using the effective interest method. If a derivative no longer qualifies as a cash flow or fair value hedge, we discontinue hedge accounting prospectively. We continue to carry the derivative on the consolidated balance sheets at fair value and record further fair value gains and losses as Derivative gains (losses) in our consolidated statements of income until the derivative is terminated or redesignated.

The periodic interest cash flows related to derivative contracts currently accrued, which are derived primarily from interest-rate swap contracts, are classified as Income (expense) related to derivatives for derivatives in hedge relationships and as Derivative gains (losses) for derivatives not in hedge accounting relationships.

### **Real Estate Owned**

REO is carried at the lower of cost or market, net of estimated disposition costs. Amounts we expect to be received from third-party insurance or other credit enhancements are reported when the claim is filed and are recorded as a component of Accounts and other receivables, net in the consolidated balance sheets. Material development and improvement costs relating to REO are capitalized. Operating expenses on the properties, net of any rental or other income, are included in REO operations income (expense). Estimated declines in REO fair value that result from ongoing valuation of the properties are provided for and charged to REO operations income (expense) when identified. The resulting valuation allowance is treated as a lower of cost or market adjustment to the basis of the properties. Any gains and losses on REO dispositions are included in REO operations income (expense).

### **Income Taxes**

We use the asset and liability method of accounting for income taxes pursuant to SFAS No. 109, "Accounting for Income Taxes." Under this method, deferred tax assets and liabilities are recognized based upon the expected future tax consequences of existing temporary differences between the financial reporting and the tax reporting basis of assets and liabilities using enacted statutory tax rates. To the extent tax laws change, deferred tax assets and liabilities are adjusted, when necessary, in the period that the tax change is enacted. Valuation allowances are recorded to reduce deferred tax assets when it is more likely than not that a tax benefit will not be realized. For all periods presented, no such valuation allowance was deemed necessary by our management. Reserves are recorded for income tax contingencies and contingent interest where the potential for loss is probable and reasonably estimable in accordance with SFAS 5.

Income tax expense includes (a) deferred tax expense, which represents the net change in the deferred tax asset or liability balance during the year plus any change in a valuation allowance and (b) current tax expense, which represents the amount of tax currently payable to or receivable from a tax authority plus amounts accrued for expected tax deficiencies (including both tax and interest). Income tax expense excludes the tax effects related to adjustments recorded to AOCI as well as the tax effects of the cumulative effect of changes in accounting principles.

## **Stock-Based Compensation**

We record compensation expense equal to the estimated fair value of the stock-based compensation on the grant date, which is generally the effective date of the grant, amortized on a straight-line basis over the vesting period. The vesting period is generally three to five years for options, restricted stock and restricted stock units and three months for the Employee Stock Purchase Plan, or ESPP. The recorded compensation expense is offset by an adjustment to Additional paid-in capital in our consolidated balance sheets.

The fair value of options to purchase shares of our common stock, including options issued pursuant to the ESPP, is estimated using a Black-Scholes option pricing model, taking into account the exercise price and an estimate of the expected life of the option, the market value of the underlying stock, expected volatility, expected dividend yield, and the risk-free interest rate for the expected life of the option. The fair value of restricted stock and restricted stock unit awards is based on the fair value of our common stock on the grant date.

Incremental compensation expense related to modification of awards is based on a comparison of the fair value of the modified award with the fair value of the original award before modification (measured using the shorter of the remaining or revised term). We generally expect to settle our stock-based compensation awards in shares. In limited cases an award may be cash-settled upon a contingent event such as involuntary termination. These awards are accounted for as an equity award until the contingency becomes probable of occurring, then the award is reclassified from equity to liability. Such liabilities are initially measured at intrinsic value with changes in intrinsic value recognized as an adjustment to Salaries and employee benefits.

In December 2004, the FASB issued SFAS No. 123 (revised 2004), "Share-Based Payment," or SFAS 123(R). SFAS 123(R) requires companies to measure and record compensation expense for share-based payments based on the instruments' fair value reduced by expected forfeitures. The adoption of the revision to this statement did not have a material impact on our financial position or results of operations.

## **Earnings Per Common Share**

Basic earnings per common share is computed as net income available to common stockholders divided by the weighted average common shares outstanding for the period. Diluted earnings per common share is determined using the weighted average number of common shares during the period, adjusted for the dilutive effect of common stock equivalents. Dilutive common stock equivalents reflect the assumed net issuance of additional common shares pursuant to certain of our stock-based compensation plans that could potentially dilute earnings per common share.

## **Comprehensive Income**

Comprehensive income is the change in equity, on a net of tax basis, resulting from transactions and other events and circumstances from non-owner sources during a period. It includes all changes in equity during a period, except those resulting from investments by stockholders. We define comprehensive income as consisting of net income plus changes in the unrealized gains and losses on available-for-sale securities, the effective portion of derivatives accounted for as cash flow hedge relationships, and changes in the minimum pension liability.

## **Reportable Segments**

We have one business segment for financial reporting purposes under SFAS No. 131, "Disclosures About Segments of an Enterprise and Related Information," or SFAS 131, for all periods presented in the consolidated financial statements.

## **Recently Issued Accounting Standards, Not Yet Adopted**

*Accounting for Certain Hybrid Instruments* — In February 2006, the FASB issued SFAS No. 155, "Accounting for Certain Hybrid Financial Instruments," or SFAS 155. This statement amends SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," or SFAS 133, and SFAS No. 140. The objective of this statement is to simplify the accounting for certain hybrid financial instruments, permitting fair value measurement for any hybrid financial instrument with an embedded derivative that otherwise would require bifurcation. In addition, this statement establishes a requirement to evaluate interests in securitized financial assets to identify instruments that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation. SFAS 155 is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. Since SFAS 155 is to be adopted prospectively, it will not result in a cumulative effect of a change in accounting principle. We are presently assessing which instruments will be affected and how other potential accounting standards may interact with SFAS 155. With respect to mortgage-related security purchases beginning in 2007, this standard could require us to account for these securities, or a portion of these securities, by recognizing changes in fair values in current earnings.

*Determining Variability in Applying FASB Interpretation No. 46(R)* — In April 2006, the FASB issued FASB Staff Position No. FSP FIN 46(R)-6, "Determining the Variability to Be Considered in Applying FASB Interpretation



No. 46(R),” or FSP FIN 46(R)-6. FSP FIN 46(R)-6 addresses how a reporting enterprise should determine the variability to be considered in applying FASB Interpretation No. 46 (revised December 2003) “Consolidation of Variable Interest Entities,” or FIN 46(R). It requires the variability to be considered to be based on the design of the entity. This statement is effective for us beginning July 1, 2006. We do not expect the adoption of FSP FIN 46(R)-6 to be material to our financial condition or results of operations.

## NOTE 2: TRANSFERS OF SECURITIZED INTERESTS IN MORTGAGE-RELATED ASSETS

### Securitization Transactions Executed By Us

As discussed in “NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES,” we issue two types of mortgage-related securities: PCs and Structured Securities.

Table 2.1 below presents the unpaid principal balances of issued PCs and Structured Securities as of December 31, 2005 and 2004.

**Table 2.1 — Guaranteed PCs and Structured Securities Issued Based on Unpaid Principal Balances<sup>(1)(2)</sup>**

	December 31,	
	2005	2004
	(in millions)	
Guaranteed PCs and Structured Securities Issued:		
Held by third parties . . . . .	\$ 974,200	\$ 852,270
Held in the Retained portfolio . . . . .	361,324	356,698
Total Guaranteed PCs and Structured Securities issued <sup>(3)(4)</sup> . . . . .	<u>\$1,335,524</u>	<u>\$1,208,968</u>

(1) Excludes mortgage loans and mortgage-related securities traded, but not yet settled.

(2) Due to timing differences in our receipt of principal and interest payments from mortgage servicers and subsequent pass-through of payments to PC investors, the unpaid principal balances of the underlying mortgage loans do not equal the unpaid principal balances of issued PCs and Structured Securities. See “NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — Due to Participation Certificate Investors” for more information.

(3) As further discussed in “NOTE 4: FINANCIAL GUARANTEES,” we guarantee certain mortgage-related securities issued by third parties.

(4) Guaranteed PCs and Structured Securities exclude \$961,776 million and \$723,429 million at December 31, 2005 and 2004, respectively, of Structured Securities backed by resecuritized PCs and other previously issued Structured Securities. These excluded Structured Securities do not increase our credit-related exposure and consist of single-class and multiclass Structured Securities backed by PCs, REMICs and principal-only strips. The notional balance of interest-only strips of \$132,883 million and \$105,703 million at December 31, 2005 and 2004, respectively, is excluded because this table is based on unpaid principal balances. Also excluded are modifiable and combinable REMIC tranches and interest and principal classes where the holder has the option to exchange the security tranches for other pre-defined security tranches. These tranches and classes collectively totaled \$1,495,501 million and \$1,097,336 million at December 31, 2005 and 2004, respectively.

At December 31, 2005 and 2004, approximately 92 percent and 87 percent, respectively, of issued PCs and Structured Securities (excluding securities we issued that are backed by Ginnie Mae Certificates or non-agency mortgage-related securities and other securities issued by third-parties that we guaranteed) had a corresponding Guarantee asset, Guarantee obligation or PC residual recognized on our consolidated balance sheets. The percentage of these PCs and Structured Securities that had a corresponding Guarantee asset, Guarantee obligation or PC residual due to the adoption of FIN 45 accounting on January 1, 2003 was 50 percent and 40 percent, at December 31, 2005 and 2004, respectively. At December 31, 2005 and 2004, 93 percent and 89 percent, respectively, of PCs and Structured Securities held by third parties had a related Guarantee asset and Guarantee obligation established.

### *Gains and Losses on Transfers of PCs and Structured Securities that are Accounted for as Sales*

We recognized net pre-tax gains of approximately \$364 million, \$356 million and \$711 million for the years ended December 31, 2005, 2004 and 2003, respectively, on transfers of PCs and Structured Securities that were accounted for as sales under SFAS 125/140.

In connection with the derivation of such gains (losses) upon sale prior to October 1, 2005, we had consistently applied a methodology for determining the order in which to record extinguishments of unamortized deferred guarantee income, buy-down fees and credit fees as adjustments to the carrying value of the repurchased securities. Beginning October 1, 2005, we changed our method for determining gains (losses) upon the re-sale of PCs and Structured Securities related to unamortized deferred guarantee income, buy-down fees and credit fees. Our methodology is now to apply a specific identification method of associating the extinguished deferred guarantee income, buy-down fees and credit fees to the specific portions of purchased PCs and Structured Securities and to relieve those carrying value adjustments through the gains (losses) when the specific portion of the PC or Structured Security is re-sold. This change in accounting principle was facilitated by system changes that now allow us to apply and track the extinguished carrying value adjustments to the specific portions of the purchased PCs and Structured Securities.



## Valuation of Recognized Guarantee Asset, Guarantee Obligation and PC Residuals

### *Recognized Guarantee asset*

Effective January 1, 2005, we enhanced our approach for estimating the fair value of the Guarantee asset to make greater use of third-party market data. For approximately 70 percent of the Guarantee asset, the new valuation approach involves obtaining dealer quotes on proxy securities with collateral similar to aggregated characteristics of our portfolio, effectively equating the Guarantee asset with current, or “spot,” market values for excess servicing interest-only, or IO, securities, which trade at a discount to trust IO security prices. We consider excess servicing securities to be comparable to the Guarantee asset, in that they represent an IO-like income stream, have less liquidity than trust IO securities and do not have matching principal-only securities. The remaining 30 percent of the Guarantee asset, which relates to underlying loan products for which comparable market prices are not readily available, is valued using an expected cash flow approach with market input assumptions extracted from the dealer quotes provided on the more liquid products, reduced by an estimated liquidity discount.

For periods prior to January 1, 2005, we calculated the Guarantee asset fair value using an expected cash flow approach. Specifically, Monte Carlo projections were used to forecast Guarantee asset-related future cash flows. The forecasted cash flows were then discounted using factors that were derived from modeled forward interest rates for each scenario path, to which we then applied a trailing average option-adjusted spread of up to 24 months that was based on trust IO security prices.

### *Recognized Guarantee obligation*

Effective January 1, 2005, we enhanced our approach for estimating the fair value of the Guarantee obligation to make greater use of third-party market data. We concluded that the structured credit market has evolved to the point where we can now look to that market for fair value discovery. We have divided our Guarantee obligation portfolio into three primary components: performing loans, non-performing loans and manufactured housing. For each component, we have developed a specific valuation approach for capturing its unique characteristics.

For performing loans, our enhanced approach uses the capital markets to obtain estimated subordination levels based on rating agency models and dealer price quotes on proxy securities with collateral characteristics matched to our portfolio to value the expected credit losses and the risk premium for unexpected losses related to our guarantee portfolio (which is predominantly prime mortgages) to reduce our reliance on internal models. We segmented the portfolio into distinct loan cohorts to differentiate between product types, coupon rate, seasoning, and interests retained by us versus those held by third parties. We use our models to adjust the dealer quotes as appropriate, including an adjustment to remove the price effects of interest rate risks not relevant to the credit loss estimation from the quoted dealer prices.

Since typical structured securitizations of single-family collateral only include performing loans, we developed a separate method for estimating the fair value of the Guarantee obligation for non-performing loans. For loans that are extremely delinquent and have been purchased out of pools, we obtained dealer indications that reflect their non-performing status. To value delinquent loans remaining in PCs, we start with the market driven performing loan and non-performing whole loan values and use empirically observed delinquency transition rates to interpolate the appropriate values in each phase of delinquency (*i.e.*, 30 days, 60 days, 90 days).

We evaluated market sources to determine the appropriate credit costs associated with the Guarantee obligation for the manufactured housing portfolio, which we estimated for purposes of our valuation approach to be approximately two percent of our total guarantee portfolio, but approximately 20 percent of the fair value of the Guarantee obligation, and determined that there is limited price discovery in the market. As a result, we used our judgment to develop an alternative approach for estimating the incremental credit costs associated with the manufactured housing portfolio. Specifically, we calculated the ratio of realized credit losses for performing loans and manufactured housing loans to determine a loss history ratio. We then applied the loss history ratio to market implied performing loan Guarantee obligation fair value estimates to calculate the implied credit costs for the manufactured housing portfolio. This approach grounds the Guarantee obligation related to manufactured housing in performing loan market prices, while adjusting for the loss history reflected in empirical data. We undertook a similar process for estimating the fair value of seriously delinquent manufactured housing loans. We then benchmarked our performing loan Guarantee obligation fair value estimate by obtaining a range of price indications that corroborated the reasonableness of our estimate through discussions with leading market participants, including third-party dealers and mortgage insurance companies. The changes to the credit components of the Guarantee obligation necessitated a change to the approach used to estimate the costs associated with administering the collection and distribution of payments on the mortgage loans underlying a PC. Finally, we use our models to estimate the present value of net cash flows related to security program cycles. This estimate is included in the Guarantee obligation valuation.

For periods prior to January 1, 2005, the Guarantee obligation fair value was calculated using internal models to estimate future cash flows using a Monte Carlo simulation. The components of estimated cash flows associated with the Guarantee obligation included estimates of expected future credit losses using statistically based models that were benchmarked periodically to the non-conforming loan, or jumbo, securitization market. For all periods our estimates included costs to administer the collection and distribution of payments on the mortgage loans underlying a PC and considered net cash flows due to security program cycles.

#### *Recognized PC residuals*

The fair value of recognized PC residuals is determined in a manner that is consistent with the approach described above for the recognized Guarantee asset and Guarantee obligation.

#### *Key assumptions used in the valuation of the Guarantee asset*

Table 2.2 summarizes the key assumptions associated with the fair value measurements of the recognized Guarantee asset. The assumptions included in this table for 2004 and 2003 relate to those used in our internal models to measure the fair value of the Guarantee asset for single-family loans at the time of securitization and the subsequent fair value measurements, which occurred throughout each year. For 2005, the fair values at the time of securitization and the subsequent fair value measurements were estimated using third party information. The assumptions included in this table for 2005 are those implied by our fair value estimates, with the Internal Rates of Return, or IRRs, adjusted where necessary to align our internal models with estimated fair values determined using third party information. Prepayment rates are presented as implied by our internal models and have not been similarly adjusted.

**Table 2.2 — Key Assumptions Utilized in Fair Value Measurements of the Guarantee Asset**

Valuation Assumptions for the Guarantee Asset	2005		2004		2003	
	Range <sup>(3)</sup>	Mean <sup>(4)</sup>	Range <sup>(3)</sup>	Mean <sup>(4)</sup>	Range <sup>(3)</sup>	Mean <sup>(4)</sup>
Internal rates of return <sup>(1)</sup> .....	1.8% - 13.8%	8.7%	(1.4)% - 13.6%	6.7%	4.5% - 15.1%	9.4%
Prepayment rates <sup>(2)</sup> .....	7.6% - 59.8%	17.2%	6.9% - 58.6%	19.1%	8.0% - 62.9%	23.3%

- (1) The IRRs reported above represent a duration-weighted average of the discount rates used to value the recognized Guarantee asset. In 2004 and 2003, such rates were derived by determining a single rate that equated (a) the simple average of future cash flows of the Guarantee asset for each Loan Group with that of (b) the calculated fair value of the Guarantee asset for each Loan Group. In 2005, the IRRs represent a duration-weighted average of the discount rates as adjusted to align with our estimated fair values. Negative IRRs can occur when sufficiently large negative option-adjusted spreads are applied to LIBOR. When we calibrate our modeled discounted cash flows to the traded price of an IO security, a negative option-adjusted spread can result when the traded price exceeds the implied market value of the modeled discounted cash flows. A negative option-adjusted spread is necessary to calibrate the implied market value of the modeled discounted cash flows to the traded price.
- (2) Average Prepayment rates are simulated on a monthly frequency, although rates reported above represent an unpaid principal balance weighted average of annualized values of such Prepayment rates.
- (3) The lowest value in each presented range represents the first percentile IRRs and prepayment rates throughout 2005, 2004 and 2003. Likewise, the highest value in each range represents the 99th percentile IRRs and prepayment rates throughout 2005, 2004 and 2003.
- (4) Reported values represent the weighted average value of all IRRs and prepayment rates throughout the 2005, 2004 and 2003 periods.

Weighted average lives of the Guarantee asset during 2005, 2004 and 2003 ranged between 1.6 and 8.9 years, 1.2 and 8.7 years, and 1.0 and 8.5 years, respectively, while the average derived weighted average lives of the Guarantee asset for the same periods were 5.1, 5.3 and 4.8 years, respectively. Such derived weighted average lives are reflective of prepayment speed assumptions cited in Table 2.2 above.

At December 31, 2005, the fair value of the recognized Guarantee asset was based upon a valuation approach that incorporates market-based information. In order to report the hypothetical sensitivity of the carrying value of the Guarantee asset to changes in key assumptions, we used internal models to approximate their reported carrying values. We then measured the hypothetical impact of changes in key assumptions using our models to estimate the potential view of fair value the market might have in response to those changes. In our models, the assumed Internal Rates of Return were adjusted to calibrate our model results with the reported carrying value. The sensitivity analysis in Table 2.3 illustrates hypothetical adverse changes in the fair value of the Guarantee asset for changes in key assumptions at December 31, 2005.

**Table 2.3 — Sensitivity Analysis of the Guarantee Asset**

	December 31, 2005
	GA <sup>(1)</sup>
	(dollars in millions)
Fair value .....	\$4,938
Weighted average IRR assumptions: .....	9.2%
Impact on fair value of 100 bps upward change .....	\$ (184)
Impact on fair value of 200 bps upward change .....	\$ (354)
Weighted average prepayment rate assumptions: .....	15.5%
Impact on fair value of 10% upward change .....	\$ (212)
Impact on fair value of 20% upward change .....	\$ (404)

- (1) At December 31, 2005, our Guarantee asset totaled \$5,083 million on our consolidated balance sheet and of that amount, approximately \$145 million (or approximately 3 percent), relates to PCs backed by multifamily mortgage loans. The sensitivity analysis presented in Table 2.3 relates solely to the Guarantee asset associated with PCs backed by single-family mortgage loans.

## Valuation of Other Retained Interests

Other retained interests include securities that were issued by us as part of a securitization transaction for which sale accounting was applied. The majority of these securities is classified as available-for-sale. The fair value of Other retained interests is generally based on independent price quotations obtained from third-party pricing services or dealer marks.

In order to report the hypothetical sensitivity of the carrying value of Other retained interests, we used internal models calibrated to the fair values. The sensitivity analysis in Table 2.4 illustrates hypothetical adverse changes in the fair value of Other retained interests for changes in key assumptions based on these models.

**Table 2.4 — Sensitivity Analysis of Other Retained Interests**

	December 31, 2005 (dollars in millions)
Fair value .....	\$124,939
Weighted average IRR assumptions: .....	5.4%
Impact on fair value of 100 bps upward change .....	\$ (4,470)
Impact on fair value of 200 bps upward change .....	\$ (8,656)
Weighted average prepayment rate assumptions: .....	11.3%
Impact on fair value of 10% upward change .....	\$ (85)
Impact on fair value of 20% upward change .....	\$ (164)

## Cash Flows on Transfers of Securitized Interests and Corresponding Retained Interests

Table 2.5 below summarizes cash flows on retained interests.

**Table 2.5 — Details of Cash Flows**

	Year Ended December 31,		
	2005	2004	2003
	(in millions)		
Cash flows from:			
Transfers of Freddie Mac securities that were accounted for as sales .....	\$86,326	\$152,662	\$347,874
Cash flows received on the Guarantee asset <sup>(1)</sup> .....	\$ 1,270	\$ 1,086	\$ 891
Other Retained Interests principal and interest <sup>(2)</sup> .....	\$25,611	\$ 28,439	\$ 35,975
Purchases of delinquent or foreclosed loans <sup>(3)</sup> .....	\$(4,373)	\$ (4,931)	\$ (5,822)

(1) Represents contractual guarantee-related cash flows received by us in connection with the recognized Guarantee asset.

(2) Excludes cash flows related to retained interests held in the portfolio of our Securities Sales and Trading Group, or SS&TG, business unit which ceased operations in the fourth quarter of 2004. Such cash flows were not material.

(3) Represents delinquent mortgage loans purchased out of securitized pools that back issued PCs or Structured Securities.

