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**INFORMATION STATEMENT  
AND  
ANNUAL REPORT TO STOCKHOLDERS  
For the fiscal year ended December 31, 2004**

Freddie Mac is a stockholder-owned, government-sponsored enterprise, or GSE, established by Congress to provide a continuous flow of funds for residential mortgages. We perform this function primarily by buying and guaranteeing residential mortgage loans and mortgage-related securities, which we finance by issuing mortgage-related securities, debt securities and equity securities. Our securities are not required to be registered under the Securities Act of 1933 or the Securities Exchange Act of 1934 and we are not currently required to file periodic reports with the Securities and Exchange Commission under the Exchange Act. However, we are committed to the voluntary registration of our common stock under the Exchange Act, which we expect to complete after we return to timely financial reporting. We alone are responsible for making payments on our securities. Neither the U.S. nor any agency or instrumentality of the U.S. other than Freddie Mac is obligated to fund our mortgage purchase or financing activities or to guarantee our securities or other obligations.

The publication of this Information Statement and Annual Report, or Information Statement, has been delayed as a result of the ongoing controls remediation and systems re-engineering and development necessary to return to timely financial reporting following the previous revision and restatement of our financial results for 2002, 2001 and 2000. For more details, see “EXPLANATORY NOTE.”

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

**Freddie Mac  
Investor Relations Department  
Mailstop D40  
1551 Park Run Drive  
McLean, Virginia 22102-3110  
Telephone: 571-382-4732 or 1-800-FREDDIE (800-373-3343)  
[shareholder@freddiemac.com](mailto:shareholder@freddiemac.com)**

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

**THIS INFORMATION STATEMENT IS DATED JUNE 14, 2005**

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**BOARD OF DIRECTORS (as of June 1, 2005)\***

**Richard F. Syron**

*Chairman and Chief Executive Officer*  
Freddie Mac  
McLean, Virginia

**Barbara T. Alexander**

*Independent Consultant*  
Monarch Beach, California

**Geoffrey T. Boisi**

*Chairman and Senior Partner*  
Roundtable Investment Partners LLC  
A private investment management firm  
New York, New York

**Michelle Engler**

*Trustee*  
JNL Investor Series Trust and JNL Series Trust  
and *Member of Board of Managers*  
JNL Variable Funds  
Each an investment company  
Lansing, Michigan

**Richard Karl Goeltz**

*Retired Vice Chairman and Chief Financial Officer*  
American Express Company  
A financial services company  
New York, New York

**Thomas S. Johnson**

*Retired Chairman and Chief Executive Officer*  
GreenPoint Financial Corp.  
A financial services company  
New York, New York

**William M. Lewis, Jr.**

*Managing Director and Co-Chairman  
of Investment Banking*  
Lazard Ltd  
An investment banking company  
New York, New York

**John B. McCoy\*\***

*Retired Chairman and Chief Executive Officer*  
Bank One Corporation  
A financial services company  
Columbus, Ohio

**Eugene M. McQuade**

*President and Chief Operating Officer*  
Freddie Mac  
McLean, Virginia

**Shaun F. O'Malley (Lead Director)**

*Chairman Emeritus*  
Price Waterhouse LLP  
An accounting and consulting firm  
Philadelphia, Pennsylvania

**Ronald F. Poe**

*President*  
Ronald F. Poe & Associates  
A private real estate investment firm  
White Plains, New York

**Stephen A. Ross**

*Professor*  
Massachusetts Institute of Technology  
Cambridge, Massachusetts

**William J. Turner**

*Manager*  
Signature Capital, Inc.  
A venture capital investment firm  
Portland, Maine

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\* Freddie Mac's enabling legislation establishes the membership of the Board of Directors at 18 directors: 13 directors elected by the stockholders and 5 directors appointed by the President of the United States. Prior to our March 31, 2004 Annual Meeting, the Office of Counsel to the President informed us that the President did not intend to reappoint any of his then-current presidential appointees. Consequently, each of their terms as presidential appointees ended on the date of that annual meeting. No new appointees have been named by the President as of June 1, 2005.

\*\* As previously announced, Mr. McCoy will not stand for re-election at our stockholders' meeting to be held on July 15, 2005.

## EXPLANATORY NOTE

This Information Statement contains forward-looking statements regarding our current expectations and objectives for financial reporting, future business plans, results of operations, financial condition and trends and other matters that could affect our business. Forward-looking statements do not relate to historical matters and involve known and unknown risks, uncertainties and other factors, including those listed in the section titled “FORWARD-LOOKING STATEMENTS.” Such statements are made as of the date of this Information Statement and we undertake no obligation to publicly update any forward-looking statement to reflect events or circumstances after the date of this Information Statement, or to reflect the occurrence of unanticipated events.

The publication of this Information Statement has been delayed as a result of the ongoing controls remediation and systems re-engineering and development necessary to return to timely financial reporting. Although we are working to address the operational weaknesses that are contributing to our current inability to release financial results on a timely basis, uncertainty regarding the expected success, scope and timing of these activities remains. See “MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS, or MD&A — RISK MANAGEMENT — Operational Risks — *Sources of Operational Risks.*”

Our current objective is to provide financial results for first and second quarter 2005 by August 31, 2005 and for third quarter 2005 by mid-November 2005. In addition, our current objective is to provide financial results for fourth quarter and full-year 2005, including the timely filing of a minimum capital report with our regulator, the Office of Federal Housing Enterprise Oversight, or OFHEO, that complies with U.S. generally accepted accounting principles, or GAAP, at the end of January 2006. In 2004 and continuing into 2005, we have focused on our controls and systems remediation efforts to address the material weaknesses and other deficiencies in our internal controls over financial reporting. We expect to continue to make significant progress in developing and building a fully capable systems infrastructure. This infrastructure will facilitate our return to timely financial reporting, enabling us to fulfill our commitment to register our common stock with the Securities and Exchange Commission, or SEC, under the Exchange Act. We anticipate filing our Form 10 registration statement with the SEC in the second quarter of 2006 and becoming an SEC reporting company as soon as possible thereafter.

Although we have made significant progress during 2004 and the first five months of 2005, significant systems revisions are still required for us to return to timely financial reporting as a result of our adoption of revised and new accounting policies in recent years. We face continuing challenges because of the prior deficiencies in our accounting infrastructure and the operational complexities caused by the volume of revised and new accounting policies that we have adopted.

Systems improvements to date have enabled us to move to a one-step financial close process in 2005, a significant improvement over the two-step process used for the production of 2003 and 2004 results that involved the “remeasurement” of preliminary financial figures. We continue, however, to rely extensively on substantial validation and analytical review procedures to verify that the financial results produced by our recently implemented systems comply with GAAP.

This Information Statement and the certifications by our Chief Executive Officer and Chief Financial Officer, which are based on the certifications required of SEC registrants as to the accuracy and completeness of the information and the fair presentation of the consolidated financial statements and other financial information in periodic reports, do not address our internal controls over financial reporting or our disclosure controls and procedures because a comprehensive evaluation of the effectiveness of these controls and procedures was not performed as of December 31, 2004. See “MD&A — RISK MANAGEMENT — Operational Risks — *Sources of Operational Risks*” for additional information regarding our internal control weaknesses and remediation efforts.

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## BUSINESS

### Overview

Freddie Mac is a stockholder-owned financial services company chartered by Congress on July 24, 1970 under the Federal Home Loan Mortgage Corporation Act, as amended, which we refer to as the Freddie Mac Act or our charter. At December 31, 2004, we had total assets of \$795.3 billion, total liabilities and minority interests of \$763.9 billion, and total stockholders' equity of \$31.4 billion. At May 13, 2005, we had 5,064 full-time and 153 part-time employees. Our principal offices are located in McLean, Virginia. We have additional offices in Washington, D.C.; Reston, Virginia; Atlanta, Georgia; Chicago, Illinois; Dallas, Texas; New York, New York; and Woodland Hills, California.

We fulfill the requirements of our charter by purchasing residential mortgage loans and mortgage-related securities from mortgage lenders and securities dealers and by providing our credit guarantee of payment of principal and interest for residential mortgages originated by mortgage lenders. Through our credit guarantee activities, we securitize mortgage loans by issuing undivided interests in pools of purchased mortgages, which are called Mortgage Participation Certificates, or PCs, to third-party investors. We also resecuritize mortgage-related securities that are issued by us or the Government National Mortgage Association, or Ginnie Mae, as well as non-agency entities. Securities issued through our resecuritization activities are referred to as Structured Securities. For further information concerning our mortgage purchase and securities issuance activity and the composition of our Retained portfolio, see "MD&A — OUR RETAINED AND TOTAL MORTGAGE PORTFOLIOS" and "MD&A — VOLUME STATISTICS."

For more than three decades, we have been one of the largest participants in the U.S. residential mortgage market. The residential mortgage market consists of a primary mortgage market that links homebuyers and lenders and a secondary mortgage market that links lenders and investors. We purchase mortgage loans that finance homes in every geographic region of the U.S., including U.S. territories (Puerto Rico, Guam, U.S. Virgin Islands). By providing liquidity and efficiency in the secondary mortgage market, we reduce the cost of homeownership and rental housing and improve the quality of life by making the American dream of access to a decent and affordable home possible.

In the primary market, residential mortgage lenders originate or provide mortgages to homebuyers. These lenders include mortgage banking companies, commercial banks, savings banks, savings and loan associations, credit unions and state and local housing finance agencies. Lenders may choose to replenish their supply of lending capital by selling the mortgage loans they originate into the secondary mortgage market.

We compete in the secondary mortgage market with the Federal National Mortgage Association, or Fannie Mae, and other financial institutions that retain or securitize mortgages, such as banks, dealers and thrift institutions, and the Federal Home Loan Banks. We compete, primarily on the basis of price, products, structure and service, by buying and selling mortgages in the form of whole loans (*i.e.*, mortgage loans that have not been securitized) and mortgage-related securities. We also compete for low-cost debt funding with Fannie Mae, the Federal Home Loan Banks and other institutions that hold mortgage portfolios. Competition from these entities can vary with economic, financial market and regulatory environments.

We compete in the large and growing mortgage debt market. Total U.S. residential mortgage debt was \$8.7 trillion as of December 31, 2004, according to reports from the Federal Reserve System. In relation to this market, our Total mortgage portfolio was \$1.5 trillion as of December 31, 2004. See further discussion of our mortgage portfolio holdings in "MD&A — OUR RETAINED AND TOTAL MORTGAGE PORTFOLIOS." Total residential mortgage debt outstanding in the U.S. grew at an annual rate of 13 percent in both 2003 and 2004. We expect economic and demographic trends will continue to increase the total amount of mortgage debt outstanding, though at a slower rate than in the past few years. The share of the mortgage debt market attributed to Fannie Mae and us, however, has declined recently due to the increasing proportion of adjustable rate mortgages, or ARMs, and other non-traditional mortgage products originated. Banks have tended to retain these mortgages rather than sell them to the GSEs. In addition, there has been strong demand for mortgages in general by other investors, particularly banks.

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## Availability of Documents

Our Information Statements, Supplements and other financial disclosure documents are available free of charge on our website at [www.FreddieMac.com](http://www.FreddieMac.com). (We are providing this Internet address solely for the information of interested persons. We do not intend this Internet address to be an active link and are not using references to this Internet address here or elsewhere in this Information Statement to incorporate additional information into this Information Statement.) Our corporate governance guidelines, codes of conduct for employees and members of the Board of Directors (and any amendments or waivers that would be required to be disclosed), and the charters of the Board's five standing committees (*i.e.*, the Audit, Compensation and Human Resources, Finance and Capital Deployment, Governance and Nominating, and Mission and Sourcing Committees) are also available on our website. Printed copies of these documents may be obtained upon request.

## Information About Business Segments

We have determined that we had one business segment for the periods presented in this Information Statement.

## Our Charter and Mission

Our charter serves as the foundation of our business, forms the framework for our business activities, shapes the products we bring to market and drives the services we provide to the nation's housing and mortgage industry. Our mission is to provide liquidity, stability and affordability in the residential mortgage markets. We accomplish this by securitizing mortgages and by purchasing mortgages and mortgage-related securities to hold in our own portfolio.

Specifically, our statutory purposes are:

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

Our charter also provides us with special attributes such as:

- exemption from Securities Act and Exchange Act securities registration requirements (although we are subject to the antifraud provisions of those laws and are committed to the voluntary registration of our common stock with the SEC under the Exchange Act);
- favorable treatment of our securities under various legal investment laws and other regulations;
- access to the Federal Reserve Banks' book-entry system, which provides book-entry issuance, transfer, payment and settlement for our mortgage-related and debt securities;
- discretionary authority of the Secretary of the Treasury to purchase obligations we issue up to a maximum of \$2.25 billion principal balance outstanding at any one time; and
- exemption from state and local taxes, except tax on real property that we own.

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## Loans Eligible for Purchase under Our Charter

### *Conforming Loan Limits*

Our charter places a dollar amount cap on the size of the original principal balance of each single-family mortgage loan we purchase, referred to as the conforming loan limit. The conforming loan limit is established annually pursuant to a procedure prescribed by OFHEO. Table 1 presents a summary of the conforming loan limits for 2005, 2004 and 2003.

**Table 1 — Conforming Loan Limits<sup>(1)(2)</sup>**

	Effective as of January 1,		
	2005	2004	2003
<b>First-lien conventional, single-family mortgage loan limits:</b>			
One-family residence <sup>(3)</sup> .....	\$359,650	\$333,700	\$322,700
Two-family residence .....	\$460,400	\$427,150	\$413,100
Three-family residence .....	\$556,500	\$516,300	\$499,300
Four-family residence .....	\$691,600	\$641,650	\$620,500

(1) The dollar limits shown are those effective January 1st through December 31st of each calendar year.

(2) The applicable conforming loan limits are 50 percent higher for mortgages secured by properties in Alaska, Guam, Hawaii and the U.S. Virgin Islands.

(3) The conforming loan limit for second-lien mortgages on one-family residences is 50 percent of the limit for first-lien mortgages on such residences. When both first- and second-lien mortgages are purchased, the total amount purchased may not exceed the applicable conforming first-lien limit.

