

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

**RESTATEMENT RESULTS**

As announced on November 21, 2003, the net cumulative effect of the restatement through December 31, 2002 was an increase to our net income of \$5.0 billion, which includes a net cumulative increase of \$4.4 billion for 2000, 2001 and 2002 and \$0.6 billion related to periods prior to 2000. While the net cumulative effect of the restatement provided a significant increase in net income, 2001's net income decreased by \$1.0 billion compared to previously reported results, primarily due to unrealized losses on derivatives not in hedge accounting relationships. The restatement also resulted in a net increase in regulatory core capital for each of the year ends affected and in a cumulative increase of \$5.2 billion in our regulatory core capital as of December 31, 2002. Our core capital equals Stockholders' equity excluding Accumulated other comprehensive income, or AOCI.

**Summary of Restatement Results**

The restatement and related re-audit arose from our re-evaluation, in conjunction with PwC, our independent auditors, of numerous accounting policies and their application to our transactions. Our Board of Directors appointed PwC in March 2002, replacing Arthur Andersen LLP. We are responsible for the preparation, integrity and fair presentation of the company's consolidated financial statements. *Table 6* summarizes key results of the restatement for the three years ended December 31, 2002.

**Table 6 — Restated Financial Results for the Three Years Ended December 31, 2002**

Year Ended	Net Income (in millions) <sup>(1)</sup>			Diluted EPS (in dollars)			Regulatory Core Capital (in millions) <sup>(2)</sup>			Stockholders' Equity (in millions)		
	As Previously Reported	As Restated	Change	As Previously Reported	As Restated	Change	As Previously Reported	As Restated	Change	As Previously Reported	As Restated	Change
December 31, 2000 . . . .	\$2,547	\$ 3,666	\$1,119	\$3.40	\$ 5.01	\$ 1.61	\$14,380	\$16,273	\$1,893	\$14,837	\$17,357	\$2,520
December 31, 2001 . . . .	4,147	3,158	(989)	5.64	4.23	(1.41)	19,336	20,181	845	15,373	19,624	4,251
December 31, 2002 . . . .	5,764	10,090	4,326	7.95	14.18	6.23	23,792	28,990	5,198	24,629	31,330	6,701

(1) The net cumulative effect of the restatement through December 31, 2002 also includes \$0.6 billion for periods prior to 2000. Included in 2002 results is \$82 million of net income related to events occurring in 2003, but affecting 2002. The \$82 million of net income consists of \$155 million of tax benefit attributable to favorable Court rulings occurring in 2003 offset by \$73 million in additional expense, net of tax, related to adjustments in reserves and accruals due to events occurring in 2003.

(2) See "— Restatement Effect on Regulatory Capital," below, for more information.

**Restatement Effect on Volatility of Income**

Our restated net income reflects significantly greater volatility than previously reported, and we anticipate that our net income for periods following the restatement will continue to reflect greater volatility than previously reported from quarter to quarter. For example, during 2001 and 2002, quarterly net income ranged from a loss of \$111 million in the first quarter of 2001 to income of \$5.7 billion in the third quarter of 2002. This volatility results in large part from recording in current period earnings changes in fair values of a significantly higher proportion of our derivatives portfolio, mortgage-related securities, guarantee assets and guarantee obligations.

Our securities portfolio classified as trading totaled approximately \$64 billion at December 31, 2002. Of this amount, approximately \$29 billion was held in the retained portfolio. We expect that the income statement effects of these retained portfolio securities classified as trading will diminish in results reported for periods following restated periods. However, we expect that net income going forward will continue to reflect potentially significant sources of volatility, including the effects of our derivatives portfolio and certain mortgage guarantee activities. With respect to derivatives, our entire portfolio of option-based derivatives (e.g., swaptions) as well as certain other derivatives were not in hedge accounting relationships at December 31, 2002. We are evaluating whether to designate these and other derivatives in qualifying hedge relationships for purposes of GAAP accounting. However, there is uncertainty as to whether we will ultimately pursue such designations, which, in any event, were not executed in 2003 and therefore will not affect financial results for 2003. With respect to our guarantee activities, the potential additional source of income volatility is attributable to the possible effect of the implementation of Financial Accounting Standards Board Interpreta-

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tion, or FIN, No. 45, “Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others,” which applies to reporting periods beginning in 2003.

### Restatement Effect on Interest-Rate Risk Measures

We provide investors with monthly interest-rate risk sensitivity disclosures using two separate estimates:

- Portfolio market value sensitivity, or PMVS, which estimates the percentage of our fair value of common Stockholders’ equity at risk from immediate, adverse interest-rate shifts; and
- Duration gap, which estimates the average daily difference (measured in months) between the estimated weighted-average lives of our financial assets, liabilities and derivatives.

In connection with the restatement, we have reviewed our interest-rate risk sensitivity disclosures for 2002 and 2001 to assess the impact of securities and derivatives valuation errors, described in “FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA — NOTE 1: RESTATEMENT,” and to correct other identified errors. We believe the errors identified in connection with this review do not significantly impact our interest-rate risk position as previously reported in our monthly interest-rate risk sensitivity disclosures. We estimate that the errors do not change monthly average PMVS estimates by more than 2 percentage points or duration gap by more than one month for each previously reported month in 2002 and 2001. For example, *Table 7* below summarizes the daily average portfolio market value sensitivity, or PMVS-L, and duration gap estimates for December 2002 and December 2001, as originally reported and as restated. See “— RISK MANAGEMENT — Interest-Rate Risk and Other Market Risks — Measurement of Interest-Rate Risk” for more detail.

**Table 7 — Impact of Valuation Errors on Portfolio Market Value Sensitivity and Duration Gap Estimates**

<u>Monthly Average</u>	<u>Portfolio Market Value Sensitivity Estimate (PMVS-L)</u>		<u>Duration Gap Estimate (in months)</u>	
	<u>As Reported</u>	<u>As Restated</u>	<u>As Reported</u>	<u>As Restated</u>
December 2002 .....	2.7%	2.3%	0	0
December 2001 .....	3.9%	3.6%	1	1

### Restatement Effect on Regulatory Capital

On December 17, 2003, OFHEO affirmed that Freddie Mac, following the restatement process, remains adequately capitalized for the periods presented in *Table 8*.

**Table 8 — Estimated Regulatory Minimum Capital Surplus<sup>(1)</sup>**

	<u>2000</u>	<u>2001</u>				<u>2002</u>			
	<u>Year-End</u>	<u>1Q</u>	<u>2Q</u>	<u>3Q</u>	<u>4Q</u>	<u>1Q</u>	<u>2Q</u>	<u>3Q</u>	<u>4Q</u>
		(dollars in millions)							
As reported regulatory minimum capital surplus .....	\$ 202	\$ 606	\$ 567	\$ 408	\$ 821	\$1,169	\$1,925	\$2,118	\$2,172
As restated regulatory minimum capital surplus <sup>(2)</sup> .....	\$1,876	\$1,383	\$1,113	\$2,109	\$1,167	\$1,014	\$2,514	\$6,634	\$6,651

(1) We are required to hold “Core Capital” generally equal to the sum of 2.5 percent of aggregate on-balance sheet assets, as measured under GAAP, and 0.45 percent of aggregate off-balance sheet obligations. Core Capital available to meet the minimum capital requirement is effectively equal to Stockholders’ equity less AOCI. This table shows the excess of estimated Core Capital over the regulatory minimum capital requirement for prior periods.

(2) Minimum capital amounts for each quarter in 2002 and 2001, as well as for year-end 2000, are based on amended reports to OFHEO that correct results included in our November 21, 2003 Information Statement Supplement. The impact of this change on the restated regulatory minimum capital surplus was a decrease of \$1 million as of December 31, 2002, as compared to those results presented in our November 21, 2003 Information Statement Supplement. The impacts on other periods presented were also reductions, but in no one period did such reductions exceed \$11 million.

Starting in the third quarter of 2002, to be classified as adequately capitalized, we must meet both risk-based and minimum capital standards. On December 17, 2003, OFHEO concluded that Freddie Mac is not required to resubmit risk-based capital reports for September 2002 and December 2002, based on OFHEO’s

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conclusion that our minimum capital remains binding as the determining factor for our capital adequacy classification for these periods.

We believe the current level of our capital is adequate to meet regulatory capital requirements. We do not expect to engage in share repurchases until we resume timely financial reporting. See “SUBSEQUENT EVENTS — Regulatory Developments” for information concerning the capital monitoring framework OFHEO has established, which includes restrictions on share repurchases and certain other capital transactions.

### **Restatement Background and Remediation Program**

We announced the need to restate our financial results in January 2003. In connection with that announcement, the outside directors of our Board of Directors retained Baker Botts as our independent investigative counsel to review the facts and circumstances relating to certain of the accounting errors identified during the restatement process. In June 2003, we reported on Baker Botts’ preliminary findings presented to the Audit Committee and the Board of Directors as to the factors contributing to the need for the restatement. In July 2003, we released the Baker Botts report. In November 2003, Baker Botts submitted to the Board additional findings covering certain transactions known to require further inquiry or raised after delivery of the original report. The specific events described in the Baker Botts reports have been considered by the Board and appropriate remedial action has been taken by the Board and management. Baker Botts’ reports are available on our website, and certain of the transactions reviewed in them are discussed in “FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA — NOTE 1: RESTATEMENT.” We accept the conclusions of Baker Botts, which are summarized in “FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA — NOTE 1: RESTATEMENT.”

In connection with their audits of the restatement of the previously issued financial statements and our 2002 financial statements, PwC has identified and communicated to management and the Audit Committee that “material weaknesses” (as defined under standards established by the American Institute of Certified Public Accountants, or AICPA) in internal controls existed during the time periods covered by the restated financial statements. See “— RISK MANAGEMENT — Operational Risk — *Internal Control Weaknesses*” for more information.

The Board of Directors is overseeing our implementation of a comprehensive remediation program to address each of the principal factors that contributed to the need for the restatement. In 2003, the Board’s Governance Committee overseeing the remediation program, and the Audit and Ad Hoc Committees overseeing the restatement, held individual or joint committee meetings on 55 separate occasions. The remediation program addresses the actions required by the consent order Freddie Mac entered into with OFHEO in December 2003 as well as areas of improvement identified by the Board of Directors and management, by Baker Botts in the course of their reviews and reports to the Board of Directors, and by PwC. The program is effecting sweeping changes in our financial reporting and management functions. It includes initiatives relating to corporate culture, governance, accounting staffing and expertise, accounting policies, processes and controls as well as financial reporting and disclosure. We report our progress on this initiative on an ongoing basis to OFHEO and to the Governance Committee.

To date, we have made significant progress in strengthening resources and personnel dedicated to accounting, control and reporting issues. We have hired a host of accounting professionals, including a significant number of new officers and senior managers. In addition, in October 2003 we announced the creation of a new position of Senior Vice President and Chief Compliance Officer. We also have retained David Martin, the immediate-past Director of the SEC’s Division of Corporation Finance, to assist us in designing and implementing exemplary disclosure processes and practices, and Charles Elson, the Edgar S. Woolard, Jr. Chair in Corporate Governance and the Director of the John L. Weinberg Center for Corporate Governance at the University of Delaware, to assist us in designing and implementing exemplary corporate governance principles and practices.

In addition to addressing accounting staffing and expertise issues, remediation activities include an assessment of corporate culture, significant enhancements to the documentation of all accounting policies and implementation of corporate-wide employee training on the Sarbanes-Oxley Act and our Code of Conduct.

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## Summary of Accounting Corrections and Changes by Category

Table 9 summarizes the net cumulative impact of the changes to net income through December 31, 2002. We have classified the accounting errors and related corrections that have been addressed by the restatement into the five categories listed in Table 9 below. The five error categories involve subjective judgments by us regarding classification of amounts and particular accounting errors that may fall within more than one category. While such classifications are not required under GAAP, we believe these classifications may assist investors in understanding the nature and impact of the corrections made in completing the restatement. The descriptions of the five classifications provide only a summary of primary accounting issues and are not a comprehensive discussion of accounting errors and corrections, which are described in “FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA — NOTE 1: RESTATEMENT.” In addition, we made changes in our accounting for two other matters as reported in the “Other accounting changes” caption in Table 9.

**Table 9 — Net Cumulative Income (Expense) Impact Through December 31, 2002<sup>(1)</sup>**

	Net Cumulative Income (Expense) Impact Through 12/31/02
	(dollars in millions)
Security classification (pre-tax) .....	\$1,700
Accounting for derivative instruments (pre-tax) .....	4,980
Asset transfers and securitizations (pre-tax) .....	181
Valuation of financial instruments (pre-tax) .....	214
All other corrections (pre-tax) .....	<u>383</u>
Subtotal of accounting corrections (pre-tax) .....	7,458
Other accounting changes (pre-tax) <sup>(2)</sup> .....	<u>168</u>
Total accounting corrections and changes (pre-tax) .....	7,626
Tax impact of accounting corrections and changes <sup>(3)</sup> .....	<u>(2,591)</u>
Total net income impact (including subsequent events) <sup>(4)</sup> .....	<u>\$5,035</u>
Total net income impact (excluding subsequent events) .....	<u>\$4,953</u>

(1) See “— QUARTERLY SELECTED FINANCIAL DATA” for a reconciliation of previously reported to restated/revised results by selected consolidated statements of income captions.

(2) Represents the net cumulative impact of (i) accounting changes we elected to make related to stock-based compensation and (ii) enhancements to the methodology used to estimate the lives used in the amortization of certain premiums and discounts.

(3) Virtually all of the \$2.6 billion tax impact represents an increase in deferred taxes not currently payable. See “FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA — NOTE 1: RESTATEMENT” for more information.

(4) Included in 2002 results is \$82 million of net income related to events occurring in 2003 but affecting 2002. The \$82 million of net income consists of \$155 million of tax benefit attributable to favorable Court rulings occurring in 2003 offset by \$73 million in additional expense, net of tax, related to adjustments in reserves and accruals due to events occurring in 2003.

## FINANCIAL HIGHLIGHTS

### 2002, 2001 and 2000 Performance

Net income for 2002, 2001 and 2000 totaled \$10.1 billion, \$3.2 billion and \$3.7 billion, respectively. These results were primarily driven by increases in net interest income, or NII, and fluctuations in total non-interest income.

Net interest income totaled \$8.9 billion, \$7.0 billion and \$3.8 billion for 2002, 2001 and 2000, respectively. The increases in net interest income were attributable to a decrease in short-term interest rates along with growth in the retained portfolio, which grew by 14 percent in 2002 and 27 percent in 2001. The decrease in short-term interest rates, along with an increase in amortization income, was chiefly responsible for

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a 40 basis point increase in net interest yield, to 137 basis points in 2001 from 97 basis points in 2000. One basis point, or bp, is equivalent to one one-hundredth of a percent. Net interest yield increased by 3 basis points in 2002 to 140 basis points. This modest increase was the result of generally falling interest rates offset by accelerated amortization expense due to a decrease in the estimated life of the mortgage assets in the retained portfolio.

Non-interest income totaled \$7.8 billion in 2002, compared to expense of \$1.1 billion in 2001 and income of \$2.6 billion in 2000. The volatility in non-interest income was largely due to the amount of derivatives, mortgage securities and guarantee assets and guarantee obligations marked to fair value through earnings, with the most significant driver being derivatives gains and losses.

We achieved these results while adhering to our credit and interest-rate risk disciplines. See “— CONSOLIDATED RESULTS OF OPERATIONS” for more information concerning our financial results.

### CRITICAL ACCOUNTING POLICIES

Our financial statements are prepared in accordance with GAAP. In the application of GAAP, we are required to make certain estimates and assumptions. We have presented below a summary of those accounting policies that are particularly sensitive to management judgment and also are considered highly complex in nature. Actual results could differ from estimates used and it is possible that such differences could have a material impact on the financial statements. See “FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA — NOTE 2: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES” for additional information regarding these and other accounting policies.

#### Fair Value

A significant estimate that is pervasive in our financial statements is the determination of fair value for financial instruments required to be recorded at fair value under GAAP. The measurement of fair value is fundamental to the presentation of our financial condition and results of operations and in many instances requires management to make complex judgments. In general, we record many of our financial instruments at fair value in the consolidated balance sheets and changes in these fair values as gains and losses in the consolidated results of operations. Fair value is an estimate of the amount at which the instrument could be bought and sold between willing parties, in an active market and not in a forced or liquidation sale.

The assumptions used to determine or estimate fair values reflect our best judgment regarding appropriate valuation methods. Under SFAS 107, “Disclosures about Fair Values of Financial Instruments,” or SFAS 107, and other GAAP guidance, the method used to determine fair value for each type of financial instrument depends on the reliability and availability of relevant market data, which is known as price transparency. The price transparency of a particular financial instrument determines the amount of judgment involved in estimating the fair value of our financial instruments. Price transparency is affected by a significant number of factors, including, for example, the type of financial instrument, whether it is new and not yet established in the marketplace, and the characteristics of the financial instrument. Financial instruments for which actively quoted prices or pricing parameters are available or for which fair value is derived from actively quoted prices or pricing parameters will generally have a higher degree of price transparency. The fair value of a substantial portion of our financial instruments is based on observable prices or market parameters obtained from third-party pricing services or broker-dealers in active markets or derived from such prices or parameters. Examples of these financial instruments include securities issued by the U.S. government and its agencies, most mortgage-related securities, most derivatives and mortgage loans.