## NOTE 3: VARIABLE INTEREST ENTITIES

We are a party to numerous entities that are considered to be variable interest entities, or VIEs. These VIEs include low-income housing tax credit partnerships, certain Structured Securities transactions and a mortgage reinsurance company. In addition, we buy the highly-rated senior securities in certain mortgage securitization trusts that are VIEs. Highly-rated senior securities issued by these securitization trusts are not designed to absorb a significant portion of the variability created by the assets/collateral in the trusts. Our investments in these securities do not represent a significant variable interest in the securitization trusts. Further, we invest in securitization entities that are qualifying special purpose entities which are not subject to consolidation because of our inability to unilaterally liquidate or change the qualifying special purpose entity. See “NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — Consolidation and Equity Method of Accounting” for further information regarding the consolidation practices of our VIEs.

### Low-Income Housing Tax Credit Partnerships

We invest as a limited partner in low-income housing tax credit partnerships formed for the purpose of providing funding for affordable multifamily rental properties. These low-income housing tax credit partnerships invest directly in limited partnerships that develop or rehabilitate multifamily rental properties. Completed properties are rented to qualified low-income tenants, allowing the properties to be eligible for federal tax credits. A general partner operates the partnership, identifying investments and obtaining debt financing as needed to finance partnership activities. Although these partnerships generate operating losses, we realize a return on our investment through reductions in income tax expense that result from tax credits and the deductibility of the operating losses. The partnership agreements are typically structured to meet a required 15-year period of occupancy by qualified low-income tenants. These investments were made between 1989 and 2005. At December 31, 2005 and 2004, we did not guarantee any obligations of these partnerships and our exposure was limited to the amount of our investments. At December 31, 2005 and 2004, we were the primary beneficiary of investments in six and five low-income housing tax credit partnerships, respectively, and we consolidated these investments. The investors in the obligations of the consolidated low-income housing tax credit partnerships have recourse only to the assets of those VIEs and do not have recourse to us.

## Asset-Backed Investment Trusts

We invest in a variety of mortgage and non-mortgage-related, asset-backed investment trusts. These investments represent interests in trusts consisting of a pool of receivables or other financial assets, typically credit card receivables, auto loans or student loans. These trusts act as vehicles to allow originators to securitize assets. Securities are structured from the underlying pool of assets to provide for varying degrees of risk. Primary risks include potential loss from the credit risk and interest-rate risk of the underlying pool. The originators of the financial assets or the underwriters of the deal create the trusts and typically own the residual interest in the trust assets. At December 31, 2005 and 2004, we were not the primary beneficiary of any asset-backed investment trusts.

## Structured Securities — T-Series Transactions

In T-Series transactions (or alternative collateral deals), a seller or sellers of mortgage loans transfers mortgage loans to a trust specifically for the purpose of issuing securities collateralized by the mortgage loans. These T-Series trusts issue various senior interests, subordinated interests or both. We guarantee and purchase certain of the senior interests. Simultaneous with this guarantee and purchase, we issue and guarantee Structured Securities. These Structured Securities represent an interest in the senior interests of the T-Series transactions. The subordinated interests are generally either held by the seller or other party or sold in the capital markets. At December 31, 2005 and 2004, we were not the primary beneficiary of any T-Series transactions.

## Consolidated VIEs

Table 3.1 represents the carrying amounts and classification of consolidated assets that are collateral for the consolidated VIEs.

**Table 3.1 — Assets of Consolidated VIEs**

Consolidated Balance Sheets Line Item	December 31,	
	2005	2004
	(in millions)	
Cash and cash equivalents .....	\$ 45	\$ 51
Accounts and other receivables, net .....	167	170
Total assets of consolidated VIEs .....	<u>\$212</u>	<u>\$221</u>

## VIEs Not Consolidated

### *Low-Income Housing Tax Credit Partnerships*

At December 31, 2005 and 2004, we had unconsolidated investments in 168 and 149 low-income housing tax credit partnerships, respectively, in which we had a significant variable interest. The size of these partnerships at December 31, 2005 and 2004, as measured in total assets, was \$8.1 billion and \$6.7 billion, respectively. These partnerships are accounted for using the equity method, as described in “NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES.” As a limited partner, our maximum exposure to loss equals the undiscounted book value of our equity investment. At December 31, 2005 and 2004, our maximum exposure to loss on unconsolidated low-income housing tax credit partnerships, in which we had a significant variable interest, was \$3.7 billion and \$3.1 billion, respectively.

### *Asset-Backed Investment Trusts*

At December 31, 2005, we no longer had a significant variable interest in any trusts related to non-mortgage-related, asset-backed securities. At December 31, 2004, we had investments in three trusts related to non-mortgage-related, asset-backed securities in which we had a significant variable interest. These investments had been made between 2000 and 2004 and were typically senior interests rated A1 and P1 by Standard & Poor’s, or S&P, and Moody’s, respectively. These ratings are the short-term equivalent of between A and AAA in typical long-term rating scales. These trusts had total assets at December 31, 2004 of \$12.8 billion. As an investor, our maximum exposure to loss consisted of the book value of our investment. At December 31, 2004, our maximum exposure to loss on non-mortgage-related, asset-backed investment trusts, in which we had a significant variable interest, was approximately \$3.4 billion.

### *Structured Securities — T-Series Transactions*

At both December 31, 2005 and 2004, we had investments or guarantees related to two T-Series transactions in which we had a significant variable interest. Our involvement in these two T-Series transactions began in 1996 and 2002, respectively. The size of these two transactions at December 31, 2005 and 2004, as measured in total assets, was \$105 million and \$170 million, respectively. At December 31, 2005 and 2004, our maximum exposure to loss on these



T-Series transactions, in which we had a significant variable interest, was \$88 million and \$147 million, respectively, consisting of the book value of our investments plus incremental guarantees of the senior interests that are held by third parties.

#### NOTE 4: FINANCIAL GUARANTEES

##### Principal and Interest Guarantees of PCs and Structured Securities

We guarantee the payment of principal and interest on the PCs and Structured Securities we issue that are held by third parties. At December 31, 2005 and 2004, the maximum potential amount of future payments under these guarantees is approximately the amount of the total unpaid principal balance of our PCs and Structured Securities held by third parties which was \$974 billion and \$852 billion, respectively. However, the actual amount of future payments under these guarantees will be determined by the performance of the mortgage loans that underlie these PCs and Structured Securities.

During 2005 and 2004, we guaranteed \$397.9 billion and \$365.1 billion, respectively, of PCs and Structured Securities to third parties. Upon completion of the transfer of PCs or Structured Securities to third parties, we recognize the initial fair value of our obligation to make guarantee payments. The accounting methods for our guarantees of PCs and Structured Securities are further discussed in “NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES.” At December 31, 2005 and 2004, we had a recognized Guarantee obligation on the consolidated balance sheets of \$5.5 billion and \$4.1 billion, respectively, which included \$1.8 billion and \$1.4 billion, respectively, of Deferred Guarantee Income. In addition, we have a Reserve for guarantee losses on Participation Certificates that totals \$295 million and \$150 million at December 31, 2005 and 2004, respectively, for incurred credit losses that were recognized in conjunction with PCs and Structured Securities held by third parties. The balance of PCs and Structured Securities held by third parties also includes securities issued by third parties that we guarantee totaling \$6.6 billion and \$6.8 billion at December 31, 2005 and 2004, respectively. Details of these guarantees are as follows:

- *Multifamily:* We guarantee multifamily housing revenue bonds totaling \$5.8 billion and \$5.0 billion at December 31, 2005 and 2004, respectively, via two principal forms. First, we provide a guarantee of the payment of principal and interest on tax-exempt multifamily housing revenue bonds that support pass-through certificates issued by third parties. These housing revenue bonds are collateralized by mortgage loans on low- and moderate-income multifamily housing projects. Second, we provide a guarantee of principal and interest on multifamily mortgage loans that are originated and held by state and municipal housing finance agencies to support tax-exempt multifamily housing revenue bonds.
- *Single-family:* We guarantee single-family mortgage loans held by third parties totaling \$0.8 billion and \$1.8 billion at December 31, 2005 and 2004, respectively.

As part of the guarantee arrangements pertaining to multifamily housing revenue bonds, we also provide a commitment to advance funds, commonly referred to as “liquidity guarantees,” totaling \$5.7 billion and \$5.1 billion at December 31, 2005 and 2004, respectively, to enable the repurchase by others of tendered tax-exempt pass-through certificates and housing revenue bonds that are unable to be remarketed. Any repurchased securities would be pledged to us to secure such funding until such time as the securities could be remarketed. We have not made any payments to date under these liquidity guarantees.

Generally, the contractual terms of our guarantees on PCs and Structured Securities are 15 to 30 years. However, the actual term of each guarantee may be significantly less than the contractual term due to the prepayment characteristics of the mortgage-related assets that back PCs and Structured Securities. We do not expect the maximum potential interest payments we would be required to make associated with these guarantees to significantly exceed 120 days of interest at the certificate rate, given that we generally begin a process to purchase the defaulted mortgages when they have been delinquent for 120 consecutive days.

At December 31, 2005 and 2004, in connection with PCs or Structured Securities backed by single-family mortgage loans, we had maximum coverage totaling \$27.5 billion and \$27.2 billion, respectively, in primary mortgage insurance, \$3.6 billion and \$3.5 billion, respectively, in pool insurance and other credit enhancements and \$5.6 billion and \$4.1 billion, respectively, in recourse to lenders. In addition, at December 31, 2005 and 2004, \$1.9 billion and \$2.6 billion, respectively, of outstanding Structured Securities related to Ginnie Mae Certificates, which are backed by the full faith and credit of the U.S. government. With respect to PCs and Structured Securities backed by multifamily mortgage loans, we had maximum combined credit enhancements totaling \$7.3 billion and \$9.1 billion at December 31, 2005 and 2004, respectively. At December 31, 2005 and 2004, our recorded balance of credit enhancements on our consolidated balance sheets was \$420 million and \$295 million, respectively.



### **Guarantees of Stated Final Maturity of Issued Structured Securities**

We commonly issue Structured Securities with stated final maturities that are shorter than the stated maturity of the underlying mortgage loans. If the assets that back such Structured Securities have not fully matured as of the stated final maturity date of such securities, we may sponsor an auction of the underlying assets. To the extent that auction proceeds are insufficient to cover unpaid principal amounts due to investors in such Structured Securities, we are obligated to fund such principal. Such guarantees of stated final maturity are accounted for as derivative instruments.

At December 31, 2005 and 2004, the maximum potential amount of payments we could be required to make under guarantees of stated final maturity of issued Structured Securities was \$11.7 billion and \$9.0 billion, respectively, which represents the outstanding unpaid principal balance of the underlying mortgage loans. At December 31, 2005 and 2004, the total fair value of recognized liabilities concerning such guarantees was \$2 million and \$1 million, respectively.

### **Indemnifications**

In connection with various business transactions, we provide indemnification to counterparties for breaches of standard representations and warranties in contracts entered into in the normal course of business. It is difficult to estimate our maximum exposure under these indemnification arrangements since in many cases there are no stated or notional amounts included in the indemnification clauses. However, no claim for indemnification pursuant to these provisions has been made. At December 31, 2005, our assessment is that the risk of such claim for indemnification is remote. Such representations and warranties pertain to hold harmless clauses, adverse changes in tax laws and potential claims from third parties related to items such as actual or alleged infringement of intellectual property. We have not recorded any liabilities related to these indemnifications in our consolidated balance sheets at December 31, 2005 and 2004 because we do not expect material amounts to be paid under these agreements.

### **Other Guarantees**

We have guaranteed the performance of interest-rate swap contracts in two circumstances. First, as part of a securitization transaction, we transferred certain swaps and related assets to a third party. We guaranteed that interest income generated from the assets would be sufficient to cover the required payments under the interest-rate swap contracts. Second, we guaranteed that a borrower would perform under an interest-rate swap contract linked to a customer's variable-rate mortgage. The maximum remaining terms of any of these guarantees at both December 31, 2005 and 2004 was 29 years; however, the actual terms may be significantly less than the contractual terms because the mortgage loans underlying the swaps are prepayable. The maximum potential amount of future undiscounted payments under the guarantees was \$717 million and \$591 million at December 31, 2005 and 2004, respectively. At December 31, 2005 and 2004, the total fair value of recognized liabilities concerning such guarantees was \$2 million and \$1 million, respectively.

During 2005, we issued written call options with a notional amount of \$25 million with respect to PCs issued by us. The maximum amount of future payments under these call options is unlimited. The fair value of these options recorded on our consolidated balance sheet at December 31, 2005 was not material. We did not issue written options on our PCs in 2004.

We provide guarantees to reimburse servicers for premiums paid to acquire servicing in situations where we require the original seller to repurchase the loan and the original seller is unable to perform under its separate servicing agreement to reimburse the servicer for those servicing premiums. Our servicing-related premium guarantees are payable according to a vesting schedule for up to five years from the date of purchase of servicing rights. The maximum potential amount of future payments under these servicing-related premium guarantees was \$54 million and \$113 million at December 31, 2005 and 2004, respectively. We have not established a liability on our consolidated balance sheets at December 31, 2005 and 2004 because we do not expect material amounts to be paid under these arrangements.

## NOTE 5: RETAINED PORTFOLIO AND CASH AND INVESTMENTS PORTFOLIO

Table 5.1 summarizes amortized cost, estimated fair values and corresponding gross unrealized gains and gross unrealized losses by major security type for available-for-sale securities.

**Table 5.1 — Available-For-Sale Securities**

December 31, 2005	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(in millions)			
<b>Retained portfolio</b>				
Mortgage-related securities issued by:				
Freddie Mac .....	\$354,573	\$1,848	\$(4,974)	\$351,447
Fannie Mae .....	43,784	389	(867)	43,306
Ginnie Mae .....	1,085	33	(3)	1,115
Other .....	231,693	692	(1,029)	231,356
Obligations of states and political subdivisions .....	11,022	272	(53)	11,241
Total mortgage-related securities .....	<u>642,157</u>	<u>3,234</u>	<u>(6,926)</u>	<u>638,465</u>
<b>Cash and investments portfolio</b>				
Non-mortgage-related securities:				
Asset-backed securities .....	30,712	22	(156)	30,578
Obligations of states and political subdivisions .....	5,835	—	(12)	5,823
Commercial paper .....	5,764	—	—	5,764
Total non-mortgage-related securities .....	<u>42,311</u>	<u>22</u>	<u>(168)</u>	<u>42,165</u>
Total available-for-sale securities .....	<u>\$684,468</u>	<u>\$3,256</u>	<u>\$(7,094)</u>	<u>\$680,630</u>
<b>December 31, 2004</b>				
<b>Retained portfolio</b>				
Mortgage-related securities issued by:				
Freddie Mac .....	\$348,034	\$5,506	\$(1,438)	\$352,102
Fannie Mae .....	58,922	950	(353)	59,519
Ginnie Mae .....	1,677	86	(1)	1,762
Other .....	166,738	1,700	(380)	168,058
Obligations of states and political subdivisions .....	8,751	301	(32)	9,020
Total mortgage-related securities .....	<u>584,122</u>	<u>8,543</u>	<u>(2,204)</u>	<u>590,461</u>
<b>Cash and investments portfolio</b>				
Non-mortgage-related securities:				
Asset-backed securities .....	21,668	120	(55)	21,733
Obligations of states and political subdivisions .....	8,098	—	(1)	8,097
Total non-mortgage-related securities .....	<u>29,766</u>	<u>120</u>	<u>(56)</u>	<u>29,830</u>
Total available-for-sale securities .....	<u>\$613,888</u>	<u>\$8,663</u>	<u>\$(2,260)</u>	<u>\$620,291</u>

Table 5.2 shows the fair value of available-for-sale securities in a gross unrealized loss position at December 31, 2005, and how long they have been in that position.

**Table 5.2 — Available-For-Sale Securities in a Gross Unrealized Loss Position**

	Less than 12 months		12 months or Greater		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
December 31, 2005	(in millions)					
<b>Retained portfolio</b>						
Mortgage-related securities issued by:						
Freddie Mac .....	\$158,235	\$(1,975)	\$ 93,056	\$(2,999)	\$251,291	\$(4,974)
Fannie Mae .....	12,084	(182)	19,918	(685)	32,002	(867)
Ginnie Mae .....	111	(3)	25	—	136	(3)
Other .....	55,213	(627)	13,859	(402)	69,072	(1,029)
Obligations of states and political subdivisions .....	2,186	(32)	860	(21)	3,046	(53)
Total mortgage-related securities .....	<u>227,829</u>	<u>(2,819)</u>	<u>127,718</u>	<u>(4,107)</u>	<u>355,547</u>	<u>(6,926)</u>
<b>Cash and investments portfolio</b>						
Non-mortgage related securities:						
Asset-backed securities .....	11,715	(78)	5,485	(78)	17,200	(156)
Obligations of states and political subdivisions .....	1,207	(12)	—	—	1,207	(12)
Total non-mortgage-related securities .....	<u>12,922</u>	<u>(90)</u>	<u>5,485</u>	<u>(78)</u>	<u>18,407</u>	<u>(168)</u>
Total available-for-sale securities in a gross unrealized loss position .....	<u>\$240,751</u>	<u>\$(2,909)</u>	<u>\$133,203</u>	<u>\$(4,185)</u>	<u>\$373,954</u>	<u>\$(7,094)</u>

At December 31, 2005, gross unrealized losses on available-for-sale securities were \$(7,094) million, or approximately 2 percent of the fair value of such securities in an unrealized loss position, as noted in Table 5.1 and Table 5.2. The gross unrealized losses relate to approximately 85,000 individual lots representing approximately 16,000 separate securities. We

routinely purchase multiple lots of individual securities at different times and at different costs. We determine gross unrealized gains and gross unrealized losses by specifically identifying investment positions at the lot level; therefore, some of the lots we hold for a single security may be in an unrealized gain position while other lots for that security are in an unrealized loss position, depending upon the amortized cost of the specific lot.

We have the ability and intent to hold the available-for-sale securities in an unrealized loss position for a period of time sufficient to recover all unrealized losses. Based on our ability and intent to hold the available-for-sale securities and our consideration of other factors described below, we have concluded that the impairment of these securities is temporary.

- **Freddie Mac securities.** The unrealized losses on our securities are primarily a result of movements in interest rates. Since we guarantee the payment of principal and interest on these securities, we review the estimated credit exposure of the mortgages underlying these securities in evaluating potential impairment. The extent and duration of the decline in fair value relative to the amortized cost have met our criteria that are used to indicate that the impairment of these securities is temporary.
- **Fannie Mae securities and Obligations of states and political subdivisions.** The unrealized losses on Fannie Mae securities and Obligations of states and political subdivisions are primarily a result of movements in interest rates. The extent and duration of the decline in fair value relative to the amortized cost have met our criteria that are used to indicate that the impairment of these securities is temporary and no other facts or circumstances existed to suggest that the decline was not temporary. The issuer guarantees related to these securities have led us to conclude that any credit risk is minimal.
- **Other securities in the Retained portfolio and Asset-backed securities in the Cash and Investment portfolio.** The unrealized losses on mortgage-related securities included in Other and Asset-backed securities are principally a result of movements in interest rates. The extent and duration of the decline in fair value relative to the amortized cost have met our criteria that are used to indicate that the impairment of these securities is temporary. The vast majority of these securities are investment grade (*i.e.*, rated BBB– or better on a S&P equivalent scale).

Table 5.3 below illustrates the gross realized gains and gross realized losses received from the sale of available-for-sale securities.

**Table 5.3 — Gross Realized Gains and Gross Realized Losses on Available-For-Sale Securities**

	Year Ended December 31,		
	2005	2004	2003
	(in millions)		
Gross realized gains .....	\$ 891	\$ 787	\$ 1,903
Gross realized (losses) .....	(345)	(203)	(1,077)
Net realized gains .....	<u>\$ 546</u>	<u>\$ 584</u>	<u>\$ 826</u>

Table 5.4 summarizes, by major security type, the remaining contractual maturities and weighted average yield of available-for-sale securities at December 31, 2005.

**Table 5.4 — Maturities and Weighted Average Yield of Available-For-Sale Securities**

December 31, 2005	Amortized Cost	Fair Value	Weighted Average Yield <sup>(1)</sup>
	(dollars in millions)		
<b>Retained portfolio</b>			
Total mortgage-related securities <sup>(2)</sup>			
Due 1 year or less	\$ 22	\$ 22	5.80%
Due after 1 through 5 years	3,565	3,609	5.35
Due after 5 through 10 years	13,078	13,227	5.73
Due after 10 years	625,492	621,607	4.94
Total	<u>\$642,157</u>	<u>\$638,465</u>	4.96
<b>Cash and investments portfolio</b>			
Non-mortgage-related securities:			
Asset-backed securities <sup>(2)</sup>			
Due 1 year or less	\$ 3	\$ 3	4.29
Due after 1 through 5 years	21,466	21,369	4.12
Due after 5 through 10 years	7,132	7,095	4.16
Due after 10 years	2,111	2,111	4.42
Total	<u>30,712</u>	<u>30,578</u>	4.15
Obligations of states and political subdivisions			
Due 1 year or less	95	95	3.13
Due after 1 through 5 years	1,163	1,153	3.07
Due after 5 through 10 years	82	82	3.40
Due after 10 years	4,495	4,493	3.71
Total	<u>5,835</u>	<u>5,823</u>	3.57
Commercial paper			
Due 1 year or less	5,764	5,764	3.67
Due after 1 through 5 years	—	—	—
Due after 5 through 10 years	—	—	—
Due after 10 years	—	—	—
Total	<u>5,764</u>	<u>5,764</u>	3.67
Total non-mortgage-related securities			
Due 1 year or less	5,862	5,862	3.66
Due after 1 through 5 years	22,629	22,522	4.07
Due after 5 through 10 years	7,214	7,177	4.16
Due after 10 years	6,606	6,604	3.94
Total	<u>\$ 42,311</u>	<u>\$ 42,165</u>	4.01
<b>Total available-for-sale securities for Retained portfolio and Cash and investments portfolio</b>			
Due 1 year or less	\$ 5,884	\$ 5,884	3.67
Due after 1 through 5 years	26,194	26,131	4.24
Due after 5 through 10 years	20,292	20,404	5.17
Due after 10 years	632,098	628,211	4.93
Total	<u>\$684,468</u>	<u>\$680,630</u>	4.90

(1) The weighted average yield is calculated based on a yield for each individual security held at the balance sheet date. The numerator for the individual security yield consists of the sum of (a) the year-end interest coupon rate multiplied by the year-end unpaid principal balance and (b) the annualized amortization income or expense calculated for December 2005 (excluding any adjustments recorded for changes in the effective rate). The denominator for the individual security yield consists of the year-end amortized cost of the security excluding effects of other-than-temporary impairments on the unpaid principal balances of impaired securities.