### *Loan-to-Value Ratios and Credit Enhancements*

Conventional mortgages are mortgages that are not guaranteed or insured by any agency or instrumentality of the U.S. government. Our charter prohibits us from purchasing first-lien conventional, single-family mortgages if the unpaid principal balance at the time of purchase exceeds 80 percent of the value of the property securing the mortgage, unless we have one or more of the following credit protections:

- mortgage insurance from an approved mortgage insurer that covers at least the portion of the mortgage balance that exceeds 80 percent of the property's value;
- a seller's agreement to repurchase or replace (for periods and under conditions as we may determine) any mortgage in default; or
- retention by the seller of at least a ten percent participation interest in the mortgages.

The loan-to-value ratio, or LTV, restriction does not apply to multifamily mortgages or to mortgages insured by the Federal Housing Administration, or FHA, or the Rural Housing Service, or RHS, or partially guaranteed by the Department of Veterans Affairs, or VA.

### *Loan Quality*

Under our charter we must limit our mortgage purchase and securitization activities, so far as practicable, to mortgages that are of a quality, type and class that generally meet the purchase standards of private institutional mortgage investors. This means the mortgage loans we purchase must be readily marketable to institutional mortgage investors.

We design our mortgage loan underwriting guidelines to assess the creditworthiness of the borrower and the borrower's capacity to fulfill the obligations of the mortgage. We continuously review these guidelines to ensure their effectiveness in order to address the changing needs of the marketplace so that more borrowers can access mortgage financing. In some circumstances, we grant waivers or variances from our guidelines.

We also seek to distribute our guidelines through the most efficient means possible, including using Loan Prospector®, our automated underwriting service. While the ultimate responsibility for a lending decision rests with the lender, Loan Prospector® provides our lender customers with a quick assessment of a loan's eligibility for our purchase.

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## **Business Activities**

We connect Main Street — the residential mortgage market — to Wall Street — dealers and investors — through our mortgage purchase, credit guarantee and portfolio investment activities.

Our customers are predominantly lenders in the primary mortgage market. Our activity in the secondary mortgage market supports a continuous flow of funds to the primary market, which leads to consumer benefits in the form of a steady flow of low-cost mortgage funding. This flow of funds helps moderate cyclical swings in the housing market, redistributes the flow of mortgage funds regionally throughout the U.S. and provides for the availability of mortgage funds at all times. In addition, the supply of cash made available to lenders through this process lowers mortgage rates, making homeownership affordable for more families and individuals.

*Single-Family Mortgages.* Lending institutions extend mortgage loans directly to their customers who wish to purchase or refinance a home. Often, lenders look to us to purchase those mortgage loans from them, replenishing the supply of money for lending. We purchase single-family mortgage loans, which are secured by one- to four-family properties, mainly from mortgage bankers, dealers, insurance companies and federally insured financial institutions.

The types of single-family mortgage loans we purchase typically include 30-year, 20-year, 15-year and 10-year fixed-rate mortgages, initial interest-only mortgages, ARMs and balloon/reset mortgages. The substantial majority of the mortgage loans we purchase are conventional mortgages. However, we purchase some mortgages that are fully insured by the FHA or the RHS, and some mortgages that are partially guaranteed by the VA. Single-family mortgage loans generally are subject to our internal credit policies and credit, appraisal, underwriting and other purchase policies and guidelines as set forth in our Single-Family Seller/Servicer Guide.

A significant portion of our single-family mortgage purchase volume is generated from several large mortgage lenders. During 2004, Wells Fargo Home Mortgage, Inc., Chase Home Finance LLC, ABN Amro Mortgage Group, Inc. and National City Mortgage Co. accounted for approximately 63 percent of our mortgage purchase volume. Wells Fargo was the largest source and accounted for approximately 33 percent of our mortgage purchase volume during 2004, while Chase Home Finance LLC, our second largest source, accounted for approximately 14 percent of our mortgage purchase volume.

As the mortgage industry has been consolidating, we and our competitors have been seeking business from a decreasing number of key lenders. We are exposed to the risk that we will lose significant business volume and will be unable to replace this business if one or more of our key lenders chooses to reduce significantly the volume of mortgages it delivers to us or ceases to exist because of a merger or an acquisition. The loss of business from any one of our key lenders could adversely affect our market share, our revenues, the use of our technology by participants in the mortgage market and the performance of our mortgage-related securities. We are actively working to diversify our customer base and thus reduce the potential impact of losing a key customer. We believe that we would be able to recover from a significant decrease in, or loss of, business volume from one or more of our largest customers through such means as strengthening our relationships with other major lenders and servicers or modifying our business strategies.

*Multifamily Mortgages.* We purchase multifamily mortgages, which are secured by structures with five or more units designed principally for residential use, from approved mortgage lenders. These lenders include federally insured financial institutions, mortgage bankers, investment bankers and insurance companies. These mortgages have terms generally ranging from five to thirty years. Our multifamily mortgage products, services and initiatives are designed primarily to finance rental housing affordable to low- and moderate-income families.

We have established multifamily mortgage credit, appraisal and underwriting guidelines as set forth in our internal credit policies and our Multifamily Seller/Servicer Guide. We may modify these guidelines or grant waivers for some multifamily mortgages, including mortgages on properties that have favorable debt coverage or loan-to-value ratios (a) that we consider to have superior management, (b) that are located where the demand for rental housing is strong, (c) that serve our affordable housing mission, or (d) for which we are seeking to match competitive bids by other lenders.

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## Credit Guarantee Activities

The following discussion summarizes our credit guarantee activities.

*Guarantees of PCs.* One of the means by which we fund purchases of mortgage loans is through the use of securitization-based financing. We issue PCs that represent undivided interests in the mortgage loans we purchase and which, in some cases, we sell to investors for cash. However, most of our credit guarantee activity occurs through mortgage swap transactions in which a mortgage lender or other seller delivers mortgages to us in exchange for our PCs. Our customers may choose to hold these PCs in their portfolios or sell them to other investors. We guarantee the payment of principal and interest on all PCs. Our guarantee increases the marketability of our PCs, providing additional liquidity to the marketplace.

*Guarantees Issued Through Resecuritization.* Our credit guarantee activities also involve the resecuritization of mortgage-related securities. In the resecuritization process, we issue securities representing undivided interests in PCs and certain other types of mortgage-related securities. In general, we issue the following two types of Structured Securities:

- **Single-Class Structured Securities.** We issue single-class Structured Securities backed by PCs and by non-Freddie Mac mortgage-related securities, including Ginnie Mae Certificates.
- **Multi-Class Structured Securities.** We issue multi-class Structured Securities that divide the cash flows of the underlying PCs, Ginnie Mae Certificates and other mortgage-related securities into two or more classes that meet the investment criteria and portfolio needs of different types of investors. Our principal multi-class Structured Securities activity is the issuance and sale of securities that qualify for tax treatment as Real Estate Mortgage Investment Conduits, or REMICs. Structured Securities backed by non-agency mortgage-related securities are also referred to as multi-class Structured Securities for purposes of this report.

The non-agency mortgage-related securities may be backed by mortgages originated using underwriting standards that differ from our normal criteria; however, most of these securities are significantly credit-enhanced at issuance. By issuing Structured Securities backed by these securities, we seek to provide liquidity to alternative segments of the mortgage market. See “MD&A — RISK MANAGEMENT — Credit Risks — *Mortgage Credit Risk* — Mortgage Credit Risk Management Strategies — *Portfolio Diversification*” for more information concerning the additional credit risk related to these transactions.

We commonly transfer Structured Securities to third parties in exchange for either cash or the collateral underlying the Structured Securities (*e.g.*, mortgage-related securities that third-party securities dealers deliver to us).

*Guarantees on Non-Freddie Mac-Issued Securities or Loan Portfolios.* We also provide guarantees of the payment of principal and interest on tax-exempt multifamily housing revenue bonds that support pass-through certificates issued by third parties. These housing revenue bonds are collateralized by mortgage loans on low- and moderate-income multifamily housing projects. In addition, we guarantee the payment of principal and interest related to low- and moderate-income multifamily mortgage loans that are originated and held by state and municipal housing finance agencies to support tax-exempt multifamily housing revenue bonds. For more information see “MD&A — OUR RETAINED AND TOTAL MORTGAGE PORTFOLIOS” — “Table 10 — Freddie Mac Single-Class and Multi-Class PCs and Other Structured Securities Based on Unpaid Principal Balances.”

## The To-Be-Announced Market

In connection with our credit guarantee activities, we issue PCs that represent pools of mortgages with similar characteristics — such as PCs relating to a pool of 30-year, fully amortizing fixed-rate mortgages with mortgage coupons within a specified range. Because these PCs are generally homogeneous and are issued in high volume, they are highly liquid and trade on a “generic” basis, also referred to as trading in the To-Be-Announced, or TBA, market. A TBA trade represents a contract for the purchase or sale of PCs to be delivered at a future date; however, the specific PCs that will be delivered to fulfill the trade obligation, and

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thus the specific characteristics of the mortgages underlying those PCs, are not known (*i.e.*, not “announced”) at the time of the trade, but only subsequently when the trade is to be settled.

While the majority of TBA trades are performed manually, with purchases and sales occurring through direct contact between or among the parties to the trade, dealers often trade as anonymous participants through an inter-dealer broker or electronic trading system.

Purchases and sales of TBA-eligible PCs occur daily. Prices are generally quoted and accepted based only upon the name of the issuer (*e.g.*, Freddie Mac), the type of PC (*e.g.*, 30-year fixed rate), the coupon of the PC, the quantity and the settlement month. Each type of TBA trade has a single designated settlement date in each month, and 48 hours before the settlement date the parties identify the specific PCs to be delivered to fulfill the TBA trade obligation. During 2004 and 2003, we issued approximately \$272.2 billion and \$564.3 billion, respectively, of PCs that were eligible to be delivered to settle TBA trades, representing approximately 76 percent and 80 percent, respectively, of our total PC issuances.

Lenders use the TBA market to hedge the risk of changes in the fair value of mortgage loans caused by fluctuations in mortgage interest rates that occur after the lender “locks” a mortgage interest rate with a borrower, but before the mortgage loan is originated. When a lender locks in a rate for a borrower, the lender may sell PCs in the TBA market for delivery at a future date. After the lender originates the mortgages, it delivers the mortgages to us in a swap transaction and receives PCs in return. Those PCs can then be used to settle the TBA trade, or the lender can settle the trade with any of our other existing PCs that meet the generic terms of the trade.

We use the TBA market to manage cash purchase transactions. When a lender commits to deliver mortgages to us in exchange for cash at a specified price, we may sell PCs in the TBA market for delivery at a future date. By using the TBA market, we can manage the risk of fluctuations in interest rates by locking in the price at which we will sell the PCs that will ultimately be formed from the mortgages we purchase from lenders in cash transactions.

The use of the TBA market increases the liquidity of mortgage investments and improves the distribution of investment capital available for residential mortgage financing, thereby helping us to accomplish our statutory mission.

### **Portfolio Investment Activities**

We purchase mortgage loans and mortgage-related securities (including PCs and Structured Securities we previously issued to third parties) and hold them in our Retained portfolio for investment purposes. We finance these purchases by issuing short-, medium- and long-term debt and subordinated debt and equity securities. Our purchases of mortgage loans and mortgage-related securities replenish the sources of capital available for mortgage lending to consumers.

Our Retained portfolio is managed through a disciplined strategy of long-term capital deployment. We apply our mortgage market expertise to support our asset selection while managing our credit and interest-rate risk. We invest in agency securities, non-agency mortgage-related securities and whole mortgage loans. Agency securities are mortgage-related securities issued by GSEs or governmental agencies.

We manage interest-rate risk and reduce the funding cost of the debt we issue by:

- issuing a mixture of debt of various maturities, either callable (that is, redeemable at our option at one or more times before its scheduled maturity) or non-callable;
- using a variety of derivatives; and
- restructuring mortgage-related securities cash flows and retaining a portion of these restructured cash flows in the form of Structured Securities.

See “MD&A — RISK MANAGEMENT — Interest-Rate Risk and Other Market Risks” for more information.

*Freddie Mac*

## **Mortgage Security Performance and Other Market Support Activities**

We support the liquidity and depth of the market for PCs through various activities, including:

- educating dealers and investors about the merits of trading and investing in PCs;
- purchasing and selling PCs and other mortgage-related securities through the Retained portfolio; and
- introducing new mortgage-related securities products and initiatives.

We may increase, reduce or discontinue these or other related activities at any time, which could affect the liquidity and depth of the market for PCs. We support the execution of our credit guarantee business by adjusting our guarantee fee. For example, if the price performance of, and demand for, our PCs is not comparable to Fannie Mae securities on future mortgage deliveries by sellers, we may use market-adjusted pricing where we provide guarantee fee price adjustments to partially offset weaknesses in prevailing security prices and increase the competitiveness of our credit guarantee business. The use of such market-adjusted pricing could have a material adverse effect on the profitability of our new credit guarantee business over its life.

Our strategies to support PC price performance include the purchase and sale by our Retained portfolio of TBA PCs and other agency securities, including Fannie Mae securities. While some purchases of PCs may result in an expected return on equity substantially below our normal thresholds, this strategy is not currently expected to have a material effect on the overall performance of our Retained portfolio. Depending upon market conditions, including the relative prices and relative supply of and demand for PCs and comparable Fannie Mae securities, there may be substantial variability in any period in the total amount of securities we purchase or sell for our Retained portfolio in accordance with this strategy.

In the fourth quarter of 2004, as part of our effort to realign our business around our mission and core business, we ceased our PC market making and support activities accomplished through our Securities Sales & Trading Group business unit and our external Money Manager program. For more information, see “CONSOLIDATED RESULTS OF OPERATION — Net Interest Income” and “NOTE 5: RETAINED PORTFOLIO AND CASH AND INVESTMENTS PORTFOLIO” to our consolidated financial statements.