In contrast, certain of our financial instruments exhibit little or no price transparency. Examples include guarantee assets and guarantee obligations recognized pursuant to sales of PCs. Generally, the fair value of guarantee assets is determined using internally developed models that facilitate simulation of multiple future scenarios that may occur. The guarantee obligation uses internal models incorporating empirical data coupled with the results of an effort to benchmark default and capital assumptions observed in actual jumbo securities market trades adjusted (as appropriate) to reflect differences in underlying collateral and other factors. The use of different pricing models and assumptions could produce materially different estimates of fair value. However, we believe the fair values used are reasonable based on internal reviews of significant pricing models

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and methodologies as well as verification of financial instrument pricing with third party broker-dealers or pricing services.

Table 10 summarizes our assets and liabilities that are recorded at fair value.

**Table 10 — Assets and Liabilities Recorded at Fair Value**

	December 31,	
	2002	2001
	(dollars in millions)	
<i>Retained portfolio</i>		
Mortgage-related securities:		
Available-for-sale, at fair value .....	\$496,265	\$398,921
Trading, at fair value .....	29,104	41,400
<i>Investments</i>		
Mortgage-related securities:		
Trading, at fair value .....	32,366	27,194
Non-mortgage-related securities:		
Available-for-sale, at fair value .....	66,419	54,810
Trading, at fair value .....	2,409	1,539
<i>Other assets</i>		
Derivative assets, at fair value .....	10,393	1,996
Guarantee asset for Participation Certificates, at fair value .....	2,445	3,156
<i>Other liabilities</i>		
Guarantee obligation for Participation Certificates, at fair value .....	1,427	1,155
Derivative liabilities, at fair value .....	967	2,644

**Transfers of Financial Assets**

Freddie Mac purchases residential mortgage loans originated by mortgage lenders, as well as mortgage-related securities. One of the means by which we fund purchases of mortgage loans is through the use of securitization-based financing. That is, we fund the purchases of such financial assets by issuing undivided interests in purchased mortgage loans and transferring such interests to investors in exchange for cash consideration. We account for transfers of financial assets pursuant to the requirements of SFAS 140, “Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities” and, prior to April 1, 2001, SFAS 125, “Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities” (collectively, “SFAS 125 / 140”). If we determine that we have surrendered control over assets that we transfer to a third party, we account for the transfers as sales to the extent the counterparty provides consideration other than beneficial interests in the transferred assets.

If a transfer of financial assets qualifies as a sale, we continue to carry on our consolidated balance sheets any retained interests in financial assets that were securitized or re-securitized. These retained interests include guarantee assets, PCs and Structured Securities that are not transferred to third parties. Retained PCs and Structured Securities are accounted for as either available-for-sale or trading securities in accordance with SFAS 115, “Accounting for Certain Investments in Debt and Equity Securities,” or SFAS 115. The carrying amount of retained interests is determined by allocating the previous carrying amount of the transferred assets between assets sold and the retained interests based on their relative fair value at the date of transfer. We also recognize as part of a securitization the fair value of our recourse obligation to guarantee the timely payment of principal and interest of PCs and Structured Securities transferred in sale transactions. The securitization gain or loss involves our best estimate of key assumptions, including expected credit losses and the exposure to credit losses that could deviate from expected credit losses, prepayment rates, forward yield curves and discount rates. We believe that the above assumptions are comparable to those used by the other market participants.

Table 11 summarizes securitization activity in 2002 and 2001.

**Table 11 — Securitization Activity**

	Year Ended	
	2002	2001
	(dollars in millions)	
Assets transferred .....	\$241,214	\$158,166
Gain on sale .....	1,072	468

The recording of a sale also requires an estimation of the fair value of the retained interests and the recourse obligations. See “FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA — NOTE 3: SECURITIZATION OF MORTGAGE-RELATED ASSETS” for discussion of the fair values above. The use of different pricing models and assumptions could produce materially different results.

### Hedge Accounting

We recognize all derivatives as either assets or liabilities on our consolidated balance sheets at fair value.

Subject to certain qualifying conditions, we may designate a derivative as either a hedge of the cash flows of a variable-rate instrument or a forecasted transaction (or cash flow hedge), a hedge of the changes in fair value of a fixed-rate instrument (or fair value hedge), or a foreign currency fair value or cash flow hedge (or foreign currency hedge). The determination of whether a derivative qualifies for hedge accounting requires judgment about the application of SFAS 133, “Accounting for Derivative Instruments and Hedging Activities,” as amended by SFAS 138, “Accounting for Certain Derivative Instruments and Certain Hedging Activities” (collectively, “SFAS 133”). SFAS 133 requires us to develop documentation of our hedges and to perform certain computations to assess the historical and expected effectiveness of the hedge to qualify for hedge accounting. Even if hedge accounting is not pursued, all derivatives are recorded at their estimated fair value on our consolidated balance sheets.

A portion of our derivative portfolio is designated in fair value and cash flow hedge accounting relationships. For a derivative qualifying as a cash flow hedge, we report changes in the fair value of these instruments in a separate component of “Accumulated other comprehensive income (loss), net of taxes” to the extent the hedge is effective. For a derivative qualifying as a fair value hedge, we report changes in the fair value of the derivative along with the changes in the fair value of the hedged item attributable to the risk being hedged in the consolidated statements of income. 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 yield 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 subsequent fair value gains and losses in the consolidated statements of income as “Derivative gains (losses)” until the derivative is terminated or redesignated. Thus, not qualifying for hedge accounting may introduce material income statement volatility. See Table 39 for additional information regarding derivatives in hedge accounting relationships.

For a more detailed description of our use of derivatives and summaries of derivative positions, see “— RISK MANAGEMENT — Interest-Rate Risk and Other Market Risks — *Interest-Rate Risk Management and Use of Derivatives.*”

### Reserves for Losses on Mortgage Loans Held for Investments and Losses on PCs

We maintain a “Reserve for losses on mortgage loans held for investment” to provide for credit losses on mortgages included in our retained portfolio (excluding mortgage loans held for sale). We also maintain a “Reserve for guarantee losses on Participation Certificates” to provide for credit losses on mortgages underlying PCs held by third parties that have never previously been accounted for as sales by us under SFAS 125 / 140 (and which, therefore, have no recognized guarantee obligation).

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The “Reserve for losses on mortgage loans held for investment” and “Reserve for guarantee losses on Participation Certificates” are increased through charges to the “Provision for credit losses” and decreased by charge-offs, net of recoveries. Setting the level of reserves requires significant judgment and the resulting reserve levels are regularly evaluated by us. These reserves are also affected by SFAS 125/140. More specifically, if the underlying loans are subject to a SFAS 125/140 sale, then the SFAS 5, “Accounting for Contingencies,” reserve is reduced because the guarantee obligation recognized under SFAS 125/140 will now incorporate the fair value of the credit loss expectations. However, these reserves will increase upon repurchase of delinquent loans out of PC pools that have been sold pursuant to SFAS 125/140, reducing the related guarantee obligation previously recognized under SFAS 125/140.

We estimate incurred credit losses on homogeneous pools of single-family loans using statistically based models that evaluate a variety of factors, resulting in a range of probable losses related to impaired single-family loans at the balance sheet date. The factors used to estimate incurred losses as of period-end include: actual and estimated loss severity trends for similar loans; actual and estimated default experience; actual and estimated proceeds from private mortgage insurance and other credit enhancements; actual and estimated pre-foreclosure real estate taxes and insurance; the year of the loan origination; geographic location; and estimated selling costs should the underlying property ultimately be foreclosed upon and sold.

We review the range of probable losses to determine the point within the range that represents the best estimate of incurred losses. The level of reserves is then adjusted to our best estimate of incurred losses. We also consider macroeconomic factors, including regional housing trends, applicable home price indices, unemployment and the employment dislocation trends, consumer credit statistics, recent changes in credit underwriting practices, 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 factors produce a reserve requirement toward the lower end of the range; adverse trends in these factors produce a reserve requirement toward the higher end of the range.

We estimate a range of incurred credit losses on the multifamily portfolio based on an individual review of each loan as well as an evaluation of loan-level and market level risk characteristics of the portfolio in the aggregate to determine reserve needs. We review the range of probable losses to determine the point within the range that represents the best estimate of incurred losses. The level of reserves is then adjusted to our best estimate of incurred losses. Loans individually evaluated for impairment include loans that become 60 days past due for principal and interest, loans with observable collateral deficiencies, and loans whose contractual terms have been modified due to credit concerns.

Emphasizing one of the above factors over another or considering additional factors could materially impact the loan loss reserves. We believe the loan loss reserves are appropriate for the incurred losses inherent in the portfolio as of the reported balance sheet dates.

Table 12 summarizes the activity in Loan Loss Reserves in 2002 and 2001.

**Table 12 — Loan Loss Reserves**

	December 31,	
	2002	2001
	(dollars in millions)	
Beginning balance . . . . .	\$ 224	\$ 229
Provision for credit losses . . . . .	128	32
Charge-offs . . . . .	(171)	(129)
Recoveries <sup>(1)</sup> . . . . .	84	92
Charge-offs, net . . . . .	(87)	(37)
Ending balance . . . . .	<u>\$ 265</u>	<u>\$ 224</u>

(1) Includes recoveries of charge-offs primarily resulting from foreclosure alternatives and real estate owned, or REO, acquisitions on loans where the primary default risk has been assumed by servicers, mortgage insurers, or third parties through credit enhancements.

## Premiums and Discounts

For most of our investments in mortgage-related securities and non-mortgage related securities classified as available-for-sale, which had a carrying value at December 31, 2002 of \$496 billion and \$66 billion, respectively, interest income is recognized using the effective interest method in accordance with SFAS 91, "Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases," or SFAS 91. Deferred items, including premiums, discounts and other basis adjustments, are amortized into interest income over the estimated lives of the securities using the effective interest method in accordance with SFAS 91.

We use actual prepayment experience and estimates of future prepayments to determine the constant yield needed to apply the effective interest method. In estimating future prepayments and cash flows, we aggregate securities by similar characteristics of their underlying collateral such as origination date, coupon and maturity. For securities with structured cash flow payments, such as Structured Securities, estimates of future prepayments and cash flows also consider the characteristics of other security classes within the same transaction structure. Estimates of future prepayments are derived from market sources and prepayment models.

On a periodic basis, we recalculate the constant effective yield based on changes in estimated prepayments as a result of changes in interest rates and actual prepayments versus anticipated prepayments. When the constant effective yield changes, an adjustment to interest income is made for the amount of premiums and discounts that would have been recorded if the new effective yield had been applied since the mortgage assets were acquired.

For a significant portion of our investments in mortgage-related securities and non-mortgage related securities classified as available-for-sale, interest income is recognized using the prospective effective interest method in accordance with EITF 99-20, "Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets," or EITF 99-20. The company specifically applies such guidance to beneficial interests (including undivided interests similar to beneficial interests) in securitized financial assets that (i) can contractually be prepaid or otherwise settled in such a way that the company may not recover substantially all of its recorded investment (such as IO strips) or (ii) are not of high credit quality at the effective date of EITF 99-20 (April 1, 2001) or at the date that Freddie Mac acquired them, if later.

EITF 99-20 requires that we recognize as interest income (throughout the life of a retained interest) the excess of all estimated cash flows attributable to the retained beneficial interest of our initial investment 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.

The above accounting estimates require us to use judgment and make assumptions about borrower prepayments that involve a significant amount of uncertainty. We periodically re-evaluate our estimates used in amortization calculations and appropriately adjust interest income based on the above amortization policies. We believe that the above assumptions are comparable to those used by other market participants.

See "FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA — NOTE 2: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES" for more information concerning new accounting pronouncements.

## CONSOLIDATED RESULTS OF OPERATIONS

The MD&A, and the following discussion of our consolidated results of operations in particular, should be read in conjunction with the notes to our consolidated financial statements.

Table 13 summarizes our financial performance for the periods presented.

**Table 13 — Summary of Consolidated Results**

	2002 vs. 2001				2001 vs. 2000		
	Year Ended December 31,		Dollar Change	Percent Change	Year Ended December 31, 2000	Dollar Change	Percent Change
	2002	2001					
Net interest income	\$ 8,886	\$ 6,992	\$ 1,894	27%	\$ 3,758	\$ 3,234	86%
Non-interest income							
Management and guarantee income	1,516	1,392	124	9	1,252	140	11
Gains (losses) on "Guarantee asset for Participation Certificates, at fair value"	(2,176)	(789)	(1,387)	176	(1,197)	408	(34)
Gains (losses) on "Guarantee obligation for Participation Certificates, at fair value"	592	203	389	192	443	(240)	(54)
Derivative gains (losses)	5,941	(1,857)	7,798	(420)	1,483	(3,340)	(225)
Hedge accounting gains (losses)	187	(294)	481	(164)	—	(294)	(100)
Gains (losses) on investment activity	1,812	191	1,621	849	492	(301)	(61)
Gains (losses) on debt retirement	(674)	(356)	(318)	89	13	(369)	(2,838)
Resecuritization fees	276	135	141	104	15	120	800
Other income	308	229	79	34	146	83	57
Total non-interest income	7,782	(1,146)	8,928	(779)	2,647	(3,793)	(143)
Non-interest expense							
Provision for credit losses	(128)	(32)	(96)	300	(79)	47	(59)
REO operations income (expense)	13	(7)	20	(286)	4	(11)	(275)
Salaries and employee benefits	(593)	(537)	(56)	10	(433)	(104)	24
Occupancy expense	(42)	(35)	(7)	20	(35)	—	—
Housing tax credit partnerships	(160)	(121)	(39)	32	(104)	(17)	16
Minority interests in earnings of consolidated subsidiaries	(184)	(208)	24	(12)	(231)	23	(10)
Other expenses	(771)	(452)	(319)	71	(357)	(95)	27
Total non-interest expense	(1,865)	(1,392)	\$ (473)	34	(1,235)	(157)	13
Income before income tax expense and cumulative effect of change in accounting principles	14,803	4,454	10,349	232	5,170	(716)	(14)
Income tax expense	(4,713)	(1,339)	(3,374)	252	(1,504)	165	(11)
Income before cumulative effect of change in accounting principles, net of taxes	10,090	3,115	6,975	224	3,666	(551)	(15)
Cumulative effect of change in accounting principles, net of taxes	—	43	(43)	(100)	—	43	100
Net income	10,090	3,158	6,932	220	3,666	(508)	(14)
Preferred stock dividends	(234)	(217)	(17)	8	(179)	(38)	21
Net income available to common stockholders	9,856	2,941	6,915	235	3,487	(546)	(16)
Diluted earnings per common share after cumulative effect of change in accounting principles, net of taxes	\$ 14.18	\$ 4.23	\$ 9.95	235%	\$ 5.01	\$(0.78)	(16)%

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## Net Interest Income

Net interest income, the principal source of earnings for us, is the difference between interest income and interest expense. Net interest income is affected by changes in the balance and contractual rates associated with our assets, liabilities and derivative contracts, as adjusted for amortization of purchase premiums and discounts and hedging gains and losses as explained below in "Analysis of Quarterly Results." We discuss net interest income and the related interest yield on a taxable-equivalent basis to consistently reflect income from taxable and tax-exempt investments based on a 35 percent marginal tax rate.

### 2002 versus 2001

Table 14 summarizes net interest income for 2002 compared to 2001, and the related rate/volume analysis for the changes between 2002 and 2001.

**Table 14 — Net Interest Income and Rate/Volume Analysis (2002 compared to 2001)**

	2002		2001		Increase (Decrease) to NII	Attributable to Changes in <sup>(1)</sup>	
	NII	Yield	NII	Yield		Rate	Volume
(dollars in millions)							
Interest income:							
Mortgage loans	\$ 4,290	7.04%	\$ 4,385	7.23%	\$ (95)	\$ (116)	\$ 21
Mortgage-related securities	30,039	6.38	26,847	6.91	3,192	(2,187)	5,379
Total retained portfolio	34,329	6.46	31,232	6.96	3,097	(2,303)	5,400
Cash and investments	4,147	3.41	4,136	4.82	11	(1,448)	1,459
Total interest-earning assets	38,476	5.89	35,368	6.62	3,108	(3,751)	6,859
Interest expense:							
Short-term debt	(4,303)	(2.03)	(9,056)	(4.23)	4,753	4,670	83
Long-term debt	(21,025)	(5.16)	(17,466)	(5.99)	(3,559)	2,678	(6,237)
Total contractual debt	(25,328)	(4.09)	(26,522)	(5.25)	1,194	7,348	(6,154)
Due to Participation Certificate investors	(1,236)	(6.82)	(1,027)	(7.27)	(209)	66	(275)
Total interest-bearing liabilities	(26,564)	(4.17)	(27,549)	(5.30)	985	7,414	(6,429)
Income (expense) related to derivatives	(3,026)	(0.47)	(827)	(0.16)	(2,199)	(2,199)	—
Impact of net non-interest-bearing funding	—	0.12	—	0.18	—	—	—
Net interest income <sup>(2)</sup>	\$ 8,886	1.36	\$ 6,992	1.32	\$ 1,894	\$ 1,464	\$ 430
Fully taxable-equivalent adjustment	252	0.04	237	0.04	15	4	11
Net interest income (fully taxable- equivalent basis) <sup>(2)</sup>	\$ 9,138	1.40%	\$ 7,229	1.37%	\$ 1,909	\$ 1,468	\$ 441

(1) Combined rate/volume changes are allocated to the individual rate and volume changes based on their relative size.