(2) Information provided for mortgage-related securities and asset-backed securities is based on contractual maturities, which may not represent their expected lives. Obligations underlying these securities may be prepaid at any time without penalty.

Table 5.5 presents the changes in AOCI, net of taxes, related to available-for-sale securities. The Net unrealized holding (losses), net of tax, represents the net fair value adjustments recorded on available-for-sale securities throughout the year, after the effects of our statutory tax rate of 35 percent. The Net reclassification adjustment for net realized (gains), net of tax, represents the amount of those fair value adjustments, after the effects of our statutory tax rate of 35 percent, that have been recognized in earnings due to a sale of an available-for-sale security or the recognition of an impairment loss. See “NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES” for further information regarding the component of AOCI related to available-for-sale securities.

**Table 5.5 — AOCI, Net of Taxes, Related to Available-For-Sale Securities**

	Year Ended December 31,		
	2005	2004	2003
	(in millions)		
Beginning balance.....	\$ 4,339	\$ 6,349	\$12,217
Net unrealized holding (losses), net of tax <sup>(1)</sup> .....	(6,707)	(1,709)	(5,770)
Net reclassification adjustment for net realized (gains), net of tax <sup>(2)(3)</sup> .....	(117)	(301)	(98)
Ending balance .....	<u>\$ (2,485)</u>	<u>\$ 4,339</u>	<u>\$ 6,349</u>

(1) Net of tax (benefit) of \$(3,611) million, \$(920) million and \$(3,107) million for the years ended December 31, 2005, 2004 and 2003, respectively.

(2) Net of tax (expense) of \$(63) million, \$(162) million and \$(53) million for the years ended December 31, 2005, 2004 and 2003, respectively.

(3) Includes the reversal of previously recorded unrealized losses that have been recognized as impairment losses on available-for-sale securities of \$234 million, \$72 million and \$438 million, net of taxes, for the years ended December 31, 2005, 2004 and 2003, respectively.

Table 5.6 summarizes the estimated fair values by major security type for trading securities held in our Retained portfolio.

**Table 5.6 — Trading Securities in the Retained Portfolio**

	December 31,	
	2005	2004
	(in millions)	
<b>Retained portfolio</b>		
Mortgage-related securities issued by:		
Freddie Mac .....	\$8,156	\$11,398
Fannie Mae .....	534	385
Ginnie Mae .....	204	59
Total trading securities in the Retained portfolio.....	<u>\$8,894</u>	<u>\$11,842</u>

The net unrealized holding losses on trading securities we still hold that have been recognized in earnings for the years ended December 31, 2005, 2004 and 2003 were \$(261) million, \$(240) million and \$(402) million, respectively.

## Collateral Pledged

### *Collateral Pledged to Freddie Mac*

Our counterparties are required to pledge collateral for reverse repurchase transactions and most interest-rate swap agreements, after giving consideration to collateral posting thresholds generally related to a counterparty’s credit rating. Even though it is our practice not to repledge assets held as collateral, based on master agreements a portion of the collateral may be repledged. At December 31, 2005, we did not have collateral in the form of securities pledged to and held by us under secured lending transactions and interest-rate swap agreements. At December 31, 2004, the fair value amount of collateral pledged to and held by us, in the form of securities, was \$466 million, of which approximately \$3 million was available for repledging.

### *Collateral Pledged by Freddie Mac*

We are also required to pledge collateral for margin requirements with third-party custodians in connection with secured financings, interest-rate swap agreements, futures and daily trade activities with some counterparties. We pledge collateral to meet these requirements upon a demand by the respective counterparty. Based on agreements with our custodians, some collateral may be permitted by contract to be repledged by the custodian. Table 5.7 summarizes all securities pledged as collateral by us, including assets that the secured party may repledge and those that may not be repledged.



**Table 5.7 — Collateral in the Form of Securities Pledged**

	December 31,	
	2005	2004
	(in millions)	
Securities pledged with ability for secured party to repledge (parenthetically disclosed on our consolidated balance sheets)		
Available-for-sale .....	\$168	\$194
Securities pledged without ability for secured party to repledge		
Available-for-sale .....	161	221
Total assets pledged .....	<u>\$329</u>	<u>\$415</u>

**NOTE 6: LOAN LOSS RESERVES**

We maintain separate loan loss reserves for mortgage loans in the Retained portfolio that we classify as held-for-investment and for credit-related losses associated with certain mortgage loans that underlie guaranteed PCs and Structured Securities held by third parties.

Table 6.1 summarizes loan loss reserve activity during 2005, 2004 and 2003.

**Table 6.1 — Detail of Loan Loss Reserves**

	Year-Ended December 31,								
	2005			2004			2003		
	Reserves related to:			Reserves related to:			Reserves related to:		
	Retained Mortgages	PCs Outstanding	Total Loan Loss Reserves	Retained Mortgages	PCs Outstanding (in millions)	Total Loan Loss Reserves	Retained Mortgages	PCs Outstanding	Total Loan Loss Reserves
Beginning balance .....	\$ 114	\$150	\$ 264	\$ 174	\$125	\$ 299	\$ 177	\$ 88	\$ 265
Provision for credit losses .....	106	145	251	111	32	143	76	(81)	(5)
Charge-offs <sup>(1)</sup> .....	(294)	—	(294)	(300)	—	(300)	(224)	—	(224)
Recoveries <sup>(1)</sup> .....	185	—	185	160	—	160	145	—	145
Adjustment for change in accounting <sup>(2)</sup> .....	—	—	—	—	—	—	—	110	110
Transfers-out <sup>(3)</sup> .....	—	(11)	(11)	—	(20)	(20)	—	(11)	(11)
Other, net <sup>(4)</sup> .....	8	11	19	(31)	13	(18)	—	19	19
Ending balance .....	<u>\$ 119</u>	<u>\$295</u>	<u>\$ 414</u>	<u>\$ 114</u>	<u>\$150</u>	<u>\$ 264</u>	<u>\$ 174</u>	<u>\$125</u>	<u>\$ 299</u>

- (1) It is our practice to purchase mortgage loans from the pools that underlie PCs principally at the point the mortgage loan is identified as being 120 days past due. Upon repurchase, that portion of amounts classified in Reserve for guarantee losses on Participation Certificates that relates to a purchased loan is reclassified to Reserve for losses on mortgage loans held-for-investment. Since all credit losses related to off-balance sheet PCs are preceded by the purchase of a delinquent mortgage loan from the PC pool, all charge-offs or recoveries are presented in the Retained Mortgages columns above.
- (2) On January 1, 2003, \$110 million of the recognized Guarantee obligation that was attributable to estimated incurred losses on outstanding PCs or Structured Securities was reclassified to Reserve for guarantee losses on Participation Certificates.
- (3) Represents the reclassification of the reserve amount attributable to uncollectible interest on outstanding PCs and Structured Securities which is included as an offset to the related receivable balance within Accounts and other receivables, net on the consolidated balance sheets.
- (4) Represents the portion of the Guarantee obligation recognized upon the sale of PCs or Structured Securities that corresponds to incurred credit losses reclassified to Reserve for guarantee losses on Participation Certificates upon initial recognition of a Guarantee obligation. In addition, the amount includes an increase (reduction) of loan loss reserves of \$9 million and \$(31) million in 2005 and 2004, respectively, related to prior period adjustments for which the related income was recorded in Other income.

**Impaired Loans**

Total loan loss reserves, as presented in “Table 6.1 — Detail of Loan Loss Reserves,” consists of a specific valuation allowance related to impaired loans, which are presented in Table 6.2, and an additional reserve for other probable incurred losses which equaled \$398 million, \$261 million and \$289 million at December 31, 2005, 2004 and 2003, respectively. Our recorded investment in impaired loans and the related valuation allowance are summarized in Table 6.2.

**Table 6.2 — Impaired Loans<sup>(1)</sup>**

	December 31,								
	2005			2004			2003		
	Recorded Investment <sup>(2)</sup>	Specific Reserve	Net Investment	Recorded Investment <sup>(2)</sup>	Specific Reserve	Net Investment	Recorded Investment <sup>(2)</sup>	Specific Reserve	Net Investment
	(in millions)								
Impaired loans having:									
Related-valuation allowance .....	\$ 54	\$(16)	\$ 38	\$ 46	\$(3)	\$ 43	\$ 60	\$(10)	\$ 50
No related-valuation allowance <sup>(3)</sup> .....	2,536	—	2,536	2,261	—	2,261	2,309	—	2,309
Total .....	<u>\$2,590</u>	<u>\$(16)</u>	<u>\$2,574</u>	<u>\$2,307</u>	<u>\$(3)</u>	<u>\$2,304</u>	<u>\$2,369</u>	<u>\$(10)</u>	<u>\$2,359</u>

- (1) Single-family impaired loans include performing and non-performing troubled debt restructurings. Multifamily impaired loans are defined as performing and non-performing troubled debt restructurings, loans that are 60 days or more delinquent except for certain credit enhanced loans and certain mortgage loans with real estate collateral values less than the outstanding unpaid principal balances. For more details on multifamily impaired loans, see “NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES.”
- (2) Recorded Investment includes the unpaid principal balance of mortgage loans plus other amortized basis adjustments, which are modifications to their carrying value.
- (3) Impaired loans with no related valuation allowance primarily represent performing single-family troubled debt restructuring loans.

For the years ended December 31, 2005, 2004 and 2003, the average recorded investment in impaired loans was \$2,601 million, \$2,311 million and \$2,330 million, respectively. The increase in impaired loans in 2005 is primarily due to Hurricane Katrina.

Interest income on multifamily impaired loans is recognized on an accrual basis for loans performing under the original or restructured terms and on a cash basis for non-performing loans, which collectively totaled approximately \$24 million, \$13 million and \$16 million for the years ended December 31, 2005, 2004 and 2003, respectively. For single-family performing and non-performing loans, we recognize interest income on an accrual basis and establish reserves for estimated accrued but uncollectible interest for these loans at the consolidated balance sheet dates. Gross interest income on impaired single-family loans totaled \$149 million, \$157 million and \$160 million for the years ended December 31, 2005, 2004 and 2003, respectively.

## Delinquency Rates

Table 6.3 summarizes the delinquency rates for our Total mortgage portfolio, excluding non-Freddie Mac mortgage-related securities and that portion of Structured Securities that is backed by Ginnie Mae Certificates, at December 31, 2005, 2004 and 2003.

**Table 6.3 — Delinquency Performance<sup>(1)</sup>**

	December 31,		
	2005	2004	2003
Delinquencies, end of period:			
<b>Single-family:<sup>(2)</sup></b>			
Non-credit-enhanced portfolio:			
Delinquency rate .....	0.30%	0.24%	0.27%
Total number of delinquent loans .....	26,037	19,691	21,063
Credit-enhanced portfolio:			
Delinquency rate .....	2.46%	2.75%	2.96%
Total number of delinquent loans .....	47,000	54,913	66,283
Total portfolio:			
Delinquency rate .....	0.69%	0.73%	0.86%
Total number of delinquent loans .....	73,037	74,604	87,346
<b>Multifamily:<sup>(3)</sup></b>			
Total portfolio:			
Delinquency rate .....	—%	0.06%	0.05%
Net carrying value of delinquent loans (in millions) .....	\$ 2	\$ 35	\$ 24

(1) Based on mortgage loans in the Retained portfolio and Total Guaranteed PCs and Structured Securities Issues, excluding that portion of Structured Securities backed by Ginnie Mae Certificates.

(2) Based on the number of mortgage loans 90 days or more delinquent or in foreclosure.

(3) Based on net carrying value of mortgage loans 60 days or more delinquent.

## NOTE 7: REAL ESTATE OWNED

We obtain REO properties when we are the highest bidder at foreclosure sales of properties that collateralize non-performing single-family and multifamily mortgage loans owned by us. Upon acquiring single-family properties, we establish a marketing plan to sell the property as soon as practicable by either listing it with a sales broker or by other means, such as arranging a real estate auction. Upon acquiring multifamily properties, we may operate them with third-party property-management firms for a period to stabilize value and then sell the properties through commercial real estate brokers. For each of the years ended December 31, 2005, 2004 and 2003, the weighted average holding period for our disposed REO properties was less than one year. Table 7.1 provides a summary of our REO activity.

**Table 7.1 — Real Estate Owned**

	REO, Gross	Valuation Allowance (in millions)	REO, Net
Balance, December 31, 2002 .....	\$ 670	\$ (76)	\$ 594
Additions .....	1,663	(93)	1,570
Dispositions and write-downs .....	(1,422)	53	(1,369)
Balance, December 31, 2003 .....	911	(116)	795
Additions .....	1,641	(95)	1,546
Dispositions and write-downs .....	(1,685)	85	(1,600)
Balance, December 31, 2004 .....	867	(126)	741
Additions .....	1,390	(78)	1,312
Dispositions and write-downs .....	(1,513)	89	(1,424)
Balance, December 31, 2005 .....	<u>\$ 744</u>	<u>\$ (115)</u>	<u>\$ 629</u>

We recognized losses of \$67 million, \$67 million and \$50 million on REO dispositions for the years ended December 31, 2005, 2004 and 2003, respectively, which are included in REO operations income (expense).

## NOTE 8: DEBT SECURITIES AND SUBORDINATED BORROWINGS

Debt securities are classified as either due within one year or due after one year based on their remaining contractual maturity. Table 8.1 summarizes the balances and effective interest rates at December 31, 2005 and 2004 for debt securities, as well as subordinated borrowings.

**Table 8.1 — Total Debt Securities, Net**

	December 31,			
	2005		2004	
	Balance, Net <sup>(1)</sup>	Effective Rate <sup>(2)</sup>	Balance, Net <sup>(1)</sup>	Effective Rate <sup>(2)</sup>
	(dollars in millions)			
Senior debt, due within one year:				
Short-term debt securities	\$192,713	4.02%	\$196,639	2.05%
Current portion of long-term debt	95,819	3.42	85,664	3.33
Senior debt, due within one year	288,532	3.82	282,303	2.44
Senior debt, due after one year	454,627	4.64	443,772	4.36
Subordinated debt, due after one year	5,633	6.15	5,622	6.15
Senior and subordinated debt, due after one year	460,260	4.66	449,394	4.38
Total debt securities, net	<u>\$748,792</u>		<u>\$731,697</u>	

(1) Includes unamortized discounts and premiums, and foreign-currency-related and hedging-related basis adjustments.

(2) Represents the weighted average effective rate at the end of the period, which includes the amortization of discounts or premiums and issuance costs, but excludes the amortization of foreign-currency-related and hedging-related basis adjustments.

We finance the purchase of mortgage loans and mortgage-related securities primarily through the issuance of senior debt and subordinated debt.

### Senior Debt, Due Within One Year

As indicated in Table 8.2, a majority of Senior debt, due within one year (excluding current portion of long-term debt) consisted of Reference Bills® securities and discount notes, paying only principal at maturity. Reference Bills® securities, discount notes and Medium-term Notes are unsecured general obligations. Certain Medium-term Notes that have original maturities of one year or less are classified as Short-term debt securities. Securities sold under agreements to repurchase are effectively collateralized borrowing transactions where we sell securities with an agreement to repurchase such securities. These agreements require the underlying securities to be delivered to the dealers who arranged the transactions. Federal funds purchased are unsecuritized borrowings from commercial banks that are members of the Federal Reserve System.

Table 8.2 provides additional information related to our debt securities due within one year.

**Table 8.2 — Senior Debt, Due Within One Year**

	December 31,					
	2005			2004		
	Par Value	Balance, Net <sup>(1)</sup>	Effective Rate <sup>(2)</sup>	Par Value	Balance, Net <sup>(1)</sup>	Effective Rate <sup>(2)</sup>
	(dollars in millions)					
Reference Bills® securities and discount notes	\$183,357	\$181,468	4.00%	\$181,071	\$180,198	2.04%
Medium-term Notes	2,035	2,032	4.17	162	162	2.51
Securities sold under agreements to repurchase and Federal funds purchased	450	450	4.26	—	—	—
Swap collateral obligations	8,736	8,768	4.30	16,279	16,279	2.24
Hedging-related basis adjustments	N/A	(5)	N/A	N/A	—	N/A
Short-term debt securities	194,578	192,713	4.02	197,512	196,639	2.05
Current portion of long-term debt	95,596	95,819	3.42	83,625	85,664	3.33
Senior debt, due within one year	<u>\$290,174</u>	<u>\$288,532</u>	3.82	<u>\$281,137</u>	<u>\$282,303</u>	2.44

(1) Represents par value, net of associated discounts or premiums. Swap collateral obligations include the related accrued interest payable.

(2) Represents the weighted average effective rate at the end of the period, which includes the amortization of discounts or premiums and issuance costs, but excludes the amortization of foreign-currency-related and hedging-related basis adjustments.

## Senior and Subordinated Debt, Due After One Year

Table 8.3 summarizes our Senior and subordinated debt, due after one year at December 31, 2005 and 2004.

**Table 8.3 — Senior and Subordinated Debt, Due After One Year**

		December 31,					
		2005			2004		
	Contractual Maturity <sup>(1)</sup>	Par Value	Balance, Net <sup>(2)</sup>	Interest Rates	Par Value	Balance, Net <sup>(2)</sup>	Interest Rates
(dollars in millions)							
Senior debt, due after one year: <sup>(3)</sup>							
Fixed-rate:							
Medium-term Notes — Callable <sup>(4)</sup>	2007 - 2035	\$182,251	\$182,173	2.00% - 7.91%	\$181,094	\$180,957	1.63% - 8.05%
Medium-term Notes — Non-callable	2007 - 2028	19,927	19,936	1.00% - 7.69%	8,574	8,587	1.00% - 7.69%
U.S. dollar Reference Notes® securities — Non-callable	2007 - 2032	172,551	171,962	2.38% - 7.00%	167,836	167,622	1.88% - 7.00%
€Reference Notes® securities — Non-callable	2007 - 2014	25,528	25,478	3.50% - 5.75%	29,035	28,967	3.50% - 5.75%
Variable-rate:							
Medium-term Notes — Callable <sup>(5)</sup>	2007 - 2030	28,709	28,709	Various	33,033	33,041	Various
Medium-term Notes — Non-callable <sup>(6)</sup>	2007 - 2026	5,809	5,858	Various	1,183	1,207	Various
Zero-coupon:							
Medium-term Notes — Callable	2007 - 2035	39,939	7,675	—%	35,903	7,078	—%
Medium-term Notes — Non-callable	2007 - 2034	9,598	5,287	—%	5,528	1,968	—%
Foreign-currency-related and hedging-related basis adjustments		N/A	7,549		N/A	14,345	
Total senior debt, due after one year		484,312	454,627		462,186	443,772	
Subordinated debt, due after one year:							
Fixed-rate <sup>(7)</sup>	2011 - 2016	5,564	5,550	5.25% - 8.25%	5,564	5,547	5.25% - 8.25%
Zero coupon	2019	332	83	—%	332	75	—%
Total subordinated debt, due after one year		5,896	5,633		5,896	5,622	
Total senior and subordinated debt, due after one year		\$490,208	\$460,260		\$468,082	\$449,394	

(1) Represents contractual maturities at December 31, 2005.

(2) Represents par value of long-term debt securities and subordinated borrowings, net of associated discounts or premiums.

(3) For debt denominated in a currency other than the U.S. dollar, the outstanding balance is based on the exchange rate at the date of the debt issuance. Subsequent changes in exchange rates are reflected in Foreign-currency-related and hedging-related basis adjustments.

(4) Includes callable Estate Notes<sup>SM</sup> securities and FreddieNotes® securities of \$11,805 million and \$11,850 million at December 31, 2005 and 2004, respectively. These debt instruments represent Medium-term Notes that permit persons acting on behalf of deceased beneficial owners to require us to repay principal prior to the contractual maturity date.

(5) Includes callable Estate Notes<sup>SM</sup> securities and FreddieNotes® securities of \$6,987 million and \$6,142 million at December 31, 2005 and 2004, respectively. See related footnote (4) above concerning the nature of these debt instruments.

(6) Includes Medium-term Notes of \$800 million at December 31, 2005 and 2004, which are repayable in whole or in part at the option of the beneficial owner, acting through the holder, on or after November 22, 2002 and prior to November 20, 2007 at 100 percent of the principal amount plus accrued interest.

(7) Balance, Net includes callable subordinated debt of \$3,493 million and \$3,491 million at December 31, 2005 and 2004, respectively.

A portion of our long-term debt is callable. Callable debt gives us the option to redeem the debt security on one or more specified call dates or at any time on or after a specified call date.

Table 8.4 summarizes the contractual maturities of long-term debt securities (including current portion of long-term debt) and subordinated borrowings outstanding at December 31, 2005, assuming callable debt is paid at contractual maturity.

**Table 8.4 — Senior and Subordinated Debt, Due After One Year (including current portion of long-term debt)**

Annual Maturities	Contractual Maturity <sup>(1)(2)</sup> (in millions)
2006	\$ 95,596
2007	106,696
2008	72,125
2009	47,348
2010	52,249
Thereafter	211,790
Total <sup>(1)</sup>	585,804
Net discounts, premiums and foreign-currency-related and hedging-related basis adjustments <sup>(2)</sup>	(29,725)
Senior and subordinated debt, due after one year, including current portion of long-term debt	\$556,079

(1) Represents par value of long-term debt securities and subordinated borrowings.

(2) For debt denominated in a currency other than the U.S. dollar, the par value is based on the exchange rate at the date of the debt issuance. Subsequent changes in exchange rates are reflected in Net discounts, premiums and foreign-currency-related and hedging-related basis adjustments.

We record gains and losses on debt repurchases that are accounted for as debt extinguishments based on the difference between the principal amount of the debt securities repurchased (adjusted for deferred premiums, discounts and hedging gains and losses) and proceeds paid and the write-off of related deferred debt issuance costs. We recognized a pre-tax gain of \$206 million and pre-tax losses of \$(327) million and \$(1,775) million on the repurchase of approximately \$11.7 billion, \$14.5 billion and \$27.3 billion in principal amount of debt outstanding in 2005, 2004 and 2003, respectively.