### **Predatory Lending**

We have instituted anti-predatory lending policies designed to prevent the purchase or assignment of mortgage loans with unacceptable terms or conditions or resulting from unacceptable practices. In accordance with these policies, the following mortgages are not eligible for purchase:

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

In addition, we require the third parties who service the loans we hold in our Retained portfolio and the loans underlying our PCs and Structured Securities to report all borrower credit information, including monthly mortgage payments, to all credit bureau and reporting agencies. Several states have enacted laws aimed at predatory lending practices, generally with regard to loans exceeding thresholds based on annual percentage rates or financing costs. For some states, the high-cost home loan thresholds are defined by statutes that trigger state law liabilities for subsequent purchasers or assignees of such loans that may be more significant than liabilities imposed upon such purchasers or assignees under the Home Ownership and Equity Protection Act. Currently, we do not purchase such “high-cost home loans” in the states of Arkansas, Georgia, Illinois, Indiana, Kentucky, Maine, Massachusetts, Nevada, New Jersey, New Mexico, New York and Oklahoma. We continue to assess newly enacted and proposed state laws to determine our policies with respect to the purchase of loans affected by those laws.

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## Regulatory and Governmental Matters

### HUD

The U.S. Department of Housing and Urban Development, or HUD, has general regulatory power over us. HUD's oversight to date has focused on housing goals, fair lending and new program approval.

#### *Housing Goals*

The GSEs are subject to affordable housing goals set by HUD. The goals are targeted to low- and moderate-income families, very low-income families and low-income families living in low-income areas, and families living in HUD-defined underserved areas. The HUD goals, which are set as a percent of total purchases, have risen steadily since they became permanent in 1995.

If the Secretary of HUD were to find that we failed, or that there was a substantial probability that we would fail, to meet any housing goal and that achievement of the housing goal was or is feasible, the Secretary could require us to submit a housing plan. The housing plan would describe the actions we will take to achieve the goal in the future. HUD also has the authority to issue a cease and desist order and to assess civil money penalties against us in the event that we fail to submit a required housing plan or fail to make a good faith effort to comply with a plan approved by HUD.

We have reported to HUD that we achieved each of the affordable housing goals in 2004 and 2003. Our purchases, as reported to HUD, are set forth in Table 2 below.

**Table 2 — Prior Period Housing Goals and Results<sup>(1)</sup>**

	Year Ended December 31,			
	2004		2003	
	Goal	Result	Goal	Result
Low- and moderate-income goal . . . . .	50%	54%	50%	51%
Underserved areas goal . . . . .	31	34	31	33
Special affordable goal . . . . .	20	24	20	20
Multifamily special affordable volume target (dollars in billions) . . . . .	\$2.11	\$9.83	\$2.11	\$8.00

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

On May 4, 2004 and August 3, 2004, we received letters from HUD requesting information pertaining to certain transactions entered into in calendar years 2001, 2002 and 2003. As part of the information request, HUD asked us to describe how each identified transaction complied with HUD's rules for counting units financed toward the housing goals in these years. We fully complied with these requests for information. Following its review, HUD determined that we failed to meet our underserved areas goal of 31 percent for 2002 by 1,222 units (or approximately 0.03 percent). Because this shortfall occurred in 2002 and we exceeded the underserved areas goal in 2003 by approximately 95,000 units (or 1.7 percent), HUD did not require us to submit a housing plan as a result of missing the 2002 underserved areas goal. We are engaged in ongoing discussions with HUD regarding certain interpretive issues relating to the treatment of our mortgage purchases under the housing goals. If these discussions result in additional guidance from HUD that requires us to modify our reporting of housing goal results, we will make any necessary adjustments at the appropriate time.

Effective January 1, 2005, HUD established new and increasing affordable housing goal levels for the GSEs for the years 2005 through 2008, as summarized in "Table 3 — Current and Future Housing Goals for 2005, 2006, 2007 and 2008" below. In addition, HUD established three new home purchase subgoals for mortgages that finance purchases of single-family, owner-occupied properties located in metropolitan areas (refinanced mortgages are excluded). Finally, the existing dollar-based target for multifamily mortgage purchases increased to \$3.92 billion, based on HUD's established formula setting the goal as the average of the previous three years' volume. In total, beginning in 2005 and continuing through 2008, we are required to achieve six different and increasing HUD goals and subgoals and a higher multifamily dollar-based target, as summarized in Table 3 below.

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**Table 3 — Current and Future Housing Goals<sup>(1)</sup> for 2005, 2006, 2007 and 2008**

**Current and Future Housing Goals for 2005, 2006, 2007 and 2008**

*Housing Goals Levels*

	<u>2005 Goal</u>	<u>2006 Goal</u>	<u>2007 Goal</u>	<u>2008 Goal</u>
Low and moderate- income goal .....	52%	53%	55%	56%
Underserved areas goal .....	37	38	38	39
Special affordable goal .....	22	23	25	27
Multifamily special affordable volume target (dollars in billions) .....	\$3.92	\$3.92	\$3.92	\$3.92

*Home Purchase Subgoals*

	<u>2005 Goal</u>	<u>2006 Goal</u>	<u>2007 Goal</u>	<u>2008 Goal</u>
Low and moderate- income goal .....	45%	46%	47%	47%
Underserved areas goal .....	32	33	33	34
Special affordable goal .....	17	17	18	18

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

We believe that meeting these goals and subgoals will be challenging and there can be no assurance that we will meet all of them in 2005 or beyond. We are making significant efforts to meet the new goals and subgoals through adjustments to our mortgage sourcing and purchase strategies, including changes to our underwriting guidelines and expanded and targeted initiatives to reach underserved populations.

Our strategies to meet the new goals and subgoals may result in the purchase of loans that offer lower expected returns on our investment and are likely to increase our exposure to potential credit losses. Increasing the concentration of our purchases of goal-eligible loans also may require us to forego other purchase opportunities that we would expect to be more profitable. If our current efforts to meet the new goals and subgoals prove to be insufficient, we may need to take additional steps that could lead to a significant reduction of service to portions of the conventional conforming mortgage market, and also a reduction in our profitability.

We view the purchase of mortgage loans benefiting low- and moderate-income families and neighborhoods as a principal part of our mission and business, and remain committed to fulfilling the needs of these borrowers and markets.

*Fair Lending*

Our mortgage purchase activities are subject to federal anti-discrimination laws. In addition, the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, or the GSE Act, requires the Secretary of HUD to adopt regulations prohibiting discriminatory practices in our mortgage purchase activities and periodically to review and comment on our underwriting and appraisal guidelines for consistency with the Fair Housing Act and the fair housing provisions of the GSE Act. The GSE Act also requires the Secretary of HUD to direct that we:

- submit data to HUD to assist it in investigating whether a mortgage lender with which we do business has failed to comply with the Fair Housing Act or the Equal Credit Opportunity Act; and
- undertake remedial actions, including suspension, probation, reprimand or settlement, against lenders that are found to have engaged in discriminatory lending practices in violation of the Fair Housing Act or Equal Credit Opportunity Act pursuant to a final adjudication and after opportunity for an administrative hearing.

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

Under the GSE Act, we must obtain the approval of the Secretary of HUD for any new program for the purchasing, servicing, selling, lending on the security of or otherwise dealing in conventional mortgages that:

- is significantly different from programs that were previously approved under the GSE Act or that were approved or engaged in before the date the GSE Act was enacted; or
- represents an expansion, of the dollar volume or number of mortgages or securities involved, of programs above limits expressly contained in any prior approval.

HUD has issued regulations implementing the new program approval authority granted under the GSE Act. The Secretary of HUD is required to approve any new program unless the Secretary determines that the new program is not authorized under the Freddie Mac Act or that the program is not in the public interest.

### **OFHEO**

Regulation of our financial safety and soundness is vested in OFHEO. Organizationally, OFHEO is located within HUD; however, it operates independently of the Secretary of HUD in most respects. Among other regulations relating to safety and soundness, OFHEO implements, monitors, and enforces capital standards that apply to us. In addition, OFHEO conducts comprehensive examinations of our operations.

OFHEO's regulatory capital requirements include a ratio-based minimum capital requirement and a risk-based capital requirement designed to ensure that we maintain sufficient capital to survive a sustained severe downturn in the economic environment. OFHEO is required to classify our capital adequacy at least quarterly. OFHEO has never classified us as other than "adequately capitalized," the highest possible classification.

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

On January 29, 2004, OFHEO announced the creation of a framework for monitoring our capital due to the temporarily higher operational risks arising from our current inability to produce timely financial statements in accordance with GAAP. The framework includes a target capital surplus of 30 percent of our minimum capital requirement, subject to certain conditions and variations; weekly monitoring; and prior approval of certain capital transactions, to verify that appropriate levels of capital are maintained. While OFHEO's framework includes weekly monitoring and imposes restrictions on share repurchases and other capital activities, we do not expect it to adversely affect our ability to grow in most scenarios. For additional information about the OFHEO target capital surplus framework, see "NOTE 10: REGULATORY CAPITAL" to the consolidated financial statements.

### **Treasury**

Under the Freddie Mac Act, the Secretary of the Treasury has approval authority over all of our issuances of notes, debentures and substantially identical types of unsecured debt obligations (including the interest rates and maturities on these securities), as well as new types of mortgage-related securities issued subsequent to the enactment of the Financial Institutions Reform, Recovery and Enforcement Act of 1989. The Secretary of the Treasury has historically performed this debt securities approval function by coordinating GSE debt offerings with Treasury funding activities.

### **SEC**

While we are exempt from the Securities Act and Exchange Act securities registration requirements, we are dedicated to fulfilling our commitment to register our common stock under the Exchange Act. Once this process is complete, we will be subject to the financial reporting requirements applicable to registrants under the Exchange Act, including filing with the SEC annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K. We anticipate filing our Exchange Act registration statement with the SEC in the second quarter of 2006 and becoming an SEC reporting company as soon as possible thereafter.

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

### **GSE Regulatory Oversight Legislation**

We face an uncertain regulatory environment in light of legislative reforms currently being discussed. We strongly support enactment of regulatory oversight legislation that ensures our regulator has authority to conduct effective oversight. We believe appropriate regulatory oversight legislation would strengthen market confidence and promote our mission. In our view, a strong regulator that values housing, capital requirements tied to risk, and legislative provisions that maintain our GSE status are among the key elements of appropriate GSE regulatory oversight legislation. We will continue to work with the Congress, the Administration and other interested parties toward enacting such legislation.

Both the Senate and the House of Representatives have indicated that they will consider GSE regulatory oversight legislation during the current session of Congress. Separate bills concerning regulatory oversight are under consideration in the Senate and the House of Representatives, and others are likely to be introduced, that address key elements of the GSE's business and regulation including regulatory structure, capital standards, receivership, scope of GSE activities, affordable housing goals, portfolio growth and expanded regulatory oversight over GSE officers and directors.

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

It is also possible that the enactment of legislative provisions that go beyond the key elements identified above could further erode or eliminate the special abilities and responsibilities set forth in our charter that make it possible for us to pursue our mission effectively. The enactment into law of the various legislative provisions under consideration, depending on their final terms and on how they were applied by our regulator within the scope of its authority, could have a material adverse effect on Freddie Mac's future earnings, stock price and shareholder returns, ability to fulfill its mission, and ability to recruit and retain qualified officers and directors.

While we continue to work toward enactment of appropriate GSE regulatory oversight legislation, we cannot predict the prospects for the enactment, timing or content of any legislation or its impact on our financial prospects.

### **Other Regulatory Matters**

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

Legislative or regulatory provisions that create or remove incentives for these entities either to sell mortgage loans to us or to purchase our securities, could have a material effect on our business results.

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## PROPERTIES

We own a 75 percent interest in a limited partnership that owns our principal offices, consisting of four office buildings in McLean, Virginia that comprise approximately 1.2 million square feet. We occupy the headquarters complex under a long-term lease from the partnership. We also lease other office space in McLean, Virginia; Washington, D.C.; Reston, Virginia; Atlanta, Georgia; Chicago, Illinois; Dallas, Texas; New York, New York; and Woodland Hills, California.

## LEGAL PROCEEDINGS

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

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

We are also subject to various legal proceedings, including regulatory investigations and administrative and civil litigation, arising from the restatement. These proceedings include class action and stockholder derivative lawsuits, administrative enforcement proceedings commenced by OFHEO, and investigations by the SEC, Department of Labor, the U.S. Attorney's office and the FEC. Recently, we have been named in multiple lawsuits alleging violations of federal and state antitrust laws and state consumer protection laws in connection with the setting of our guarantee fees.

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



## SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

The following matters were presented for stockholder vote at the November 4, 2004 Annual Meeting of Stockholders: (a) election of 13 members to our Board of Directors, each for a term ending on the date of the next annual meeting of our stockholders; (b) ratification of the appointment of PricewaterhouseCoopers LLP as our independent auditors for 2004; (c) approval of the 2004 Stock Compensation Plan; and (d) approval of the Amended and Restated Employee Stock Purchase Plan. Of the 689,544,489 shares of common stock outstanding on the record date for the meeting, 602,265,372 shares were present in person or by proxy at the meeting. As shown in Table 4 below, the following persons were elected to our Board of Directors at the meeting by the respective votes indicated:

**Table 4 — Submission of Matters to a Vote of Security Holders**

	<u>Votes For</u>	<u>Votes Withheld</u>
Barbara T. Alexander .....	588,912,902	13,352,470
Geoffrey T. Boisi .....	589,092,865	13,172,507
Michelle Engler .....	556,672,196	45,593,176
Richard Karl Goeltz .....	588,955,520	13,309,852
Thomas S. Johnson .....	569,820,155	32,445,217
William M. Lewis, Jr. ....	589,119,835	13,145,537
John B. McCoy .....	566,411,920	35,853,452
Eugene M. McQuade .....	585,483,822	16,781,550
Shaun F. O'Malley .....	570,164,908	32,100,464
Ronald F. Poe .....	566,582,087	35,683,285
Stephen A. Ross .....	571,402,848	30,862,524
Richard F. Syron .....	578,824,360	23,441,012
William J. Turner .....	569,823,326	32,442,046

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

<u>Votes for</u>	<u>Votes Against</u>	<u>Abstentions</u>
597,300,503	1,572,056	3,392,813

The 2004 Stock Compensation Plan was approved at the meeting by the following votes:

<u>Votes for</u>	<u>Votes Against</u>	<u>Abstentions</u>
444,307,818	47,005,047	4,459,507

The Amended and Restated Employee Stock Purchase Plan was approved at the meeting by the following votes:

<u>Votes for</u>	<u>Votes Against</u>	<u>Abstentions</u>
466,370,480	25,541,493	3,860,399

No matters were submitted to stockholders from November 5, 2004 through the date of this Information Statement.