(2) May not sum due to rounding.

Net interest income on a fully taxable-equivalent basis increased \$1.9 billion, or 26 percent, to \$9.1 billion in 2002 from \$7.2 billion in 2001. The increase in net interest income was primarily due to a continuation during 2002 of the steep yield curve environment that existed in 2001. A steepening yield curve means that short-term interest rates are decreasing more than long-term rates, or are increasing at a slower rate than long-term rates. This environment resulted in (i) wide initial spreads between the yield on asset purchases and the cost of the debt issued to fund those purchases (referred to as "mortgage-to-debt spreads") since a portion of the debt issued is shorter-term than the corresponding asset funded, as well as (ii) continued decreases in short-term debt costs in 2002. An increase of \$83 billion, or 18 percent, in the average balance of the retained portfolio also contributed to the increase in net interest income (see "— CONSOLIDATED BALANCE SHEETS ANALYSIS — Retained Portfolio" for a discussion regarding changes in the balance of the retained portfolio).

The positive effects of the steep yield curve and retained portfolio growth on net interest income were partially offset by increased amortization expense associated with (i) net purchase premiums on mortgage investments and (ii) deferred hedging losses related to terminated pay-fixed swaps. These expenses were

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caused by decreases in long-term rates during 2002, which shortened the expected lives of mortgage investments resulting in accelerated amortization of related premiums, as well as the termination of pay-fixed swaps. As discussed in “— CONSOLIDATED BALANCE SHEETS ANALYSIS — Total Debt Securities, Net,” we terminated pay-fixed swaps during 2002 as a result of the decrease in the expected lives of mortgage investments and an increase in the balance of long-term debt. For further information regarding amortization of premiums, discounts and hedging gains and losses, see “— Analysis of Quarterly Results” below and “FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA — NOTE 2: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — Securities” and “— Derivatives.”

Net interest yield on a fully taxable-equivalent basis increased by 3 basis points to 140 basis points in 2002 from 137 basis points in 2001. This relatively small change in net interest yield was the net result of the effects of the steep yield curve and increased amortization expense, as discussed above, as well as a shift in the mix of interest-earning assets toward cash and investments. The average balance of cash and investments increased by 42 percent, fueled by cash inflows to us from prepayments on outstanding PCs. Prepayments on outstanding PCs tend to increase the balance of short-term investments since we invest the prepayments pending remittance to investors. In addition, limited retained portfolio investment opportunities during certain periods of 2002 also contributed to growth in the average balance of cash and investments. When growth in capital, generally driven by net income, outpaces opportunities to grow the retained portfolio, we may temporarily deploy capital in cash and investments until the capital can be redeployed into retained portfolio investments. Increases in short-term investments contribute to net interest income, but generally decrease net interest yield since the net yield on short-term investments is generally lower than the net yield on longer-term retained portfolio assets.

### 2001 versus 2000

Table 15 summarizes net interest income for 2001 compared to 2000, and the related rate/volume analysis for the changes between 2001 and 2000.

**Table 15 — Net Interest Income and Rate/Volume Analysis (2001 compared to 2000)**

	2001		2000		Increase (Decrease) to NII	Attributable to Changes in <sup>(1)</sup>	
	NII	Yield	NII	Yield		Rate	Volume
	(dollars in millions)						
Interest income:							
Mortgage loans	\$ 4,385	7.23%	\$ 4,177	7.32%	\$ 208	\$ (54)	\$ 262
Mortgage-related securities	26,847	6.91	20,536	7.01	6,311	(285)	6,596
Total retained portfolio	31,232	6.96	24,713	7.06	6,519	(339)	6,858
Cash and investments	4,136	4.82	4,469	6.01	(333)	(1,006)	673
Total interest-earning assets	35,368	6.62	29,182	6.88	6,186	(1,345)	7,531
Interest expense:							
Short-term debt	(9,056)	(4.23)	(10,492)	(6.00)	1,436	3,535	(2,099)
Long-term debt	(17,466)	(5.99)	(14,639)	(6.39)	(2,827)	964	(3,791)
Total contractual debt	(26,522)	(5.25)	(25,131)	(6.22)	(1,391)	4,499	(5,890)
Due to Participation Certificate investors	(1,027)	(7.27)	(352)	(6.53)	(675)	(44)	(631)
Total interest-bearing liabilities	(27,549)	(5.30)	(25,483)	(6.23)	(2,066)	4,455	(6,521)
Income (expense) related to derivatives	(827)	(0.16)	59	0.01	(886)	(886)	—
Impact of net non-interest-bearing funding	—	0.18	—	0.26	—	—	—
Net interest income <sup>(2)</sup>	\$ 6,992	1.32	\$ 3,758	0.92	\$ 3,234	\$ 2,224	\$ 1,010
Fully taxable-equivalent adjustment	237	0.04	224	0.05	13	(16)	29
Net interest income (fully taxable- equivalent basis) <sup>(2)</sup>	\$ 7,229	1.37%	\$ 3,982	0.97%	\$ 3,247	\$ 2,208	\$ 1,039

(1) Combined rate/volume changes are allocated to the individual rate and volume changes based on their relative size.

(2) May not sum due to rounding.

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Net interest income on a fully taxable-equivalent basis increased by \$3.2 billion, or 82 percent, to \$7.2 billion in 2001 from \$4.0 billion in 2000. Net interest income was driven by a significant decrease in short-term interest rates, a steepening of the yield curve, and growth in interest-earning assets, particularly the retained portfolio. The decrease in short-term interest rates coupled with the steepening yield curve resulted in a reduction in short-term debt costs and wider initial mortgage-to-debt spreads on additions to the retained portfolio. Retained portfolio purchases in 2001 totaled approximately \$253 billion, which, net of repayments and sales, resulted in a 28 percent increase in the average balance of the retained portfolio.

Also contributing to the increase in net interest income was an increase in amortization income related to net purchase discounts and deferred hedging gains, and the change in accounting for the cost of purchased options as a result of the implementation of SFAS 133 on January 1, 2001. Prior to the implementation of SFAS 133, we amortized purchased option premiums and amounts paid or received to acquire interest-rate swaps to net interest income. This amortization expense totaled \$168 million in 2000. After the adoption of SFAS 133, options are marked to fair value with changes in fair value reported as “Derivative gains (losses).”

Net interest yield on a fully taxable-equivalent basis increased by 40 basis points from 97 basis points in 2000 to 137 basis points in 2001. This increase was primarily due to the reduction in short-term interest rates, wider spreads on new purchases as described above and the increase in amortization income.

### *Analysis of Quarterly Results*

Table 16 summarizes quarterly net interest income and net interest yield for 2001 and 2002.

**Table 16 — Quarterly Net Interest Income (quarterly yields annualized)**

	<u>1Q 2001</u>	<u>2Q 2001</u>	<u>3Q 2001</u>	<u>4Q 2001</u>	<u>2001</u>
	(dollars in millions)				
Net interest income . . . . .	\$1,295	\$1,518	\$2,158	\$2,021	\$6,992
Fully taxable-equivalent adjustment . . . . .	<u>57</u>	<u>63</u>	<u>59</u>	<u>58</u>	<u>237</u>
Net interest income (fully taxable-equivalent basis) . . . . .	<u>\$1,352</u>	<u>\$1,581</u>	<u>\$2,217</u>	<u>\$2,079</u>	<u>\$7,229</u>
Net interest yield (fully taxable-equivalent basis) . . . . .	<u>1.14%</u>	<u>1.23%</u>	<u>1.63%</u>	<u>1.43%</u>	<u>1.37%</u>
	<u>1Q 2002</u>	<u>2Q 2002</u>	<u>3Q 2002</u>	<u>4Q 2002</u>	<u>2002</u>
	(dollars in millions)				
Net interest income . . . . .	\$2,414	\$2,123	\$2,079	\$2,270	\$8,886
Fully taxable-equivalent adjustment . . . . .	<u>66</u>	<u>65</u>	<u>66</u>	<u>55</u>	<u>252</u>
Net interest income (fully taxable-equivalent basis) . . . . .	<u>\$2,480</u>	<u>\$2,188</u>	<u>\$2,145</u>	<u>\$2,325</u>	<u>\$9,138</u>
Net interest yield (fully taxable-equivalent basis) . . . . .	<u>1.59%</u>	<u>1.38%</u>	<u>1.32%</u>	<u>1.34%</u>	<u>1.40%</u>

Changes in quarterly net interest income and net interest yield in 2001 and 2002 were driven primarily by changes in short-term interest rates and growth in the retained portfolio during 2001 and 2002 as described above in the analysis of annual results. However, quarterly results were also affected by fluctuations in the amortization of deferred purchase premiums and discounts, amortization of hedging gains and losses, interest expense related to amounts due to PC investors and changes in the mix of short- and long-term debt funding. These drivers are described in detail below, followed by a tabular presentation (*see Table 17*) discussing the impact of these drivers on net interest income during the quarterly periods of 2002 and 2001.

- **Amortization of premiums and discounts.** When we buy mortgage-related securities, the amount we pay for the asset generally does not equal the security UPB. We pay more than the UPB (referred to as a premium) when the coupon on the security is greater than the current market yield for that security. We pay less than the UPB (referred to as a discount) when the coupon on the security is less than the current market yield for that security. During 2001, premiums and discounts related to the retained portfolio resulted in a net discount position.

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Because of declining interest rates during 2002, we paid premiums on a higher percentage of the mortgage-related securities acquired during the year. This resulted in a shift to a net premium position during 2002 for the portfolio.

As described in “FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA — NOTE 2: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — Securities,” these premiums and discounts are amortized over the estimated life of the purchased assets as an adjustment to interest income based on the effective interest method in accordance with SFAS 91. This method of amortization results in periodic adjustments to interest income when the effective interest rate changes due to differences between actual and estimated prepayments and changes in estimated future prepayments. In addition, we implemented several enhancements as described in “FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA — NOTE 1: RESTATEMENT” resulting in a \$305 million increase to net interest income during the fourth quarter of 2002.

- **Amortization of hedging gains and losses.** Certain derivative contracts are accounted for as cash flow hedges of forecasted debt issuances (primarily pay-fixed swaps and Eurodollar futures), while other derivative contracts are accounted for as fair value hedges of existing debt (primarily receive-fixed swaps). In both cases, termination of the hedge relationship results in the associated deferred hedging gain or loss being amortized into net interest income. Amortization related to terminated cash flow hedges is included in “Income (expense) related to derivatives,” while amortization related to terminated fair value hedges is included in interest expense on long-term debt. For further information concerning our accounting policies related to cash flow and fair value hedge relationships, *see* “FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA — NOTE 2: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — Derivatives — Accounting for Derivatives under SFAS 133.” As a result of increased long-term debt issuances and declining interest rates during 2002, we terminated pay-fixed swaps, triggering amortization of deferred hedging losses.
- **Interest expense related to amounts due to Participation Certificate investors.** As a result of the payment remittance cycle associated with Gold PCs, which is described in “FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA — NOTE 2: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — Due to Participation Certificate Investors,” interest expense related to amounts due to PC investors will increase during periods of high prepayments and decrease during periods of low prepayments. Because of changes in interest rates and mortgage prepayment rates, interest expense related to amounts due to PC investors fluctuated from period to period in 2001 and 2002.
- **Debt funding mix.** As discussed in “— CONSOLIDATED BALANCE SHEETS ANALYSIS — Total Debt Securities, Net,” we use our derivative portfolio to address differences between outstanding debt and our funding needs. Because of declining interest rates in 2002, the expected lives of assets held in the retained portfolio decreased, reducing the need from an asset/liability management perspective for long-term debt. However, the volume of long-term debt issued is generally determined by our commitment to our Reference Notes securities calendar. To shorten the effective duration of our debt and thereby manage the funding mismatch created by the decline in interest rates, we terminated certain pay-fixed swaps and entered into receive-fixed swaps. Receive-fixed swaps effectively convert a fixed-rate debt payment into a variable-rate payment.

The following discussion describes the effect of these factors on changes in quarterly net interest income.

**Table 17 — Explanation of Quarterly Changes in Net Interest Income and Net Interest Yield**

Period	Increase (Decrease) in Net Interest Income (in millions)	Increase (Decrease) in Net Interest Yield (in bps)	Comments
2Q01 vs. 1Q01	\$ 229	9	Increases were driven by retained portfolio growth of \$25 billion and reductions in short-term interest rates. These positive factors were partially offset by an increase in interest expense related to amounts due to PC investors as the liquidation rate on total PCs issued increased to 30 percent from 21 percent in the first quarter of 2001. Liquidation rate is defined as the balance of scheduled and unscheduled principal payments during the period as a percent of the balance of total PCs issued at the beginning of the period.
3Q01 vs. 2Q01	636	40	Increases were driven by retained portfolio growth of \$20 billion and decreases in short-term interest rates. Accelerated amortization income on deferred discounts (due to shortened expected asset lives in response to decreases in long-term interest rates) and a decrease in interest expense related to amounts due to PC investors also contributed to the increase in net interest income and net interest yield. The decrease in interest expense related to amounts due to PC investors was due to a decrease in liquidation rates on total PCs issued, combined with a change in the PC remittance cycle implemented during the quarter that accelerated the remittance of mortgage prepayments to PC investors.
4Q01 vs. 3Q01	(138)	(20)	Decreases were driven by a decrease in amortization income from deferred discounts and an increase in interest expense related to amounts due to PC investors. The decrease in amortization income was due to an increase in long-term interest rates, which resulted in an increase in expected asset lives causing the reversal of amortization income recognized in the prior periods in accordance with SFAS 91. The increase in interest expense related to amounts due to PC investors was driven by an increase in the liquidation rate on total PCs issued to 43 percent due to decreases in long-term interest rates in the third quarter. Liquidation rates are typically driven by changes in interest rates in the prior quarter given the time lag between decreases in interest rates and the mortgage prepayments. These negative factors were partially offset by retained portfolio growth of \$26 billion and a decrease in short-term debt costs as a result of continued decreases in short-term interest rates.
1Q02 vs. 4Q01	401	16	Increases were driven by retained portfolio growth of \$38 billion and a return to more typical amortization income on the retained portfolio's net deferred discount position as a result of relatively stable interest rates during the quarter. These favorable factors were partially offset by a shift in funding mix from short-term to long-term debt.
2Q02 vs. 1Q02	(292)	(21)	Decreases were driven by a continued shift in debt funding from short-term debt to long-term debt and increased amortization of deferred hedging losses resulting from terminated pay-fixed swaps, as described above in "Debt funding mix."

**Table 17 — Explanation of Quarterly Changes in Net Interest Income and Net Interest Yield (continued)**

Period	Increase (Decrease) in Net Interest Income (in millions)	Increase (Decrease) in Net Interest Yield (in bps)	Comments
3Q02 vs. 2Q02	(43)	(6)	Decreases were due to increased amortization expense related to (i) deferred premiums on retained portfolio purchases and (ii) hedging losses associated with terminated pay-fixed swaps. As discussed above in “Amortization of premiums and discounts,” the deferred amount related to the retained portfolio shifted to a premium position in 2002. The increase in amortization expense was partially offset by an increase in interest income from derivative contracts as a result of increases in the notional amount of receive-fixed swaps.
4Q02 vs. 3Q02	180	2	Increases were driven by an increase in amortization income and interest income on derivative contracts, partially offset by increased amortization of deferred hedging losses and increased interest expense related to amounts due to PC investors. The increase in amortization income was due to a \$305 million adjustment related to the enhancements described above in “Amortization of premiums and discounts.” The increase in interest income on derivative contracts and amortization of deferred hedging losses was due to an increase in the notional amount of receive-fixed swaps combined with the termination of pay-fixed swaps. Interest expense on amounts due to PC investors increased as the liquidation rate on total PCs issued increased from 40 percent in the third quarter of 2002 to 65 percent in the fourth quarter of 2002.

**Non-Interest Income**

*Management and Guarantee Income*

Management and guarantee income primarily represents the net contractual cash flows we receive on mortgage-related securities issued and guaranteed by us and held by third party investors. For securities we hold, the associated components of guarantee income are included in “Net interest income.”