## NOTE 9: STOCKHOLDERS' EQUITY

### Preferred Stock

During 2005 and 2004, we completed no preferred stock offerings. All 17 classes of preferred stock outstanding at December 31, 2005 have a par value of \$1 per share. We have the option to redeem these shares, on specified dates, at their redemption price plus dividends accrued through the redemption date. In addition, all 17 classes of preferred stock are perpetual and non-cumulative, and carry no significant voting rights or rights to purchase additional Freddie Mac stock or securities. Costs incurred in connection with the issuance of preferred stock are charged to Additional paid-in capital.

Table 9.1 provides a summary of our preferred stock outstanding at December 31, 2005.

**Table 9.1 — Preferred Stock**

	Issue Date	Shares Authorized	Shares Outstanding	Total Par Value	Redemption Price per Share	Total Outstanding Balance <sup>(1)</sup>	Redeemable On or After <sup>(2)</sup>	NYSE Symbol <sup>(3)</sup>
			(in millions, except redemption price per share)					
1996 Variable-rate <sup>(4)</sup> . . .	April 26, 1996	5.00	5.00	\$ 5.00	\$50.00	\$ 250	June 30, 2001	FRE.prB
6.14% . . . . .	June 3, 1997	12.00	12.00	12.00	50.00	600	June 30, 2002	FRE.prD
5.81% . . . . .	October 27, 1997	3.00	3.00	3.00	50.00	150	October 27, 1998	(5)
5% . . . . .	March 23, 1998	8.00	8.00	8.00	50.00	400	March 31, 2003	FRE.prF
1998 Variable-rate <sup>(6)</sup> . . .	September 23 and 29, 1998	4.40	4.40	4.40	50.00	220	September 30, 2003	FRE.prG
5.1% . . . . .	September 23, 1998	8.00	8.00	8.00	50.00	400	September 30, 2003	FRE.prH
5.3% . . . . .	October 28, 1998	4.00	4.00	4.00	50.00	200	October 30, 2000	(5)
5.1% . . . . .	March 19, 1999	3.00	3.00	3.00	50.00	150	March 31, 2004	(5)
5.79% . . . . .	July 21, 1999	5.00	5.00	5.00	50.00	250	June 30, 2009	FRE.prK
1999 Variable-rate <sup>(7)</sup> . . .	November 5, 1999	5.75	5.75	5.75	50.00	287	December 31, 2004	FRE.prL
2001 Variable-rate <sup>(8)</sup> . . .	January 26, 2001	6.50	6.50	6.50	50.00	325	March 31, 2003	FRE.prM
2001 Variable-rate <sup>(9)</sup> . . .	March 23, 2001	4.60	4.60	4.60	50.00	230	March 31, 2003	FRE.prN
5.81% . . . . .	March 23, 2001	3.45	3.45	3.45	50.00	173	March 31, 2011	FRE.prO
6% . . . . .	May 30, 2001	3.45	3.45	3.45	50.00	173	June 30, 2006	FRE.prP
2001 Variable-rate <sup>(10)</sup> . . .	May 30, 2001	4.02	4.02	4.02	50.00	201	June 30, 2003	FRE.prQ
5.7% . . . . .	October 30, 2001	6.00	6.00	6.00	50.00	300	December 31, 2006	FRE.prR
5.81% . . . . .	January 29, 2002	6.00	6.00	6.00	50.00	300	March 31, 2007	(5)
Total . . . . .		<u>92.17</u>	<u>92.17</u>	<u>\$92.17</u>		<u>\$4,609</u>		

- (1) Amounts stated at redemption value.
- (2) As long as the capital monitoring framework established by the Office of Federal Housing Enterprise Oversight, or OFHEO, in January 2004 remains in effect, any preferred stock redemption will require prior approval by OFHEO. See "NOTE 10: REGULATORY CAPITAL" for more information.
- (3) Preferred stock is listed on the New York Stock Exchange, or NYSE, unless otherwise noted.
- (4) Dividend rate resets quarterly and is equal to the sum of three-month LIBOR plus 1 percent divided by 1.377, and is capped at 9.00 percent.
- (5) Not listed on any exchange.
- (6) Dividend rate resets quarterly and is equal to the sum of three-month LIBOR plus 1 percent divided by 1.377, and is capped at 7.50 percent.
- (7) Dividend rate resets on January 1 every five years after January 1, 2005 based on a five-year Constant Maturity Treasury, or CMT, rate, and is capped at 11.00 percent. Optional redemption on December 31, 2004 and on December 31 every five years thereafter.
- (8) Dividend rate resets on April 1 every two years after April 1, 2003 based on the two-year CMT rate plus 0.10 percent, and is capped at 11.00 percent. Optional redemption on March 31, 2003 and on March 31 every two years thereafter.
- (9) Dividend rate resets on April 1 every year based on 12-month LIBOR minus 0.20 percent, and is capped at 11.00 percent. Optional redemption on March 31, 2003 and on March 31 every year thereafter.
- (10) Dividend rate resets on July 1 every two years after July 1, 2003 based on the two-year CMT rate plus 0.20 percent, and is capped at 11.00 percent. Optional redemption on June 30, 2003 and on June 30 every two years thereafter.

### Stock Repurchase and Issuance Programs

On October 5, 2005, our board of directors authorized us to repurchase up to \$2 billion of outstanding shares of our common stock, all of which remained available for repurchase at December 31, 2005, and to issue up to \$2 billion of non-cumulative, perpetual preferred stock, in each case, from time to time depending on market conditions and other factors. Completion of the authorized capital transactions will have no material impact on our regulatory minimum capital surplus, including the 30 percent mandatory target set in January 2004 by OFHEO. In accordance with the existing capital monitoring framework established by OFHEO in January 2004, we obtained OFHEO's approval for this common stock repurchase. The repurchase authorization replaces all unused repurchase authority remaining under the common stock repurchase plan approved by our board of directors in September 1997.

## NOTE 10: REGULATORY CAPITAL

### Regulatory Capital Standards

The Federal Housing Enterprises Financial Safety and Soundness Act of 1992, or GSE Act, established minimum, critical and risk-based capital standards for us.

Those standards determine the amounts of Core capital and Total capital that we must maintain to meet regulatory capital requirements. Core capital consists of the par value of outstanding common stock (common stock issued less



common stock held in treasury), the par value of outstanding non-cumulative perpetual preferred stock, additional paid-in capital and retained earnings, as determined in accordance with GAAP. Total capital includes Core capital and general reserves for mortgage and foreclosure losses and any other amounts available to absorb losses that OFHEO includes by regulation.

#### *Minimum Capital*

The minimum capital standard requires us to hold an amount of Core capital that is generally equal to the sum of 2.50 percent of aggregate on-balance sheet assets and approximately 0.45 percent of the sum of outstanding mortgage-related securities we guaranteed and other aggregate off-balance sheet obligations. As discussed below, in 2004 OFHEO implemented a framework for monitoring our capital adequacy, which includes a mandatory target capital surplus of 30 percent over the minimum capital requirement.

#### *Critical Capital*

The critical capital standard requires us to hold an amount of Core capital that is generally equal to the sum of 1.25 percent of aggregate on-balance sheet assets and approximately 0.25 percent of the sum of outstanding mortgage-related securities we guaranteed and other aggregate off-balance sheet obligations.

#### *Risk-Based Capital*

The risk-based capital standard requires the application of a stress test to determine the amount of Total capital that we must hold to absorb projected losses resulting from adverse interest-rate and credit-risk conditions specified by the GSE Act and adds 30 percent additional capital to provide for management and operations risk. The adverse interest-rate conditions prescribed by the GSE Act include one scenario in which 10-year Treasury yields rise by as much as 75 percent (up-rate scenario) and one in which they fall by as much as 50 percent (down-rate scenario). The credit risk component of the stress tests simulates the performance of our mortgage portfolio based on loss rates for a benchmark region. The criteria for the benchmark region are established by the GSE Act and are intended to capture the credit-loss experience of the region that experienced the highest historical rates of default and severity of mortgage losses for two consecutive origination years.

#### **Classification**

OFHEO monitors our performance with respect to the three regulatory capital standards by classifying our capital adequacy not less than quarterly.

To be classified as “adequately capitalized,” we must meet both the risk-based and minimum capital standards. If we fail to meet the risk-based capital standard, we cannot be classified higher than “undercapitalized.” If we fail to meet the minimum capital requirement but exceed the critical capital requirement, we cannot be classified higher than “significantly undercapitalized.” If we fail to meet the critical capital standard, we must be classified as “critically undercapitalized.” In addition, OFHEO has discretion to reduce our capital classification by one level if OFHEO determines that we are engaging in conduct OFHEO did not approve that could result in a rapid depletion of Core capital or determines that the value of property subject to mortgage loans we hold or guarantee has decreased significantly.

When we are classified as adequately capitalized, we generally can pay a dividend on our common or preferred stock or make other capital distributions (which includes common stock repurchases and preferred stock redemptions) without prior OFHEO approval so long as the payment would not decrease Total capital to an amount less than our risk-based capital requirement and would not decrease our Core capital to an amount less than our minimum capital requirement.

If we were classified as undercapitalized, we would be prohibited from making a capital distribution that would decrease our Core capital to an amount less than our minimum capital requirement. We also would be required to submit a capital restoration plan for OFHEO approval, which could adversely affect our ability to make capital distributions.

If we were classified as significantly undercapitalized, we would be able to make a capital distribution only if OFHEO determined that the distribution satisfied certain statutory standards. Under these circumstances, we would be prohibited from making any capital distribution that would decrease our Core capital to less than the critical capital level, and OFHEO also could take action to limit our growth, require us to acquire new capital or restrict us from activities that create excessive risk. We also would be required to submit a capital restoration plan for OFHEO approval, which could adversely affect our ability to make capital distributions.

If we were classified as critically undercapitalized, OFHEO would be required to appoint a conservator for us unless OFHEO made a written finding that it should not do so and the Secretary of the Treasury concurred in that determination.

#### **Performance Against Regulatory Capital Standards**

OFHEO has never classified us as other than “adequately capitalized,” the highest possible classification, reflecting our consistent compliance with the minimum, critical and risk-based capital requirements.

Table 10.1 summarizes our regulatory capital requirements and surpluses.

**Table 10.1 — Regulatory Capital Requirements<sup>(1)</sup>**

	December 31,	
	2005	2004
	(in millions)	
<i>Minimum capital requirement<sup>(2)</sup></i> .....	\$25,010	\$24,131
Core capital <sup>(2)</sup> .....	35,964	35,009
Minimum capital surplus <sup>(2)</sup> .....	10,954	10,878
<i>Critical capital requirement<sup>(2)</sup></i> .....	\$12,782	\$12,308
Core capital <sup>(2)</sup> .....	35,964	35,009
Critical capital surplus <sup>(2)</sup> .....	23,182	22,701
<i>Risk-based capital requirement<sup>(3)</sup></i> .....	\$11,282	\$11,108
Total capital <sup>(3)</sup> .....	36,781	34,691
Risk-based capital surplus <sup>(3)</sup> .....	25,499	23,583

(1) OFHEO is the authoritative source of the capital calculations that underlie our capital classifications.

(2) Amounts for 2005 are based on amended reports we submitted to OFHEO on May 30, 2006.

(3) Amounts for 2005 and 2004 are those calculated by OFHEO prior to the issuance of our 2005 and 2004 financial results.

Factors that could adversely affect the adequacy of our regulatory capital for future periods include declines in GAAP income; increases in our risk profile; changes in the economic environment, such as large interest-rate or implied volatility moves or house-price declines; changes in option-adjusted spreads; legislative or regulatory action that could increase capital requirements or changes in or adoption of new accounting standards such as SFAS 155. See “NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — Recently Issued Accounting Standards, Not Yet Adopted” for more information regarding SFAS 155. In particular, interest-rate levels or implied volatility can affect the amount of our Core capital, even if we were economically well hedged against interest-rate changes, because certain gains or losses are recognized through GAAP earnings while other offsetting gains or losses may not be. Changes in option-adjusted spreads can also affect the amount of our Core capital, because option-adjusted spreads are a factor in the valuation of our guaranteed mortgage portfolio.

#### Subordinated Debt Commitment

In October 2000, we announced our voluntary adoption of a series of commitments designed to enhance market discipline, liquidity and capital. In September 2005, we entered into a written agreement with OFHEO that updated those commitments and set forth a process for implementing them. Under the terms of this agreement, we committed to issue qualifying subordinated debt for public secondary market trading and rated by no less than two nationally recognized statistical rating organizations in a quantity such that the sum of Total capital plus the outstanding balance of qualifying subordinated debt will equal or exceed the sum of 0.45 percent of outstanding guaranteed PCs and Structured Securities and 4 percent of on-balance sheet assets at the end of each quarter. Qualifying subordinated debt is defined as subordinated debt that contains a deferral of interest payments for up to five years if our Core capital falls below 125 percent of our critical capital requirement or our Core capital falls below our minimum capital requirement and pursuant to our request, the Secretary of the Treasury exercises discretionary authority to purchase our obligations under Section 306(c) of our charter. Qualifying subordinated debt will be discounted for the purposes of this commitment as it approaches maturity with one-fifth of the outstanding amount excluded each year during the instrument’s last five years before maturity. When the remaining maturity is less than one year, the instrument is entirely excluded.

Table 10.2 summarizes our compliance with our subordinated debt commitment.

**Table 10.2 — Subordinated Debt Commitment**

	December 31, 2005
	(in millions)
Total on-balance sheet assets and guaranteed PCs and Structured Securities outstanding target <sup>(1)(2)</sup> .....	\$36,633
Total capital plus qualifying subordinated debt <sup>(2)</sup> .....	41,831
Surplus <sup>(2)</sup> .....	5,198

(1) Equals the sum of 0.45 percent of outstanding guaranteed PCs and Structured Securities and 4 percent of on-balance sheet assets.

(2) Amounts for 2005 are based on amended reports we submitted to OFHEO on May 30, 2006.

#### Regulatory Capital Monitoring Framework

In a letter dated January 28, 2004, OFHEO created a framework for monitoring our capital due to our higher operational risk, including our inability to produce timely financial statements in accordance with GAAP. The letter directed that we maintain a mandatory target capital surplus of 30 percent over our minimum capital requirement, subject to certain conditions and variations; that we submit weekly reports concerning our capital levels; and that we obtain prior approval of certain capital transactions.

Our failure to meet the mandatory target capital surplus would result in an OFHEO inquiry regarding the reason for such failure. If OFHEO were to determine that we had acted unreasonably regarding our compliance with the framework, as set forth in OFHEO's letter, OFHEO could seek to require us to submit a remedial plan or take other remedial steps.

In addition, under this framework, we are required to obtain prior written approval from the Director of OFHEO before engaging in certain capital transactions, including the repurchase of any shares of common stock, redemption of any preferred stock or payment of preferred stock dividends above stated contractual rates. We must also submit a written report to the Director of OFHEO after the declaration, but before the payment, of any dividend on our common stock. The report must contain certain information on the amount of the dividend, the rationale for the payment and the impact on our capital surplus.

This framework will remain in effect until the Director of OFHEO determines that it should be modified or expire. OFHEO's letter indicated that this determination would consider our resumption of timely financial and regulatory reporting that complies with GAAP, among other factors.

Table 10.3 summarizes our compliance with the mandatory target capital surplus portion of OFHEO's capital monitoring framework.

**Table 10.3 — Mandatory Target Capital Surplus**

	December 31,	
	2005	2004
	(in millions)	
Minimum capital requirement plus 30% add-on <sup>(1)</sup> .....	\$32,513	\$31,370
Core capital <sup>(1)</sup> .....	35,964	35,009
Surplus <sup>(1)</sup> .....	3,451	3,639

(1) Amounts for 2005 are based on amended reports we submitted to OFHEO on May 30, 2006.

#### NOTE 11: STOCK-BASED COMPENSATION

We have three stock-based compensation plans under which grants are currently being made: (i) the Employee Stock Purchase Plan, or ESPP, as amended and restated in 2004; (ii) the 2004 Stock Compensation Plan, or 2004 Employee Plan; and (iii) the 1995 Directors' Stock Compensation Plan, or Directors' Plan. Prior to the stockholder approval of the 2004 Employee Plan on November 4, 2004, employee stock-based compensation was awarded in accordance with the terms of the stockholder-approved 1995 Stock Compensation Plan, or 1995 Employee Plan. We collectively refer to the 2004 Employee Plan and 1995 Employee Plan as the Employee Plans.

Common stock delivered under these plans may be shares currently held by us as treasury stock, shares purchased by us in the open market or authorized but previously unissued shares. At December 31, 2005, our stock-based awards consisted of stock options, restricted stock units and restricted stock. Such awards, discussed below, are generally forfeitable for at least one year after the grant date, with vesting provisions contingent upon service requirements.

- Stock options granted allow for the purchase of our common stock at an exercise price equal to the fair market value of our common stock on the grant date. Options generally may be exercised for a period of 10 years from the grant date, subject to a vesting schedule commencing on the grant date. Stock options granted by us include dividend equivalent rights.

On November 30, 2005, the Compensation and Human Resources Committee of our board of directors approved a change in the manner in which dividend equivalents are paid out on certain stock option awards. This change affected all stock options outstanding at December 31, 2005 and unvested at December 31, 2004 (affected stock options) and was made to bring the awards into operational and documentary compliance with Internal Revenue Code Section 409A. In 2006, we made a lump sum payment for all previously accrued dividend equivalents to grantees holding affected stock options at December 31, 2005. With the change, dividend equivalents on affected stock options are paid when and as dividends on common stock are declared. In addition, dividend equivalent rights will no longer be granted in connection with awards of stock options to grantees. For options not affected by the change approved on November 30, 2005, the dividend equivalent right provides option holders with the right to receive, at the time stock options are exercised or upon expiration, an amount equal to the accumulated dividends declared on the stock from the grant date.

- A restricted stock unit entitles the grantee to receive one share of common stock at a specified future date. Restricted stock units do not have voting rights, but do have dividend equivalent rights, which are (a) paid to restricted stock

unit holders who are employees as and when dividends on common stock are declared or (b) which are accrued as additional restricted stock units for non-employee directors.

- Restricted stock entitles participants to all the rights of a stockholder, including dividends, except that the shares awarded are subject to a risk of forfeiture and may not be disposed of by the participant until the end of the restriction period established at the time of grant.

**ESPP:** We have established a stockholder-approved ESPP, which was amended and restated as of January 1, 2005, that is qualified under Internal Revenue Code Section 423. Under the ESPP, substantially all full-time and part-time employees that choose to participate in the ESPP have the option to purchase shares of common stock at specified dates, with an annual maximum market value of \$20,000 per employee as determined on the subscription (grant) date. The purchase price is equal to 85 percent of the lower of the average price (average of the daily high and low prices) of the stock on the subscription date or the average price of the stock on the purchase (exercise) date.

On November 4, 2004, stockholders approved the amendment and restatement of the ESPP effective as of January 1, 2005. The restated ESPP authorized granting 3.6 million shares in addition to the 3.2 million shares remaining under the former ESPP. At December 31, 2005, the maximum number of shares of common stock authorized for grant to employees, including those additional shares granted in accordance with the amended and restated ESPP, totaled 6.8 million shares, of which approximately 0.2 million shares had been issued and approximately 6.6 million shares remained available for grant. At December 31, 2005, 2004 and 2003, no options were exercisable under the ESPP, as the options outstanding at year-end become exercisable subsequent to year-end, and are exercised or forfeited during the subsequent year.

**2004 Employee Plan:** Under the stockholder-approved 2004 Employee Plan, we may grant employees stock-based awards, including stock options, restricted stock units and restricted stock. In addition, we have the right to impose performance conditions with respect to these awards. Under the 2004 Employee Plan, employees may also be granted stock appreciation rights; however, at December 31, 2005, no stock appreciation rights had been granted under the 2004 Employee Plan. At December 31, 2005, the maximum number of shares of common stock authorized for grant to employees in accordance with the 2004 Employee Plan totaled 13.8 million shares, of which approximately 1.8 million shares had been issued and approximately 12.0 million shares remained available for grant.

**Directors' Plan:** Under the stockholder-approved Directors' Plan, which was amended and restated in 1998, we are permitted to grant to non-employee directors stock options, restricted stock units and restricted stock. At December 31, 2005, the maximum number of shares of common stock authorized for grant to directors in accordance with the Directors' Plan totaled 2.4 million shares, of which approximately 0.8 million shares had been issued and approximately 1.6 million shares remained available for grant.

See "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES," for a description of the accounting treatment for employee stock-based compensation, including grants under the ESPP, Employee Plans and Directors' Plan.

Table 11.1 provides a summary of activity related to the option to purchase stock under the ESPP.

**Table 11.1 — ESPP Activity**

	Year Ended December 31,					
	2005		2004		2003	
	Options to Purchase Stock	Weighted Average Exercise Price	Options to Purchase Stock	Weighted Average Exercise Price	Options to Purchase Stock	Weighted Average Exercise Price
Outstanding, beginning of year . . . . .	60,416	\$56.83	65,257	\$48.08	1,000,370	\$52.27
Granted . . . . .	258,061	53.58	250,899	53.40	145,866	44.16
Exercised . . . . .	(239,873)	52.78	(244,625)	50.53	(355,485)	41.76
Forfeited or expired . . . . .	(17,020)	53.22	(11,115)	50.77	(725,494)	43.02
Outstanding, end of year . . . . .	61,584	52.16	60,416	56.83	65,257	48.08
Weighted-average fair value of options granted during year . . . . .	\$ 11.56		\$ 11.23		\$ 10.72	

Table 11.2 provides a summary of activity related to stock options under the Employee Plans and the Directors' Plan.

**Table 11.2 — Employee Plans and Directors' Plan Stock Options Activity**

	Year Ended December 31,					
	2005		2004		2003	
	Stock Options	Weighted Average Exercise Price	Stock Options	Weighted Average Exercise Price	Stock Options	Weighted Average Exercise Price
Outstanding, beginning of year . . . . .	7,627,941	\$52.94	8,656,340	\$46.89	9,231,105	\$44.21
Granted . . . . .	1,199,586	62.80	1,343,554	61.09	1,216,442	53.28
Exercised . . . . .	(1,563,477)	43.55	(1,861,617)	29.06	(1,052,156)	23.12
Forfeited or expired . . . . .	(570,366)	61.17	(510,336)	58.84	(739,051)	57.18
Outstanding, end of year . . . . .	6,693,684	56.20	7,627,941	52.94	8,656,340	46.89
Options exercisable at year-end . . . . .	3,590,168	52.14	4,018,666	47.46	4,755,640	38.23
Weighted-average fair value of options granted during year . . . . .	\$ 26.84		\$ 25.04		\$ 21.84	

Table 11.3 provides a summary of activity related to restricted stock and restricted stock units under the Employee Plans and the Directors' Plan.