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

**Market Information**

Our common stock, par value \$0.21 per share, is listed on the New York Stock Exchange, or NYSE, and the Pacific Stock Exchange under the symbol FRE. From time to time, our common stock may be admitted to unlisted trading status on other national securities exchanges. Put and call options on our common stock are traded on U.S. options exchanges. As of December 31, 2004, there were 690,606,185 shares outstanding of our common stock.

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

**Table 5 — Quarterly Common Stock Information**

	Sale Prices <sup>(1)</sup>	
	High	Low
<b>2005 Quarter Ended</b>		
March 31 .....	\$73.91	\$59.74
<b>2004 Quarter Ended</b>		
December 31 .....	\$74.20	\$64.15
September 30 .....	69.50	61.73
June 30 .....	64.62	56.45
March 31 .....	65.15	57.60
<b>2003 Quarter Ended</b>		
December 31 .....	\$59.75	\$52.65
September 30 .....	56.04	47.35
June 30 .....	61.40	46.48
March 31 .....	64.78	49.53

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

As of May 23, 2005, the closing price for our common stock was \$64.52 per share. As part of a stock repurchase plan approved by our Board of Directors, we are authorized to repurchase our common stock in an amount up to five percent of our shares outstanding as of September 5, 1997, which was approximately 34 million shares. At December 31, 2004, approximately 13 million common shares remained available for repurchase under this plan. We did not repurchase any common stock during 2004 or the first five months of 2005, and we do not expect to engage in share repurchases until after we are timely in our financial reporting. See “BUSINESS — Regulatory and Governmental Matters — OFHEO” for more information.

**Dividends**

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

**Table 6 — Dividends Per Common Share**

	Regular Cash Dividend Per Share
<b>2005 Quarter Ended</b>	
March 31 .....	\$0.35
<b>2004 Quarter Ended</b>	
December 31 .....	\$0.30
September 30 .....	0.30
June 30 .....	0.30
March 31 .....	0.30
<b>2003 Quarter Ended</b>	
December 31 .....	\$0.26
September 30 .....	0.26
June 30 .....	0.26
March 31 .....	0.26

We have historically paid dividends to our stockholders in each quarter. Our Board of Directors intends to continue declaring dividends quarterly, but further dividends will depend upon our capital position, earnings and growth prospects and other factors our Board of Directors considers relevant to our payment of dividends and the declaration of specific dividends. See “NOTE 10: REGULATORY CAPITAL” to the consolidated

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financial statements for additional information regarding dividend payments and “NOTE 9: STOCKHOLDERS’ EQUITY” to the consolidated financial statements for additional information regarding our preferred stock dividend payments.

### Holders

As of May 13, 2005, we had approximately 2,500 common stockholders of record.

### Securities Authorized for Issuance under Equity Compensation Plans

Table 7 provides information about our common stock that may be issued upon the exercise of options, warrants and rights under our existing equity compensation plans as of December 31, 2004. Our stockholders have approved the Amended and Restated Employee Stock Purchase Plan, the 2004 Stock Compensation Plan and the 1995 Directors’ Stock Compensation Plan, as amended and restated in 1998.

**Table 7 — Securities Authorized for Issuance under Equity Compensation Plans**

<u>Plan Category</u>	<u>(a) Number of securities that may be issued upon exercise of outstanding options, warrants and rights</u>	<u>(b) Weighted-average exercise price of outstanding options, warrants and rights</u>	<u>(c) Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))</u>
Equity compensation plans approved by stockholders . . . . .	9,312,985 <sup>(1)</sup>	\$43.73 <sup>(2)</sup>	17,720,244 <sup>(3)</sup>
Equity compensation plans not approved by stockholders . . . . .	None	N/A	None

- (1) Includes 1,624,628 restricted stock units, or RSUs, issued under the 1995 Directors’ Stock Compensation Plan and the 1995 and 2004 Stock Compensation Plans and options to purchase 60,416 shares under the Amended and Restated Employee Stock Purchase Plan.
- (2) For the purpose of calculating this amount, the restricted stock units are assigned an exercise price of zero.
- (3) Consists of 12,910,468 shares, 3,237,149 shares and 1,572,627 shares available for issuance under the 2004 Stock Compensation Plan, the Amended and Restated Employee Stock Purchase Plan, and the 1995 Directors’ Stock Compensation Plan, as amended and restated in 1998, respectively.

### NYSE Corporate Governance Listing Standards

On November 30, 2004, our Chief Executive Officer submitted to the NYSE the certification required by Section 303A.12(a) of the NYSE Listed Company Manual regarding our compliance with the NYSE’s corporate governance listing standards.

### FORWARD-LOOKING STATEMENTS

We regularly communicate information concerning our business activities to investors, securities analysts, the news media and others as part of our normal operations. Some of these communications include “forward-looking statements” pertaining to our current expectations about our objectives for financial reporting, future business plans, results of operations, financial condition and trends. Forward-looking statements are typically accompanied by, and identified with, terms such as “estimates,” “continue,” “ongoing,” “anticipates,” “believes,” “expects,” “intends,” “plans,” “endeavors,” “future,” “seeks,” “potential,” “objectives,” “goal,” “will,” “may,” “might,” “should,” “could,” “would,” “likely” and similar phrases. This Information Statement includes forward-looking statements. These statements are not historical facts, but rather represent our expectations based on current information, plans, estimates and projections. Forward-looking statements involve known and unknown risks, uncertainties and other factors, some of which are beyond our control. You should be careful about relying on any forward-looking statements. You should also consider all risks, uncertainties and other factors described in this Information Statement in considering any forward-looking statements. Factors that could cause actual results to differ materially from the expectations expressed in these and other forward-looking statements by management include, among others:

- Changes in applicable legislative or regulatory requirements, including our Congressional charter, affordable housing goals, or regulatory capital requirements (including the temporary 30 percent target capital surplus imposed on us by OFHEO in January 2004), the exercise or assertion of regulatory or

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administrative authority beyond current practice, or the enactment of proposed legislation (in whole or in part) discussed in “BUSINESS — Regulatory and Governmental Matters — GSE Regulatory Oversight Legislation;”

- Actions by governmental entities, securities rating agencies or others that could adversely affect the supply or cost of equity capital or debt financing available to us;
- Our ability to effectively and timely implement the remediation plan undertaken as a result of the restatement of our consolidated financial statements and the consent order entered into with OFHEO, including particular initiatives relating to technical infrastructure and controls over financial reporting;
- Our ability to identify, manage, mitigate and/or remedy internal control weaknesses and deficiencies and other risks;
- Developments in, outcomes of, impacts of, and costs, expenses, settlements and judgments related to regulatory investigations and civil litigation in which we are involved;
- Political conditions and related actions by the U.S. or abroad, which may adversely affect our businesses and economic conditions as a whole;
- Changes in our strategies for and results of credit loss mitigation, interest-rate and other market risk management activities and investment activities;
- Our ability to implement changes, developments and/or impacts of new, pending or existing accounting standards, including the timely development of supporting systems;
- Changes in pricing or valuation methodologies, models, assumptions and/or estimates;
- The degree to which our business and financial forecasting methods accurately predict actual results and our ability to implement business processing improvements;
- Volatility of reported results due to changes in fair value of certain instruments or assets;
- Changes in, and volatility of, the general economy, including interest rates, housing prices and employment rates;
- The availability of debt financing and equity capital in sufficient quantity and at attractive rates to support continued growth in our retained portfolio, to refinance maturing debt and to meet regulatory capital requirements;
- The availability of derivative financial instruments (such as options and interest-rate and currency swaps) from acceptable counterparties of the types and in the quantities needed for investment funding and risk management purposes;
- The rate of growth in total outstanding U.S. residential mortgage debt and the size of the U.S. residential mortgage market;
- The possibility of further concentration of mortgage loan sourcing in a smaller number of originators;
- Preferences of originators in selling into the secondary market. See “BUSINESS — Regulatory and Governmental Matters — Other Regulatory Matters” for additional information;
- Borrower preferences for fixed-rate mortgages or ARMs;
- Investor preferences for mortgage loans and mortgage-related and debt securities versus other investments;
- Competition and liquidity in the market for mortgage-related and debt securities;
- Changes in foreign exchange rates;
- Significant business disruptions resulting from acts of war or terrorism;
- The occurrence of a major natural or other disaster in geographic areas in which portions of our total mortgage portfolio are concentrated; and
- Our ability to effectively manage these and other risks.

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

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

	At or for the Year Ended December 31,				
	2004	2003	2002	2001	2000
	(dollars in millions, except share-related amounts)				
<b>Income Statement Data</b>					
Net interest income	\$ 9,137	\$ 9,498	\$ 9,525	\$ 7,448	\$ 3,758
Non-interest income (loss) <sup>(2)</sup>	(3,039)	(244)	7,154	(1,591)	2,656
Income before cumulative effect of change in accounting principles, net of taxes	2,937	4,816	10,090	3,115	3,666
Cumulative effect of change in accounting principles, net of taxes	—	—	—	43	—
Net income	\$ 2,937	\$ 4,816	\$ 10,090	\$ 3,158	\$ 3,666
Earnings per common share before cumulative effect of change in accounting principles, net of taxes					
Basic	\$ 3.96	\$ 6.69	\$ 14.22	\$ 4.19	\$ 5.04
Diluted	3.94	6.68	14.17	4.17	5.01
Earnings per common share after cumulative effect of change in accounting principles, net of taxes					
Basic	\$ 3.96	\$ 6.69	\$ 14.22	\$ 4.25	\$ 5.04
Diluted	3.94	6.68	14.17	4.23	5.01
Dividends per common share	\$ 1.20	\$ 1.04	\$ 0.88	\$ 0.80	\$ 0.68
Weighted average common shares outstanding (in thousands)					
Basic	689,282	687,094	692,727	692,603	692,097
Diluted	691,521	688,675	695,116	695,973	695,307
<b>Balance Sheet Data</b>					
Total assets	\$ 795,284	\$ 803,449	\$ 752,249	\$ 641,100	\$462,803
Senior debt securities, net due within one year	282,303	295,262	244,429	264,227	183,374
Senior debt securities, net due after one year	443,772	438,738	415,662	311,013	244,732
Subordinated debt, due after one year	5,622	5,613	5,605	3,128	144
Miscellaneous liabilities <sup>(3)</sup>	30,662	30,420	52,914	40,489	14,252
Minority interest in consolidated subsidiaries	1,509	1,929	2,309	2,619	2,944
Stockholders' equity	31,416	31,487	31,330	19,624	17,357
<b>Portfolio Balances <sup>(4)</sup></b>					
Retained portfolio (unpaid principal balances) <sup>(5)</sup>	\$ 652,936	\$ 645,466	\$ 567,272	\$ 497,639	\$392,298
Total PCs issued and Structured Securities (unpaid principal balances) <sup>(6)</sup>	1,208,968	1,162,068	1,090,624	961,511	838,323
Total mortgage portfolio (unpaid principal balances)	1,505,206	1,414,399	1,316,609	1,150,723	975,612
<b>Ratios</b>					
Return on average assets <sup>(7)</sup>	0.4%	0.6%	1.4%	0.6%	0.9%
Return on common equity <sup>(8)</sup>	10.2	17.2	47.2	20.2	39.0
Return on total equity <sup>(9)</sup>	9.3	15.3	39.6	17.1	30.2
Dividend payout ratio on common stock <sup>(10)</sup>	30.7	15.6	6.2	18.9	13.6
Equity to assets ratio <sup>(11)</sup>	3.9	4.0	3.7	3.4	2.9

(1) Effective January 1, 2003, we adopted the provisions of the Financial Accounting Standards Board, or FASB, Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others," or FIN 45, and FASB Staff Position 45-2, "Whether FASB Interpretation No. 45, 'Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others,' or Provides Support for Subsequently Accounting for a Guarantor's Liability at Fair Value," or FIN 45-2. We also adopted the provisions of Statement of Financial Accounting Standards, or SFAS, No. 133, "Accounting for Derivative Instruments and Hedging Activities," or SFAS 133, and the provisions of Emerging Issues Task Force No. 99-20, "Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets," or EITF 99-20 as of January 1, 2001 and April 1, 2001, respectively. See "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES" to our consolidated financial statements for more information.

(2) Non-interest income (loss) was increased by \$11 million and \$9 million for 2001 and 2000, respectively, to conform to the 2004 presentation.

(3) Includes Due to Participation Certificate investors, Accrued interest payable, Guarantee obligation for Participation Certificates, Derivative liabilities, at fair value, Reserve for guarantee losses on Participation Certificates and Other liabilities.

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

(5) The Retained portfolio presented in our consolidated balance sheets differs from the Retained portfolio on this table because the consolidated balance sheets caption includes valuation adjustments (e.g., fair value adjustments for securities classified as available-for-sale and trading and the Reserve for losses on mortgage loans held-for-investment) and deferred balances (e.g., premiums and discounts). See "Table 9 — Reconciliation of Retained Portfolio Unpaid Principal Balances to the Consolidated Balance Sheets" in "MD&A — OUR RETAINED AND TOTAL MORTGAGE PORTFOLIOS" for more information.

(6) Represents PCs and Structured Securities backed by non-Freddie Mac mortgage-related securities and other credit guarantees of mortgage loans held by third parties. The balances are based on the underlying collateral, which ultimately affects the principal amount of PCs, Structured Securities and other credit guarantees of mortgage loans held by third parties.