Table 18 provides summary information about management and guarantee income for 2002, 2001 and 2000.

**Table 18 — Management and Guarantee Income**

	2002	2001	2000
	(dollars in millions)		
Management and guarantee income . . . . .	\$ 1,516	\$ 1,392	\$ 1,252
Average outstanding PCs <sup>(1)</sup> . . . . .	\$687,942	\$589,772	\$531,207
Management and guarantee rate (in basis points) . . . . .	22.0	23.6	23.6

(1) Average outstanding PCs were calculated by including PCs and Structured Securities that are backed by non-agency mortgage-related securities held by third parties.

Management and guarantee income increased by \$124 million, or 9 percent, to \$1.5 billion in 2002 from \$1.4 billion in 2001. In 2001, management and guarantee income increased \$140 million, or 11 percent. These increases in guarantee income were primarily due to an increase in the average balance of outstanding PCs, which increased by 17 percent in 2002 and 11 percent in 2001.

The effective management and guarantee rate, which consists of the contractual management and guarantee rate as adjusted for amortization of deferred fees, including credit fees, buy-down fees and other items, as described in “FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA — NOTE 2: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — Guarantee Fees, Buy-Up Fees and Buy-

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Down Fees,” decreased by 1.6 basis points to 22.0 basis points in 2002 from 23.6 basis points in 2001 and was unchanged from 23.6 basis points in 2000. These results were driven by decreases in contractual management and guarantee rates as a result of declining market prices for guarantee fees and a shift away from guarantees with buy-up fees, offset by accelerated amortization of deferred fees.

As explained in “FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA — NOTE 2: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — Guarantee Fees, Buy-Up Fees and Buy-Down Fees,” we pay buy-up fees to increase the contractual management and guarantee rate we receive from the counterparty so that a mortgage loan will “fit” into a PC. Cash inflows resulting from when we buy-up the contractual fee rate are included in management and guarantee income, although the buy-up fee asset is marked to fair value through “Gains (losses) on ‘Guarantee asset for Participation Certificates, at fair value.’” As a result, the average management and guarantee rate reported on guarantees with buy-up fees will tend to be higher than the rate reported on guarantees without buy-up fees.

The effect of declining contractual management and guarantee rates was partially offset in 2002 and more than offset in 2001 by an acceleration of amortization income related to deferred fees due to a decrease in the expected lives of outstanding PCs that was driven by declining interest rates and increased prepayments. Upfront fees we receive related to guarantees issued through the Guarantor Program are deferred and amortized using the interest method in accordance with SFAS 91 and as described above under “Net Interest Income.”

Table 19 summarizes management and guarantee income and rates for each quarter in 2001 and 2002.

**Table 19 — Quarterly Management and Guarantee Income**

	<u>1Q 2001</u>	<u>2Q 2001</u>	<u>3Q 2001</u>	<u>4Q 2001</u>
	(dollars in millions)			
Management and guarantee income . . . . .	\$ 347	\$ 340	\$ 396	\$ 309
Average outstanding PCs <sup>(1)</sup> . . . . .	\$556,597	\$571,456	\$607,169	\$623,866
Management and guarantee rate (in basis points) . . . . .	24.9	23.8	26.1	19.8
	<u>1Q 2002</u>	<u>2Q 2002</u>	<u>3Q 2002</u>	<u>4Q 2002</u>
	(dollars in millions)			
Management and guarantee income . . . . .	\$ 372	\$ 385	\$ 370	\$ 389
Average outstanding PCs <sup>(1)</sup> . . . . .	\$640,816	\$686,180	\$708,003	\$716,770
Management and guarantee rate (in basis points) . . . . .	23.2	22.4	20.9	21.7

(1) Average outstanding PCs were calculated by including PCs and Structured Securities that are backed by non-agency mortgage-related securities held by third parties.

Changes in management and guarantee income and rates on a quarterly basis in 2002 and 2001 were primarily driven by declining contractual management and guarantee rates and changes in amortization of deferred fees, with the largest fluctuations in amortization occurring in the third and fourth quarters of 2001 and fourth quarter of 2002. These were periods marked by significant changes in interest rates and in the expected lives of outstanding PCs, which resulted in changes in the amount of amortization income recognized in those periods.

***Gains (Losses) on Guarantee Asset and Guarantee Obligation***

“Gains (losses) on ‘Guarantee asset for Participation Certificates, at fair value’” and “Gains (losses) on ‘Guarantee obligation for Participation Certificates, at fair value’” represent the change in fair value of the guarantee asset and guarantee obligation. For information regarding the accounting for the guarantee asset and guarantee obligation, see “FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA — NOTE 2: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES.”

Gains and losses on guarantee asset and guarantee obligation represent the change in fair value of the asset and obligation due to:

- The portion of actual cash received that is considered a return (payment) of principal as opposed to interest earned (paid) on the guarantee asset (guarantee obligation); and
- Changes in the value of future cash flows. The portion of the gains and losses on the guarantee asset and guarantee obligation attributable to these two factors is shown in *Table 20*.

**Table 20 — Attribution of Change in Fair Value**

	2002		2001		2000	
	Guarantee Asset	Guarantee Obligation	Guarantee Asset	Guarantee Obligation	Guarantee Asset	Guarantee Obligation
	(dollars in millions)					
Total cash flows (received) paid . . . .	\$ (820)	\$ 422	\$ (803)	\$ 278	\$ (777)	\$ 200
Portion of cash flows received (paid) related to imputed interest . . . . .	<u>259</u>	<u>(64)</u>	<u>273</u>	<u>(57)</u>	<u>257</u>	<u>(59)</u>
(Return of principal on guarantee assets) Reduction of principal on guarantee obligations . . . . .	(561)	358	(530)	221	(520)	141
Change in fair value of future cash flows . . . . .	<u>(1,615)</u>	<u>234</u>	<u>(259)</u>	<u>(18)</u>	<u>(677)</u>	<u>302</u>
Gains (losses) on guarantee asset and guarantee obligation . . . . .	<u>\$ (2,176)</u>	<u>\$ 592</u>	<u>\$ (789)</u>	<u>\$ 203</u>	<u>\$ (1,197)</u>	<u>\$ 443</u>

With the passage of time, actual cash flows are realized and no longer included in the valuation of the guarantee asset and the guarantee obligation. As such, actual cash flows represent a reduction of the guarantee asset and guarantee obligation (or the “principal” component of total expected gross cash flows). As depicted in *Table 20*, 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 principal (the portion of actual cash flows that represents a reduction of the guarantee asset receivable). Similarly, cash flows paid on the guarantee obligation can be allocated between interest expense and a reduction of the liability. Because the cash flows are reported as income and expense based on the nature of the cash flows (*e.g.*, guarantee fee income, provision for credit losses) and not as a direct reduction in the guarantee asset and guarantee obligation, realized cash flows result in a corresponding change in the valuation of the asset and the obligation.

The other component of gains and losses on guarantee asset and guarantee obligation is the gain or loss due to changes in the value of future expected cash flows. The value of expected cash flows is driven by the estimated lives of the mortgages underlying the outstanding PCs and other economic factors that influence the amount and timing of the future cash flows such as changes in actual and expected interest rates. Changes in the estimated lives affect the value of the guarantee asset and the guarantee obligation because Freddie Mac’s right to receive guarantee fees and its obligation to pay related expenses cease when the underlying mortgages prepay. Changes in expected lives can also affect the value of the guarantee obligation due to the remittance cycle associated with most PCs. As described in “FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA — NOTE 2: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES,” when a prepayment occurs, we assume the obligation to pay interest due to the PC investor on the prepayment proceeds from the time the mortgage prepays to the time the PC balance is reduced. We seek to offset this cost by investing the prepayment proceeds until they are remitted to the PC investor, which typically occurs 15 days after the PC balance is reduced. However, when income expected to be earned from the investment of the prepayment proceeds is less than the interest expected to be due to PC investors, the increase in expected future prepayments increases the fair value of the remaining guarantee obligation. Conversely, when the income expected to be earned is greater than the interest expected to be due to PC investors, the increase in expected prepayments decreases the fair value of the remaining guarantee obligation. The amount and timing of cash flows related to the guarantee obligation are also driven by changes in house price appreciation, short-

term interest rates and other economic factors that influence expected credit losses and expected income earned on mortgage principal and interest payments held pending remittance to PC investors.

Losses on the guarantee asset increased in 2002 mainly due to decreases in mortgage interest rates during the year, which reduced the expected lives of the mortgages underlying outstanding PCs and the amount of estimated future guarantee fee cash flows. The reduction in expected lives also resulted in an increase in gains on the guarantee obligation in 2002, although not to the same extent as the loss on the guarantee asset since higher prepayment estimates combined with lower short-term interest rates increased the expected net expense associated with amounts due to PC investors.

During 2001, losses on the guarantee asset and gains on the guarantee obligation decreased compared to 2000. These decreases were primarily driven by interest rate changes in 2001 compared to 2000, which resulted in a slight increase in the expected lives of the mortgages underlying outstanding PCs at the end of 2001 compared to the end of 2000.

Table 21 summarizes gains and losses on the guarantee asset and guarantee obligation for each quarter in 2001 and 2002.

**Table 21 — Quarterly Gains (Losses) on Guarantee Asset and Guarantee Obligation**

	<u>1Q 2001</u>	<u>2Q 2001</u>	<u>3Q 2001</u>	<u>4Q 2001</u>
	(dollars in millions)			
Gains (losses) on guarantee asset .....	\$(261)	\$24	\$(454)	\$(98)
Gains (losses) on guarantee obligation .....	(181)	41	190	153
	<u>1Q 2002</u>	<u>2Q 2002</u>	<u>3Q 2002</u>	<u>4Q 2002</u>
	(dollars in millions)			
Gains (losses) on guarantee asset .....	\$(213)	\$(658)	\$(890)	\$(415)
Gains (losses) on guarantee obligation .....	146	156	62	228

Changes in gains and losses on the guarantee asset and the guarantee obligation reported on a quarterly basis were primarily attributable to changes in the expected lives of the mortgages underlying outstanding PCs, which were driven by changes in mortgage interest rates. Fluctuations in the guarantee obligation were also driven by changes in short-term interest rates and in the credit environment, which also affect the value of future estimated cash flows.

***Derivative Gains (Losses)***

*Derivative gains (losses) represent the change in fair value of derivatives not accounted for in a hedge relationship since these transactions did not qualify for, or we did not elect to pursue, hedge accounting, resulting in fair value changes being recorded to earnings. Although derivatives are an important aspect of our management of interest-rate risk, they may increase the volatility of reported net income, particularly when they are not accounted for in a hedge relationship.*

Derivative gains (losses) totaled \$5.9 billion, (\$1.9) billion and \$1.5 billion in 2002, 2001 and 2000, respectively. These gains and losses were primarily driven by changes in the fair value of certain receive- and pay-fixed interest-rate swaps and call and put swaptions executed to manage interest-rate risk related to the retained portfolio.

We use interest-rate swaps to mitigate contractual funding mismatches between our assets and liabilities. A receive-fixed swap results in us receiving a fixed interest rate payment in exchange for a variable rate payment. Conversely, a pay-fixed swap requires us to make a fixed interest-rate payment in exchange for a variable rate payment. Call and put swaptions are options to enter into receive- and pay-fixed interest-rate 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 assets in the retained portfolio. Mortgage borrowers generally have an option to prepay their mortgages prior to contractual maturity, and this prepayment option is sensitive to changes in interest rates.

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Interest-rate swaps and swaptions not accounted for in hedge relationships may increase the volatility of reported net income since they are marked to fair value through earnings without the offsetting change in value of the hedged risk being recognized in earnings. The fair value of receive- and pay-fixed interest-rate swaps is primarily driven by changes in interest rates, with receive-fixed swaps increasing in value and pay-fixed swaps decreasing in value when interest rates decrease (and the opposite being true when interest rates increase). The fair value of call and put swaptions is sensitive to changes in interest rates in the same manner as receive- and pay-fixed swaps, respectively. Swaption values are also driven by the market's expectation of potential changes in interest rates in the future (referred to as "implied volatility"), with swaptions generally being more valuable as implied volatility increases and less valuable as implied volatility decreases. Because the fair value of options is sensitive to changes in interest rates and the implied volatility of interest rates, changes in the fair value of swaptions can be more significant than changes in the value of the underlying interest-rate swaps; however, losses on such instruments are limited to the premium paid to purchase the option plus any unrealized gains previously recognized.

Table 22 provides a quarterly summary of the period-end notional amount and gains and losses related to interest-rate swaps and swaptions used to manage interest-rate risk but not accounted for in a hedge relationship.

**Table 22 — Derivatives Not in Hedge Accounting Relationships**

	1Q 2001		2Q 2001		3Q 2001		4Q 2001		2001
	Notional	Gain (Loss)	Notional	Gain (Loss)	Notional	Gain (Loss)	Notional	Gain (Loss)	Gain (Loss)
	(dollars in billions)								
Call swaptions . . . . .	\$83.0	\$ —	\$88.9	\$(0.7)	\$ 96.0	\$ 1.8	\$ 97.1	\$(1.0)	\$ 0.1
Put swaptions . . . . .	29.8	(0.1)	56.2	0.2	70.4	(0.6)	84.2	1.0	0.5
Receive-fixed swaps . . . . .	46.8	0.3	61.4	(1.1)	130.1	6.3	131.6	(3.7)	1.8
Pay-fixed swaps . . . . .	81.9	(1.4)	72.6	1.7	110.7	(7.2)	100.3	2.7	(4.2)
Subtotal . . . . .		(1.2)		0.1		0.3		(1.0)	(1.8)
Other <sup>(1)</sup> . . . . .		0.1		(0.2)		0.1		(0.1)	(0.1)
Total . . . . .		<u>\$(1.1)</u>		<u>\$(0.1)</u>		<u>\$ 0.4</u>		<u>\$(1.1)</u>	<u>\$(1.9)</u>
	(dollars in billions)								
	1Q 2002		2Q 2002		3Q 2002		4Q 2002		2002
	Notional	Gain (Loss)	Notional	Gain (Loss)	Notional	Gain (Loss)	Notional	Gain (Loss)	Gain (Loss)
Call swaptions . . . . .	\$106.6	\$(1.0)	\$129.0	\$ 1.7	\$120.9	\$ 5.3	\$131.4	\$(0.6)	\$ 5.4
Put swaptions . . . . .	91.4	(0.2)	88.4	(1.3)	73.3	(0.5)	129.9	(0.6)	(2.6)
Receive-fixed swaps . . . . .	82.3	(0.4)	54.2	2.0	70.2	4.1	65.4	—	5.7
Pay-fixed swaps . . . . .	63.4	0.8	49.2	(1.9)	55.3	(2.9)	43.4	0.2	(3.8)
Subtotal . . . . .		(0.8)		0.5		6.0		(1.0)	4.7
Other <sup>(1)</sup> . . . . .		(0.2)		0.4		0.4		0.6	1.2
Total . . . . .		<u>\$(1.0)</u>		<u>\$ 0.9</u>		<u>\$ 6.4</u>		<u>\$(0.4)</u>	<u>\$ 5.9</u>

(1) Other consists of basis swaps, asset swaps, purchased caps and floors, written options, futures and forward purchase and sale commitments and other derivatives not accounted for in hedge relationships. For the total notional balance of derivatives not in hedge accounting relationships, see Table 39.

Derivative gains (losses) were largest over this time period in the third quarter of 2002 when the gains totaled \$6.4 billion. This gain was driven by a \$4.8 billion increase in the fair value of call swaptions, net of losses on put swaptions, and a \$1.2 billion increase in the fair value of receive-fixed swaps, net of losses on pay-fixed swaps. The increase in the fair value of the call swaptions reflects a decrease in interest rates and an increase in the implied volatility of interest rates during the quarter. The decrease in interest rates increased the fair value of the interest-rate swaps underlying the call swaptions, which, combined with the increase in implied volatility, resulted in a significant increase in the value of the call swaptions. While increases in implied volatility also had a favorable effect on the value of put swaptions, the decrease in fair value of the underlying interest-rate swaps due to the decrease in interest rates resulted in a net decrease in the fair value of these swaptions.

### **Hedge Accounting Gains (Losses)**

For those derivatives that are accounted for in a hedge relationship, “Hedge accounting gains (losses),” or hedge accounting ineffectiveness, generally arises when the fair value change of a derivative financial instrument does not exactly offset the fair value change of the hedged item. Our hedge relationships primarily consist of derivatives linked to either existing debt in a fair value hedge relationship or the forecasted issuance of debt in a cash flow hedge relationship. We began recording hedge accounting gains (losses) in 2001 in conjunction with the implementation of SFAS 133.

Hedge accounting gains were \$187 million in 2002, compared to hedge accounting losses of \$294 million in 2001. Hedge ineffectiveness in both years related primarily to our fair value hedge relationships. Hedge accounting gains (losses) will vary from period to period based on the notional amount of derivatives accounted for in hedge relationships and 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 do not exactly offset.