**Table 11.3 — Employee Plans and Directors' Plan Restricted Stock and Restricted Stock Unit Activity**

	Year Ended December 31,					
	2005		2004		2003	
	Restricted Stock	Restricted Stock Units	Restricted Stock	Restricted Stock Units	Restricted Stock	Restricted Stock Units
Outstanding, beginning of year . . . . .	164,781	1,624,628	566,635	1,295,722	1,089,327	359,227
Granted <sup>(1)</sup> . . . . .	—	838,576	—	698,587	—	1,146,164
Lapse of restrictions . . . . .	(79,961)	(659,946)	(240,514)	(145,340)	(381,103)	(114,240)
Forfeited . . . . .	(15,118)	(329,075)	(161,340)	(224,341)	(141,589)	(95,429)
Outstanding, end of year . . . . .	69,702	1,474,183	164,781	1,624,628	566,635	1,295,722
Weighted-average fair value of awards granted during year . . . . .		\$ 62.68		\$ 62.97		\$ 55.01

(1) Restricted stock units granted under the Employee Plans were 831,730, 673,720 and 1,143,810 in 2005, 2004 and 2003, respectively. Restricted stock units granted under the Directors' Plan were 6,846, 24,867 and 2,354 in 2005, 2004 and 2003, respectively.

Table 11.4 provides additional information for stock options outstanding under the Employee Plans and the Directors' Plan at December 31, 2005 by range of exercise prices.

**Table 11.4 — Employee Plans and Directors' Plan Stock Options Outstanding**

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Outstanding at December 31, 2005	Weighted Average Remaining Contract Life in Years	Weighted Average Exercise Price	Exercisable at December 31, 2005	Weighted Average Exercise Price
\$15.00 - 24.99 . . . . .	235,040	0.4	\$20.90	235,040	\$20.90
25.00 - 34.99 . . . . .	266,550	1.4	34.27	266,550	34.27
35.00 - 44.99 . . . . .	703,326	4.0	41.57	703,326	41.57
45.00 - 54.99 . . . . .	1,145,870	5.8	51.23	553,125	49.37
55.00 - 64.99 . . . . .	3,595,381	7.3	62.21	1,300,868	62.01
65.00 - 68.99 . . . . .	747,517	5.3	67.59	531,259	67.65
\$15.00 - 68.99 . . . . .	6,693,684	6.0	56.20	3,590,168	52.14

Table 11.5 summarizes the weighted-average assumptions used in determining the fair values of options granted under our stock-based compensation plans using a Black-Scholes option pricing model. Estimates used to determine the weighted-average assumptions noted in the table below are determined as follows: (i) the expected dividend yield is based on the most recent dividend announcement relative to the grant date and the stock price at the grant date, (ii) the expected



volatility is based on the historical volatility of the stock over a time period equal to the expected life and (iii) the expected life is based on historical option exercise trends.

**Table 11.5 — Weighted Average Assumptions Used to Determine the Fair Value of Options**

	Employee Stock Purchase Plan			Employee Plans and Directors' Plan		
	2005	2004	2003	2005	2004	2003
Expected dividend yield <sup>(1)</sup>	2.15%	1.85%	2.01%	—	—	—
Expected life	3 months	3 months	3 months	7.4 years	7.0 years	7.0 years
Expected volatility	19.7%	17.8%	35.0%	30.0%	31.5%	32.0%
Risk-free interest rate	3.20%	1.33%	0.95%	4.23%	3.55%	3.40%

(1) The value of the dividend equivalent feature of options for the Employee Plans and Directors' Plan was incorporated into the Black-Scholes model by using an expected dividend yield of zero percent. To account for a modification of stock options on November 30, 2005, the dividend equivalent feature of affected stock options for the Employee Plans and Directors' Plan was valued separately. Other assumptions used to value the affected stock options were as follows: (i) expected dividend yield of 2.96 percent, (ii) expected life of 5.1 years, (iii) expected volatility of 25.4 percent, and (iv) risk-free interest rate of 4.34 percent.

**Compensation Expense:** Compensation expense related to stock-based compensation plans recorded in Salaries and employee benefits was \$69 million, \$59 million and \$65 million for the years ended December 31, 2005, 2004 and 2003, respectively.

## NOTE 12: DERIVATIVES

We use derivatives to conduct our risk management activities. We principally use the following types of derivatives:

- LIBOR-based interest-rate swaps;
- LIBOR- and Treasury-based options (including swaptions);
- LIBOR- and Treasury-based exchange-traded futures; and
- Foreign-currency swaps.

Our derivative portfolio also includes certain forward purchase and sale commitments and other contractual agreements including (a) credit risk sharing agreements where we remit and receive payments based upon the default performance of certain mortgage loans; (b) swap guarantee derivatives where we guarantee the sponsor's or the borrower's performance as a counterparty on certain interest-rate swaps; and (c) a prepayment management agreement (which was terminated effective December 31, 2005) in which we were partially compensated for the adverse impacts caused by disproportionately higher mortgage prepayments on certain mortgage pools.

### Hedging Activity

Derivative instruments are reported at their fair value, generally netted by counterparty (provided that a legally enforceable master netting agreement exists), as either Derivative assets, at fair value, or Derivative liabilities, at fair value, on the consolidated balance sheets. See "NOTE 17: CONCENTRATION OF CREDIT AND OTHER RISKS" for further information related to our derivative counterparties.

#### No Hedge Designation

At December 31, 2005 and 2004, most of our derivative portfolio was not designated in hedge accounting relationships. We report changes in the fair value of derivatives not in hedge accounting relationships as Derivative gains (losses) on the consolidated statements of income. For derivatives that are not designated in hedge accounting relationships, any associated interest received or paid is recognized on an accrual basis and recorded in Derivative gains (losses) on the consolidated statements of income.

Effective at the beginning of the second quarter of 2004, we determined that substantially all pay-fixed interest-rate swaps and other derivatives that previously had been in cash flow hedge accounting relationships no longer met the hedged item shared risk exposure requirement and hedge effectiveness assessment as required by SFAS 133. Consequently, we discontinued hedge accounting treatment for these relationships for financial reporting purposes at that time, resulting in pay-fixed swaps with a notional balance of approximately \$108 billion being moved from the cash flow hedge designation to no hedge designation. We also voluntarily discontinued hedge accounting treatment for a significant amount of our receive-fixed interest-rate swaps effective November 1, 2004, resulting in receive-fixed interest-rate swaps with a notional balance of approximately \$50 billion being moved from a fair value hedge designation to no hedge designation. Effective at the beginning of the second quarter of 2005, we voluntarily discontinued hedge accounting treatment for all new forward purchase commitments and the majority of our new commitments to forward sell mortgage-related securities.

#### Fair Value Hedges

Fair value hedges represent hedges of exposure to foreign-currency fluctuations and changes in the fair value of a recognized liability. We primarily use interest-rate swaps and foreign-currency swaps to hedge against the changes in fair value of fixed-rate debt due to changes in benchmark interest rates, either LIBOR or the Euro Interbank Offered Rate, or

Euribor, or foreign-currency fluctuations, or a combination of both. During 2005 and 2004, these derivatives in fair value hedge relationships were executed to manage interest-rate risk or foreign-currency risk at an individual debt instrument level. In 2004, these derivatives in fair value hedge relationships were also used to manage interest-rate risk at an aggregate portfolio level. Derivatives executed to manage interest-rate risk at an aggregate portfolio level were linked to specific debt positions for hedge accounting purposes. We frequently reset the amount of fixed-rate debt being hedged in order to maintain highly effective accounting hedges. To accomplish this, the accounting hedges were typically terminated at the time of reset and the derivatives were contemporaneously redesignated in new hedge accounting relationships of fixed-rate debt. Alternatively, when derivatives are executed for specific debt instruments, redesignation is not necessary to maintain highly effective accounting hedges. Derivatives used to manage interest-rate risk at an aggregate portfolio level were moved to no hedge designation effective November 1, 2004 as part of the voluntary discontinuance of hedge accounting treatment, as discussed above.

For a derivative in a fair value hedge relationship, we report changes in the fair value of the derivative as Hedge accounting gains (losses) on the consolidated statements of income along with the offsetting changes in the fair value of the hedged item attributable to the risk being hedged. Any differences arising from fair value changes that are not exactly offset result in hedge ineffectiveness. Hedge accounting gains (losses) will vary from period to period based on the notional amount of derivatives accounted for in hedge accounting relationships and the extent of hedge ineffectiveness.

Table 12.1 summarizes certain gains (losses) recognized related to our hedge accounting categories.

**Table 12.1 — Hedge Accounting Categories Information**

	Year Ended December 31,		
	2005	2004	2003
	(in millions)		
<b>Fair value hedges</b>			
Hedge ineffectiveness recognized in Hedge accounting gains (losses) — pre-tax <sup>(1)</sup>	\$ 22	\$742	\$697
<b>Cash flow hedges</b>			
Hedge ineffectiveness recognized in Hedge accounting gains (losses) — pre-tax <sup>(1)</sup>	—	1	(53)
Net pre-tax gains (losses) resulting from the determination that it was probable that forecasted transactions would not occur	(25)	2	29

(1) No amounts have been excluded from the assessment of effectiveness.

### *Cash Flow Hedges*

Cash flow hedges represent hedges of exposure to the variability in the cash flows of a variable-rate or foreign-currency denominated instrument or relate to a forecasted transaction. We use interest-rate swaps, foreign-currency swaps and forward purchase and sale commitments to hedge the changes in cash flows associated with the forecasted issuances of debt, forecasted purchase or sale of mortgage-related assets, and foreign-currency fluctuations.

For a derivative qualifying as a cash flow hedge, changes in fair value are generally reported in AOCI, net of taxes, on the consolidated balance sheets to the extent the hedge is effective. The remaining ineffective portion of changes in fair value is reported as Hedge accounting gains (losses) on the consolidated statements of income. As shown in Table 12.2 below, the total AOCI, net of taxes, related to cash flow hedge relationships was a loss of \$(6,287) million at December 31, 2005, primarily composed of deferred net losses on closed cash flow hedges. Closed cash flow hedges involve derivatives that have been terminated or are no longer designated as cash flow hedges. Fluctuations in prevailing market interest rates have no impact on the deferred portion of AOCI relating to losses on closed cash flow hedges.

Over the next 12 months, we estimate that approximately \$1,280 million of deferred losses in AOCI, net of taxes, will be reclassified into earnings. The maximum remaining length of time over which we have hedged the exposure related to the variability in future cash flows on forecasted transactions, primarily forecasted debt issuances, is 28 years. However, over 90 percent of the AOCI, net of taxes, balance at December 31, 2005 relating to cash flow hedges is linked to forecasted transactions occurring in the next 10 years. The occurrence of forecasted transactions may be satisfied by either periodic issuances of short-term debt over the required time period or longer-term debt, such as Reference Notes® securities.

Table 12.2 presents the changes in AOCI, net of taxes, related to derivatives designated as cash flow hedges. Net change in fair value related to cash flow hedging activities, net of tax, represents the net change in the fair value of the derivatives that were designated as cash flow hedges, after the effects of our statutory tax rate of 35 percent, to the extent the hedges were effective. Net reclassifications of losses to earnings, net of tax, represent the AOCI amount, after the effects of our statutory tax rate of 35 percent, that was recognized in earnings as the originally hedged forecasted transactions affected earnings unless it was deemed probable that the forecasted transaction would not occur. If it is probable that the forecasted transaction will not occur, then the entire deferred gain or loss associated with the hedge related to the forecasted transaction is reclassified into earnings immediately.

**Table 12.2 — AOCI, Net of Taxes, Related to Cash Flow Hedge Relationships**

	Year Ended December 31,		
	2005	2004	2003
	(in millions)		
Beginning balance <sup>(1)</sup>	\$(7,924)	\$(7,837)	\$(9,877)
Net change in fair value related to cash flow hedging activities, net of tax (benefit) expense of \$27, \$(1,089) and \$(352), respectively <sup>(2)</sup>	50	(2,021)	(653)
Net reclassifications of losses to earnings, net of tax benefit of \$855, \$1,042 and \$1,450, respectively <sup>(2)</sup>	1,587	1,934	2,693
Ending balance <sup>(1)</sup>	<u>\$(6,287)</u>	<u>\$(7,924)</u>	<u>\$(7,837)</u>

(1) Represents the effective portion of the fair value of open derivative contracts (*i.e.*, net unrealized gains and losses) and net deferred gains and losses on closed (*i.e.*, terminated or redesignated) cash flow hedges.

(2) Includes the accrual of periodic cash settlements for derivatives designated in cash flow hedge relationships.

### NOTE 13: LEGAL CONTINGENCIES

We are involved as a party to a variety of legal proceedings arising from time to time in the ordinary course of business including, among other things, contractual disputes, personal injury claims, employment-related litigation and other legal proceedings incidental to our business. We are frequently involved, directly or indirectly, in litigation involving mortgage foreclosures. From time to time, we are also involved in proceedings arising from our termination of a seller/servicer's eligibility to sell mortgages to, and service mortgages for, us. In these cases, the former seller/servicer sometimes seeks damages against us for wrongful termination under a variety of legal theories. In addition, we are sometimes sued in connection with the origination or servicing of mortgages. These suits typically involve claims alleging wrongful actions of seller/servicers. Our contracts with our seller/servicers generally provide for them to indemnify us against liability arising from their wrongful actions.

We are subject to various other legal proceedings, including regulatory investigations and administrative and civil litigation, arising from the restatement of our previously issued consolidated financial statements for the years 2000 and 2001 and the first three quarters of 2002 and the revision of fourth quarter and full-year consolidated financial statements for 2002 (collectively referred to as the "restatement"). We established a reserve in accordance with SFAS 5 of \$75 million in the second quarter of 2003 for this loss contingency. In the first quarter of 2005, we recorded a \$339 million expense related to our litigation reserves for legal settlements including our settlement of the securities class action lawsuits and the shareholder derivative lawsuits discussed below. We continue to believe that an additional loss is probable in connection with the remaining legal proceedings related to the restatement. Litigation and claims resolution are subject to many uncertainties and are not susceptible to accurate prediction. It is not possible for us to reasonably estimate the upper end of the range of any additional losses that might result from the adverse resolution of any of the remaining legal proceedings and such losses could be greater than our current reserves.

**SEC Investigation.** In June 2003, the SEC initiated a formal investigation of us in connection with the restatement. On August 18, 2004, we announced that we had received a "Wells Notice" from the staff of the SEC. The Wells Notice advised us that the SEC staff is considering recommending that the SEC initiate a civil injunctive action against us for possible violations of federal securities laws, including Section 10(b) of the Securities Exchange Act of 1934 and the SEC's Rule 10b-5, as well as Sections 17(a)(1), (2) and (3) of the Securities Act of 1933. The Wells Notice also indicated that the SEC staff may seek a permanent injunction and a civil money penalty in connection with the contemplated action. We continue to cooperate fully with the SEC's investigation as we evaluate our response to the Wells Notice.

**Securities Class Action Lawsuits.** In June 2003, and thereafter, securities class action lawsuits were brought in three separate federal district courts against us and certain former executive officers in connection with the restatement. While most of the cases were voluntarily dismissed by the plaintiffs, the two remaining ones were consolidated in the U.S. District Court for the Southern District of New York. In essence, the plaintiffs in the consolidated action claimed that the defendants improperly managed earnings to create a misleading impression of steady earnings by Freddie Mac. Plaintiffs further alleged that the defendants engaged in a number of improper transactions that violated GAAP and that they made false and misleading statements regarding our financial status. The complaint covered the period from June 15, 1999 through June 6, 2003.

On April 20, 2006, we announced an agreement in principle to settle the securities class action lawsuits, as well as the shareholder derivative actions described below. The settlement of these actions includes a cash payment of \$410 million, including the application of expected net insurance proceeds. The settlement does not include any admission of wrongdoing by the company. The parties have completed and filed with the court the necessary settlement documents and are awaiting preliminary court approval. However, no assurances can be made that the court will approve the settlement or its terms in the form and substance negotiated among the parties.

**Shareholder Derivative Lawsuits.** Two shareholder derivative lawsuits were filed during 2003 against us and certain former and current executives and, in one of the suits, members of our board of directors, alleging breach of fiduciary duty and seeking indemnification in connection with the restatement. Both cases were ultimately assigned to the same judge in New York who is handling the securities class action lawsuits described above. In July 2003, all of the then current Board members were dismissed from the lawsuits in which they were named with the consent of the plaintiff. On January 16, 2004, we moved to dismiss one of the lawsuits brought by the Ester Sadowsky Testamentary Trust because of the plaintiff's failure to make a pre-suit demand. The court dismissed the case without prejudice on July 19, 2004. Subsequently, the Sadowsky plaintiff sent a demand notice to us and on March 4, 2005, filed a new complaint in an action in the same court.

On May 13, 2005, the Sadowsky plaintiff filed an amended complaint that was purportedly brought on our behalf (as a nominal defendant) as a derivative action by a purported shareholder to recover damages we allegedly suffered in connection with certain events underlying the restatement. The defendants in the action included former officers, ten current Directors, ten former Directors, and five counterparties to transactions we executed. The plaintiff alleged claims for breach of fiduciary duties, indemnification, waste of corporate assets, unjust enrichment, and aiding and abetting breach of fiduciary duties.

As described above, we announced on April 20, 2006, an agreement in principle to settle both shareholder derivative actions. The settlement of these cases was based in part on corporate governance reforms we instituted under our current management. The parties have completed and filed with the court the necessary settlement documents and are awaiting preliminary court approval. However, no assurances can be made that the court will approve the settlement or its terms in the form and substance negotiated among the parties.

**ERISA Lawsuits.** Two class action lawsuits were filed in 2003 in the U.S. District Court for the Southern District of Ohio against us, certain individuals, and our Retirement Committee alleging violations of the Employee Retirement Income Security Act, or ERISA. Both actions were consolidated and transferred to the same judge in New York who is handling the securities and derivative lawsuits described above and are still pending.

**Department of Labor Investigation.** In July 2003, the Department of Labor, or DOL, began an investigation of our Thrift/401(k) Savings Plan in relation to the restatement. On December 28, 2005, we and five former members of our Retirement Committee entered into an agreement with the DOL that extended the period for DOL to commence an action until December 28, 2006. The investigation is still pending and we continue to cooperate fully with the DOL.

**OFHEO Proceedings.** In June 2003, OFHEO commenced a special investigation of the company in connection with the restatement. On December 9, 2003, Freddie Mac and OFHEO entered into a consent order and settlement that concluded OFHEO's investigation of the company. Under the terms of the consent order, we agreed to pay a civil money penalty of \$125 million, which was recorded in the second quarter of 2003 (the period in which OFHEO commenced its special investigation), as well as to undertake certain remedial actions relating to governance, corporate culture, internal controls, accounting practices, disclosure and oversight. In agreeing to the consent order, we made no admission regarding any wrongdoing or any asserted or implied findings.

In December 2003, OFHEO filed administrative notices of charges against us and Messrs. Brendsel and Clarke, two of our former executive officers. In its charge against us, OFHEO sought to have us take certain actions in connection with these individuals' salaries and compensation as well as their termination status with the company. On February 18, 2005, OFHEO filed an amended notice of charges against Messrs. Brendsel and Clarke, who opposed the amended notice on several grounds. On April 26, 2005, the Administrative Law Judge presiding over the OFHEO administrative proceeding ruled that the amended notice of charges against Messrs. Brendsel and Clarke did not clearly identify the factual and legal issues, and consequently ordered OFHEO to file a second amended notice of charges clearly setting forth the factual and legal bases for the charges and satisfying several other requirements identified by the judge. On June 24, 2005 OFHEO filed its second amended notice of charges against Messrs. Brendsel and Clarke. The parties are also engaged in the discovery phase of the case.

On September 9, 2005, we entered into a stipulated consent order with OFHEO to settle the administrative notice of charges against us. Under the terms of the consent order, we agreed to produce certain documents and make available any current employees that OFHEO requests to interview in connection with its ongoing administrative actions against Messrs. Brendsel and Clarke, and to take certain additional steps following the administrative actions against the former officers in accordance with any final order resulting in those actions. The text of this consent order and a related production agreement are available on OFHEO's website at [www.ofheo.gov](http://www.ofheo.gov). In agreeing to the consent order, we made no admission regarding any wrongdoing or any asserted or implied findings. Based on the consent order, OFHEO has dismissed the administrative notice of charges against us.



**U.S. Attorney's Investigation.** In June 2003, the U.S. Attorney's Office in Alexandria, Virginia commenced an investigation of us surrounding the restatement. We will continue to cooperate with the U.S. Attorney's Office if and as requested.

**Antitrust Lawsuits.** We and Fannie Mae were named in a consolidated lawsuit alleging that both companies conspired to establish and maintain artificially high guarantee fees. The complaint covers the period January 1, 2001 to the present and asserts a variety of claims under federal and state antitrust laws, as well as claims under consumer-protection and similar state laws. The plaintiffs seek injunctive relief, unspecified damages (including treble damages with respect to the antitrust claims and punitive damages with respect to some of the state claims) and other forms of relief. We filed a motion to dismiss the action and are awaiting a ruling from the court. At present, it is not possible for us to predict the probable outcome of the consolidated lawsuit or any potential impact on our business, financial condition or results of operations.

**Other Inquiries.** We receive inquiries from the Internal Revenue Service, or IRS, in connection with its regular audits of our tax returns for prior years, some of which relate to matters connected with the restatement. We continue to respond to these inquiries. See "NOTE 14: INCOME TAXES" for more information.

**FEC Investigation.** In March 2004, we provided certain information to the Federal Election Commission, or FEC, concerning compliance with federal election laws. The FEC conducted an investigation into this matter and, on April 18, 2006, we announced we had entered into a conciliation agreement with the FEC. Under the terms of the conciliation agreement, we agreed to pay a civil penalty of \$3.8 million and to cease and desist from engaging in activities that violate specified provisions of the Federal Election Campaign Act relating to prohibitions on the use of corporate resources for political fundraising. This amount was recorded in the 2005 consolidated statements of income as a component of Other expense.