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

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

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

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

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

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

The discussion that follows includes forward-looking statements describing results and trends for business performance metrics during the first part of 2005, as well as our outlook for certain metrics for the full year ending December 31, 2005. Actual results will depend on a number of factors such as changes in interest rates and other market conditions and may differ from the outlook discussed below. See "FORWARD-LOOKING STATEMENTS" for a list of such factors.

### EXECUTIVE SUMMARY

#### Overview

We generate revenue from two primary sources: management and guarantee income from our credit guarantee activities and net interest income from our portfolio investment activities.

Management and guarantee income represents the fee we charge mortgage originators or servicers to guarantee the payment of principal and interest. This fee is compensation for:

- Guaranteeing the payment of principal and interest to security holders; and
- Costs incurred in administering payments on these securities.

Net interest income is primarily the difference between interest income earned on mortgages and mortgage-related assets and interest expense owed on debt. To manage the interest-rate and other market risks associated with funding portfolio investments and to reduce financing costs, we enter into interest-rate swaps, options and other derivatives. Although we believe the derivative transactions we execute are effective in managing interest-rate risk from an economic perspective, they may significantly affect, and increase the volatility of, our reported earnings. This is particularly the case where the derivative is not accounted for in a hedge accounting relationship, because the fair value gains and losses on such transactions are recorded on our consolidated statements of income in Non-interest income (loss) without the offsetting change in the value of the economically hedged risk being recognized in earnings.

In addition to management and guarantee income and net interest income, we generate revenue from fee-based activities. For instance, we earn fees associated with servicing and technology-related programs, including Loan Prospector® (our automated underwriting system).

#### Summary of Our 2004 Financial Results

##### *GAAP Results*

Our Net income was \$2.9 billion for 2004, a decrease of 39 percent from \$4.8 billion for 2003. Diluted earnings per common share were \$3.94 for 2004, a decrease of 41 percent from Diluted earnings per common share of \$6.68 for 2003. The decrease in net income for 2004 was primarily due to losses in Derivative gains (losses), a component of Non-interest income (loss), related to derivative instruments not in qualifying hedge accounting relationships. However, these derivatives continued to be an effective component of our risk management activities. Changes in the level and volatility of interest rates have resulted in significant period-to-period volatility in our reported net income. It is important to note that while our reported net income under GAAP was volatile, our interest-rate risk remained low as demonstrated by the low levels of our portfolio market value sensitivity, or PMVS, and duration gap throughout 2004, which are discussed more fully in "RISK MANAGEMENT — Interest-Rate Risk and Other Market Risks — *Measurement of Interest-Rate Risk.*"

Net interest income was \$9.1 billion in 2004, compared to \$9.5 billion in 2003. Net interest yield decreased to 124 basis points in 2004 from 130 basis points in 2003 on a fully taxable-equivalent basis. The decline in 2004 net interest yield was attributable to lower yields on assets acquired in 2004 and runoff of higher-yielding assets, partially offset by a decrease in average debt funding yields, lower derivative-related expenses associated with derivatives in qualifying hedge accounting relationships and lower interest expense

*Freddie Mac*

related to amounts due to holders of PCs and Structured Securities. Net derivative-related interest expense declined primarily because we moved a significant amount of pay-fixed swaps to no-hedge designation effective at the beginning of the second quarter of 2004 and the related interest expense on these contracts was recognized as a component of Non-interest income (loss) in periods following the move to no-hedge designation.

For 2005, we expect to report Net interest income materially lower than that reported for 2004, primarily due to compression in net interest margins on our existing portfolio and lower nominal margins on floating-rate mortgage-related security purchases. However, we expect this decrease to be significantly offset by decreased losses in Non-interest income (loss), assuming current forward rates are realized.

Management and guarantee income, which is a component of Non-interest income (loss) on the consolidated statements of income, was \$1.4 billion in 2004, compared to \$1.7 billion in 2003. The total management and guarantee income rate recognized in 2004 was 17.5 basis points, compared to 23.3 basis points in 2003. Management and guarantee income consists of the guarantee fee on outstanding PCs and Structured Securities and certain pre-2003 fees that seller/servicers paid to us at the time of securitization that are amortized into Management and guarantee income over the estimated life of the PC. The decrease in the total Management and guarantee income rate in 2004 was driven by a decrease in the amortization of the pre-2003 deferred fees and a decrease in the average contractual guarantee fee rate on outstanding PCs, partially offset by higher levels of outstanding PCs.

Non-interest income (loss), excluding Management and guarantee income, totaled (\$4.4) billion in 2004, compared to (\$1.9) billion in 2003. The increase in the loss compared to 2003 was primarily due to net losses on derivative instruments not in qualifying hedge accounting relationships in 2004 of (\$4.5) billion, compared to a net gain of \$39 million in 2003. The loss in 2004 was partly attributable to a decline in swap rates during 2004, which resulted in losses on our pay-fixed swap portfolio. In addition, there were net losses on our call and put swaptions as the fair value of these positions was affected by changes in swap rates and the decline in implied volatilities of interest rates during the year. However, these derivatives continued to be an effective component of our risk management activities. The net loss on our derivatives not in hedge accounting relationships also included higher net losses related to the accrual of periodic settlements, primarily because we moved a significant amount of pay-fixed swaps to no hedge designation effective at the beginning of the second quarter of 2004. The accrual of periodic settlements on these pay-fixed swaps was recognized as a component of Derivative gains (losses) in periods following the move to no hedge designation, rather than as a component of Net interest income. Non-interest income (loss) also reflected smaller net losses on investment activity of (\$348) million in 2004, compared to net losses of (\$1.1) billion in 2003 and lower losses on debt retirements of (\$327) million in 2004, compared to losses of (\$1.8) billion in 2003.

Non-interest expense totaled \$2.4 billion in 2004, compared to \$2.2 billion in 2003. Non-interest expense includes Administrative expenses, which totaled \$1.6 billion in 2004 compared to \$1.2 billion in 2003. During 2004, we continued to incur significant Administrative expenses related to our on-going efforts to return to timely financial reporting. Our objective in 2005 is to keep Administrative expenses relatively flat compared to 2004. In addition, in 2005, we expect credit losses to increase from their recent levels, but to be low relative to historic levels.

Total stockholders' equity decreased to \$31.4 billion at December 31, 2004 from \$31.5 billion at December 31, 2003. The net decrease was attributable to a decrease in Accumulated other comprehensive income (loss), net of taxes, or AOCI, partially offset by an increase in Retained earnings. See "CONSOLIDATED BALANCE SHEETS ANALYSIS — Total Stockholders' Equity" for more information.

#### *Fair Value Balance Sheet Results*

We believe fair value measures provide an important view of our business economics and risks because fair value takes a consistent approach to the representation of all financial assets and liabilities, rather than an approach that combines historical cost and fair value techniques, as is the case with our GAAP-basis consolidated financial statements. The fair value balance sheet is an important component of our risk management processes as we use daily estimates of the changes in fair value to calculate our PMVS and duration gap measures.

*Freddie Mac*

At December 31, 2004, the fair value of net assets (net of tax effect) was \$30.9 billion, a \$3.6 billion, or 13 percent, increase from December 31, 2003. For the same period, the fair value of net assets attributable to common stockholders (representing the fair value balance sheet total net assets less the fair value of net assets attributable to preferred stockholders) was \$26.8 billion, a \$3.9 billion, or 17 percent, increase from December 31, 2003, compared to growth of \$4.6 billion, or 25 percent, in 2003. The fair value of net assets attributable to common stockholders, before common dividends and capital transactions, increased by \$4.7 billion, or 21 percent, from December 31, 2003, a return that exceeds our long-term expectations.

### **Capital**

We have submitted to OFHEO amended minimum capital reports for 2004, including estimates of our capital surpluses. Based on these estimates, we believe that we were in compliance with OFHEO's regulatory capital requirements throughout the year. The estimated minimum capital surplus at December 31, 2004, as reported to OFHEO in our amended minimum capital reports, was approximately \$10.9 billion. Our estimated surplus in excess of the 30 percent target surplus at December 31, 2004 was approximately \$3.6 billion. Our surplus over the risk-based capital requirement was approximately \$23.6 billion at December 31, 2004. We currently expect to be able to maintain a surplus over our regulatory capital requirements across a wide range of market conditions.



## OUR RETAINED AND TOTAL MORTGAGE PORTFOLIOS

Our Total mortgage portfolio includes the unpaid principal balances of mortgages and mortgage-related securities held in our Retained portfolio and the unpaid principal balances of PCs and Structured Securities held by third parties; PCs and Structured Securities held by third parties are considered outstanding and are not included on our consolidated balance sheets. Table 8 provides information about our Total mortgage portfolio as of December 31, 2004 and 2003 based on unpaid principal balances. For purposes of Table 8, the unpaid principal balances reflect all PCs issued and only that portion of Structured Securities that is backed by non-Freddie Mac mortgage-related securities as of December 31, 2004 and 2003. The unpaid principal balances of Structured Securities that directly or indirectly relate to issued PCs are excluded because such amounts are included in the amounts reported in Table 8 that relate to issued PCs.

**Table 8 — Freddie Mac’s Total Mortgage Portfolio Based on Unpaid Principal Balances<sup>(1)(2)</sup>**

	As of December 31,			
	2004		2003	
	Dollars in Millions	% of Total Mortgage Portfolio	Dollars in Millions	% of Total Mortgage Portfolio
Outstanding PCs and Structured Securities . . . . .	\$ 852,270	56%	\$ 752,164	53%
Retained portfolio:				
PCs and Structured Securities . . . . .	356,698	24	393,135	28
Non-Freddie Mac mortgage-related securities:				
Agency mortgage-related securities . . . . .	59,715	4	77,289	6
Non-agency mortgage-related securities . . . . .	175,163	12	114,772	8
Total non-Freddie Mac mortgage-related securities . . . . .	<u>234,878</u>	<u>16</u>	<u>192,061</u>	<u>14</u>
Total mortgage-related securities . . . . .	591,576	40	585,196	42
Mortgage loans . . . . .	61,360	4	60,270	4
Total Retained portfolio <sup>(3)</sup> . . . . .	652,936	44	645,466	46
PCs and Structured Securities in the Cash and investments portfolio <sup>(4)</sup> . . . . .	—	—	16,769	1
<b>Total mortgage portfolio . . . . .</b>	<u><u>\$1,505,206</u></u>	<u><u>100%</u></u>	<u><u>\$1,414,399</u></u>	<u><u>100%</u></u>

- (1) Excludes mortgage loans and mortgage-related securities traded, but not yet settled.
- (2) Due to timing differences in our receipt of principal and interest payments from mortgage servicers and the subsequent pass-through of payments to PC investors, the unpaid principal balances of the underlying mortgage loans do not always equal the unpaid principal balance of issued PCs and Structured Securities. See “NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — Due to Participation Certificate Investors” to the consolidated financial statements for more information.
- (3) The Retained portfolio presented in this table differs from the Retained portfolio presented in our consolidated balance sheets because the amounts presented in our consolidated balance sheets include valuation adjustments (*e.g.*, fair value adjustments for securities classified as available-for-sale and trading and the Reserve for losses on mortgage loans held-for-investment) and deferred balances (*e.g.*, premiums and discounts). “Table 9 — Reconciliation of Retained Portfolio Unpaid Principal Balances to the Consolidated Balance Sheets” provides a reconciliation of the Retained portfolio amounts shown in this table to the amounts shown under such caption in accordance with GAAP on our consolidated balance sheets.
- (4) Represents PCs and Structured Securities we held in connection with PC market-making and support activities, which are reflected in Investments on our consolidated balance sheets. In the fourth quarter of 2004, we ceased our PC market-making and support activities accomplished through our Securities Sales & Trading Group business unit and our external Money Manager program.

For a discussion of purchases into the Total mortgage portfolio, see “VOLUME STATISTICS.”

**Table 9 — Reconciliation of Retained Portfolio Unpaid Principal Balances to the Consolidated Balance Sheets**

	December 31,	
	2004	2003
	(dollars in millions)	
<b>Mortgage loans in the Retained portfolio:</b>		
Unpaid principal balances . . . . .	\$ 61,360	\$ 60,270
Unamortized premiums, discounts, deferred fees and other basis adjustments <sup>(1)</sup>	74	64
Less: Reserve for losses on mortgage loans held-for-investment . . . . .	(114)	(174)
Mortgage loans, net of reserve per consolidated balance sheets . . . . .	61,320	60,160
<b>Mortgage-related securities in the Retained portfolio:<sup>(2)</sup></b>		
Unpaid principal balances <sup>(3)(4)</sup> . . . . .	591,576	585,196
Unamortized premiums, discounts, deferred fees and other basis adjustments <sup>(5)</sup>	3,965	4,729
Net unrealized gains on mortgage-related securities, pre-tax . . . . .	6,762	9,601
Participation Certificate residuals, at fair value . . . . .	845	671
Mortgage-related securities per consolidated balance sheets . . . . .	603,148	600,197
<b>Total Retained portfolio per consolidated balance sheets . . . . .</b>	<b>\$664,468</b>	<b>\$660,357</b>

- (1) Other basis adjustments include lower-of-cost-or-market valuation adjustments for loans held-for-sale and basis adjustments related to purchase commitment hedging activities. Basis adjustments are modifications to the carrying value of these mortgage loans.
- (2) Includes PCs, Structured Securities and non-Freddie Mac mortgage-related securities.
- (3) Includes other-than-temporary credit-related impairments attributable to certain securities. Impairments to unpaid principal balances are recorded in certain circumstances when the fair value declines below the amortized cost basis of a security.
- (4) Consists of PCs and Structured Securities and Total non-Freddie Mac mortgage-related securities held in the Retained portfolio. See “Table 8 — Freddie Mac’s Total Mortgage Portfolio Based on Unpaid Principal Balances” for more information.
- (5) Other basis adjustments are related to (a) hedging activities for the purchase of securities, (b) certain impairments related to interest-only securities and (c) the extinguishment of the net positive difference between Guarantee assets, Guarantee obligations and credit enhancement-related assets recognized at the inception of an executed Guarantor Swap that correspond to PCs and Structured Securities that we purchase.