### **Gains (Losses) on Investment Activity**

Gains (losses) on investment activity include gains and losses on certain assets and liabilities marked to fair value through earnings. Also included are gains and losses related to sales, impairments and other valuation adjustments.

The following table summarizes the components of “Gains (losses) on investment activity.”

**Table 23 — Gains (Losses) on Investment Activity**

	<u>2002</u>	<u>2001</u>	<u>2000</u>
	(dollars in millions)		
Gains (losses) on trading securities . . . . .	\$ 921	\$144	\$357
Gains (losses) on PCRs . . . . .	(438)	(121)	(223)
Gains (losses) on sales of mortgage loans and available-for-sale securities <sup>(1)</sup> . . . . .	1,958	619	216
Security impairments <sup>(1)</sup> . . . . .	(650)	(350)	(91)
LOCOM adjustments . . . . .	8	(101)	(15)
Gain on termination of options . . . . .	—	—	235
Other . . . . .	13	—	13
Total gains (losses) on investment activity . . . . .	<u>\$1,812</u>	<u>\$191</u>	<u>\$492</u>

(1) Subsequent to the announcement of our restatement results in our November 21, 2003 Information Statement Supplement, we made a revision to reclassify impairment losses on IO securities. This revision decreased gains (losses) on sales of mortgage loans and available-for-sale securities previously reported and increased losses on security impairments previously reported by \$124 million and \$90 million for the years ended December 31, 2002 and 2001, respectively.

- **Gains (Losses) on Trading Securities.** Gains (losses) on trading securities represent changes in the fair value of our trading position, which includes trading securities held, forward commitments to purchase or sell trading securities, and Treasury and agency debt security “short sale” transactions (also referred to as “securities sold, not yet purchased”) executed for asset/liability management purposes. The trading position consists of security transactions executed in connection with our PC market-making and support activities and certain securities held in the retained portfolio, including securities transferred into trading at the beginning of 2001. Specifically, we transferred approximately \$36 billion of securities to the trading category on January 1, 2001 in conjunction with the implementation of SFAS 133, resulting in an unrealized loss of approximately \$275 million being recorded to earnings. Excluding this loss, gains (losses) on trading securities were driven by the balance of our trading position and changes in market prices during each period.
- **Gains (Losses) on PCRs.** As explained in “FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA — NOTE 2: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — Participation Certificate Residuals,” PCRs associated with certain PCs and Structured

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Securities that we hold are marked to fair value as a component of “Gains (losses) on investment activity.” Changes in the fair value of PCR, which are residual interests we retain in PCs, include gains and losses attributable to:

- The realization of cash flows; and
- Changes in the amount and timing of future cash flows and in market discount rates. Net cash payments on PCR we receive reduce the valuation of PCR since those cash flows are reported in the income statement (primarily within net interest income) and not as a direct reduction of the recorded investment. Realization of cash flows and decreases in interest rates, which reduced the expected lives of the associated securities, accounted for the reported loss in 2002. In 2001, the loss was primarily due to the realization of cash flows.
- **Gains (Losses) on Sale of Mortgage Loans and Available-for-Sale Securities.** Gains (losses) on the sale of mortgage loans and available-for-sale securities were primarily attributable to sales of PCs and Structured Securities, as well as Treasury and agency debt securities purchased for asset/liability management purposes.
- **Security Impairments.** We record impairment losses on our investment portfolio when we have concluded that a decrease in the fair value of a security is other than temporary. Impairment losses recognized in 2002, 2001 and 2000 were related to certain investments in manufactured housing securities, corporate bonds and IO securities, with the primary driver being impairments of IO securities. Impairment losses on IO securities totaled \$568 million, \$325 million and \$44 million in 2002, 2001 and 2000, respectively.

The increase in IO security impairment losses in 2001 and 2002 was due to the implementation of EITF 99-20 in the second quarter of 2001 and a general decline in interest rates during the third quarter of 2001 and the second half of 2002, which resulted in a decrease in expected cash flows and a corresponding decrease in the fair value of IO securities. EITF 99-20, which was effective April 1, 2001, requires the cost basis of an IO security to be written down to fair value when there is a decrease in estimated cash flows. EITF 99-20 introduced a lower threshold for impairment, which resulted in impairment losses being recognized more frequently. *See* “Cumulative Effect of Change in Accounting Principles, Net of Taxes” for more information on the cumulative effect to net income from the adoption of EITF 99-20. Also, *see* “FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA — NOTE 2: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — Securities” for more information regarding our accounting policies concerning impairment of IO securities.

Impairments recorded on non-IO securities totaled \$82 million, \$25 million and \$47 million in 2002, 2001 and 2000, respectively, with impairments on manufactured housing securities totaling \$67 million, \$23 million and \$3 million during the same periods. Impairment losses on manufactured housing securities exclude the effects of financial guarantee contracts since the benefits of such contracts are not recognized until actual losses are realized and claims are made under the contracts. For further information on these guarantee contracts, *see* “FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA — NOTE 17: FAIR VALUE DISCLOSURES — Valuation Methods and Assumptions — Mortgage-related securities.”

- **Mortgage Locom Adjustments.** We record mortgage loans classified as “held-for-sale” in accordance with SFAS 65, “Accounting for Certain Mortgage Banking Activities,” at Locom, with changes in the valuation of our held-for-sale portfolio recorded to this caption. Locom losses recorded to the Locom valuation account become realized when we either:
  - Sell the loans, in which case the loss is recorded to “Gains (losses) on sale of mortgage loans and available-for-sale securities”;
  - Transfer the loans from the held-for-sale category to held-for-investment; or
  - Securitize the loans and classify the resulting mortgage-related security as available-for-sale.

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Losses related to transferred loans and securities are recorded as a reduction to the cost basis in the retained assets and amortized back into income over the estimated life of the assets as an addition to net interest income.

Mortgage LOCOM losses were greatest in the fourth quarter of 2001, totaling \$99 million. These losses were caused by an increase in interest rates at the end of the quarter, which reduced the value of our held-for-sale portfolio.

- **Gain on Termination of Options.** Prior to the implementation of SFAS 133 on January 1, 2001, premiums paid to purchase certain options were amortized as expense to net interest income over the life of the option. When the option was terminated, the difference between the fair value received and the amortized cost basis was recognized as a gain or loss on termination. In 2000, the gain on termination of options totaled \$235 million. Because all derivatives are recorded at fair value in accordance with SFAS 133 beginning in 2001, the termination of options in 2002 and 2001 did not result in the recognition of a gain or loss.

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

*We record gains and losses on debt repurchases based on the difference between the contractual interest rates on the debt securities repurchased, adjusted for deferred premiums, discounts and hedging gains and losses, and current market interest rates. To the extent we issue new debt securities to replace the debt that we retire, the difference in the debt costs will positively or negatively affect net interest income to be reported in future periods.*

*During the second quarter of 2002, we modified our reporting of gains (losses) on debt retirements with the adoption of SFAS 145, "Rescission of Financial Accounting Standards Board, or FASB, Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections," or SFAS 145. This standard eliminated the treatment of the gains and losses on our debt repurchases as extraordinary items due to their recurring nature. For comparative purposes, all prior periods have been reclassified to conform to the current presentation.*

We incurred pre-tax losses of \$674 million and \$356 million on the retirement of \$20.3 billion and \$4.7 billion in principal amount of debt outstanding in 2002 and 2001, respectively. During 2000, we realized a pre-tax gain of \$13 million on the retirement of \$3.6 billion in principal amount of debt.

### ***Resecuritization Fees***

*Resecuritization fees are revenues we earn primarily in connection with the creation of Structured Securities for which a REMIC election was made by Freddie Mac; however, these fees are also generated in connection with the creation of IO and PO strips as well as other Structured Securities.*

Resecuritization fees totaled \$276 million, \$135 million and \$15 million in 2002, 2001 and 2000, respectively. Investors' demand for REMIC securities increased significantly in 2001 and 2002 largely due to the steepening of the yield curve during that period. A steep yield curve generally increases the value of structured cash flows, which results in greater value differences between PCs and Structured Securities.

### ***Other Income***

*Other income primarily consists of fees associated with servicing and technology-related programs, including Loan Prospector, various fees related to multifamily loans (including application and other fees) and various other fees received from mortgage originators and servicers.*

"Other income" totaled \$308 million, \$229 million and \$146 million in 2002, 2001 and 2000, respectively. The increases in other income are primarily due to an increase in servicing and transaction fees resulting from increased business volumes and use of our automated underwriting tools.

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## Non-Interest Expense

### *Credit-Related Expenses*

Credit-related expenses include the "Provision for credit losses" and "REO operations income (expense)." The "Provision for credit losses" includes provisions for losses incurred on mortgage loans held in the retained portfolio and outstanding PCs and that portion of Structured Securities that are backed by non-agency mortgage-related securities not subject to sales treatment under SFAS 125 / 140 or impairments under SFAS 115. "REO operations income (expense)" includes gains and losses on the sale of foreclosed properties we hold, as well as the cost to hold these properties, including real estate taxes, insurance, repairs and fees incurred to prepare the properties for sale, and valuation losses.

Table 24 summarizes the components of credit-related expenses (expenses are reflected as negative amounts in this table).

**Table 24 — Credit-Related Expenses**

	<u>2002</u>	<u>2001</u>	<u>2000</u>
	(dollars in millions)		
Provision for credit losses . . . . .	\$(128)	\$(32)	\$(79)
REO operations income (expense) . . . . .	13	(7)	4
Total credit-related expenses . . . . .	<u>\$(115)</u>	<u>\$(39)</u>	<u>\$(75)</u>

Credit-related expenses increased by \$76 million in 2002, compared to a decrease of \$36 million in 2001. The increase in total credit-related expenses in 2002 primarily reflects an increase in expected losses on multifamily mortgage loans due to higher vacancy rates and a decrease in net operating income of multifamily properties in certain areas. The increase in "Provision for credit losses" was partially offset by an increase in "REO operations income (expense)." This increase was due to an increase in gains on single-family REO properties as a result of house price appreciation over the past several years. Strong house price appreciation also accounted for the reduction in credit-related expenses in 2001.

### *Salaries and Employee Benefits, Occupancy Expense and Other Expenses*

Salaries and employee benefits, occupancy expense and other expenses, collectively referred to as administrative expenses, include costs incurred to conduct daily operations and other miscellaneous expenses, such as charitable contributions and professional service fees.

Table 25 summarizes administrative expenses (expenses are reflected as negative amounts in this table).

**Table 25 — Administrative Expenses**

	<u>2002</u>	<u>2001</u>	<u>2000</u>
	(dollars in millions)		
Salaries and employee benefits . . . . .	\$ (593)	\$ (537)	\$(433)
Occupancy expense . . . . .	(42)	(35)	(35)
Other expenses . . . . .	<u>(771)</u>	<u>(452)</u>	<u>(357)</u>
Total administrative expenses . . . . .	<u>\$(1,406)</u>	<u>\$(1,024)</u>	<u>\$(825)</u>

Total administrative expenses increased by \$382 million, or 37 percent, in 2002 and \$199 million, or 24 percent, in 2001. The year-over-year increases were driven by increased compensation costs, a fourth quarter 2002 special contribution to our philanthropic program and a fourth quarter 2002 loss related to certain technology-related initiatives. Increased compensation costs were largely caused by an increase in the average number of employees, as well as annual salary increases, for all periods presented. During the fourth quarter of 2002, we announced a special \$225 million cash contribution to the Freddie Mac Foundation and corporate giving programs, which is included in "Other expenses" in the table above. This contribution is expected to provide operating funds to the Freddie Mac Foundation for six to eight years. The "Other expenses" caption also includes professional services, such as consulting, legal and audit fees, and technology-related costs,

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including a \$52 million loss recognized in the fourth quarter of 2002 related to the disposition of certain technology-related initiatives.

See “— RISK MANAGEMENT — Operational Risk” for more information concerning administrative expenses in 2003 and beyond.

#### ***Housing Tax Credit Partnerships***

*Housing tax credit partnerships represent our share of the net operating losses generated from investments in partnerships that develop or rehabilitate low-income multifamily rental properties. Although these partnerships generate operating losses, we realize a return on our investment through reductions in “Income tax expense,” which result from tax credits and the deductibility of the operating losses.*

Our share of net operating losses generated from our investment in “Housing tax credit partnerships” totaled \$160 million, \$121 million and \$104 million in 2002, 2001 and 2000, respectively. The year-over-year increases in this expense category correspond to our increased investment in such partnerships. The related tax benefits, which are reported as a reduction in “Income tax expense,” totaled \$220 million, \$172 million and \$138 million in 2002, 2001 and 2000, respectively.

#### ***Minority Interest in Earnings of Consolidated Subsidiaries***

*Minority interest in earnings of consolidated subsidiaries represents the earnings due to third party investors in our consolidated subsidiaries.*

Minority interest in earnings of consolidated subsidiaries totaled \$184 million, \$208 million and \$231 million in 2002, 2001 and 2000, respectively. The majority of this amount relates to dividends on the preferred stock issued by our two majority-owned real estate investment trust, or REIT, subsidiaries. The dividend amount declines over the years in conjunction with the decrease in the reported balance of the preferred stock.

#### **Income Tax Expense**

*Income tax expense represents our current and deferred federal income tax liability associated with current period income. We calculate income tax expense based on the statutory tax rate, which is 35 percent. However, tax credits, interest income on tax-exempt securities and other items that adjust our income tax expense result in our effective tax rate generally being less than the statutory tax rate. Income tax expense excludes the tax effects related to the cumulative effect of change in accounting principles.*

Income tax expense totaled \$4.7 billion, \$1.3 billion and \$1.5 billion in 2002, 2001 and 2000, respectively. Our effective tax rate for 2002, 2001 and 2000 was 32 percent, 30 percent and 29 percent, respectively. The increase in the effective tax rate in 2002 was due to higher growth in pre-tax income than in tax credits and interest income on tax-exempt securities, which reduce our income tax expense. Income tax expense in 2002 includes an adjustment related to favorable Court rulings issued in 2003 that caused us to reduce our tax reserves by \$155 million in the fourth quarter of 2002.

#### **Cumulative Effect of Change in Accounting Principles, Net of Taxes**

*Cumulative effect of change in accounting principles includes the effects of adopting SFAS 133 on January 1, 2001 and EITF 99-20 on April 1, 2001. The accounting requirements related to these new accounting standards are described in “FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA — NOTE 2: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES.”*

The after-tax adjustments required by SFAS 133 resulted in a \$78 million increase in net income for the first quarter of 2001. The cumulative effect on earnings from the change in accounting principle is primarily attributable to an after-tax gain of \$52 million resulting from recording certain options at their fair value and an after-tax gain of \$26 million due to cumulative accounting ineffectiveness on hedge relationships involving receive-fixed swaps previously accounted for under accrual accounting. The adoption of EITF 99-20 resulted in a \$35 million decrease to net income in the second quarter of 2001. This after-tax adjustment was related to impairment losses required under EITF 99-20 on certain IO securities held at April 1, 2001.

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## CONSOLIDATED BALANCE SHEETS ANALYSIS

Table 26 provides summary balance sheets as of December 31, 2002 and 2001. This table should be viewed in conjunction with the complete consolidated balance sheets.

**Table 26 — Summary Balance Sheets**

	As of December 31,	
	2002	2001
	(dollars in millions)	
Retained portfolio .....	\$589,722	\$503,666
Cash and investments .....	135,037	120,527
Guarantee asset for Participation Certificates, at fair value .....	2,445	3,156
Derivative assets, at fair value .....	10,393	1,996
Other items included in total assets .....	<u>14,652</u>	<u>11,755</u>
Total assets .....	<u>\$752,249</u>	<u>\$641,100</u>
Total debt securities, net .....	\$665,696	\$578,368
Due to Participation Certificate investors .....	35,080	27,375
Guarantee obligation for Participation Certificates, at fair value .....	1,427	1,155
Derivative liabilities, at fair value .....	967	2,644
Other items included in total liabilities .....	<u>15,440</u>	<u>9,315</u>
Total liabilities .....	<u>718,610</u>	<u>618,857</u>
Minority interest in consolidated subsidiaries .....	2,309	2,619
Total stockholders' equity .....	<u>31,330</u>	<u>19,624</u>
Total liabilities and stockholders' equity .....	<u>\$752,249</u>	<u>\$641,100</u>

During 2002, our total assets grew \$111.1 billion or 17 percent. This increase was driven by increases in the retained portfolio and cash and investments. During the same period, total liabilities increased by \$99.8 billion, driven by an increase in total debt securities, and stockholders' equity increased by \$11.7 billion. These and other changes in our consolidated balance sheets are discussed below.