#### NOTE 14: INCOME TAXES

We are exempt from state and local income taxes. Table 14.1 presents the components of our provision for income taxes.

**Table 14.1 — Provision for Income Taxes**

	Year Ended December 31,		
	2005	2004	2003
	(in millions)		
Current tax provision	\$1,819	\$1,136	\$1,465
Deferred tax provision	(1,452)	(346)	737
Total provision for income taxes	<u>\$ 367</u>	<u>\$ 790</u>	<u>\$2,202</u>

Table 14.2 summarizes our deferred tax assets and liabilities.

**Table 14.2 — Deferred Tax Assets and (Liabilities)**

	December 31,	
	2005	2004
	(in millions)	
Deferred tax assets:		
Deferred fees related to securitizations	\$ 1,779	\$ 1,612
Credit related items and reserve for loan losses	61	5
Employee compensation and benefit plans	168	166
Cash flow hedge deferrals and unrealized (gains) losses related to available-for-sale securities	4,724	1,930
Other items, net	39	—
Total deferred tax assets	<u>6,771</u>	<u>3,713</u>
Deferred tax liabilities:		
Premium and discount amortization	(1,679)	(1,961)
Basis differences related to assets held-for-investment	(307)	(502)
Basis differences related to derivative instruments	(1,779)	(2,478)
Other items, net	—	(43)
Total deferred tax liabilities	<u>(3,765)</u>	<u>(4,984)</u>
Net deferred tax assets and (liabilities)	<u>\$ 3,006</u>	<u>\$ (1,271)</u>

Included in deferred taxes is the tax effect on the (a) net unrealized (gains) losses on available-for-sale securities and (b) net (gains) losses related to derivatives designated in cash flow hedge relationships, which are both reported in AOCI, net of taxes and (c) cumulative effect of change in accounting principles.

We have not established a valuation allowance against our deferred tax assets at December 31, 2005 or 2004, because we have determined that it is more likely than not that all such tax assets will be realized in the future.



Table 14.3 reconciles the statutory federal tax rate to the effective tax rate for 2005, 2004 and 2003.

**Table 14.3 — Reconciliation of Statutory to Effective Tax Rate**

	Year Ended December 31,		
	2005	2004	2003
Statutory corporate rate .....	35.0%	35.0%	35.0%
Tax-exempt interest .....	(8.7)	(4.7)	(2.1)
Tax credits .....	(14.3)	(7.3)	(3.0)
Provision related to tax contingencies .....	1.9	(2.0)	0.4
Penalties .....	0.1	—	1.0
Other .....	0.4	0.2	0.1
Effective rate .....	<u>14.4%</u>	<u>21.2%</u>	<u>31.4%</u>

**Impact of tax issues.** The IRS has a policy to examine the income tax returns of large corporate taxpayers, including us, generally every year. We believe that an adequate provision has been made for contingencies related to all income taxes and related interest and potential penalties in accordance with SFAS 5. However, the ultimate outcome of these tax contingencies could result in a tax benefit or tax provision that could be material to our quarterly or annual results of operations. We do not believe that liabilities arising from these matters, if any, will have a material adverse effect on our consolidated financial condition.

**Tax Years 1985 through 1990.** We are currently in litigation in the U.S. Tax Court, or Court, to contest income tax deficiencies asserted by the IRS for years 1985 through 1990. The principal matters in controversy in the case involve questions of tax law as applied to our transition from non-taxable to taxable status in 1985 and primarily involve the amortization of certain intangible assets, the two most significant of which are:

- *Favorable Financing.* A number of financing arrangements where the contract rates of interest were less than the market rates of interest as of January 1, 1985 due to an increase in interest rates since the date on which we had entered into the respective arrangements; and
- *Customer Relationships.* Our business relationships with a substantial number of mortgage originating institutions that sold mortgages to us on a regular basis.

**Tax Court Rulings.** On September 4, 2003 and September 29, 2003, the Court decided favorably for us on two preliminary motions involving questions of law in the case. On September 4, the Court ruled favorably for us on the question whether our intangibles are amortizable using, as the adjusted basis, the higher of (a) the regular adjusted cost basis or (b) the fair market value on January 1, 1985. On September 29, the Court ruled favorably for us on the question whether, as a matter of law, “favorable financing” (as defined above) was amortizable for tax purposes. As part of this case, we claimed, and the court agreed, that the economic benefit of this below-market financing as of January 1, 1985 is an intangible asset subject to amortization. In October 2003, the Court ruled unfavorably on two other less significant issues in the case. In November 2005, the Court ruled favorably on another less significant issue in the case.

While significant, the Court’s rulings do not dispose of all of the matters in controversy in the case, which, upon final resolution by the Court of all such matters, are subject to appeal by the parties. In addition, we still had to demonstrate that the intangible assets in question have an ascertainable value and have a limited useful life, the duration of which can be ascertained with reasonable accuracy. A trial on the value and useful life of Favorable Financing was completed in early June 2005. We are awaiting the Court’s decision.

In view of the favorable rulings in September 2003 described above, we recorded in 2002 a reduction in our tax reserves in the amount of \$155 million. If the IRS were to appeal the Court decisions and an adverse ruling resulted, we may reconsider our reserves related to this matter.

If our tax position on the customer relationship amortization issue described above is upheld through the legal process, we will be able to recognize tax benefits not previously recorded that could be material in the quarter during which they are recognized. However, we are unable to provide assurances that any such tax benefits will be realized.

**Tax Years 1991 through 1993.** The IRS examination of our federal income tax returns for the years 1991 through 1993 has been completed. In 2002, we filed a petition in the Court to contest the deficiencies asserted by the IRS in a Statutory Notice of deficiency. The principal matters in controversy in this case are the same questions at issue in the 1985 through 1990 case as applied to years 1991 to 1993, plus an additional question of tax law regarding the timing of taxation of our Management and guarantee income.

**Tax Years 1994 through 1997.** In 2002, the IRS completed its examination of our federal income tax returns for the years 1994 through 1997. In October 2005 we filed a Petition in the Court to contest tax deficiencies asserted by the IRS for these years. The principal matter in controversy, other than the same questions at issue in the 1985 through 1993 cases described above, involves the character of losses on dispositions of mortgage-related securities.

*Tax Treatment of REITs.* In February 1997, we formed two REIT subsidiaries that issued a total of \$4.0 billion in step-down preferred stock to investors. Under the IRS regulations in effect when the REITs were formed, we believed that the dividend payments by the REITs to holders of the REITs' step-down preferred stock were fully tax deductible. We entered into a closing agreement with the IRS that resolved issues related to the tax treatment of dividends paid on the step-down preferred stock. We and the IRS agreed that we will only be entitled to deductions attributable to the step-down preferred stock transactions as if we had borrowed directly from the REITs' preferred shareholders. As a result of this closing agreement, we recorded a reduction in tax reserves of \$94 million in 2004. See "NOTE 18: MINORITY INTERESTS" for more information concerning the REITs.

**Tax Years 1998 through 2002.** This examination cycle includes the years for which we have restated our financial statements. The IRS has completed its regular examination of our 1998 through 2002 tax returns, but could raise additional issues. As a result of the regular examination, the principal matter in controversy, other than the same questions at issue in the 1985 through 1997 cases described above, involves questions of timing and potential penalties regarding our tax accounting method for certain hedging transactions. We believe the risk of loss due to the assertion of penalties by the IRS related to our tax accounting methods is remote. As to the questions of timing, we believe that an adequate provision has been made for contingencies related to income taxes and related interest.

*Tax Treatment of Paired Swap Transactions.* In August and September of 2001, we entered into a series of nine sets of paired swap transactions. We reported and paid tax treating each pair of those swap transactions as a single integrated transaction for federal income tax purposes. Two additional swaps were executed in November 2001. Although the facts and circumstances surrounding these swaps were different from the earlier swaps, we also reported and paid tax treating these swaps as a single integrated transaction for federal income tax purposes. The IRS examination report did not assert a tax deficiency related to any of these paired swap transactions.

## **NOTE 15: EMPLOYEE BENEFITS**

### **Defined Benefit Plans**

We maintain a tax-qualified defined benefit pension plan, or Pension Plan, covering substantially all of our employees. Pension Plan benefits are based on an employee's years of service and highest average compensation, up to legal plan limits, over any consecutive 36 months of employment. Pension Plan assets are held in trust and the investments consist primarily of funds comprised of listed stocks and corporate bonds. In addition to our Pension Plan, we maintain a nonqualified, unfunded defined benefit pension plan for our officers, referred to as our non-qualified pension plan. The related retirement benefits for our nonqualified pension plan are paid from our general assets. These nonqualified and qualified defined benefit pension plans are collectively referred to as defined benefit pension plans.

We maintain a defined benefit postretirement health care plan, or Retiree Health Plan, that generally provides postretirement health care benefits on a contributory basis to retired employees age 55 or older who rendered at least 10 years of service (five years of service if retiree is eligible to retire prior to March 1, 2007) and who, upon separation or termination, immediately elected to commence benefits under the Pension Plan in the form of an annuity. Our Retiree Health Plan is currently unfunded and the benefits are paid from our general assets. This plan and our defined benefit pension plans are collectively referred to as defined benefit plans.

For financial reporting purposes, we use a September 30 valuation measurement date for all of our defined benefit plans. We are required to accrue the estimated cost of retiree benefits as employees render the services necessary to earn their pension and postretirement health benefits. Our pension and postretirement health care costs related to these defined benefit plans for 2005, 2004 and 2003 presented in the following tables were calculated using assumptions as of September 30, 2004, 2003 and 2002, respectively. The funded status of our defined benefit plans for 2005, 2004 and 2003 presented in the following tables was calculated using assumptions as of September 30, 2005, 2004 and 2003, respectively.

Table 15.1 below shows the changes in our projected benefit obligations and fair value of plan assets using a September 30 valuation measurement date for amounts recognized on our consolidated balance sheets at December 31, 2005 and 2004, respectively.

**Table 15.1 — Defined Benefit Plan Obligation and Funded Status**

	Pension Benefits		Postretirement Health Benefits	
	2005	2004	2005	2004
	(in millions)			
<b>Change in Projected Benefit Obligation:</b>				
Projected benefit obligation at October 1 (prior year) .....	\$ 385	\$ 339	\$ 102	\$ 102
Service cost .....	27	24	9	10
Interest cost .....	22	20	6	6
Net actuarial loss (gain) .....	28	6	(6)	(15)
Benefits paid .....	(5)	(4)	(1)	(1)
Projected benefit obligation at September 30 .....	<u>457</u>	<u>385</u>	<u>110</u>	<u>102</u>
<b>Change in Fair Value of Plan Assets:</b>				
Fair value of plan assets at October 1 (prior year) .....	260	229		
Actual return on plan assets .....	29	22		
Employer contributions .....	49	13		
Benefits paid .....	(5)	(4)		
Fair value of plan assets at September 30 .....	<u>333</u>	<u>260</u>		
<b>Funded Status:</b>				
Funded status at September 30 .....	(124)	(125)	(110)	(102)
Unrecognized net actuarial loss .....	125	112	31	40
Unrecognized prior service cost .....	1	1	(5)	(6)
Initial unrecognized net transition asset .....	—	1	—	—
Net amount recognized .....	<u>\$ 2</u>	<u>\$ (11)</u>	<u>\$ (84)</u>	<u>\$ (68)</u>
<b>Amounts Recognized on our Consolidated Balance Sheets:</b>				
Other assets:				
Prepaid benefit cost .....	\$ 28	\$ —	\$ —	\$ —
Intangible and other assets .....	1	6	—	—
Other liabilities:				
Accrued benefit liability .....	(28)	(25)	(84)	(68)
<b>AOCI:</b>				
Minimum pension liability .....	1	8	—	—
Net amount recognized .....	<u>\$ 2</u>	<u>\$ (11)</u>	<u>\$ (84)</u>	<u>\$ (68)</u>

The change in the minimum pension liability recognized in AOCI, net of taxes, was a \$7 million decrease for the year ended December 31, 2005, and a \$2 million decrease for the year ended December 31, 2004. The accumulated benefit obligation for all defined benefit pension plans was \$316 million and \$282 million at September 30, 2005 and 2004, respectively. The accumulated benefit obligation represents the actuarial present value of future expected benefits, assuming current salary levels remain in effect.

Table 15.2 provides additional information for our defined benefit pension plans. The aggregate accumulated benefit obligation and fair value of plan assets are disclosed as of September 30, 2005, with the projected benefit obligation included for illustrative purposes.

**Table 15.2 — Additional Information for Defined Benefit Pension Plans**

	2005			2004		
	Pension Plan	Non-qualified Pension Plans	Total	Pension Plan	Non-qualified Pension Plans	Total
	(in millions)					
Projected benefit obligation .....	\$416	\$ 41	\$457	\$356	\$ 29	\$385
Fair value of plan assets .....	\$333	\$ —	\$333	\$260	\$ —	\$260
Accumulated benefit obligation .....	288	28	316	262	20	282
Fair value of plan assets over (under) accumulated benefit obligation ...	<u>\$ 45</u>	<u>\$(28)</u>	<u>\$ 17</u>	<u>\$ (2)</u>	<u>\$(20)</u>	<u>\$(22)</u>

The measurement of our benefit obligations includes assumptions about the rate of future compensation increases included in Table 15.3 below.

**Table 15.3 — Weighted Average Assumptions Used to Determine Projected and Accumulated Benefit Obligations**

	Pension Benefits		Postretirement Health Benefits	
	September 30,		September 30,	
	2005	2004	2005	2004
Discount rate.....	5.75%	5.75%	5.75%	5.75%
Rate of future compensation increase <sup>(1)</sup> .....	5.10% to 6.50%	4.50	—	—

(1) For the 2005 plan year for our defined benefit pension plans, we refined our assumptions used to determine our benefit obligations to include the dispersion of compensation from a flat rate to an age-graded rate.

Table 15.4 presents the components of the net periodic benefit costs with respect to pensions and postretirement health benefits for the years ended December 31, 2005, 2004 and 2003. Net periodic benefit costs are included in Salaries and employee benefits on our consolidated statements of income.

**Table 15.4 — Net Periodic Benefit Cost Detail**

	Pension Benefits			Postretirement Health Benefits		
	Year Ended December 31,			Year Ended December 31,		
	2005	2004	2003	2005	2004	2003
	(in millions)					
Service cost of current period .....	\$ 27	\$ 24	\$ 16	\$ 9	\$10	\$ 6
Interest cost on projected benefit obligation .....	22	20	16	6	6	3
Expected return on plan assets .....	(18)	(16)	(12)	—	—	—
Recognized net actuarial loss .....	5	7	3	3	5	2
Recognized prior service cost .....	1	—	—	(1)	(1)	(1)
Net periodic benefit costs .....	<u>\$ 37</u>	<u>\$ 35</u>	<u>\$ 23</u>	<u>\$17</u>	<u>\$20</u>	<u>\$10</u>

**Table 15.5 — Weighted Average Assumptions Used to Determine Net Periodic Benefit Cost**

	Pension Benefits			Postretirement Health Benefits		
	Year Ended December 31,			Year Ended December 31,		
	2005	2004	2003	2005	2004	2003
Discount rate .....	5.75%	6.00%	7.00%	5.75%	6.00%	7.00%
Rate of future compensation increase .....	4.50	4.50	4.50	—	—	—
Expected long-term rate of return on plan assets .....	7.00	7.00	7.25	—	—	—

For the 2005 benefit obligations, we determined the discount rate using a yield curve consisting of spot interest rates at half-year increments for each of the next 30 years, developed with pricing and yield information from high-quality bonds. The future benefit plan cash flows were then matched to the appropriate spot rates and discounted back to the measurement date. Finally, a single equivalent discount rate was calculated that, when applied to the same cash flows, results in the same present value of the cash flows as of the measurement date. In 2004 and 2003, we used the Moody's Aa Corporate Bond Rate Index as a basis for selecting the discount rate shown in Table 15.5. The effect of the change in our estimate of the discount rate was not material.

The expected long-term rate of return on plan assets was estimated using a portfolio return calculator model. The model considered the historical returns and the future expectations for returns for each asset class in our defined benefit plans in conjunction with our target investment allocation to arrive at the expected rate of return.

The assumed health care cost trend rates used in measuring the accumulated postretirement benefit obligation as of September 30, 2005 are 11 percent in 2006, gradually declining to an ultimate rate of 5 percent in 2011 and remaining at that level thereafter.

Table 15.6 sets forth the effect on the accumulated postretirement benefit obligation for health care benefits as of September 30, 2005, and the sum of the service cost and interest cost components of the net periodic postretirement health benefit costs that would result from a one percent increase or decrease in the assumed health care cost trend rate.

**Table 15.6 — Selected Data Regarding our Retiree Health Plan**

	One Percent Increase	One Percent Decrease
	(in millions)	
Effect on the accumulated postretirement benefit obligation for health care benefits .....	\$25	\$(19)
Effect on the service and interest cost components of the net periodic postretirement health benefit costs .....	4	(3)

## Plan Assets

Table 15.7 sets forth our Pension Plan weighted average asset allocations, based on fair value, at September 30, 2005 and 2004, and target allocation by asset category.

**Table 15.7 — Pension Plan Assets by Category**

Asset Category	Target Allocation	Plan Assets at September 30,	
		2005	2004
Equity securities .....	65%	55.9%	61.2%
Debt securities .....	35	29.4	34.0
Other <sup>(1)</sup> .....	—	14.7	4.8
Total .....	<u>100%</u>	<u>100.0%</u>	<u>100.0%</u>

(1) Consists of cash contributions made on September 30, 2005 and 2004, respectively, which were not fully invested by September 30th of that year.

The Pension Plan's retirement committee had fiduciary responsibility for establishing and overseeing our Pension Plan's investment policies and objectives. The Pension Plan's retirement committee reviewed the appropriateness of our Pension Plan's investment strategy on an ongoing basis. Our Pension Plan employed a total return investment approach whereby a diversified blend of equities and fixed income investments is used to maximize the long-term return of plan assets for a prudent level of risk. Risk tolerance is established through careful consideration of plan characteristics, such as business and financial characteristics, demographics, and actuarial and company funding policies. Furthermore, equity investments are diversified across U.S. and non-U.S. listed companies with small and large capitalizations. Derivatives may be used to gain market exposure in an efficient and timely manner; however, derivatives may not be used to leverage the portfolio beyond the market value of the underlying investments. Investment risk is measured and monitored on an ongoing basis through quarterly investment portfolio reviews, annual liability measurements and periodic asset/liability studies.

The Pension Plan assets did not include any direct ownership of our securities at September 30, 2005 and 2004.

## Defined Benefit Pension Plan Contributions

Our general practice is to contribute to our Pension Plan an amount equal to at least the minimum required contribution, if any, but no more than the maximum amount deductible for federal income tax purposes each year. On September 30, 2005, we made a tax-deductible contribution of \$48 million to our Pension Plan. We currently believe that under applicable law, no minimum contribution will be required for 2006. However, in 2006, we expect to contribute approximately \$20 million to our Pension Plan and an additional amount yet to be determined. Any contributions to our Retiree Health Plan and non-qualified pension plan will be in the form of benefit payments as these plans are required to be unfunded.

## Estimated Future Benefit Payments

Table 15.8 sets forth estimated future benefit payments expected to be paid for our defined benefit plans. The expected benefits are based on the same assumptions used to measure our benefit obligation at September 30, 2005.

**Table 15.8 — Estimated Future Benefit Payments**

	Pension Benefits	Postretirement Health Benefits
	(in millions)	
2006 .....	\$ 5	\$ 1
2007 .....	6	2
2008 .....	6	2
2009 .....	8	2
2010 .....	9	3
Years 2011-2015 .....	84	22

## Defined Contribution Plans

Our Thrift/401(k) Savings Plan, or Savings Plan, is a tax-qualified defined contribution pension plan offered to all eligible employees. Employees are permitted to contribute from 1 percent to 25 percent of their eligible compensation to the Savings Plan, subject to limits set by the Internal Revenue Code. We match employees' contributions up to 6 percent of their eligible compensation per pay period; the percentage matched depends upon the employee's length of service. Employee contributions and our matching contributions are immediately vested. In addition, we have discretionary authority to make additional contributions to our Savings Plan that are allocated uniformly on behalf of each eligible employee, based on the employee's eligible compensation. Employees become vested in our discretionary contributions after 5 years of service. We also maintain a non-qualified defined contribution plan for our officers, designed to make up for benefits lost due to limitations on eligible compensation imposed by the Internal Revenue Code and to make up for deferrals of eligible compensation under our Executive Deferred Compensation Plan. We incurred costs of \$31 million, \$29 million and



\$28 million for the years ended December 31, 2005, 2004 and 2003, respectively, related to these plans. These expenses were included in Salaries and employee benefits on our consolidated statements of income.

See “NOTE 13: LEGAL CONTINGENCIES” for more information regarding civil litigation and a Department of Labor investigation of our Savings Plan in relation to our restatement.

#### **Executive Deferred Compensation Plan**

Our Executive Deferred Compensation Plan is an unfunded, non-qualified plan that allows certain key employees to elect to defer substantially all or a portion of their annual salary and cash bonus, and certain key management employees to defer the settlement of restricted stock units received from us, as well as substantially all or a portion of their annual salary and cash bonus, for any number of years specified by the employee, but under no circumstances may the period elected exceed his or her life expectancy. During 2005, we amended the plan to modify certain provisions to comply with Internal Revenue Code Section 409A as a result of the issuance of proposed regulations and other guidance. Distributions are paid from our general assets. We record a liability equal to the accumulated deferred salary, cash bonus and accrued interest as set forth in the plan, net of any related distributions made to plan participants. We recognize expense equal to the interest accrued on deferred salary and bonus throughout the year. Expense associated with unvested deferred restricted stock units is recognized as part of stock-based compensation.

#### **NOTE 16: FAIR VALUE DISCLOSURES**

The supplemental consolidated fair value balance sheets in Table 16.1 present our estimates of the fair value of our recorded financial assets and liabilities and off-balance sheet financial instruments at December 31, 2005 and 2004. Our consolidated fair value balance sheets include the estimated fair values of financial instruments recorded in our consolidated balance sheets prepared in accordance with GAAP, as well as off-balance sheet financial instruments that represent our assets or liabilities that are not recorded in our GAAP consolidated balance sheets. These off-balance sheet items predominantly consist of: (a) the unrecognized Guarantee asset and Guarantee obligation associated with our PCs issued through our Guarantor Swap program prior to the implementation of FIN 45, (b) commitments to purchase multifamily and single-family mortgage loans that will be classified as held-for-investment in our GAAP consolidated financial statements and (c) certain credit enhancements on manufactured housing asset-backed securities. The valuations of financial instruments on our consolidated fair value balance sheets are in accordance with GAAP fair value guidelines prescribed by SFAS No. 107, “Disclosures about Fair Value of Financial Instruments,” or SFAS 107, and other relevant pronouncements.