Table 10 provides further detail regarding both issued and outstanding PCs and Other Structured Securities.

**Table 10 — Freddie Mac Single-Class and Multi-Class PCs and Other Structured Securities Based on Unpaid Principal Balances**

	December 31, 2004			
	PCs and Structured Securities in Retained Portfolio	PCs and Structured Securities in Cash and Investments Portfolio <sup>(4)</sup>	PCs and Structured Securities Outstanding (held by third parties)	Total PCs and Structured Securities Issued
	(dollars in millions)			
PCs and Structured Securities:				
Single-class <sup>(1)</sup> .....	\$219,794	\$ —	\$454,396	\$ 674,190
Multi-class <sup>(2)(3)</sup> .....	136,904	—	390,636	527,540
Other <sup>(5)</sup> .....	—	—	7,238	7,238
Total PCs and Structured Securities <sup>(6)(7)</sup> .....	<u>\$356,698</u>	<u>\$ —</u>	<u>\$852,270</u>	<u>\$1,208,968</u>
	December 31, 2003			
	PCs and Structured Securities in Retained Portfolio	PCs and Structured Securities in Cash and Investments Portfolio <sup>(4)</sup>	PCs and Structured Securities Outstanding (held by third parties)	Total PCs and Structured Securities Issued
	(dollars in millions)			
PCs and Structured Securities:				
Single-class <sup>(1)</sup> .....	\$269,442	\$15,970	\$397,009	\$ 682,421
Multi-class <sup>(2)(3)</sup> .....	123,693	799	347,833	472,325
Other <sup>(5)</sup> .....	—	—	7,322	7,322
Total PCs and Structured Securities <sup>(6)(7)</sup> .....	<u>\$393,135</u>	<u>\$16,769</u>	<u>\$752,164</u>	<u>\$1,162,068</u>

- (1) Includes PCs that do not back Structured Securities and single-class Structured Securities backed by PCs and Ginnie Mae Certificates.
- (2) Includes that portion of multi-class Structured Securities that are backed by PCs and non-agency mortgage-related securities. Also includes multi-class Structured Securities backed by Ginnie Mae Certificates.
- (3) Excludes \$43,419 million and \$42,692 million at December 31, 2004 and 2003, respectively, of total multi-class Structured Securities where we have resecuritized other already issued Structured Securities.
- (4) Represents PCs and Structured Securities held by us in connection with PC market-making and support activities, which are reflected in Investments on our consolidated balance sheets. We ceased our PC market making and support activities accomplished through our Securities Sales & Trading Group business unit and our external Money Manager program during the fourth quarter of 2004.
- (5) As further discussed in “NOTE 4: FINANCIAL GUARANTEES” to the consolidated financial statements, these amounts include:
  - \$5,432 million and \$5,044 million at December 31, 2004 and 2003, respectively, that pertain to our guarantee of the payment of principal and interest on (a) multifamily mortgage loans that are originated and held by state and municipal housing finance agencies to support tax-exempt multifamily housing revenue bonds, (b) tax-exempt multifamily housing revenue bonds that support pass-through certificates issued by third parties, and (c) Freddie Mac pass-through certificates which are backed by tax-exempt multifamily housing revenue bonds and related taxable bonds and/or loans; and
  - \$1,806 million and \$2,278 million at December 31, 2004 and 2003, respectively, of single-family mortgage loans held by third parties for which we provided a credit guarantee.
- (6) PCs and Structured Securities exclude \$723,429 million and \$637,491 million at December 31, 2004 and 2003, respectively, of Structured Securities backed by resecuritized PCs and other previously issued Structured Securities. These excluded Structured Securities, which do not increase our credit related exposure, consist of single-class Structured Securities backed by PCs, REMICs, and principal-only strips. The notional balances of interest-only strips of \$105,703 million and \$91,192 million at December 31, 2004 and 2003, respectively, are excluded because this table is based on unpaid principal balances. Also excluded are modifiable and combinable REMIC tranches and Interest and Principal classes, which collectively totaled \$1,097,336 million and \$988,600 million at December 31, 2004 and 2003, respectively, where the holder has the option to exchange the security tranches for other pre-defined security tranches. See “BUSINESS — Credit Guarantee Activities” for more information on Structured Securities.
- (7) Includes \$3,015 million and \$4,729 million of Structured Securities backed by Ginnie Mae Certificates at December 31, 2004 and 2003, respectively.

## CRITICAL ACCOUNTING POLICIES AND ESTIMATES

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

### **Fair Value Measurement**

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

Table 11 summarizes our assets and liabilities that are recorded at fair value in the GAAP-basis consolidated balance sheets at December 31, 2004 and 2003.

**Table 11 — Assets and Liabilities Recorded at Fair Value**

	December 31,	
	2004	2003
	(dollars in millions)	
<b>Retained portfolio<sup>(1)</sup></b>		
Mortgage-related securities:		
Available-for-sale, at fair value . . . . .	\$590,461	\$581,326
Trading, at fair value . . . . .	11,842	18,200
Participation Certificate residuals, at fair value . . . . .	845	671
<b>Investments</b>		
Mortgage-related securities:		
Trading, at fair value . . . . .	—	32,817
Participation Certificate residuals, at fair value . . . . .	—	(5)
Non-mortgage-related securities:		
Available-for-sale, at fair value . . . . .	29,830	31,228
Trading, at fair value . . . . .	—	1,314
<b>Other assets<sup>(2)</sup></b>		
Derivative assets, at fair value . . . . .	15,257	16,180
Guarantee asset for Participation Certificates, at fair value . . . . .	4,516	3,686
<b>Selected debt securities, net</b>		
Securities sold, not yet purchased, at fair value . . . . .	—	733
<b>Other liabilities</b>		
Derivative liabilities, at fair value . . . . .	226	357

(1) Mortgage loans classified as held-for-sale are not included in this table because they are carried on the GAAP-basis consolidated balance sheets at lower-of-cost-or-market value (*i.e.*, not at fair value). The carrying value was \$2.6 billion and \$2.5 billion at December 31, 2004 and 2003, respectively.

(2) Real estate owned is not included in this table because it is carried on the GAAP-basis consolidated balance sheets at lower-of-cost-or-fair value (after deduction for estimated disposition costs). The carrying value was \$741 million and \$795 million at December 31, 2004 and 2003, respectively.

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

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

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

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

While our general practice is to use consistent valuation methodologies over time, we periodically evaluate our methodologies and may change them to improve our fair value estimates, to accommodate market developments or to compensate for changes in data availability or other operational constraints.

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

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

The fair values for approximately 98 percent of our mortgage-related securities are based on prices obtained from third parties or are determined using models with significant market inputs. The fair values for the remainder of our mortgage-related securities are obtained from internal models with few or no market inputs. The fair values for our non-mortgage-related securities are based on prices obtained from third parties, unless their interest rates frequently reset, in which case the carrying value is presumed to be a reasonable approximation of fair value. As few of the derivative contracts we use are listed on exchanges, the majority of our derivative positions are valued using internally developed models that use market parameters as their basis. Approximately 75 percent of the gross fair value of our derivatives portfolio relates to interest-rate and cross-currency swaps that do not have embedded options. These derivatives are valued using a discounted cash flow model that projects future cash flows and discounts them at the spot rate related to each cash flow. The remaining 25 percent of our derivatives portfolio is valued based on prices obtained from third parties or is determined using models with significant market inputs. The fair values for all of our debt securities are based on prices obtained from third parties or are determined using models with significant market inputs.

Some of our financial instruments are not traded in active markets. Examples include guarantee assets, guarantee obligations and PC residuals. The fair values of these instruments are determined using internally developed models that facilitate simulation of multiple future scenarios that may occur. Our internal models incorporate empirical data coupled with the results of benchmarking default and capital assumptions observed in comparable non-conforming securities market trades adjusted, as appropriate, to reflect differences in underlying collateral and other factors. Material assumptions include:

- our projections of interest rates and housing prices;
- our expectations of prepayments, defaults and loss severity rates;

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- our estimates of market-implied option-adjusted spread data into our discount rates, including the selection of benchmark interest-only securities and the application of a trailing average option-adjusted spread assumption of up to 24 months;
- our projections of credit losses, influenced by expectations about factors such as defaults and loss severities; and
- our expectations about the estimated risk premium needed to address exposure to unexpected increases in credit losses.

We continue to improve the controls over the valuation of financial instruments. Modeling techniques used to estimate fair values are subject to review by an independent modeling group in our Enterprise Risk Oversight group led by our Chief Enterprise Risk Officer, who reports directly to the Chief Executive Officer. This group is responsible for the independent oversight and technical review of models, including evaluating the appropriateness of models used in risk management activities and financial disclosure. We have also established a senior management Valuation Committee, chaired by the Chief Financial Officer. The Valuation Committee reviews fair value estimation methodologies, assumptions, controls and results to ensure an effective process exists to provide reasonably accurate and reliable estimates for financial disclosures. To support the Valuation Committee, we have also created a Financial Valuation Control group reporting to the Chief Financial Officer with broad oversight of valuation processes. This group is responsible for performing comprehensive price verification using an array of independently obtained information to evaluate the reasonableness of fair value estimates and assumptions. This group is also responsible for reviewing and approving all valuation assumptions and methods, benchmarking valuation processes against industry practices, defining corporate valuation policies and standards and evaluating, on an ongoing basis, the effectiveness of valuation processes and controls.

As described above, the estimation of fair value requires judgment and we may have reasonably chosen different methodologies or assumptions in the current period. The use of different pricing methodologies and assumptions could have produced materially different estimates of fair value in the periods currently presented. However, we believe the fair values we estimated are reasonable based on internal reviews of significant pricing models and methodologies as well as verification of financial instrument pricing with third-party broker/dealers or pricing services. Furthermore, our estimates of fair value are likely to change in future periods to reflect changes in market factors such as interest rates and related volatility, credit performance, expectations about prepayment behavior and other factors. Our estimates of fair value for individual instruments may change by material amounts, depending on market developments. See “RISK MANAGEMENT — Interest-Rate Risk and Other Market Risks” for discussion of market risks and our interest-rate sensitivity measures, PMVS and duration gap.

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

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

We evaluate whether transfers of PCs or Structured Securities qualify as sales based upon the requirements of SFAS No. 140, “Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities” and, prior to April 1, 2001, SFAS No. 125, “Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,” which we collectively refer to as SFAS 125/140. If we determine that a transfer of PCs or Structured Securities does not qualify as a sale, we account for such transfer as a secured borrowing or as a financial guarantee transaction pursuant to the provisions of FASB Interpretation No. 45, “Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others” (“FIN 45”). In this regard, we will account for a transfer as a sale to the extent that we conclude that (1) assets that underlie transferred PCs or Structured Securities are legally beyond the reach of Freddie Mac and its creditors even in the event that Freddie Mac were to become financially insolvent, (2) a third-party buyer can freely pledge or exchange the PCs or Structured Securities that were transferred to it and (3) Freddie Mac did not maintain effective control over transferred PCs or Structured Securities through either (a) an arrangement that both entitles and obligates Freddie Mac to repurchase or redeem transferred PCs or Structured Securities before their maturity or (b) the ability to

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unilaterally cause the holder of a transferred PC or Structured Security to return specific assets (*i.e.*, other than through a clean up call).

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

Many of the transfers of PCs and Structured Securities that are made to third parties do not qualify as sales or secured borrowings, but are accounted for as financial guarantee transactions pursuant to the provisions of FIN 45. For such transactions, we recognize at the inception of an executed guarantee a guarantee obligation that is initially measured to be the greater of (a) fair value or (b) the contingent liability amount required to be recognized at inception of the guarantee by SFAS No. 5, "Accounting For Contingencies," or SFAS 5. We also recognize the fair value of any consideration received on such transactions. Positive differences between the fair value of consideration expected and received, and guarantee obligations incurred are deferred as a component of recognized guarantee obligations, while negative differences between such amounts are recognized immediately in earnings as a component of Other expense.

Table 12 summarizes securitization activity in 2004, 2003 and 2002 that relates to transfers of PCs or Structured Securities that were accounted for as sales.

**Table 12 — Securitization Activity Accounted for as Sales**

	<u>Year Ended December 31,</u>		
	<u>2004</u>	<u>2003</u>	<u>2002</u>
	(dollars in millions)		
Transfers of Freddie Mac securities that were accounted for as sales . . . .	\$152,662	\$347,874	\$241,214
Gain on sale . . . . .	\$ 356	\$ 711	\$ 874

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

**Derivative Instruments and Hedging Activities**

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

Our Retained portfolio activities and our funding of these investments with a mix of short- and long-term debt expose us to interest-rate risk and other market risks. In particular, a mortgage borrower's prepayment option makes the timing and amount of mortgage prepayments very sensitive to changes in interest rates. The

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borrower's option exposes us to a potential mismatch in cash inflows from the mortgage assets we purchase for investment as compared to cash outflows required to make payments on our debt. We manage this interest-rate risk through various investment and funding activities, as well as through the use of derivatives.

We recognize all derivatives, whether designated in hedging relationships or not, at fair value as either assets or liabilities on our consolidated balance sheets. Derivatives that are expected to be highly effective in reducing the risk associated with the exposure being hedged may be designated for accounting purposes as a hedge of:

- The cash flows of a variable-rate instrument or a forecasted transaction, or a "cash flow hedge;"
- The changes in fair value of a fixed-rate instrument, or a "fair value hedge;" or
- Foreign currency fair value or cash flow, or a "foreign currency hedge."

We report the change in fair value of derivatives that are not in hedge accounting relationships in our consolidated statements of income in the period in which the change in value occurs. We record the change in fair value of derivatives that are in cash flow hedge accounting relationships, to the extent these relationships are effective, as a separate component of AOCI and reclassify this amount into earnings when the earnings effect of the hedged risk is recorded. We record the change in fair value of derivatives in fair value hedge accounting relationships each period in earnings along with the change in fair value of the hedged item.