### Retained Portfolio

*The retained portfolio includes mortgage loans and mortgage-related securities that we acquire for investment purposes and primarily consists of Freddie Mac and other agency securities.*

The retained portfolio increased by \$86.1 billion, or 17 percent, in 2002, with the largest growth occurring in the first and fourth quarters of 2002. We generally increase our mortgage-related investment activity when market conditions provide investment returns that exceed threshold levels. Such opportunities are more likely to be available when there is less competition for mortgage-related investments from other investors. The growth in the retained portfolio for the first quarter of 2002 was primarily the result of purchases initiated at the end of 2001, when market conditions were characterized by volatile long-term interest rates and an increase in the supply of mortgage securities in the market. This increased supply resulted in increased investment opportunities, enabling us to increase our mortgage-related investment activity. Although similar market conditions existed in the second half of 2002, continued high demand for traditional mortgage-related securities (such as PCs) by other investors resulted in fewer investment opportunities. However, we were still able to grow the retained portfolio through strong asset selection and by investing in other types of mortgage-related securities, such as asset-backed securities, ARM securities and Structured Securities.

### Cash and Investments

*Cash and investments includes investments we acquire to manage recurring cash flows, provide a source of liquidity, temporarily deploy capital until the capital can be redeployed into retained portfolio investments and manage interest-rate risk exposure. Cash and investments also includes certain mortgage-related securities*

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that are not included in the retained portfolio since they are acquired in conjunction with our PC market-making and support activities.

Our cash and investments portfolio increased by \$14.5 billion, or 12 percent, in 2002 primarily due to an increase in mortgage prepayments we hold pending remittance to PC investors (*see* discussion regarding “Due to Participation Certificate Investors” below). An increase in the balance of Treasury securities we hold in conjunction with our risk management strategies also contributed to the increase.

### Guarantee Asset and Guarantee Obligation for Participation Certificates

The guarantee asset and guarantee obligation for Participation Certificates represent the fair value of future cash flows related to PC guarantees issued by us in transactions that qualify as sales. The guarantee asset also includes the fair value of future cash flows related to buy-up fees paid by us in connection with PCs issued through the Guarantor Program. Our accounting policies related to the guarantee asset and guarantee obligation are described in “FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA — NOTE 2: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES.”

In 2002, the guarantee asset decreased by \$711 million, while the guarantee obligation for Participation Certificates increased by \$272 million. The changes in the guarantee asset and guarantee obligation balances during 2001 and 2002 are summarized in *Table 27*.

**Table 27 — Changes in Guarantee Asset and Guarantee Obligation**

	2002		2001	
	Guarantee Asset	Guarantee Obligation	Guarantee Asset	Guarantee Obligation
	(dollars in millions)			
Beginning balance . . . . .	\$ 3,156	\$1,155	\$2,774	\$ 778
Additions, net . . . . .	1,465	864	1,171	580
Changes in fair value . . . . .	(2,176)	(592)	(789)	(203)
Ending balance . . . . .	<u>\$ 2,445</u>	<u>\$1,427</u>	<u>\$3,156</u>	<u>\$1,155</u>

Additions include the fair value of the asset and obligation related to guaranteed securities sold during the period, net of reductions attributable to repurchases of guaranteed securities (repurchases result in a reduction of the associated guarantee asset and guarantee obligation and re-establishment of those amounts as PCRs). The increase in net additions to the guarantee asset and guarantee obligation in 2002 compared to 2001 was primarily due to an increase in the volume of sales, which totaled approximately \$240 billion and \$160 billion, respectively.

Factors contributing to the changes in the fair value of the guarantee asset and guarantee obligation are discussed in “— CONSOLIDATED RESULTS OF OPERATION — Non-Interest Income — *Gains (Losses) on Guarantee Asset and Guarantee Obligation.*”

### Derivative Assets and Liabilities, at Fair Value

All derivatives are reported at fair value in accordance with SFAS 133 with changes in fair value of derivatives accounted for in hedge relationships recorded to AOCI or “Hedge accounting gains (losses).” Changes in fair value of derivatives not accounted for in hedge relationships are recorded to “Derivative gains (losses).” We use derivatives to manage our interest-rate risk exposure. However, hedge accounting has only been applied to some derivative transactions since a significant number of transactions did not meet hedge accounting requirements or we elected not to pursue hedge accounting. For further information, see “FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA — NOTE 1: RESTATEMENT.”

The fair value of derivatives in a gain position (reported as “Derivative assets, at fair value”) increased by \$8.4 billion, while the fair value of derivatives in a loss position (reported as “Derivative liabilities, at fair value”) decreased by \$1.7 billion during 2002. These changes in derivative fair values were driven by an increase in the fair value of swaptions and foreign currency swaps we hold. Swaptions and foreign currency

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swaps increased in fair value by approximately \$4.1 billion and \$5.1 billion, respectively, during 2002. The increase in fair value of swaptions was due to increases in implied volatility, while the increase in fair value of foreign currency swaps was driven by a decrease in the value of the U.S. dollar relative to the euro.

We purchase foreign currency swaps in connection with our €Reference Notes® securities program and other debt issuances denominated in foreign currencies. This debt and the related foreign currency swaps are accounted for in qualified hedge relationships under SFAS 133. Therefore, changes in fair value of foreign currency swaps are largely offset by changes in fair value of the related debt.

### Total Debt Securities, Net

*We issue non-callable and callable short- and long-term debt securities in domestic and global capital markets in a wide range of maturities to meet our funding needs. The balance of debt securities includes deferred premiums, discounts and hedging gains and losses.*

Total debt securities increased by \$87.3 billion, or 15 percent, during 2002. This increase corresponds to the increase in the retained portfolio as discussed above. During 2002, debt due within one year decreased by \$19.8 billion, while debt due after one year increased by \$107.1 billion. The shift in the mix of short- and long-term debt was due to our practice of issuing most of our long-term debt on a regular schedule through our Reference Notes securities program. We establish the Reference Notes securities issuance calendar based on expected long-term debt needs. We adjust for differences between scheduled long-term debt issuances and actual funding needs by increasing or decreasing the balance of short-term debt and adjusting the composition of our derivative portfolio. Because of declining interest rates in 2002, the expected lives of assets held in the retained portfolio decreased, reducing the need for long-term debt. To shorten the effective weighted average lives of our debt and thereby manage the funding mismatch created by the decline in interest rates, we extinguished long-term debt through calls and debt repurchases, terminated pay-fixed swaps and entered into additional receive-fixed swaps. Receive-fixed swaps reduce the effective lives of our debt by converting the fixed-rate debt payment into a variable-rate payment, while pay-fixed swaps have the opposite effect.

### Due to Participation Certificate Investors

*Timing differences between our receipt of principal and interest payments from mortgage servicers and the subsequent pass through to PC investors result in the liability "Due to Participation Certificate investors."*

Amounts due to PC investors increased by \$7.7 billion during 2002. This increase was due to the decrease in interest rates during 2002, which resulted in increased mortgage prepayments. The liquidation rate on total PCs issued, including PCs we hold, was 65 percent in the fourth quarter of 2002, compared to 43 percent in the fourth quarter of 2001.

### Total Stockholders' Equity

Total stockholders' equity increased by \$11.7 billion, or 60 percent, during 2002. *Table 28* summarizes the components of stockholders' equity.

**Table 28 — Total Stockholders' Equity**

	<u>2002</u>	<u>2001</u>
	(dollars in millions)	
Preferred stock . . . . .	\$ 4,609	\$ 4,596
Common stock . . . . .	152	152
Additional paid-in capital . . . . .	744	671
Retained earnings . . . . .	24,955	15,710
Accumulated other comprehensive income (loss) related to:		
Available-for-sale securities . . . . .	12,217	4,200
Cash flow hedges . . . . .	(9,877)	(4,757)
Treasury stock . . . . .	<u>(1,470)</u>	<u>(948)</u>
Total stockholders' equity . . . . .	<u>\$31,330</u>	<u>\$19,624</u>

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The primary drivers of the increase in total stockholders' equity were an increase in retained earnings and AOCI. Retained earnings increased as a result of net income in 2002, which was driven by net interest income, derivative gains and gains on investment activity as discussed above. The increase in AOCI, which is on an after-tax basis, was due to the decrease in interest rates in 2002, which resulted in an increase in the fair value of available-for-sale securities, partially offset by a decrease in the fair value of the effective portion of derivative financial instruments accounted for as cash flow hedges. Derivatives accounted for in cash flow hedge relationships primarily consist of pay-fixed interest-rate swaps, which tend to decrease in fair value when interest rates decrease. The carrying value of available-for-sale securities totaled \$562.7 billion at December 31, 2002, compared to \$453.7 billion at December 31, 2001. The notional amount of derivatives accounted for as cash flow hedges totaled approximately \$120.0 billion and \$332.9 billion at December 31, 2002 and 2001, respectively.

#### **AVERAGE BALANCE SHEETS AND RATE/VOLUME ANALYSIS**

*Table 29* reflects an analysis of net interest income and presents average balances and related yields earned on assets and rates paid on liabilities. Average balance sheet information is presented because we believe end-of-period balances may not always be representative of activity throughout the periods presented. We also believe that the rate/volume analysis may be helpful in understanding how changes in business volumes and yields influenced our financial results, particularly "Net interest income on earning assets." 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. In addition, "Net interest income/yield (fully taxable equivalent basis)" is presented on this table. Taxable equivalent adjustments to interest income involve 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 incremental tax rate (35 percent).

**Table 29 — Average Balance Sheets and Rate/Volume Analysis**

	Year Ended December 31,								
	2002			2001			2000		
	Average Balance	Interest Income/Expense	Average Rate <sup>(1)(2)</sup>	Average Balance	Interest Income/Expense	Average Rate <sup>(1)(2)</sup>	Average Balance	Interest Income/Expense	Average Rate <sup>(1)(2)</sup>
	(dollars in millions)								
<b>Interest-earning assets:</b>									
Mortgage loans <sup>(3)</sup>	\$ 60,940	\$ 4,290	7.04%	\$ 60,641	\$ 4,385	7.23%	\$ 57,023	\$ 4,177	7.32%
Mortgage-related securities in the retained portfolio <sup>(4)</sup>	470,813	30,039	6.38	388,338	26,847	6.91	292,980	20,536	7.01
Total retained portfolio	531,753	34,329	6.46	448,979	31,232	6.96	350,003	24,713	7.06
Investments <sup>(5)</sup>	91,807	3,693	3.99	63,968	3,419	5.30	48,236	3,043	6.25
Securities purchased under agreements to resell and Federal funds sold	29,026	454	1.56	21,262	717	3.37	25,700	1,426	5.55
<b>Total interest-earning assets</b>	<b>\$ 652,586</b>	<b>\$ 38,476</b>	<b>5.89</b>	<b>\$534,209</b>	<b>\$ 35,368</b>	<b>6.62</b>	<b>\$423,939</b>	<b>\$ 29,182</b>	<b>6.88</b>
<b>Interest-bearing liabilities:</b>									
Short-term debt	\$ 209,551	\$ (4,303)	(2.03)	\$211,493	\$ (9,056)	(4.23)	\$171,971	\$ (10,492)	(6.00)
Long-term debt	407,520	(21,025)	(5.16)	291,489	(17,466)	(5.99)	228,998	(14,639)	(6.39)
Total debt securities	617,071	(25,328)	(4.09)	502,982	(26,522)	(5.25)	400,969	(25,131)	(6.22)
Due to Participation Certificate investors	18,110	(1,236)	(6.82)	14,136	(1,027)	(7.27)	5,386	(352)	(6.53)
<b>Total interest-bearing liabilities</b>	<b>635,181</b>	<b>(26,564)</b>	<b>(4.17)</b>	<b>517,118</b>	<b>(27,549)</b>	<b>(5.30)</b>	<b>406,355</b>	<b>(25,483)</b>	<b>(6.23)</b>
Income (expense) related to derivatives		(3,026)	(0.47)		(827)	(0.16)		59	0.01
Impact of net non-interest bearing funding	17,405	—	0.12	17,091	—	0.18	17,584	—	0.26
<b>Total funding of interest-earning assets</b>	<b>\$ 652,586</b>	<b>\$(29,590)</b>	<b>(4.53)</b>	<b>\$534,209</b>	<b>\$(28,376)</b>	<b>(5.29)</b>	<b>\$423,939</b>	<b>\$(25,424)</b>	<b>(5.96)</b>
<b>Net interest income/yield</b>		\$ 8,886	1.36	\$ 6,992	1.32	\$ 3,758	0.92		
Fully taxable equivalent adjustment		252	0.04	237	0.04	224	0.05		
<b>Net interest income/yield (fully taxable equivalent basis)</b>		<b>\$ 9,138</b>	<b>1.40%</b>	<b>\$ 7,229</b>	<b>1.37%</b>	<b>\$ 3,982</b>	<b>0.97%</b>		

	2002 vs. 2001 Variance Due to			2001 vs. 2000 Variance Due to		
	Rate <sup>(6)</sup>	Volume <sup>(6)</sup>	Total Change	Rate <sup>(6)</sup>	Volume <sup>(6)</sup>	Total Change
	(dollars in millions)					
<b>Interest-earning assets:</b>						
Mortgages loans	\$ (116)	\$ 21	\$ (95)	\$ (54)	\$ 262	\$ 208
Mortgage-related securities in the retained portfolio	(2,187)	5,379	3,192	(285)	6,596	6,311
Total retained portfolio	(2,303)	5,400	3,097	(339)	6,858	6,519
Investments	(980)	1,254	274	(513)	889	376
Securities purchased under agreements to resell and Federal funds sold	(468)	205	(263)	(493)	(216)	(709)
<b>Total interest-earning assets</b>	<b>\$(3,751)</b>	<b>\$ 6,859</b>	<b>\$ 3,108</b>	<b>\$(1,345)</b>	<b>\$ 7,531</b>	<b>\$ 6,186</b>
<b>Interest-bearing liabilities:</b>						
Short-term debt	\$ 4,670	\$ 83	\$ 4,753	\$ 3,535	\$(2,099)	\$ 1,436
Long-term debt	2,678	(6,237)	(3,559)	964	(3,791)	(2,827)
Total debt securities	7,348	(6,154)	1,194	4,499	(5,890)	(1,391)
Due to Participation Certificate investors	66	(275)	(209)	(44)	(631)	(675)
<b>Total interest-bearing liabilities</b>	<b>7,414</b>	<b>(6,429)</b>	<b>985</b>	<b>4,455</b>	<b>(6,521)</b>	<b>(2,066)</b>
Income (expense) related to derivatives	(2,199)	—	(2,199)	(886)	—	(886)
<b>Total funding of interest-earning assets</b>	<b>\$ 5,215</b>	<b>\$(6,429)</b>	<b>\$(1,214)</b>	<b>\$ 3,569</b>	<b>\$(6,521)</b>	<b>\$(2,952)</b>
<b>Net interest income</b>	<b>\$ 1,464</b>	<b>\$ 430</b>	<b>\$ 1,894</b>	<b>\$ 2,224</b>	<b>\$ 1,010</b>	<b>\$ 3,234</b>
Fully taxable equivalent adjustment	4	11	15	(16)	29	13
<b>Net interest income/yield (fully taxable equivalent basis)</b>	<b>\$ 1,468</b>	<b>\$ 441</b>	<b>\$ 1,909</b>	<b>\$ 2,208</b>	<b>\$ 1,039</b>	<b>\$ 3,247</b>

- (1) May not sum due to rounding.
- (2) Average rates for securities classified as available-for-sale are on the historical cost basis, which is not affected by the change in fair value that is reflected in the AOCI component of Stockholders' equity.
- (3) Non-accrual loans are included in average balances.
- (4) Rates calculated on a fully taxable equivalent basis were 6.43%, 6.97% and 7.07% for the years ended December 31, 2002, 2001 and 2000, respectively, based upon related income of \$30,253 million, \$27,050 million and \$20,717 million, respectively.
- (5) Investments consist of "Cash and cash equivalents" and the "Total mortgage-related and non-mortgage-related securities" subtotal of Investments as reported on the consolidated balance sheets.
- (6) The combined rate/volume changes are allocated to the individual rate and volume change based on their relative size.

## CONSOLIDATED FAIR VALUE BALANCE SHEETS

The consolidated fair value balance sheets, or FVBS, in *Table 30* present our estimates of the fair value of the company's recorded assets and liabilities and off-balance-sheet financial instruments as of December 31, 2002 and 2001.