**Table 16.1 — Consolidated Fair Value Balance Sheets<sup>(1)</sup>**

	December 31,			
	2005		2004	
	Carrying Amount <sup>(2)</sup>	Fair Value	Carrying Amount <sup>(2)</sup>	Fair Value
	(in billions)			
<b>Assets</b>				
Mortgage loans	\$ 61.4	\$ 62.3	\$ 61.3	\$ 63.3
Mortgage-related securities <sup>(3)</sup>	648.0	648.0	603.2	603.4
Retained portfolio	709.4	710.3	664.5	666.7
Cash and cash equivalents	10.5	10.5	35.3	35.3
Investments	42.2	42.2	29.8	29.8
Securities purchased under agreements to resell and Federal funds sold	15.2	15.2	32.2	32.2
Derivative assets	7.1	7.1	15.3	15.3
Guarantee asset <sup>(4)</sup>	5.1	5.6	4.5	5.0
Other assets <sup>(5)</sup>	16.7	14.3	13.7	13.3
Total assets	<u>\$806.2</u>	<u>\$805.2</u>	<u>\$795.3</u>	<u>\$797.6</u>
<b>Liabilities and minority interests</b>				
Total debt securities, net	\$748.8	\$747.0	\$731.7	\$737.0
Guarantee obligation	5.5	3.7	4.1	2.1
Derivative liabilities	0.6	0.6	0.2	0.2
Reserve for guarantee losses on Participation Certificates	0.3	—	0.2	—
Other liabilities <sup>(5)</sup>	22.9	22.0	26.2	25.7
Minority interests in consolidated subsidiaries	0.9	1.0	1.5	1.7
Total liabilities and minority interests	<u>779.0</u>	<u>774.3</u>	<u>763.9</u>	<u>766.7</u>
<b>Net assets attributable to stockholders</b>				
Preferred stockholders	4.6	4.1	4.6	4.1
Common stockholders	22.6	26.8	26.8	26.8
Total net assets	<u>27.2</u>	<u>30.9</u>	<u>31.4</u>	<u>30.9</u>
Total liabilities and net assets	<u>\$806.2</u>	<u>\$805.2</u>	<u>\$795.3</u>	<u>\$797.6</u>

(1) The consolidated fair value balance sheets do not purport to present our net realizable, liquidation or market value as a whole. Furthermore, amounts we ultimately realize from the disposition of assets or settlement of liabilities may vary significantly from the fair values presented.

(2) Carrying amounts equal the amounts reported on our consolidated balance sheets prepared in accordance with GAAP.

(3) The fair value of Mortgage-related securities reported exceeds the carrying value because the fair value includes PC residuals related to some PCs held in the Retained portfolio that are not recognized in accordance with GAAP because such PCs were issued prior to the implementation of FIN 45 in 2003. The difference at December 31, 2005, rounds to zero.

(4) The fair value of the Guarantee asset reported exceeds the carrying value primarily because the fair value includes the Guarantee asset related to some PCs held by third parties that are not recognized in accordance with GAAP because such PCs were issued prior to the implementation of FIN 45 in 2003.

(5) Fair values include estimated income taxes calculated using the 35 percent statutory rate on the difference between the consolidated fair value balance sheets net assets, including deferred taxes from the GAAP consolidated balance sheets, and the GAAP consolidated balance sheet equity attributable to common stockholders.

## Limitations

Our consolidated fair value balance sheets do not capture all elements of value that are implicit in our operations as a going concern since our consolidated fair value balance sheets only capture the values of the current investment and securitization portfolios. For example, our consolidated fair value balance sheets do not capture the value of new investment and securitization business that would likely replace prepayments as they occur. In addition, our consolidated fair value balance sheets do not capture the value associated with future growth opportunities in our investment and securitization portfolios. Thus, the fair value of net assets attributable to stockholders presented in our consolidated fair value balance sheets does not represent an estimate of our net realizable, liquidation or market value as a whole.

We report certain assets and liabilities that are not financial instruments (such as property, plant and equipment and deferred taxes), as well as certain financial instruments that are not covered by the SFAS 107 disclosure requirements (such as pension liabilities) at their carrying amounts in accordance with GAAP in our consolidated fair value balance sheets. We believe these items do not have a significant impact on our overall fair value results. Other non-financial assets and liabilities in our GAAP consolidated balance sheets represent deferrals of costs and revenues that are amortized in accordance with GAAP, such as deferred debt issuance costs and deferred credit fees. Cash receipts and payments related to these items are generally recognized in the fair value of net assets when received or paid, with no basis reflected in the fair value balance sheets.

## Valuation Methods and Assumptions

Fair value is generally based on independent price quotations obtained from third-party pricing services, dealer marks or direct market observations, where available. However, certain financial instruments are less actively traded and, therefore, are not always able to be valued based on prices obtained from third parties. If quoted prices or market data are not

available, fair value is based on internal valuation models using market data inputs or internally developed assumptions, where appropriate.

During 2005 and 2004, our fair value results were impacted by several improvements in our approach for estimating fair values of certain financial instruments. In the first quarter of 2005, we improved our approach for estimating the fair values of certain financial instruments resulting in (a) a decrease in the fair value of Total net assets of approximately \$0.8 billion (after-tax) related to our guarantee-related assets and liabilities and (b) an increase in the fair value of Total net assets of approximately \$0.3 billion (after-tax) related to our multifamily whole loans, the minority interests in our consolidated REIT subsidiaries and other financial instruments. Also, in the second quarter of 2005, we improved our approach for estimating the fair values of certain securities we hold, which increased the fair value of Total net assets by approximately \$0.1 billion. The changes in our approach for estimating the fair values of these financial instruments are described below. In the fourth quarter of 2004, we began using newly available market prices received from broker/dealers and third-party pricing providers for the valuation of a greater portion of our debt instruments resulting in an increase in the fair value of Total net assets of approximately \$0.6 billion (after-tax).

The following methods and assumptions were used to estimate the fair value of assets and liabilities at December 31, 2005 and 2004.

#### *Mortgage loans*

Mortgage loans represent single-family and multifamily whole loans held in our Retained portfolio. For GAAP purposes, we must determine the fair value of these mortgage loans to calculate lower-of-cost-or-market adjustments for mortgages classified as held-for-sale. We use this same approach when determining the fair value of whole loans, including those held-for-investment, for fair value balance sheet purposes.

We determine the fair value of mortgage loans, excluding delinquent single-family loans purchased out of pools, based on comparisons to actively traded mortgage-related securities with similar characteristics, with adjustments for yield, credit and liquidity differences. Specifically, we aggregate mortgage loans into pools by product type, coupon and maturity and then convert the pools into notional mortgage-related securities based on their specific characteristics. We then calculate fair values for these notional mortgage-related securities using the process that is described in “*Mortgage-related securities*.”

Part of the adjustments for yield, credit and liquidity differences represent an implied guarantee fee. To accomplish this, the fair value of the single-family whole loans, excluding delinquent single-family loans purchased out of pools, includes an adjustment representing the estimated present value of the additional cash flows on the mortgage coupon in excess of the coupon expected on the notional mortgage-related securities. For multifamily whole loans, the fair value adjustment is estimated by calculating the net present value of guarantee fees we expect to retain. This retained guarantee fee is estimated by subtracting the expected cost of funding and securitizing a multifamily whole loan of a comparable maturity and credit rating from the coupon on the whole loan at the time of purchase.

The implied guarantee fee for both single-family and multifamily whole loans is also net of the related credit and other components inherent in our Guarantee obligation. For single-family whole loans, the process for estimating the related credit and other Guarantee obligation components is described in the “*Guarantee obligation*” section. For multifamily whole loans, the process for estimating the related credit and other Guarantee obligation components employs a market-based approach to estimate the potential credit obligation. This obligation is estimated by extracting the credit risk premium that multifamily whole loan investors require from market prices on similar securities. This credit risk premium is net of expected funding, liquidity and other risk premiums that are embedded in the market price of the reference securities.

Beginning in 2005, we refined the fair value estimates of multifamily whole loans by incorporating additional information and guidance from active market participants into the pricing of notional mortgage-related securities. In addition, beginning in 2005, for single-family whole loans that are extremely delinquent and have been purchased out of pools, we obtained dealer indications on aggregated groups of similar loans that reflect their current performance status. These market price indications reflect the estimated present value of all cash flows related to the whole loans, including expected credit losses and recoveries.

#### *Mortgage-related securities*

Mortgage-related securities represent passthroughs and other mortgage-related securities classified as available-for-sale and trading, which are already reflected at fair value on our GAAP consolidated balance sheets. Mortgage-related securities consist of securities issued by us, Fannie Mae and Ginnie Mae as well as non-agency mortgage-related securities.

The fair value of securities with readily available third-party market prices is generally based on market prices obtained from broker/dealers or reliable third-party pricing service providers. Fair value may be estimated by using third-party quotes for similar instruments, adjusted for differences in contractual terms. For other securities, a market option-adjusted spread approach based on observable market parameters is used to estimate fair value. Option-adjusted spreads for certain securities

are estimated by deriving the option-adjusted spread for the most closely comparable security with an available market price, using proprietary interest-rate and prepayment models. If necessary, our judgment is applied to estimate the impact of differences in prepayment uncertainty or other unique cash flow characteristics related to that particular security. Fair values for these securities are then estimated by using the estimated option-adjusted spread as an input to the interest-rate and prepayment models, and estimating the net present value of the projected cash flows. The remaining instruments are priced using other modeling techniques or by using other securities as proxies.

Mortgage-related securities also include PC residuals related to PCs held by us and reported in the mortgage-related securities line item. PC residuals are reported at fair value on our consolidated balance sheets. Fair value for PC residuals is estimated in the same manner as described for the Guarantee asset and the Guarantee obligation for PCs below.

#### *Cash and cash equivalents*

Cash and cash equivalents largely consist of highly liquid investment securities with an original maturity of three months or less used for cash management purposes, as well as cash collateral posted by our derivative counterparties. Given that these assets are short-term in nature with limited market value volatility, the carrying amount on our GAAP consolidated balance sheets is deemed to be a reasonable approximation of fair value.

#### *Investments*

At December 31, 2005 and 2004, Investments consists solely of non-mortgage-related securities, which are reported at fair value on our consolidated balance sheets. During 2004, Investments also included non-mortgage-related securities and mortgage-related securities held in connection with PC market making and support activities, which were reported at fair value on our consolidated balance sheets. We ceased our PC market making and support activities accomplished through our Securities Sales & Trading Group business unit and external Money Manager program during the fourth quarter of 2004. The fair values of those Investments were estimated using the methods described above in “*Mortgage-related securities*.”

#### *Securities purchased under agreements to resell and Federal funds sold*

Securities purchased under agreements to resell and Federal funds sold principally consists of short-term contractual agreements such as reverse repurchase agreements involving Treasury and agency securities, Federal funds sold and Eurodollar time deposits. Given that these assets are short-term in nature, the carrying amount on our GAAP consolidated balance sheets is deemed to be a reasonable approximation of fair value.

#### *Guarantee asset*

At December 31, 2005 and 2004, we had a Guarantee asset on our GAAP consolidated balance sheets for approximately 93 percent and 89 percent, respectively, of PCs and Structured Securities held by third parties. For more information regarding the accounting for the Guarantee asset related to PCs and Structured Securities, see “NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES.”

For fair value balance sheet purposes, the Guarantee asset is reflected for all PCs and Structured Securities held by third parties and is valued using the same method as used for GAAP fair value purposes. For a description of how we determine the fair value of our Guarantee asset, see “NOTE 2: TRANSFERS OF SECURITIZED INTERESTS IN MORTGAGE-RELATED ASSETS.”

#### *Derivative assets*

Derivative assets, at fair value largely consists of interest-rate swaps, option-based derivatives, futures, and forward purchase and sale commitments that we account for as derivatives, which are reflected at fair value on our GAAP consolidated balance sheets. The fair values of interest-rate swaps are determined by using the appropriate yield curves to calculate and discount the expected cash flows for both the fixed-rate and variable-rate components of the swap contracts. Option-based derivatives, which principally include call and put swaptions, are valued using an option-pricing model. This model uses market interest rates and market-implied option volatilities, where available, to calculate the option’s fair value. Market-implied option volatilities are based on information obtained from broker/dealers. The fair value of exchange-traded futures is based on end-of-day closing prices obtained from third-party pricing services. Derivative forward purchase and sale commitments are valued using the methods described for mortgage-related securities valuation above.

The fair value of derivative assets considers the impact of institutional credit risk in the event that the counterparty does not honor its payment obligation. Our fair value of derivatives is not adjusted for expected credit losses because we obtain collateral from most counterparties typically within one business day of the daily market value calculation and substantially all of our credit risk arises from counterparties with investment-grade credit ratings of A— or above.

### *Other assets*

Other assets consists of accrued interest and other receivables, investments in qualified LIHTC partnerships that are eligible for federal tax credits, credit enhancement contracts related to PCs and Structured Securities (pool insurance and recourse and/or indemnification agreements), financial guarantee contracts for additional credit enhancements on certain manufactured housing asset-backed securities, REO, property, plant and equipment, and other miscellaneous assets.

The receivables are financial instruments and are required to be measured at fair value for disclosure purposes pursuant to SFAS 107. Because these receivables are short-term in nature, we believe the carrying amount on our GAAP consolidated balance sheets is a reasonable approximation of their fair values. Our investments in LIHTC partnerships, reported as consolidated entities or equity method investments in the GAAP financial statements, are not within the scope of SFAS 107 disclosure requirements. However, we present the fair value of these investments in Other assets. For the LIHTC partnerships, the fair value of expected tax benefits is estimated using expected cash flows discounted at a market-based yield.

For the credit enhancement contracts related to PCs and Structured Securities (pool insurance and recourse and/or indemnification agreements), fair value is estimated using an expected cash flow approach, and is intended to reflect the estimated amount that a third party would be willing to pay for the contracts. On our consolidated fair value balance sheets, these contracts are reported at fair value at each balance sheet date based on current market conditions; on our GAAP consolidated balance sheets, these contracts are initially recorded at fair value at inception, then amortized to expense.

For the credit enhancements on manufactured housing asset-backed securities, the fair value is based on the difference between the market price of non-credit impaired manufactured housing securities and credit-impaired manufactured housing securities that are likely to produce future credit losses, as adjusted for our estimate of a risk premium attributable to the financial guarantee contracts. The value of the contracts, over time, will be determined by the actual credit-related losses incurred and, therefore, may have a value that is higher or lower than our market-based estimate. On our GAAP consolidated financial statements, these contracts are recognized as realized.

The other categories of assets that comprise Other assets are not financial instruments required to be valued at fair value under SFAS 107, such as REO and property, plant and equipment. For the majority of these non-financial assets in Other assets, we use the carrying amounts from our GAAP consolidated balance sheets as the reported values on our consolidated fair value balance sheets, without any adjustment. These assets represent an insignificant portion of our GAAP consolidated balance sheets, and any change in their fair value would not be a meaningful part of our fair value of net assets business results. Certain non-financial assets in Other assets on our GAAP consolidated balance sheets are assigned a zero value on our consolidated fair value balance sheets. This treatment is applied to deferred items such as deferred debt issuance costs.

We adjust the GAAP-basis deferred taxes for consolidated fair value balance sheets purposes to include estimated income taxes on the difference between our consolidated fair value balance sheets net assets, including deferred taxes from the GAAP consolidated balance sheets, and our GAAP consolidated balance sheets equity attributable to common stockholders. To the extent the adjusted deferred taxes are a net asset, this amount is included in Other assets. If the adjusted deferred taxes are a net liability, this amount is included in Other liabilities.

### *Total debt securities, net*

Total debt securities, net represents short-term and long-term debt used to finance our assets and, for GAAP presentation, is net of deferred items, including premiums, discounts and hedging-related basis adjustments. It includes both non-callable and callable debt as well as short-term zero coupon discount notes. The fair value of the short-term zero coupon discount notes is based on a discounted cash flow model with market inputs. The valuation of other debt securities is generally based on market prices obtained from broker/dealers, reliable third-party pricing service providers or direct market observations. In the fourth quarter of 2004, we began using newly available market prices received from broker/dealers and reliable third-party pricing services for the valuation of a greater portion of our debt instruments. Previously the calculation of the fair value of these instruments was based primarily on an internal model using available market inputs.

### *Guarantee obligation*

We did not establish a Guarantee obligation for GAAP purposes for PCs and Structured Securities held by third parties that were issued through our Guarantor Swap program prior to adoption of FIN 45. In addition, after it is initially recorded at fair value the Guarantee obligation is not subsequently carried at fair value for GAAP purposes. For fair value balance sheet purposes, the Guarantee obligation reflects the fair value of our Guarantee obligation on all PCs held by third parties. Additionally, for fair value balance sheet purposes, the Guarantee obligation is valued using the same method as used for GAAP to determine its initial fair value. For information concerning our valuation approach and accounting policies related



to guarantee-related credit losses, see “NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES,” and “NOTE 2: TRANSFERS OF SECURITIZED INTERESTS IN MORTGAGE-RELATED ASSETS.”

#### *Reserve for guarantee losses on Participation Certificates*

The carrying amount of the Reserve for guarantee losses on Participation Certificates on our GAAP consolidated balance sheets represents loan loss reserves for off-balance sheet PCs in accordance with GAAP that are not already accounted for under SFAS 125/140. This line item has no basis in our consolidated fair value balance sheets, because the estimated fair value of all expected default losses is included in the Guarantee obligation reported on our consolidated fair value balance sheets, as discussed above.

#### *Derivative liabilities*

See discussion under “*Derivative assets*” above.

#### *Other liabilities*

Other liabilities principally consists of amounts due to PC investors (*i.e.*, principal and interest), funding liabilities associated with investments in LIHTC partnerships, accrued interest payable on debt securities and other miscellaneous obligations of less than one year. We believe the carrying amount of these liabilities is a reasonable approximation of their fair value, except for funding liabilities associated with investments in LIHTC partnerships, for which fair value is estimated using expected cash flows discounted at a market-based yield. Furthermore, certain deferred items reported as Other liabilities on our GAAP consolidated balance sheets are assigned zero value on our consolidated fair value balance sheets, such as deferred credit fees. Also, as discussed in “*Other assets*,” Other liabilities may include a deferred tax liability adjusted for fair value balance sheet purposes.

#### *Minority interests in consolidated subsidiaries*

Minority interests in consolidated subsidiaries primarily represent preferred stock interests that third parties hold in our two majority-owned REIT subsidiaries. In accordance with GAAP, we consolidated the REITs. The preferred stock interests are not within the scope of SFAS 107 disclosure requirements. However, we present the fair value of these interests in our fair value balance sheets. The fair value of the third-party minority interests in these REITs was based on the estimated value of the underlying REIT preferred stock we determined based on a valuation model. In 2005, we improved our fair value estimates to reflect observed market activity.

#### *Net assets attributable to preferred stockholders*

To determine the preferred stock fair value, we use a market-based approach incorporating quoted dealer prices.

#### *Net assets attributable to common stockholders*

Net assets attributable to common stockholders is equal to the difference between the fair value of total assets and the sum of total liabilities and minority interests reported on our consolidated fair value balance sheets, less the fair value of net assets attributable to preferred stockholders.

### **NOTE 17: CONCENTRATION OF CREDIT AND OTHER RISKS**

#### **Mortgages and Mortgage-Related Securities**

Table 17.1 summarizes the geographical concentration of mortgages and mortgage-related securities that are held by us or that are collateral for PCs and Structured Securities, excluding:

- \$2,021 million and \$3,015 million of mortgage-related securities issued by Ginnie Mae that back Structured Securities at December 31, 2005 and 2004, respectively, because these securities do not expose us to meaningful amounts of credit risk;
- \$44,626 million and \$59,715 million of agency mortgage-related securities at December 31, 2005 and 2004, respectively, because these securities do not expose us to meaningful amounts of credit risk; and
- \$242,586 million and \$175,163 million of non-agency mortgage-related securities held in the Retained portfolio at December 31, 2005 and 2004, respectively, because geographic information regarding these securities is not available. With respect to these securities, we look to third party credit enhancements (*e.g.*, bond insurance) or other credit enhancements resulting from the securitization structure supporting such securities (*e.g.*, subordination levels) as a primary means of managing credit risk.

See “NOTE 5: RETAINED PORTFOLIO AND CASH AND INVESTMENTS PORTFOLIO” for more information about the securities we hold.

**Table 17.1 — Concentration of Credit Risk**

	December 31,			
	2005		2004	
	Amount <sup>(1)</sup>	Percentage	Amount <sup>(1)(2)</sup>	Percentage
(dollars in millions)				
<b>By Region<sup>(3)</sup></b>				
Northeast .....	\$ 340,960	24%	\$ 306,281	24%
West .....	326,952	23	296,390	23
North central .....	304,378	22	280,618	22
Southeast .....	247,494	18	223,921	18
Southwest .....	175,200	13	160,249	13
	<u>\$1,394,984</u>	<u>100%</u>	<u>\$1,267,459</u>	<u>100%</u>
<b>By State</b>				
California .....	\$ 182,178	13%	\$ 171,209	14%
Florida .....	86,988	6	75,879	6
Illinois .....	72,986	5	65,750	5
New York .....	71,998	5	65,344	5
All Others .....	980,834	71	889,277	70
	<u>\$1,394,984</u>	<u>100%</u>	<u>\$1,267,459</u>	<u>100%</u>

(1) Calculated as Total mortgage portfolio less Structured Securities backed by Ginnie Mae Certificates as well as agency and non-agency mortgage-related securities held in the Retained portfolio.

(2) Beginning in 2005, Puerto Rico and Virgin Islands were reclassified from Northeast to Southeast. The 2004 results were changed to conform with 2005 presentation.

(3) Region Designation: West (AK, AZ, CA, GU, HI, ID, MT, NV, OR, UT, WA); Northeast (CT, DE, DC, MA, ME, MD, NH, NJ, NY, PA, RI, VT, VA, WV); North central (IL, IN, IA, MI, MN, ND, OH, SD, WI); Southeast (AL, FL, GA, KY, MS, NC, PR, SC, TN, VI); Southwest (AR, CO, KS, LA, MO, NE, NM, OK, TX, WY).