The determination of whether a derivative qualifies for hedge accounting requires judgment about the application of SFAS 133. SFAS 133 requires contemporaneous documentation of our hedge relationships, including identification of the hedged item, the hedging instrument, the nature of the hedged risk and the method used to assess the effectiveness of the hedge relationship. We use statistical analysis or comparison of the critical terms of the hedging instrument to those of the hedged item to assess the effectiveness of hedges. If our documentation and assessments are not adequate, the derivative does not qualify for hedge accounting.

Hedge accounting also requires us to measure hedge ineffectiveness and recognize it currently in earnings. For certain cash flow hedging relationships, we have used the hypothetical derivative method, one of three methods acceptable under GAAP. This method requires us to develop a hypothetical derivative whose terms match those of the hedged item and compare estimated changes in its fair value to changes in the fair value of the hedging derivative. Development of hypothetical derivatives requires us to make certain assumptions and estimates. The use of different assumptions and estimates could result in a materially different amount of recorded ineffectiveness. We believe that our assumptions and estimates used to develop hypothetical derivatives are reasonable.

Derivatives designated as cash flow hedges generally hedge interest-rate risk related to forecasted issuances of debt. For these hedging relationships to qualify for hedge accounting both at inception and over the life of the derivative, we must estimate the probable future level of certain types of debt issuances. These estimates are based on our expectation of future funding needs and the future mix of funding sources. Our expectations about future funding are based upon projected growth and historical activity. If these estimates had been lower, a smaller notional amount of derivatives would have been eligible for designation as cash flow hedges and potentially material amounts that were deferred and reported in AOCI would have been reported in Derivative gains (losses) in the consolidated statements of income in the period they occurred. If estimated future fundings do not occur, or are probable of not occurring, potentially material amounts that were deferred and reported in AOCI would be immediately recognized in Derivative gains (losses) in the consolidated statements of income. We believe that the forecasted issuances of debt previously hedged in cash flow hedging relationships are sufficiently likely to occur so that we may continue recording previously deferred amounts in AOCI.

For a more detailed description of our use of derivatives and summaries of derivative positions, see "RISK MANAGEMENT — Interest-Rate Risk and Other Market Risks — *Use of Derivatives and Interest-Rate Risk Management*" and "NOTE 12: DERIVATIVES" to the consolidated financial statements.

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## Credit Losses

We maintain a Reserve for losses on mortgage loans held-for-investment to provide for credit losses incurred related to those mortgage loans. At December 31, 2004 and 2003, the Reserve for losses on mortgages held-for-investment was \$114 million and \$174 million, respectively. The Reserve for losses on mortgage loans held-for-investment is determined pursuant to the provisions of SFAS 5 and SFAS No. 114, "Accounting by Creditors for Impairment of a Loan — an Amendment of FASB Statements No. 5 and 15," or SFAS 114. We also maintain a Reserve for guarantee losses on Participation Certificates to provide for losses incurred on mortgages underlying PCs or Structured Securities held by third parties. At December 31, 2004 and 2003, the Reserve for guarantee losses on Participation Certificates was \$150 million and \$125 million, respectively. The Reserve for guarantee losses on Participation Certificates is determined pursuant to the provisions of SFAS 5 and SFAS 114. The Reserve for losses on mortgage loans held-for-investment and the Reserve for guarantee losses on Participation Certificates are collectively referred to as the loan loss reserves. Increases in loan loss reserves that relate to both mortgage loans held as a component of our Retained portfolio as well as PCs and Structured Securities held by third parties are reflected in earnings as a component of the (Provision) benefit for credit losses. Loan loss reserves decrease when charge-offs of such balances (net of recoveries) occur or when we record realized losses, which reduces our (Provision) benefit for credit losses.

Loan loss reserves are also increased upon the sale of PCs and Structured Securities for which we incurred losses on the underlying mortgage loans while such securities were held by us. From an earnings perspective, such incurred losses are recognized as a component of Gains (losses) on investment activity through, where applicable, (a) the subsequent measurement of corresponding PC residuals that are classified as trading (and to which such PCs or Structured Securities relate), (b) the recognition of impairment-related losses on such securities (*i.e.*, to the extent that such securities do not have recognized PC residual balances associated with them that are classified as trading) or (c) as a component of gain (loss) on sale of such securities. Upon the sale of such PCs or Structured Securities, incurred losses are classified on the consolidated balance sheets as Reserve for guarantee losses on Participation Certificates. See "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — Recently Adopted Accounting Standards and Accounting Changes — *Accounting for Financial Guarantees*" to the consolidated financial statements for a discussion of the impact of newly adopted accounting standards on the loan loss reserves in 2003. See "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES" and "NOTE 6: LOAN LOSS RESERVES" to the consolidated financial statements for more information about our process for determining the loan loss reserves.

The process for determining the level of loan loss reserves is subject to numerous estimates and assumptions that are uncertain and require judgment. We regularly evaluate the underlying estimates and assumptions we use when determining the loan loss reserves and update these assumptions to reflect our own historical experience and our current view of overall economic conditions and other relevant factors. Changes in one or more of these underlying estimates and assumptions could have a material impact on the loan loss reserves and the provision for credit losses. Key estimates and assumptions that could have an impact on loan loss reserves include:

- loss severity trends;
- default experience;
- expected proceeds from credit enhancements;
- evaluation of collateral; and
- identification of relevant macroeconomic factors and assessment of their applications.

Our use of specific estimates and assumptions is based on all available information and our knowledge and experience in the single-family and multifamily loan markets. We exercise a significant amount of judgment in selecting these factors and, had we made different determinations in the selection of these factors, a materially different level of loan loss reserves could have resulted. Additionally, it is possible that, given the

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same information, others could have reached different, reasonable conclusions. However, we believe the level of loan loss reserves is reasonable based on internal reviews of the factors and methodologies used.

### **Interest Income Recognition and Impairment Recognition on Investments in Securities**

For most of our mortgage-related and non-mortgage-related investments, we recognize interest income using the effective interest method in accordance with SFAS No. 91, "Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases," or SFAS 91. Deferred items, including premiums, discounts and other basis adjustments such as changes in commitment-period fair value, are amortized into interest income over the estimated lives of the securities using the retrospective effective interest method. Under this method, we recalculate the constant effective yield based on changes in estimated prepayments. Catch-up adjustments to the unamortized balance of premiums, discounts and other deferred items that result from applying the updated effective yield as if it had been in effect since acquisition are recognized through interest income.

For certain other investments in mortgage-related securities 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. Under this method, changes in the effective yield are recognized as adjustments to interest income in future periods. We specifically apply such guidance to beneficial interests (including undivided interests which are similar to beneficial interests) in securitized financial assets that:

- can contractually be prepaid or otherwise settled in such a way that we may not recover substantially all of our recorded investment (such as interest-only stripped securities); or
- were not of high credit quality at the date that we acquired them.

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

Determination of the effective yield requires significant judgment in estimating expected prepayment behavior, which is inherently uncertain. Estimates of future prepayments are derived from market sources and our internal prepayment models. Our prepayment models contemplate a variety of assumptions about borrower behavior in response to changes in interest rates and other macroeconomic factors. Judgment is involved in making initial determinations about prepayment expectations and in changing those expectations over time in response to changes in market conditions. The effects of future changes in market conditions may be material. We believe that the above assumptions are comparable to those used by other market participants. However, the use of different assumptions in our prepayment models could have resulted in materially different income recognition results.

We recognize impairment losses on available-for-sale securities in our Retained portfolio and Cash and investments portfolio when we have concluded that a decrease in the fair value of a security is other than temporary. EITF 99-20 requires impairment recognition when there is both a decline in fair value below the carrying amount and an adverse change in expected cash flows. Determination of whether an adverse change has occurred involves judgment about expected prepayments and credit events. For securities not accounted for under EITF 99-20, we review securities for possible other-than-temporary impairment whenever the security's fair value is less than its amortized cost. Impairment is evaluated considering a number of indicators which include the severity of the decline in fair value, credit ratings and the length of time the investment has been in an unrealized loss position. In addition to these indicators, we recognize impairment when qualitative factors indicate that we may not recover the unrealized loss. When evaluating the impairment indicators and qualitative factors, we consider our intent and ability to hold the investment until a point in time at which recovery can be reasonably expected to occur. We apply significant judgment in determining whether impairment loss recognition is appropriate. We believe our judgments are reasonable; however, different judgments could have resulted in materially different impairment loss recognition. See

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“NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES” to the consolidated financial statements for more information on interest income and impairment recognition on securities.

**Recently Issued Accounting Pronouncements**

See “NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES” to the consolidated financial statements for more information concerning our accounting policies and recently issued accounting pronouncements that we have not yet adopted and that will likely affect our consolidated financial statements.

## CONSOLIDATED RESULTS OF OPERATIONS

The following discussion of our consolidated results of operations should be read in conjunction with the notes to our consolidated financial statements.

**Table 13 — Summary of Consolidated Results**

	2004 vs. 2003			2003 vs. 2002	
	Year Ended December 31,			Year Ended	Change
	2004	2003	Change	December 31,	
	(in millions, except per share amounts)				
Net interest income . . . . .	\$ 9,137	\$ 9,498	\$ (361)	\$ 9,525	\$ (27)
Non-interest income (loss)					
Management and guarantee income . . . .	1,382	1,653	(271)	1,527	126
Gains (losses) on “Guarantee asset for Participation Certificates, at fair value” . . . . .	(1,135)	(1,461)	326	(2,176)	715
Income on “Guarantee obligation for Participation Certificates” . . . . .	732	925	(193)	592	333
Derivative gains (losses) . . . . .	(4,475)	39	(4,514)	5,302	(5,263)
Hedge accounting gains (losses) . . . . .	743	644	99	187	457
Gains (losses) on investment activity . . .	(348)	(1,114)	766	1,799	(2,913)
Gains (losses) on debt retirement . . . . .	(327)	(1,775)	1,448	(674)	(1,101)
Resecuritization fees . . . . .	159	352	(193)	276	76
Other income . . . . .	230	493	(263)	321	172
Total non-interest income (loss) . . . . .	(3,039)	(244)	(2,795)	7,154	(7,398)
Non-interest expense					
Salaries and employee benefits . . . . .	(758)	(624)	(134)	(593)	(31)
Professional services . . . . .	(588)	(311)	(277)	(155)	(156)
Occupancy expense . . . . .	(60)	(52)	(8)	(42)	(10)
Other administrative expenses . . . . .	(144)	(194)	50	(184)	(10)
Total administrative expenses . . . . .	(1,550)	(1,181)	(369)	(974)	(207)
(Provision) benefit for credit losses . . . .	(143)	5	(148)	(122)	127
REO operations income (expense) . . . . .	3	(7)	10	(4)	(3)
Housing tax credit partnerships . . . . .	(281)	(200)	(81)	(160)	(40)
Minority interests in earnings of consolidated subsidiaries . . . . .	(129)	(157)	28	(184)	27
Other expenses . . . . .	(271)	(696)	425	(432)	(264)
Total non-interest expense . . . . .	(2,371)	(2,236)	(135)	(1,876)	(360)
Income before income tax expense . . . . .	3,727	7,018	(3,291)	14,803	(7,785)
Income tax expense . . . . .	(790)	(2,202)	1,412	(4,713)	2,511
Net income . . . . .	2,937	4,816	(1,879)	10,090	(5,274)
Preferred stock dividends . . . . .	(210)	(216)	6	(239)	23
Net income available to common stockholders . . . . .	<u>\$ 2,727</u>	<u>\$ 4,600</u>	<u>\$(1,873)</u>	<u>\$ 9,851</u>	<u>\$(5,251)</u>
Diluted earnings per common share . . . . .	\$ 3.94	\$ 6.68	\$ (2.74)	\$ 14.17	\$ (7.49)

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## Net Interest Income

Net interest income, or NII, our principal source of earnings, represents the difference between Interest income and Interest expense. Net interest income is affected by changes in the balance and contractual rates associated with our interest-earning assets, interest-bearing liabilities and certain derivative contracts, as adjusted for amortization of premiums, discounts, deferred hedging gains and losses and other basis adjustments. We analyze Net interest income, and the related net interest yield, on a fully taxable-equivalent basis to consistently reflect income from taxable and tax-exempt investments based on a 35 percent marginal tax rate.

### Analysis of Annual Results

#### 2004 versus 2003

Table 14 summarizes Net interest income and net interest yield for 2004 compared to 2003, and the related analysis of the effect of changes in the rates and volumes of our interest-earning assets and interest-bearing liabilities on the changes in Net interest income between 2004 and 2003.

**Table 14 — Net Interest Income and Rate/Volume Analysis (2004 compared to 2003)**

	Year Ended December 31,				Change to Amounts	Attributable to Changes in <sup>(1)</sup>	
	2004		2003			Rate	Volume
	Amounts	Yield	Amounts	Yield			
	(dollars in millions)						
Interest income:							
Mortgage loans	\$ 4,007	6.51%	\$ 4,251	6.70%	\$ (244)	\$ (123)	\$ (121)
Mortgage-related securities	28,460	4.82	29,051	5.34	(591)	(2,921)	2,330
Total Retained portfolio	32,467	4.98	33,302	5.48	(835)	(3,044)	2,209
Cash and investments	3,136	2.79	3,796	2.63	(660)	18	(678)
Total income on interest-earning assets	35,603	4.66	37,098	4.93	(1,495)	(3,026)	1,531
Interest expense:							
Short-term debt	(2,908)	(1.39)	(2,785)	(1.21)	(123)	(406)	283
Long-term debt	(22,950)	(4.32)	(22,083)	(4.62)	(867)	1,472	(2,339)
Total interest expense on debt securities	(25,858)	(3.50)	(24,868)	(3.52)	(990)	1,066	(2,056)
Due to Participation Certificate investors	(708)	(5.71)	(1,641)	(6.26)	933	133	800
Total expense on interest-bearing liabilities	(26,566)	(3.54)	(26,509)	(3.62)	(57)	1,199	(1,256)
Income (expense) related to derivatives <sup>(2)</sup>	100	0.01	(1,091)	(0.15)	1,191	1,191	—
Impact of net non-interest-bearing funding	—	0.07	—	0.10	—	—	—
Total funding of interest-earning assets	(26,466)	(3.46)	(27,600)	(3.67)	1,134	2,390	(1,256)
Net interest income <sup>(3)</sup>	9,137	1.20	9,498	1.27	(361)	(636)	275
Fully taxable-equivalent adjustment	267	0.03	227	0.03	40	38	2
Net interest income (fully taxable-equivalent basis) <sup>(3)</sup>	\$ 9,404	1.24%	\$ 9,725	1.30%	\$ (321)	\$ (598)	\$ 277

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

(2) The changes in Income (expense) related to derivatives are fully attributed to rate as the derivatives have no associated principal amounts recorded on the consolidated balance sheets.