**Table 30 — Consolidated Fair Value Balance Sheets<sup>(1)</sup>**

	December 31,			
	2002		2001	
	Carrying Amount <sup>(2)</sup>	Fair Value <sup>(3)</sup>	Carrying Amount <sup>(2)</sup>	Fair Value <sup>(3)</sup>
(dollars in billions)				
<b>Assets</b>				
Mortgage loans . . . . .	\$ 63.9	\$ 67.6	\$ 62.6	\$ 63.6
Mortgage-related securities . . . . .	<u>525.8</u>	<u>526.3</u>	<u>441.1</u>	<u>441.5</u>
Retained portfolio . . . . .	589.7	593.9	503.7	505.1
Cash and cash equivalents . . . . .	10.8	10.8	3.5	3.5
Investments <sup>(4)</sup> . . . . .	101.2	101.2	83.6	83.5
Securities purchased under agreements to resell and Federal funds sold . . . . .	23.0	23.0	33.5	33.5
Derivative assets . . . . .	10.4	10.4	2.0	2.0
Guarantee asset for Participation Certificates . . . . .	2.4	3.8	3.1	4.7
Other assets <sup>(5)</sup> . . . . .	<u>14.7</u>	<u>14.2</u>	<u>11.7</u>	<u>11.9</u>
Total assets . . . . .	<u>\$752.2</u>	<u>\$757.3</u>	<u>\$641.1</u>	<u>\$644.2</u>
<b>Liabilities and minority interest</b>				
Total debt securities, net . . . . .	\$665.7	\$683.6	\$578.4	\$583.0
Guarantee obligation for Participation Certificates . . . . .	1.4	2.1	1.2	1.8
Derivative liabilities . . . . .	1.0	1.0	2.6	2.6
Reserve for guarantee losses on Participation Certificates . . . .	0.1	—	0.1	—
Other liabilities . . . . .	50.4	45.1	36.6	35.7
Minority interests in consolidated subsidiaries . . . . .	<u>2.3</u>	<u>2.6</u>	<u>2.6</u>	<u>2.8</u>
Total liabilities and minority interest . . . . .	<u>720.9</u>	<u>734.4</u>	<u>621.5</u>	<u>625.9</u>
<b>Net assets attributable to stockholders</b>				
Preferred stockholders . . . . .	4.6	4.6	4.6	4.5
Common stockholders . . . . .	<u>26.7</u>	<u>18.3</u>	<u>15.0</u>	<u>13.8</u>
Total net assets . . . . .	<u>31.3</u>	<u>22.9</u>	<u>19.6</u>	<u>18.3</u>
Total liabilities and net assets . . . . .	<u>\$752.2</u>	<u>\$757.3</u>	<u>\$641.1</u>	<u>\$644.2</u>

- (1) The FVBSs do not purport to present the net realizable, liquidation or market value of Freddie Mac as a whole.
- (2) Carrying amount is derived from our GAAP consolidated balance sheets.
- (3) The valuation of financial instruments on the FVBS is in accordance with GAAP fair value guidelines prescribed by SFAS 107. See "NOTE 17: FAIR VALUE DISCLOSURES" for more information.
- (4) Includes mortgage-related securities held in connection with PC market-making and support activities.
- (5) Fair values at December 31, 2002 and 2001 include estimated income taxes on the difference between FVBS and the GAAP balance sheets.

### Overview

The FVBS includes all items recorded in the consolidated balance sheets prepared in accordance with GAAP, as well as all off-balance-sheet financial instruments that are not recorded in the GAAP consolidated balance sheets. These off-balance-sheet items predominantly consist of the unrecognized portion of guarantee contracts associated with PCs issued through our Guarantor Program as well as commitments to purchase multifamily and single-family mortgage loans that will be classified as held-for-investment in the GAAP financial statements, and insurance contracts on manufactured housing investments. See "FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA — NOTE 2: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES" for more information.

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The valuation of financial instruments on the FVBS is in accordance with GAAP fair value guidelines prescribed by SFAS 107. The fair value of a financial instrument is defined in SFAS 107 as “. . . the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.” The assumptions used to determine or estimate fair values reflect management’s best judgment regarding appropriate valuation methods.

Under SFAS 107 and other GAAP guidance, the method used to determine fair value for each type of financial instrument depends on the availability of relevant market data. For financial instruments with active markets and readily available market prices, we determine fair value based on price quotations obtained from third-party pricing services and broker-dealers or transaction data, where available. For financial instruments where such prices are not available, we determine fair values using appropriate valuation techniques, including estimates of the present value of expected future cash flows using a discount rate commensurate with the risks involved and internal valuation models that incorporate relevant market data inputs obtained from third-party pricing services and broker-dealers. The use of different pricing models and assumptions could produce materially different estimates of fair value. We use the same valuation techniques for preparing the FVBS as we do for those elements of our GAAP consolidated financial statements which are recorded at fair value, such as derivatives and securities as well as guarantee contracts for a portion of the PC portfolio. See “FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA — NOTE 2: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES” for more information concerning how we determine fair values for our GAAP consolidated balance sheets. See “FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA — NOTE 17: FAIR VALUE DISCLOSURES” for more information about our fair value estimates and the valuation methods and assumptions we use to prepare the FVBS.

The FVBS does not capture all elements of value that are implicit in our operations as a going concern, since it only captures the values of the current investment and securitization portfolios. For example, the FVBS does not capture the value of new investment and securitization business that would likely replace prepayments as they occur. In addition, the FVBS also does 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, or FVBS net assets, presented in the FVBS does not represent an estimate of the net realizable, liquidation or market value of Freddie Mac as a whole.

We report assets and liabilities that are not financial instruments (such as our 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 GAAP carrying amounts in the FVBS. We believe these items do not have a significant impact on Freddie Mac’s overall financial prospects or fair value results.

### **Key Components of Changes in FVBS Net Assets**

Changes in the FVBS net assets from period to period result from returns (measured on a fair value basis) and capital transactions. The key components of returns on FVBS net assets are as follows:

- **Core spread income.** We define core spread income as returns generated from the option-adjusted spread between interest-bearing assets and liabilities in the retained portfolio. We estimate core spread income for a given period to include estimated future costs related to the funding and hedging activities that are likely to be required to achieve our risk management objectives for the retained portfolio.
- **Fee-based income.** This includes the guarantee income from our single-family and multifamily securitization businesses, adjusted to account for estimated default costs, remittance cycle costs and general and administrative costs. Fee-based income also includes delivery fees on some mortgage purchases, fees collected through our automated underwriting service, fee income associated with resecuritization activities and unrealized gains (losses) related to securities classified as trading associated with our PC market-making and support activities.
- **Return on market risk positions.** Our interest-rate risk positions and other risk positions, such as basis risk and volatility risk, produce year-to-year fair value gains or losses that are reflected in FVBS net assets. We monitor the fair value returns associated with these risk positions and reflect our

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duration and convexity risk positions in our PMVS and duration gap risk estimates. See “— RISK MANAGEMENT — Interest-Rate Risk and Other Market Risks — *Interest-Rate Derivative Tables*” for more information.

- **Changes in mortgage-to-debt OAS.** Any change in the relationship between the option-adjusted yield on a previously acquired mortgage and the option-adjusted yield on previously issued debt will lead to a change in the fair value of existing FVBS net assets. An increase in the mortgage-to-debt OAS will result in a decrease in the fair value of our existing FVBS net assets. Conversely, a decline in mortgage-to-debt OAS will result in an increase in the fair value of existing FVBS net assets.

Given the size of our retained mortgage portfolio, year-to-year changes in mortgage-to-debt OAS could have a significant impact on annual fair value results. However, because we generally hold a substantial portion of these assets for the long term and realize core spread income (as described above) over this time frame, we do not believe period-to-period fluctuations in fair value driven by changes in mortgage-to-debt OAS will significantly affect the long-term return on our existing retained portfolio.

- **Change in fair value of guarantee portfolio.** The fair value of the existing guarantee portfolio fluctuates with changes in interest rates and credit expectations. While year-to-year changes in the fair value of the guarantee portfolio may have a significant impact on annual fair value results, we believe that changes in the fair value of our existing guarantee portfolio are not a good indication of long-term fair value expectations because such changes do not reflect the strong probability that replacement business will largely replenish any guarantee fee income lost because of prepayments over time.

## Discussion of Fair Value Results

FVBS net assets increased by \$4.6 billion during 2002, from \$18.3 billion at December 31, 2001 to \$22.9 billion at December 31, 2002. The fair value of net assets attributable to common stockholders (representing the FVBS net assets, less the fair value of net assets attributable to preferred stockholders) increased by an estimated \$4.5 billion during 2002, from \$13.8 billion at December 31, 2001 to \$18.3 billion at December 31, 2002.

The increase in the fair value of net assets attributable to common stockholders in 2002 is presented net of significant capital transactions executed during the year, including common stock repurchases totaling \$0.6 billion and common dividends paid totaling \$0.6 billion. Both common dividends and common stock repurchases represent returns distributed to common stockholders and thereby reduce the remaining fair value of net assets attributable to common stockholders. The change in fair value of net assets attributable to common stockholders excluding these capital outflows was approximately \$5.7 billion in 2002.

Among the primary factors in the increase in 2002 FVBS net assets were core spread income and fee-based income. Core spread income benefited from strong retained portfolio growth of approximately 14 percent and the attractiveness of mortgage-to-debt OAS at the time the mortgages were purchased. Returns on market risk positions also provided a positive contribution. In addition to the factors noted above, tighter mortgage-to-debt spreads, which were the result of the continuing high demand for mortgage-related securities by other investors, contributed significantly to the overall increase in our 2002 fair value results. This effect was partially offset by a significant decline in the fair value of our existing guarantee portfolio. As noted above, we believe that changes in mortgage-to-debt OAS and the fair value of the existing guarantee portfolio will fluctuate from year to year, but will not have a significant impact on the FVBS net assets over the longer term.

Our increase in 2002 FVBS net assets demonstrates that our investment and risk management discipline can foster fair value growth in a year when there was high interest-rate volatility and a wide range of interest-rate environments. We caution, however, that the strong fair value results achieved in 2002 exceed our long-term expectations for FVBS net asset growth.

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## VOLUME STATISTICS

Table 31 summarizes our purchase and securitization activity for the periods presented.

**Table 31 — Volume Statistics<sup>(1)</sup>**

	Year Ended December 31,					
	2002	2001		2000		
	(dollars in millions)					
New business purchases <sup>(2)</sup>						
Mortgage purchases						
30-year fixed-rate .....	\$316,389	48%	\$273,850	57%	\$122,240	59%
15-year fixed-rate .....	153,354	23	79,494	16	16,780	8
ARMs/floating-rate .....	44,918	7	22,206	5	20,579	10
Alternative collateral deals <sup>(3)</sup> .....	14,507	2	9,031	2	7,450	3
Balloon/resets .....	18,533	3	8,574	2	1,213	1
Total single-family .....	547,701	83	393,155	82	168,262	81
Multifamily .....	10,654	2	9,510	2	6,032	3
Total mortgage purchases <sup>(4)</sup> .....	558,355	85	402,665	84	174,294	84
Non-Freddie Mac mortgage-related securities						
Fixed rate .....	64,195	10	67,270	14	29,503	14
ARMs/floating-rate .....	36,515	5	12,433	2	4,840	2
Total new business purchases .....	<u>\$659,065</u>	<u>100%</u>	<u>\$482,368</u>	<u>100%</u>	<u>\$208,637</u>	<u>100%</u>
Percentage of refinance mortgage purchases <sup>(5)</sup> .....						
	74%		62%		28%	
Average LTV of purchases <sup>(5)</sup>						
Refinance mortgages .....	67		70		70	
Purchase money mortgages .....	79		80		81	
Total purchases .....	70		74		78	
Mortgage liquidations <sup>(6)</sup> .....	\$461,009		\$295,414		\$104,713	
Mortgage liquidation rate <sup>(6)</sup> .....	40%		31%		12%	
Securities settlements: <sup>(5)</sup>						
Single-family PCs .....	\$543,451		\$387,234		\$165,294	
Multifamily PCs .....	3,596		2,357		1,607	
Total .....	<u>\$547,047</u>		<u>\$389,591</u>		<u>\$166,901</u>	
Structured securitizations <sup>(7)</sup> .....	\$331,672		\$192,437		\$ 48,203	

(1) Based on UPB.

(2) Based on our total mortgage portfolio, except these amounts exclude Structured Securities backed by Ginnie Mae Certificates.

(3) Includes Structured Securities backed by non-agency securities, which are typically backed by subprime mortgages.

(4) The percentage of mortgages that were credit-enhanced was 20% and 28% for the years ended December 31, 2002 and 2001, respectively. Credit enhancements include loans for which the lender or a third party has retained primary default risk by pledging collateral or agreeing to accept losses on loans that default. In some cases, the lender's or the third party's risk is limited to a specific level of losses at the time the credit enhancement becomes effective.

(5) Amount excludes Structured Securities backed by non-Freddie Mac mortgage-related securities.

(6) Excludes sales of non-Freddie Mac mortgage-related securities and liquidations of Structured Securities that are backed by Ginnie Mae Certificates.

(7) Includes issuances of mortgage-related securities in which the cash flows are structured into various classes, the majority of which qualify for treatment as REMICs under the Internal Revenue Code.

Our 2002 business volume was the highest in our history. Interest rates for fixed-rate mortgages reached 36-year lows in 2002, and were also low in 2001, resulting in a surge of mortgage refinancing activity during both years. As a result of these market trends, purchase volume increased by nearly 40 percent from 2001 to 2002 and more than doubled in 2001 compared to 2000. Mortgage lenders tend to deliver more fixed-rate residential mortgages to the GSEs as compared to ARM/floating-rate products. Fixed-rate mortgages represented 81 percent of our purchases for 2002, down from 87 percent in 2001. Fixed-rate 15-year mortgage volume rose in 2001 and 2002, as declining mortgage rates increased the number of borrowers that qualified for this mortgage product. Refinanced mortgages represented 74 percent of our total 2002 purchases, up from 62 percent in 2001.

The average loan to value, or LTV, ratio on total purchases declined to 70 percent in 2002 from 74 percent in 2001 and 78 percent in 2000. Increases in home prices in 2002 and 2001, combined with the

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previously mentioned rise in refinance volume, resulted in the reduction in the average LTV on total purchase volume.

The liquidation rate on the total mortgage portfolio increased to 40 percent for 2002, compared to 31 percent for 2001. The higher liquidation rate in 2002 compared to 2001 reflects accelerated borrower prepayments due to lower fixed mortgage rates during much of 2002, as evidenced by the increase in the percentage of refinance mortgage purchases in 2002 compared to 2001.

The percentage of credit-enhanced purchases decreased to 20 percent for 2002 from 28 percent for 2001 due primarily to a decline in the number of loans purchased that are covered by primary mortgage insurance, or primary MI. The portion of our purchases with primary MI declined primarily because primary MI is not required on loans with low LTV ratios. The low LTV ratio on purchases resulted from the increases in home prices and rise in refinance activity in 2002. Our ability and desire to utilize credit enhancements will depend on management's evaluation of the credit quality of new business purchase opportunities and the future availability of effective credit enhancements at prices that permit an attractive return. See “— RISK MANAGEMENT — Credit Risk — *Mortgage Credit Risk* — Mortgage Credit Risk Management Strategies” for more information.

A significant portion of our mortgage purchase volume is generated from several key mortgage lenders that have entered into special business arrangements with us. See “BUSINESS — Mortgage Purchase and Guarantee Activity” for more information about these relationships and consequent risks.

Volumes associated with the issuance of Structured Securities, particularly REMICs, vary based on market conditions that affect demand by us and other investors. Our structured securitization activity (pertaining to REMICs, Structured Securities backed by non-agency securities and IO and PO strips) was a record \$332 billion in 2002, compared to \$192 billion in 2001. The steep yield curve and significant refinance activity in 2002 resulted in continued strong investor demand for REMIC securities and an increased supply of REMIC collateral.

## LIQUIDITY AND CAPITAL RESOURCES

### Liquidity

Our business activities present liquidity demands driven by maturities of our debt, purchases of mortgage loans and mortgage-related securities, payments of principal and interest to PC holders, and general operations. Our sources of cash to meet the needs of our business activities and general operations include:

- Issuances of long-term and short-term debt;
- Repayment and sales of, and borrowings against, mortgage-related and other investments;
- Cash flows from operating activities; and
- Issuances of common and preferred stock.

Depending on market conditions and the mix of our derivatives employed 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 to either make interest payments to the counterparty or receive interest payments from the counterparty.

We will not issue common stock until we have returned to timely financial reporting. In addition, our ability to issue preferred stock or subordinated debt may be limited during this period. *See* “SUBSEQUENT EVENTS — Regulatory Developments” for more information concerning common stock repurchases, preferred stock redemptions and dividend payments on common and preferred stock. Furthermore, our inability to prepare timely consolidated financial statements as discussed in “— RISK MANAGEMENT — Operational Risk” or any change in legislative or regulatory exemptions as described in “BUSINESS — Regulation and Governmental Relationships — *Legislative Environment*” could adversely affect our access to some debt investors, thereby potentially increasing our debt funding costs. In addition, to refinance maturing debt we depend on the continuing willingness of investors to purchase and hold our debt securities (for more information regarding the maturity profile of our outstanding debt securities, *see Table 33 — Total Capitalization*). However, because of our financial performance and our regular and significant participation as an issuer in the funding markets, our sources of liquidity have remained adequate to meet our needs and we anticipate that they will continue to do so.

### *Debt Securities*

We finance our purchases of mortgage loans and mortgage-related securities primarily through the issuance of both long-term and short-term debt. During 2002, we received proceeds totaling \$269 billion from the issuance of long-term debt and \$2.05 trillion from the issuance of short-term debt. During 2001, we received proceeds totaling \$205 billion from the issuance of long-term debt and \$2.46 trillion from the issuance of short-term debt.