## Mortgage Lenders

A significant portion of our single-family mortgage purchase volume is generated from several key mortgage lenders that have entered into special business arrangements with us. These individually negotiated arrangements generally involve a lender's commitment to sell a high proportion of its conforming mortgage origination volume to us. During 2005, three mortgage lenders each accounted for 10 percent or more of our mortgage purchase volume and in the aggregate they accounted for approximately 47 percent of this volume. These three lenders are among the largest mortgage loan originators in the United States. We are exposed to the risk that we could lose purchase volume to the extent these arrangements are terminated or modified without replacement from other lenders.

## Derivative Portfolio

On an ongoing basis, we review the credit fundamentals of all of our derivative counterparties to confirm that they continue to meet our internal standards. We assign internal ratings, credit, capital and trading limits to each counterparty based on quantitative and qualitative analysis, which we update and monitor on a regular basis. We conduct additional reviews when market conditions dictate or events affecting an individual counterparty occur.

**Derivative Counterparties.** Our use of derivatives exposes us to counterparty credit risk, which arises from the possibility that the derivative counterparty will not be able to meet its contractual obligations. Exchange-traded derivatives, such as futures contracts, do not measurably increase our counterparty credit risk because changes in the value of open exchange-traded contracts are settled daily through a financial clearinghouse established by each exchange. Over-the-counter, or OTC, derivatives, however, expose us to counterparty credit risk because transactions are executed and settled between us and the counterparty. Our use of OTC interest-rate swaps, option-based derivatives and foreign-currency swaps is subject to rigorous internal credit and legal reviews. Our derivative counterparties carry external credit ratings among the highest available from major rating agencies. All of these counterparties are major financial institutions and are experienced participants in the OTC derivatives market.

**Master Netting and Collateral Agreements.** We use master netting and collateral agreements to reduce our credit risk exposure to our active OTC derivative counterparties for interest-rate swaps, option-based derivatives and foreign-currency swaps. Master netting agreements provide for the netting of amounts receivable and payable from an individual counterparty, which reduces our exposure to a single counterparty in the event of default. On a daily basis, the market value of each counterparty's derivatives outstanding is calculated to determine the amount of our net credit exposure, which is equal to derivatives in a net gain position by counterparty after giving consideration to collateral posted. Our collateral agreements require most counterparties to post collateral for the amount of our net exposure to them above the applicable threshold. Bilateral collateral agreements are in place for the majority of our counterparties. Collateral posting thresholds are tied to a counterparty's credit rating. Derivative exposures and collateral amounts are monitored on a daily basis using both internal pricing models and dealer price quotes. Collateral is typically transferred within one business day based on the

values of the related derivatives. This time lag in posting collateral can affect our net uncollateralized exposure to derivative counterparties.

Collateral posted by a derivative counterparty is typically in the form of cash, U.S. Treasury securities, our PCs and Structured Securities or our debt securities. In the event a counterparty defaults on its obligations under the derivatives agreement and the default is not remedied in the manner prescribed in the agreement, we have the right under the agreement to direct the custodian bank to transfer the collateral to us or, in the case of non-cash collateral, to sell the collateral and transfer the proceeds to us.

Our uncollateralized exposure to counterparties for OTC interest-rate swaps, option-based derivatives and foreign-currency swaps, after applying netting agreements and collateral, was \$190 million and \$601 million at December 31, 2005 and 2004, respectively. In the event that all of our counterparties for these derivatives were to have defaulted simultaneously on December 31, 2005, our maximum loss for accounting purposes would have been approximately \$190 million.

Our exposure to counterparties for OTC forward purchase and sale commitments treated as derivatives was \$35 million and \$40 million at December 31, 2005 and 2004, respectively. Since the typical maturity for our OTC commitments is less than one year, we do not require master netting and collateral agreements for the counterparties of these commitments. Therefore, the exposure to our OTC commitments counterparties is uncollateralized. Similar to counterparties for our OTC interest-rate swaps, option-based derivatives and foreign-currency swaps, we monitor the credit fundamentals of our OTC commitments counterparties on an ongoing basis to ensure that they continue to meet our internal risk-management standards.

#### **NOTE 18: MINORITY INTERESTS**

The equity and net earnings attributable to the minority stockholder interests in consolidated subsidiaries are reported on our consolidated balance sheets as Minority interests in consolidated subsidiaries and on our consolidated statements of income as Minority interests in earnings of consolidated subsidiaries. The majority of the balances in these accounts relate to our two majority-owned REITs.

In February 1997, we formed two majority-owned REIT subsidiaries funded through the issuance of common stock (99.9 percent of which is held by us) and a total of \$4.0 billion of perpetual, step-down preferred stock issued to outside investors. The dividend rate on the step-down preferred stock is 13.3 percent from initial issuance through December 2006 (the initial term). Beginning in 2007, the dividend rate will step-down to 1.0 percent. Dividends on this preferred stock accrue in arrears. The balance of the two step-down preferred stock issuances as recorded within Minority interests in consolidated subsidiaries on our consolidated balance sheets totaled \$934 million and \$1,488 million at December 31, 2005 and 2004, respectively.

On November 10, 2005, we offered to purchase for cash any and all of the outstanding shares of the outstanding step-down preferred stock, of which \$142 million was purchased between the offer date and December 31, 2005. The preferred stock continues to be redeemable by the REITs under certain circumstances described in the preferred stock offering documents as a “tax event redemption.” See “NOTE 14: INCOME TAXES” for more information concerning the REITs.

#### **NOTE 19: EARNINGS PER COMMON SHARE**

Basic earnings per common share are computed as Net income available to common stockholders divided by Weighted average common shares outstanding-basic for the period. Diluted earnings per common share are computed as Net income available to common stockholders divided by Weighted average common shares outstanding-diluted for the period, which consider the effect of dilutive common equivalent shares outstanding. The effect of dilutive common equivalent shares outstanding includes: (a) the weighted average shares related to stock options (including the ESPP) that have an exercise price lower than the average market price during the period; (b) the weighted average of non-vested restricted shares; and (c) all restricted stock units. Such items are excluded from Weighted average common shares outstanding — basic. See “NOTE 11: STOCK-BASED COMPENSATION” for additional information. Net income available to common stockholders is not affected by dilutive potential common shares for the years ended December 31, 2005, 2004 and 2003. For the years ended December 31, 2005, 2004 and 2003, there are approximately 1,929,000, 2,239,000 and 1,581,000 of dilutive common equivalent shares outstanding that could potentially dilute earnings per common share, based on the treasury stock method.

Options to purchase 2.3 million, 2.4 million and 3.4 million shares of common stock were excluded from the computation of Diluted earnings per common share at December 31, 2005, 2004 and 2003, respectively, because the options’ exercise price exceeded the average market price of the common stock for the years ended December 31, 2005, 2004 and 2003, respectively.

## **CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURES**

None.

## **CONTROLS AND PROCEDURES**

See “MD&A — RISK MANAGEMENT — Operational Risks — *Internal Control over Financial Reporting*” for a description of our material weaknesses and other deficiencies.

## **DIRECTORS AND EXECUTIVE OFFICERS**

Information regarding our Directors and Executive Officers is set forth under “Proposal 1: Election of Directors — Nominees for Election” and “Executive Officers” of our Proxy Statement for our annual meeting of stockholders to be held on September 8, 2006, and is incorporated herein by reference. Additional information concerning our Audit Committee may be found under the caption “Corporate Governance — Audit Committee Financial Expert” in our Proxy Statement. We also provide information regarding our Section 16 compliance under “Section 16(a) Beneficial Ownership Reporting” in our Proxy Statement, incorporated by reference herein.

## BOARD OF DIRECTORS (as of June 1, 2006)<sup>(1)</sup>

### **Richard F. Syron**

*Chairman and Chief Executive Officer*

Freddie Mac

McLean, Virginia

### **Barbara T. Alexander**<sup>C, E</sup>

*Independent Consultant*

Monarch Beach, California

### **Geoffrey T. Boisi**<sup>B, D, E</sup>

*Chairman and Senior Partner*

Roundtable Investment Partners LLC

A private investment management firm

New York, New York

### **Michelle Engler**<sup>B, E</sup>

*Trustee*

JNL Investor Series Trust and JNL Series Trust

and *Member of Board of Managers*

JNL/NY Variable Funds

Each an investment company

Lansing, Michigan

### **Richard Karl Goeltz**<sup>A, C, D</sup>

*Retired Vice Chairman and Chief Financial Officer*

American Express Company

A financial services company

New York, New York

### **Thomas S. Johnson**<sup>A, B</sup>

*Retired Chairman and Chief Executive Officer*

GreenPoint Financial Corp.

A financial services company

New York, New York

### **William M. Lewis, Jr.**<sup>C, E</sup>

*Managing Director and Co-Chairman  
of Investment Banking*

Lazard Ltd.

An investment banking company

New York, New York

### **Eugene M. McQuade**

*President and Chief Operating Officer*

Freddie Mac

McLean, Virginia

### **Shaun F. O'Malley** (Lead Director)<sup>A, B, D</sup>

*Chairman Emeritus*

Price Waterhouse LLP

An accounting and consulting firm

Philadelphia, Pennsylvania

### **Jeffrey M. Peek**<sup>C, E</sup>

*Chairman and Chief Executive Officer*

CIT Group, Inc.

A provider of commercial and consumer finance solutions

New York, New York

### **Ronald F. Poe**<sup>B, D, E</sup>

*President*

Ronald F. Poe & Associates

A private real estate investment firm

White Plains, New York

### **Stephen A. Ross**<sup>A, C, D</sup>

*Professor*

Massachusetts Institute of Technology

Cambridge, Massachusetts

### **William J. Turner**<sup>A, C</sup>

*Manager*

Signature Capital, Inc.

A venture capital investment firm

Portland, Maine

Committees	A Audit
	B Compensation and Human Resources
	C Finance and Capital Deployment
	D Governance, Nominating and Risk Oversight
	E Mission and Sourcing

(1) Our enabling legislation establishes the membership of the board of directors at 18 directors: 13 directors elected by the stockholders and 5 directors appointed by the President of the United States. Prior to our March 31, 2004 Annual Meeting, the Office of Counsel to the President informed us that the President did not intend to reappoint any of his then-current presidential appointees. Consequently, each of their terms as presidential appointees ended on the date of that annual meeting. No new appointees have been named by the President as of June 1, 2006.



## EXECUTIVE COMPENSATION

Information regarding executive compensation is set forth under the section titled “Executive Compensation” of our Proxy Statement and is incorporated by reference into this Information Statement. Information regarding compensation of our board of directors is set forth under the section titled “Proposal 1: Election of Directors — Board Compensation” and information concerning members of the Compensation and Human Resources Committee is set forth under “Proposal 1: Election of Directors — Compensation Committee Interlocks and Insider Participation” of our Proxy Statement, incorporated by reference herein.

## SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

### Securities Authorized for Issuance under Equity Compensation Plans

Table 52 provides information about our common stock that may be issued upon the exercise of options, warrants and rights under our existing equity compensation plans at December 31, 2005. Our stockholders have approved the ESPP, the 2004 Employee Plan, the 1995 Employee Plan and the Directors’ Plan.

**Table 52 — Equity Compensation Plan Information**

Plan Category	(a) Number of securities to be issued upon exercise of outstanding options, warrants and rights	(b) Weighted-average exercise price of outstanding options, warrants and rights	(c) Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))
Equity compensation plans approved by stockholders .....	8,229,451 <sup>(1)</sup>	\$46.10 <sup>(2)</sup>	20,159,506 <sup>(3)</sup>
Equity compensation plans not approved by stockholders .....	None	N/A	None

(1) Includes 1,474,183 restricted stock units issued under the Directors’ Plan and the Employee Plans and options to purchase up to 61,584 shares under the ESPP, which are issuable in connection with the offering period ended on January 31, 2006.

(2) For the purpose of calculating this amount, the restricted stock units are assigned an exercise price of zero.

(3) Consists of 12,005,314 shares, 6,597,276 shares and 1,556,916 shares available for issuance under the 2004 Employee Plan, the ESPP and Directors’ Plan, respectively.

### Security Ownership of Management

Information regarding the beneficial ownership of our common stock by each of our directors, each director nominee, certain executive officers and by all directors and executive officers as a group is set forth under the section titled “Corporate Governance — Stock Ownership by Directors, Executive Officers and Greater than 5% Holders” of our Proxy Statement for our annual meeting of stockholders to be held on September 8, 2006 and is incorporated by reference into this Information Statement.

### Security Ownership of Certain Beneficial Owners

Information regarding the beneficial ownership of our common stock by certain beneficial owners is set forth under the section titled “Corporate Governance — Stock Ownership by Directors, Executive Officers and Greater than 5% Holders” of our Proxy Statement for our annual meeting of stockholders to be held on September 8, 2006 and is incorporated by reference into this Information Statement.

## CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

Information regarding certain relationships and related transactions is set forth under the section titled “Proposal 1: Election of Directors — Transactions with Institutions Related to Directors” of our Proxy Statement for our annual meeting of stockholders to be held on September 8, 2006 and is incorporated by reference into this Information Statement.

## PRINCIPAL ACCOUNTING FEES AND SERVICES

Information regarding principal accountant fees and services is set forth under the section titled “Proposal 2: Ratification of Appointment of Independent Auditors” of our Proxy Statement for our annual meeting of stockholders to be held on September 8, 2006 and is incorporated by reference into this Information Statement.

### CERTIFICATION\*

I, Richard F. Syron, certify that:

1. I have reviewed this Information Statement of Freddie Mac;
2. Based on my knowledge, this Information Statement 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 Information Statement; and
3. Based on my knowledge, the consolidated financial statements, and other financial information included in this Information Statement, fairly present in all material respects the financial condition, results of operations and cash flows of Freddie Mac as of, and for, the periods presented in this Information Statement.

Date: June 28, 2006



Richard F. Syron  
Chairman and Chief Executive Officer

### CERTIFICATION\*

I, Eugene M. McQuade, certify that:

1. I have reviewed this Information Statement of Freddie Mac;
2. Based on my knowledge, this Information Statement 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 Information Statement; and
3. Based on my knowledge, the consolidated financial statements, and other financial information included in this Information Statement, fairly present in all material respects the financial condition, results of operations and cash flows of Freddie Mac as of, and for, the periods presented in this Information Statement.

Date: June 28, 2006



Eugene M. McQuade  
President and Chief Operating Officer

\* For a detailed discussion of our progress with respect to our internal control over financial reporting and disclosure controls and procedures, see "RISK MANAGEMENT — Operational Risks — *Internal Control over Financial Reporting*."

## RATIO OF EARNINGS TO FIXED CHARGES

	Year Ended December 31,				
	2005	2004	2003	2002	2001
	(dollars in millions)				
Net income before cumulative effect of changes in accounting principles	\$ 2,189	\$ 2,937	\$ 4,816	\$10,090	\$ 3,115
Add:					
Income tax expense	367	790	2,202	4,713	1,339
Minority interests in earnings of consolidated subsidiaries	96	129	157	184	208
Total interest expense	29,899	26,566	26,509	26,876	27,577
Interest factor in rental expenses	6	6	5	5	5
Capitalized interest	—	1	—	1	1
Earnings, as adjusted	<u>\$32,557</u>	<u>\$30,429</u>	<u>\$33,689</u>	<u>\$41,869</u>	<u>\$32,245</u>
Fixed charges:					
Total interest expense	\$29,899	\$26,566	\$26,509	\$26,876	\$27,577
Interest factor in rental expenses	6	6	5	5	5
Capitalized interest	—	1	—	1	1
Total fixed charges	<u>\$29,905</u>	<u>\$26,573</u>	<u>\$26,514</u>	<u>\$26,882</u>	<u>\$27,583</u>
Ratio of earnings to fixed charges <sup>(1)</sup>	<u>1.09</u>	<u>1.15</u>	<u>1.27</u>	<u>1.56</u>	<u>1.17</u>

(1) Ratio of earnings to fixed charges is computed by dividing Earnings, as adjusted by Total fixed charges.

## RATIO OF EARNINGS TO COMBINED FIXED CHARGES AND PREFERRED STOCK DIVIDENDS

	Year Ended December 31,				
	2005	2004	2003	2002	2001
	(dollars in millions)				
Net income before cumulative effect of changes in accounting principles	\$ 2,189	\$ 2,937	\$ 4,816	\$10,090	\$ 3,115
Add:					
Income tax expense	367	790	2,202	4,713	1,339
Minority interests in earnings of consolidated subsidiaries	96	129	157	184	208
Total interest expense	29,899	26,566	26,509	26,876	27,577
Interest factor in rental expenses	6	6	5	5	5
Capitalized interest	—	1	—	1	1
Earnings, as adjusted	<u>\$32,557</u>	<u>\$30,429</u>	<u>\$33,689</u>	<u>\$41,869</u>	<u>\$32,245</u>
Fixed charges:					
Total interest expense	\$29,899	\$26,566	\$26,509	\$26,876	\$27,577
Interest factor in rental expenses	6	6	5	5	5
Capitalized interest	—	1	—	1	1
Preferred stock dividends <sup>(1)</sup>	261	266	315	351	310
Total fixed charges including preferred stock dividends	<u>\$30,166</u>	<u>\$26,839</u>	<u>\$26,829</u>	<u>\$27,233</u>	<u>\$27,893</u>
Ratio of earnings to combined fixed charges and preferred stock dividends <sup>(2)</sup>	<u>1.08</u>	<u>1.13</u>	<u>1.26</u>	<u>1.54</u>	<u>1.16</u>

(1) Preferred stock dividends represent pre-tax earnings required to cover any preferred stock dividend requirements using our effective tax rate for the relevant periods.

(2) Ratio of earnings to combined fixed charges and preferred stock dividends is computed by dividing Earnings, as adjusted by Total fixed charges including preferred stock dividends.

## ADDITIONAL FINANCIAL INFORMATION

For more information about Freddie Mac stock contact:

Freddie Mac  
Mailstop D40  
1551 Park Run Drive  
McLean, Virginia 22102-3110  
Investor Relations: (571) 382-4732  
Toll Free: (800) FREDDIE  
On the Internet: <http://www.FreddieMac.com/investors>

## ANNUAL MEETING

The annual meeting of Freddie Mac's stockholders will be held:

September 8, 2006  
9:00 a.m. eastern time  
8000 Jones Branch Drive  
McLean, Virginia 22102

Proxy materials will be mailed to stockholders of record in accordance with Freddie Mac's bylaws and New York Stock Exchange requirements.

## DIVIDEND PAYMENTS

Approved by Freddie Mac's board of directors, dividends on the company's common stock and non-cumulative preferred stock in 2005 and the first six months of 2006 were or are expected to be paid on:

March 31, 2005  
June 30, 2005  
September 29, 2005  
December 29, 2005  
March 31, 2006  
June 30, 2006

Subject to approval by Freddie Mac's board of directors, dividends on the company's common stock and non-cumulative preferred stock in the last six months of 2006 are expected to be paid on or about:

September 30, 2006  
December 31, 2006

## CORPORATE HEADQUARTERS

8200 Jones Branch Drive  
McLean, Virginia 22102-3110  
(703) 903-2000

## NEW YORK CITY OFFICE

575 Lexington Avenue, Suite 1800  
New York, New York 10022-6102  
(212) 418-8900

## NORTH CENTRAL REGION

333 West Wacker Drive, Suite 2500  
Chicago, Illinois 60606-1287  
(312) 407-7400

## SOUTHEAST REGION

North Tower, Suite 200  
2300 Windy Ridge Parkway SE  
Atlanta, Georgia 30339-5665  
(770) 857-8800

## SOUTHWEST REGION

5000 Plano Parkway  
Carrollton, Texas 75010-4902  
(972) 395-4000

## WESTERN REGION

21700 Oxnard Street, Suite 1900  
Woodland Hills, California 91367-3642  
(818) 710-3000

## INDEX OF ACRONYMS

We are providing this index of acronyms used in this Information Statement for the convenience of the reader. All of the acronyms listed below are defined at their first use in this document.

AOCI	Accumulated other comprehensive income (loss), net of taxes
ARM	Adjustable-rate mortgage
CMBS	Commercial mortgage-backed securities
CMT	Constant Maturity Treasury
DOL	Department of Labor
EITF	Emerging Issues Task Force
ERISA	Employee Retirement Income Security Act
ESPP	Employee Stock Purchase Plan
Euribor	Euro Interbank Offered Rate
Fannie Mae	Federal National Mortgage Association
FASB	Financial Accounting Standards Board
FEC	Federal Election Commission
FHA	Federal Housing Administration
FICO	Credit scores initially developed by Fair, Issac and Co., Inc.
FIN	Financial Accounting Standards Board Interpretation
FSP	Financial Accounting Standards Board Staff Position
GAAP	U.S. generally accepted accounting principles
Ginnie Mae	Government National Mortgage Association
GSE	Government-sponsored enterprise
GSE Act	The Federal Housing Enterprises Financial Safety and Soundness Act of 1992
HUD	Department of Housing and Urban Development
IO	Interest only
IRR	Internal rates of return
IRS	Internal Revenue Service
LIBOR	London Interbank Offered Rate
LIHTC	Low-Income Housing Tax Credit
LTV	Loan-to-Value
MD&A	Management's Discussion and Analysis of Financial Condition and Results of Operations
NPV	Net present value
NYSE	New York Stock Exchange
OAS	Option-Adjusted Spread
OFHEO	Office of Federal Housing Enterprise Oversight
OTC	Over-the-Counter
PC	Mortgage Participation Certificate
PCAOB	Public Company Accounting Oversight Board
PMVS	Portfolio Market Value Sensitivity
PMVS-L	Portfolio Market Value Sensitivity-Level
PMVS-YC	Portfolio Market Value Sensitivity-Yield Curve
PwC	PricewaterhouseCoopers LLP
REIT	Real Estate Investment Trust
REMIC	Real Estate Mortgage Investment Conduit
REO	Real Estate Owned
RHS	Rural Housing Service
S&P	Standard & Poor's
SEC	Securities and Exchange Commission
SFAS	Statement of Financial Accounting Standards
SS&TG	Securities Sales and Trading Group
TBA	To Be Announced
VA	Department of Veterans Affairs
VIE	Variable interest entity





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