We have two primary debt-financing programs: Reference Notes securities for longer-term financing and Reference Bills securities for shorter-term financing. These debt-financing programs enable us to sell large issues of long-term and short-term debt that provide investors with high-quality, liquid debt securities. During 2002, we issued \$78.7 billion par value of non-callable U.S. dollar-denominated Reference Notes securities and \$446.3 billion of short-term debt under our Reference Bills securities program. During 2001, we issued \$84.0 billion par value of non-callable U.S. dollar-denominated Reference Notes securities and \$567.2 billion of short-term debt under our Reference Bills securities program.

We also issued \$200.5 billion par value and \$113.5 billion par value in long-term callable debt in 2002 and 2001, respectively. Additionally, we issued €15.0 billion and €15.0 billion of €Reference Notes securities in 2002 and 2001, respectively. The €Reference Notes securities are traded on Euro MTS (an interdealer trading system), which facilitates more transparent secondary market prices and narrower spreads between the price offered to purchase these securities and the price offered to sell them. During 2002, we completed two Freddie SUBS subordinated debt offerings, raising approximately \$2.5 billion in net proceeds, which increased the principal amount of the outstanding Freddie SUBS to \$5.5 billion. During 2001, we completed two Freddie SUBS subordinated debt offerings, raising approximately \$3.0 billion in net proceeds.

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We issued Reference Notes securities and €Reference Notes securities during 2002 in accordance with our previously announced financing calendar for 2002. Our financing calendar is intended to provide clarity and transparency with regard to the timing of new debt issues and reopening of prior issues, the anticipated size of individual offerings and settlement dates.

By adhering to our financing calendar, we are able to provide our debt investors with a predictable source of investment opportunities. However, to continue our debt offerings as scheduled and properly manage our asset/liability mix, we regularly conduct repurchases of outstanding debt securities. Our repurchase program reflects the input of numerous domestic and international investors and supports the transparency, liquidity, and predictability of Reference Notes securities and €Reference Notes securities. Repurchases focus on older, off-the-run securities and preserve the outstanding supply of active, on-the-run securities. During 2002 and 2001, we repurchased approximately \$18.9 billion and \$4.0 billion, respectively, of our higher-rate outstanding debt under this program. In addition, as a response to declining interest rates, we called approximately \$99.3 billion and \$124.8 billion of our higher-rate long-term callable debt during 2002 and 2001, respectively.

### *Equity Securities*

During 2002, we redeemed \$287 million of 6.125 percent preferred stock, issued in November 1996, and replaced it with a 5.81 percent perpetual non-cumulative preferred stock issuance with a redemption value of \$300 million, raising approximately \$13 million in net proceeds. During 2001, we completed six preferred stock offerings, raising approximately \$1.4 billion in net proceeds.

### *Liquid Investments*

To protect ourselves against temporary disruptions in our ability to obtain funding for our business operations, we maintain a cash and investments portfolio of liquid assets that can be sold or financed to manage recurring cash flows and meet other cash management needs, maintain capital reserves to meet mortgage funding needs, provide diverse sources of liquidity and help manage the interest-rate risk inherent in mortgage-related assets. Through this portfolio, we are also able to strategically utilize our available capital. This portfolio is important to our financial management and our ability to provide liquidity and stability to the mortgage market.

The cash and investments portfolio consists principally of cash and cash equivalents, asset-backed securities, corporate debt securities, and other marketable assets that can be readily converted to cash. The non-mortgage investments in this portfolio may expose us to institutional credit risk and the risk that the investments will 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 Risk — *Institutional Credit Risk*” for more information.

Table 32 summarizes the majority of the non-mortgage-related products held in this portfolio at December 31, 2002 and December 31, 2001. In addition, information regarding maturities and credit ratings is provided to assist in understanding our credit risk related to this portfolio.

**Table 32 — Investments**

	December 31, 2002			December 31, 2001		
	Ending Balance at Fair Value	Average Maturity (Months)	% of Portfolio A Rated <sup>(1)</sup> or Better	Ending Balance at Fair Value	Average Maturity (Months)	% of Portfolio A Rated <sup>(1)</sup> or Better
	(dollars in millions)					
<b>Investments:</b>						
Non-mortgage related securities						
Asset-backed securities <sup>(2)</sup> . . . . .	\$ 34,694	N/A	100%	\$26,275	N/A	100%
Debt securities issued by the U.S.						
Treasury and other government corporations and agencies . . . . .	12,493	136	100	1,750	349	100
Corporate debt securities . . . . .	10,102	33	64	9,649	37	60
Obligations of states and municipalities . . . . .	6,641	307	100	4,286	264	100
Commercial paper . . . . .	2,240	1	100	11,905	1	98
Preferred stock . . . . .	249	19	92	945	8	97
Subtotal . . . . .	66,419		94%	54,810		93%
Other mortgage-related and non- mortgage-related securities held for PC market-making and support activities <sup>(3)</sup> . . . . .	34,783			28,753		
Total mortgage-related and non- mortgage-related securities in the Investments per consolidated balance sheets . . . . .	<u>\$101,202</u>			<u>\$83,563</u>		

- (1) The lower of Standard & Poor's, or S&P, and Moody's ratings.
- (2) Consists primarily of securities that can be prepaid prior to their contractual maturity without penalty. Maturity information related to these securities is not included because the contractual maturity does not represent the expected lives of the securities.
- (3) See "BUSINESS — PC Market-Making and Support Activities" for more information. The majority of these securities are agency mortgage-related securities and thus the disclosures concerning average maturity and rating are not provided.

See "— VOLUNTARY COMMITMENTS — *Liquidity Management and Contingency Planning*" for more information on how we manage our liquidity.

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. This authority has never been exercised, and would not be a meaningful source of liquidity to meet our obligations if it were exercised. See "BUSINESS — Regulation and Governmental Relationships" for more information.

## Capital Resources

We manage our capital resources to provide attractive returns on common equity, maintain sufficient capital to satisfy internal capital adequacy standards as well as regulatory capital requirements, and absorb unforeseen losses that might arise in fulfilling our obligations and conducting our business programs.

### Capital Transactions

Table 33 sets forth our capitalization as of the dates presented.

**Table 33 — Total Capitalization**

	December 31, 2002	December 31, 2001
	(dollars in millions)	
Debt securities:		
Due within one year:		
Discount notes, medium-term notes and securities sold under agreements to repurchase . . . . .	\$194,044	\$245,722
Current portion of long-term debt . . . . .	50,385	18,505
Total due within one year . . . . .	244,429	264,227
Due after one year . . . . .	415,662	311,013
Subordinated borrowings due after one year . . . . .	5,605	3,128
Total due after one year . . . . .	421,267	314,141
Total debt securities, net . . . . .	665,696	578,368
Stockholders' equity . . . . .	31,330	19,624
Total capitalization . . . . .	<u>\$697,026</u>	<u>\$597,992</u>

See "FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA — NOTE 8: DEBT SECURITIES AND SUBORDINATED BORROWINGS" and "NOTE 9: STOCKHOLDERS' EQUITY" for further information.

We engage in transactions affecting stockholders' equity from time to time and issue or retire debt obligations on an ongoing basis. In addition, implementation of SFAS 133 on January 1, 2001 affected the volatility of both "Net income" and "Total stockholders' equity" in subsequent periods. On any date after December 31, 2002, Stockholders' equity and the amount of debt obligations outstanding will differ (perhaps substantially) from the figures contained in this capitalization table.

Table 34 summarizes the components of our core capital. Core capital excludes AOCI, consistent with our regulatory capital requirements, which are described under "— Capital Adequacy" below.

**Table 34 — Summary of Core Capital**

	December 31, 2002	December 31, 2001
	(dollars in millions)	
Common stock:		
Par value . . . . .	\$ 152	\$ 152
Additional paid-in capital . . . . .	744	671
Qualifying preferred stock (at redemption value) . . . . .	4,609	4,596
Retained earnings . . . . .	24,955	15,710
Treasury stock, at cost . . . . .	(1,470)	(948)
Core capital . . . . .	<u>\$28,990</u>	<u>\$20,181</u>

During 2002, we added approximately \$8.8 billion to "Core capital" primarily from retained earnings and one preferred stock issuance, partially offset by payment of common and preferred stock dividends. During 2001, we added \$3.9 billion to "Core capital" from retained earnings and six preferred stock issuances, partially offset by payment of common and preferred stock dividends. We actively manage our capital to ensure that we have a strong capital base and sufficient capital to support future growth opportunities. Until we

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resume timely financial reporting and are able to consider issuing and repurchasing common stock, our changes in “Core Capital” will generally be limited to retained earnings, offset by stock dividends.

In periods of timely financial reporting and when attractive investment opportunities are not available, we consider open market common share repurchases with the purpose of returning capital to our stockholders in the form of capital gains rather than dividends. In addition, we periodically reissue treasury stock to employees and non-employee directors as part of our stock-based compensation plans. *See* “FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA — NOTE 11: STOCK-BASED COMPENSATION” for a description of these plans. The amount of capital available to repurchase common stock will be affected primarily by:

- Mortgage portfolio growth opportunities;
- Our assessment of the adequacy of our capital; and
- Regulatory capital standards and supervisory requirements.

All common stock repurchases have been made as part of a plan approved by our Board of Directors. The plan allows repurchases of common stock not to exceed 5 percent of shares outstanding as of September 5, 1997, which was approximately 34 million shares. During periods when current consolidated financial statements are available, the frequency and amount of repurchases will depend on market conditions. We repurchased approximately 9.1 million common shares during 2002 for approximately \$555 million. During 2001, we did not repurchase any shares. We will not consider repurchasing common shares until we resume timely financial reporting. *See* “SUBSEQUENT EVENTS — Regulatory Developments” for a discussion of the framework established by OFHEO for monitoring our capital, which includes a requirement for prior written approval of common share repurchases and preferred stock redemptions.

Table 35 details, as of December 31, 2002, our outstanding preferred stock issuances that are redeemable at December 31, 2002, redeemable beginning in 2003 and redeemable after more than one year (2004 or later).

**Table 35 — Preferred Stock**

<u>Earliest Optional Redemption Dates<sup>(1)</sup></u>	<u>Rate</u>	<u>Redemption Value<sup>(1)</sup></u> (dollars in millions)
<i>Issuances redeemable at December 31, 2002</i>		
October 27, 1998 .....	5.81%	\$ 150
October 30, 2000 .....	5.3%	200
June 30, 2001 .....	variable	250
June 30, 2002 .....	6.14%	<u>600</u>
		1,200
<i>Issuances redeemable beginning in 2003</i>		
March 31, 2003 .....	5.00%	400
March 31, 2003 <sup>(2)</sup> .....	variable	325
March 31, 2003 <sup>(3)</sup> .....	variable	230
June 30, 2003 <sup>(4)</sup> .....	variable	201
September 30, 2003 .....	5.1%	400
September 30, 2003 .....	variable	<u>220</u>
		1,776
<i>Issuances redeemable beginning in 2004</i>		
March 31, 2004 .....	5.1%	150
December 31, 2004 <sup>(5)</sup> .....	variable	288
June 30, 2006 .....	6%	173
December 31, 2006 .....	5.7%	300
March 31, 2007 .....	5.81%	300
June 30, 2009 .....	5.79%	250
March 31, 2011 .....	5.81%	<u>172</u>
		1,633
		<u><u>\$4,609</u></u>
Total Preferred Stock at Redemption Value <sup>(6)</sup> .....		

(1) Optional redemption on or after dates indicated.

(2) Optional redemption on March 31, 2003 and on March 31 every two years thereafter.

(3) Optional redemption on March 31, 2003 and on March 31 every year thereafter.

(4) Optional redemption on June 30, 2003 and on June 30 every two years thereafter.

(5) Optional redemption on December 31, 2004 and on December 31 every five years thereafter.

(6) No preferred stock was redeemed in 2003.

### **Capital Adequacy**

We regularly assess the adequacy of our capital to ensure that we hold capital sufficient to satisfy all of our financial obligations, even if economic circumstances deteriorate unexpectedly and severely.

The GSE Act establishes our capital standards, and OFHEO has issued regulations that set our minimum, critical and risk-based capital requirements. We operate so that our capital exceeds all regulatory requirements. See “SUBSEQUENT EVENTS — Regulatory Developments” for a discussion of the framework established by OFHEO for monitoring our capital, which includes a target capital surplus.

In general, our minimum capital requirement is the sum of 2.50 percent of our on-balance sheet assets and 0.45 percent of our off-balance sheet obligations, subject to certain adjustments specified in the GSE Act and in OFHEO’s regulations. Our critical capital requirement is approximately half of our minimum capital requirement. The risk-based capital standard determines the amount of capital that Freddie Mac must hold to absorb projected losses from future adverse interest-rate and credit-risk conditions specified by the GSE Act. The risk-based capital standard is based on stress test results calculated under two interest-rate scenarios prescribed by the GSE Act. In general, the risk-based capital requirement for Freddie Mac is the amount of

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capital that would enable us to absorb the stress test losses in whichever scenario is more adverse, plus 30 percent of that amount to cover management and operations risk.

OFHEO is required to classify Freddie Mac's capital adequacy not less than quarterly. Prior to the third quarter of 2002, we were classified using the minimum and critical capital standards only. In the third quarter of 2002, OFHEO commenced quarterly classifications using the risk-based, minimum and critical capital standards.

To be classified as "adequately capitalized," Freddie Mac must meet both the risk-based and minimum capital standard. If Freddie Mac fails to meet the risk-based capital standard, it cannot be classified higher than "undercapitalized." If Freddie Mac fails to meet the minimum capital standard, it cannot be classified higher than "significantly undercapitalized." If Freddie Mac fails to meet the critical capital standard, it must be classified as "critically undercapitalized." OFHEO retains discretion to reduce Freddie Mac's capital classification by one level if OFHEO determines that we are engaging in conduct not approved by OFHEO that could result in a rapid depletion of our core capital or that the value of property subject to mortgages held or secured by us has decreased significantly.

When Freddie Mac is classified as adequately capitalized, we can pay a dividend on our common or preferred stock without prior OFHEO approval so long as our payment would not cause us to fail to meet either our risk-based capital requirement or our minimum capital requirement. If Freddie Mac were classified as undercapitalized, we would be prohibited from making capital distributions that would cause us to fail to meet our minimum capital requirement. We also would be required to submit a capital restoration plan for OFHEO's approval. If Freddie Mac 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 cause us to fail to meet our critical capital requirement, 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's approval. If Freddie Mac were classified as critically undercapitalized, OFHEO would be required to appoint a conservator for the company unless OFHEO made a written finding that it should not do so and the Secretary of the Treasury concurred in that determination.

OFHEO has never classified Freddie Mac as other than "adequately capitalized," the highest possible classification.

Table 36 summarizes our regulatory capital requirements and surpluses at December 31, 2002 and 2001.

Our core capital and minimum and critical capital surpluses as presented in Table 36 are based on restated net income for 2002 and 2001. However, our total capital and risk-based capital surpluses as presented in Table 36 do not reflect the effect of the restatement. OFHEO determined not to recalculate the risk-based capital amounts given that the minimum capital requirement remained the determining requirement for Freddie Mac's classification as adequately capitalized.

**Table 36 — Regulatory Capital Requirements**

	<u>December 31, 2002</u>	<u>December 31, 2001</u>
	(dollars in millions)	
<b>As restated</b>		
<i>Minimum capital requirement</i> <sup>(1)</sup> .....	\$22,339	\$19,014
Core capital <sup>(2)</sup> .....	28,990	20,181
Minimum capital surplus <sup>(1)</sup> .....	6,651	1,167
<i>Critical capital requirement</i> <sup>(1)</sup> .....	11,369	9,677
Core capital <sup>(2)</sup> .....	28,990	20,181
Critical capital surplus <sup>(1)</sup> .....	17,621	10,504
<b>As reported</b>		
<i>Risk-based capital requirement</i> <sup>(3)</sup> .....	\$ 4,743	N/A
Total capital <sup>(3)(4)</sup> .....	24,222	N/A
Risk-based capital surplus <sup>(3)</sup> .....	19,479	N/A

(1) Minimum and critical capital requirements are based on amended reports to OFHEO that correct results included in our November 21, 2003 Information Statement Supplement. The impact of this change on the restated regulatory minimum capital surplus was a decrease of \$1 million and \$7 million as of December 31, 2002 and 2001, respectively, as compared to those results presented in our November 21, 2003 Information Statement Supplement.

(2) Core capital consists of the par value of outstanding common stock (common stock issued less common stock held in treasury), par value of outstanding perpetual preferred stock, additional paid in capital and retained earnings, as determined in accordance with GAAP.

(3) Risk-based and total capital amounts are those calculated by OFHEO prior to the restatement of our 2002 financial results.

(4) Total capital includes "core capital" and general reserves for mortgage and foreclosure losses.