(3) Yields may not sum due to rounding.

Net interest income on a fully taxable-equivalent basis decreased by \$321 million to \$9,404 million in 2004 from \$9,725 million in 2003. During 2004, Interest income on Mortgage loans and Mortgage-related securities declined by \$835 million, or 3 percent. We earned lower Interest income on these investments during 2004 compared to 2003 because we earned lower yields on newly acquired assets, primarily due to purchases of lower-coupon non-agency mortgage-related securities (such as floating-rate securities that tend to earn lower initial yields than fixed-rate securities), coupled with the continued liquidation of relatively higher-coupon assets during 2004. The decline in our Retained portfolio yields during 2004 more than offset the positive impact of 7 percent growth in the Retained portfolio's average unpaid principal balance. We also earned lower interest income related to our Cash and investments portfolio during 2004 as compared to 2003.

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The average balance of this portfolio declined by 22 percent during 2004 as we ceased the PC market-making and support activities conducted through our Securities Sales & Trading Group business unit and our external Money Manager program during the fourth quarter of 2004. The decline in the average balance of the Cash and investments portfolio more than offset a 16 basis point increase in the yield we earned on this portfolio during 2004 as compared to 2003, due to a change in the asset mix and increases in short-term interest rates during 2004. During the first quarter of 2004, we implemented enhancements to certain assumptions and calculations in the amortization process for deferred fees recorded as basis adjustments on assets in our Retained portfolio. The effect on Net interest income of these enhancements, which were treated as changes in estimates, was the recognition of \$86 million of additional amortization expense during the first quarter of 2004.

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

Income (expense) related to derivatives improved to income of \$100 million during 2004 from expense of (\$1,091) million in 2003 primarily as a result of the movement of certain pay-fixed swaps out of hedge accounting relationships. As discussed below, in Derivative Gains (Losses) we determined that substantially all pay-fixed interest-rate swaps and certain other derivatives that previously had been in cash flow hedge accounting relationships no longer met hedge accounting requirements in accordance with SFAS 133, effective at the beginning of the second quarter of 2004. Consequently, we discontinued hedge accounting treatment for these relationships, resulting in pay-fixed swaps with a notional balance of approximately \$108 billion being moved from the cash flow hedge designation to no hedge designation. The movement of these pay-fixed swaps to no hedge designation had a significant impact on Net interest income during 2004 because the related net interest expense is no longer reported as a component of Net interest income in periods following the move, but as a component of Derivative gains (losses). We also voluntarily discontinued hedge accounting treatment for the majority of our receive-fixed interest-rate swaps effective November 1, 2004, resulting in receive-fixed interest-rate swaps with a notional balance of approximately \$50 billion being moved from the fair value hedge designation to no hedge designation.

Our Due to Participation Certificate investors interest expense decreased by \$933 million as liquidation rates on outstanding PCs and Structured Securities declined to 29 percent in 2004 from 63 percent in 2003. For a further discussion of how the prepayments of the collateral underlying outstanding PCs affect Net interest income, see “*Analysis of Quarterly Results — Interest expense related to amounts Due to Participation Certificate investors*” below.

As discussed above, in the fourth quarter of 2004, we decided to cease the PC market-making and support activities accomplished through our Securities Sales & Trading Group business unit and our external Money Manager program. By the end of 2004, we had divested the trading portfolio related to these activities in the Cash and investments portfolio. See “NOTE 5 — RETAINED PORTFOLIO AND CASH AND INVESTMENTS PORTFOLIO” to the consolidated financial statements for further information. In conjunction with these activities, our investments in mortgage-related securities were generally hedged by entering into forward sales of mortgage-related securities. When determining the fair value of these positions, the held investment was valued at the current market, or spot price, while the forward sale commitment was valued at the discounted sales, or forward price. The spot-forward difference between the trading security and the forward sale commitment resulted in a loss in Gains (losses) on investment activities that was offset by Net interest income on the held position. This spot-forward difference was \$976 million, \$981 million and \$938 million in 2004, 2003 and 2002, respectively.

Net interest yield on a fully taxable-equivalent basis decreased by 6 basis points to 124 basis points in 2004 from 130 basis points in 2003, as the decline in yields on interest-earning assets exceeded the benefit of lower debt funding costs. The yield on interest-earning assets declined due to the Retained portfolio's acquisition of relatively lower-yielding assets and the liquidation of higher-coupon securities, partially offset by

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an improvement in the yield on the Cash and investments portfolio as short-term interest rates increased during 2004. The yield on interest-bearing liabilities declined due to the maturity and repurchase of higher cost long-term debt and the issuance of new long-term debt at lower rates, coupled with lower costs associated with the amounts of interest expense Due to Participation Certificate investors. This decline was partially offset by higher short-term debt yields as average short-term rates were higher in 2004 as compared to 2003. Income (expense) related to derivatives improved during 2004, as we moved a significant amount of our pay-fixed swaps to no hedge designation and the related net interest expense was reported as Derivative gains (losses) effective at the beginning of the second quarter of 2004 (as described above). The impact of this movement was slightly offset by the movement of a significant amount of our receive-fixed swaps to no hedge designation in the fourth quarter of 2004 and the recording of the related Net interest income in Derivative gains (losses) in periods subsequent to the move.

#### 2003 versus 2002

Table 15 summarizes Net interest income and net interest yield for 2003 as compared to 2002, and the related analysis of the effect of changes in the rates and volumes of our interest-earning assets and interest-bearing liabilities on the changes in Net interest income between 2003 and 2002.

**Table 15 — Net Interest Income and Rate/Volume Analysis (2003 compared to 2002)**

	Year Ended December 31,				Change to Amounts	Attributable to Changes in <sup>(1)</sup>	
	2003		2002			Rate	Volume
	Amounts	Yield	Amounts	Yield			
	(dollars in millions)						
Interest income:							
Mortgage loans	\$ 4,251	6.70%	\$ 4,290	7.02%	\$ (39)	\$ (199)	\$ 160
Mortgage-related securities	29,051	5.34	30,039	6.39	(988)	(5,330)	4,342
Total Retained portfolio	33,302	5.48	34,329	6.46	(1,027)	(5,529)	4,502
Cash and investments	3,796	2.63	4,147	3.41	(351)	(718)	367
Total income on interest-earning assets	37,098	4.93	38,476	5.89	(1,378)	(6,247)	4,869
Interest expense:							
Short-term debt	(2,785)	(1.21)	(4,303)	(2.03)	1,518	1,849	(331)
Long-term debt	(22,083)	(4.62)	(21,337)	(5.24)	(746)	2,725	(3,471)
Total interest expense on debt securities	(24,868)	(3.52)	(25,640)	(4.15)	772	4,574	(3,802)
Due to Participation Certificate investors	(1,641)	(6.26)	(1,236)	(6.82)	(405)	110	(515)
Total expense on interest-bearing liabilities	(26,509)	(3.62)	(26,876)	(4.23)	367	4,684	(4,317)
Income (expense) related to derivatives <sup>(2)</sup>	(1,091)	(0.15)	(2,075)	(0.32)	984	984	—
Impact of net non-interest-bearing funding	—	0.10	—	0.13	—	—	—
Total funding of interest-earning assets	(27,600)	(3.67)	(28,951)	(4.43)	1,351	5,668	(4,317)
Net interest income <sup>(3)</sup>	9,498	1.27	9,525	1.46	(27)	(579)	552
Fully taxable-equivalent adjustment	227	0.03	252	0.04	(25)	9	(34)
Net interest income (fully taxable-equivalent basis) <sup>(3)</sup>	\$ 9,725	1.30%	\$ 9,777	1.50%	\$ (52)	\$ (570)	\$ 518

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

(2) The changes in Income (expense) related to derivatives are fully attributed to rate as the derivatives have no associated principal amounts recorded on the consolidated balance sheets.

(3) Yields may not sum due to rounding.

Net interest income on a fully taxable-equivalent basis decreased by \$52 million to \$9,725 million in 2003 from \$9,777 million in 2002. During 2003, interest income on mortgage-related securities declined by \$988 million, or 3 percent. The interest income generated by the 14 percent growth in the average unpaid principal balance of the Retained portfolio was more than offset by the accelerated amortization of net premiums on Retained portfolio securities, lower yields on assets acquired due to the low interest-rate environment during 2003, and the continued liquidation of higher-yielding assets. Net interest income and net interest yield were reduced as the yield on interest-earning assets declined at a faster rate than the cost of debt funding during 2003. During the first quarter of 2003, we refined the assumptions and calculations for the amortization of certain deferred fees recorded as basis adjustments on assets in our Retained portfolio. The

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effect on Net interest income of refining these assumptions, which was treated as a change in estimate under GAAP, was the recognition of \$31 million of additional amortization income during the first quarter of 2003. These refined assumptions also affected Management and guarantee fee income as discussed in “Management and Guarantee Income” below. Interest income related to Cash and investments declined by \$351 million, or 8 percent, during 2003 as the negative impact of declining interest rates during the first half of the year was only partially offset by the 19 percent increase in the average balances of Cash and investments.

The decline in short-term interest rates during the first half of 2003 was the primary factor in the \$1,518 million, or 35 percent decline in interest expense related to short-term debt for 2003. This decline was only partially offset by an 8 percent increase in the average balance of short-term debt during the year. Interest expense related to long-term debt increased by \$746 million, or 3 percent, during 2003 as the average balances of long-term debt increased by 17 percent, offsetting the benefit of issuing new debt at lower rates. We repurchased approximately \$27.3 billion of long-term debt during 2003 and issued new debt at lower average rates in most cases. The most significant debt repurchases in 2003 occurred in the second quarter when we repurchased an aggregate of approximately \$17.1 billion of U.S. dollar and Euro-denominated debt securities, most of which followed the announcement of changes in our senior management. We executed these particular repurchases to support the liquidity and price performance of these securities. Gains (losses) on debt retirement are reported as a component of Non-interest income (loss).

Interest expense related to amounts Due to investors in PCs and Structured Securities increased by \$405 million to (\$1,641) million in 2003 from (\$1,236) million in 2002 as prepayments on the collateral underlying PCs and Structured Securities accelerated during the first part of 2003 in response to declining interest rates. The liquidation rate on outstanding PCs and Structured Securities increased to 63 percent in 2003 from 47 percent in 2002. For a further discussion of how the prepayments of the collateral underlying PCs affect Net interest income, see “*Analysis of Quarterly Results — Interest expense related to amounts Due to Participation Certificate investors.*”

Income (expense) related to derivatives, which includes the accrual of periodic cash settlements on interest-rate swap transactions accounted for as hedges and amortization of net deferred losses on closed cash flow hedges, improved by \$984 million with expenses decreasing to (\$1,091) million in 2003 from (\$2,075) million in 2002. During 2002 and into 2003, we terminated pay-fixed swaps to help manage the funding mismatch caused by the decrease in the expected lives of mortgage investments and increase in the balance of long-term debt. In 2002, the portfolio of swaps designated in hedge accounting relationships was in a net pay-fixed position, which resulted in increasing interest expense as market interest rates declined.

Net interest yield on a fully taxable-equivalent basis decreased by 20 basis points to 130 basis points in 2003 from 150 basis points in 2002. For 2003, net interest yield was lower as declines in yields on interest-earning assets outpaced the benefit of lower funding costs. The yield on interest-earning assets declined as a result of high liquidations in the first three quarters of 2003 and the acquisition of new assets in a lower rate environment. The yield on debt securities issued declined as the result of our long-term debt retirements, primarily in the second quarter of 2003, and subsequent refinance activity, primarily decreasing our short-term funding costs.

## Analysis of Quarterly Results

Table 16 summarizes quarterly Net interest income and net interest yield for 2004 and 2003.

**Table 16 — Quarterly Net interest income (quarterly yields annualized)**

	<u>1Q 2004</u>	<u>2Q 2004</u>	<u>3Q 2004</u>	<u>4Q 2004</u>	<u>Full year 2004</u>
	(dollars in millions)				
Contractual amounts of net interest income . . . . .	\$3,146	\$2,897	\$3,008	\$2,695	\$11,746
Deferred item amortization expense, net <sup>(1)</sup>					
Asset-related amortization expense, net . . . . .	(592)	(62)	(446)	(308)	(1,408)
Debt-related amortization expense, net . . . . .	<u>(298)</u>	<u>(322)</u>	<u>(366)</u>	<u>(315)</u>	<u>(1,301)</u>
Amortization expense, net . . . . .	(890)	(384)	(812)	(623)	(2,709)
Income (expense) related to derivatives					
Amortization of deferred balances in AOCI, net <sup>(2)</sup> . .	(367)	(482)	(481)	(484)	(1,814)
Accrual of periodic settlements of derivatives <sup>(3)</sup>					
Pay-fixed swaps . . . . .	(427)	—	—	—	(427)
Receive-fixed swaps . . . . .	527	494	525	422	1,968
Foreign-currency swaps . . . . .	138	101	82	55	376
Other . . . . .	<u>(1)</u>	<u>(1)</u>	<u>(1)</u>	<u>—</u>	<u>(3)</u>
Accrual of periodic settlements of derivatives . . .	237	594	606	477	1,914
Total income (expense) related to derivatives . . . . .	<u>(130)</u>	<u>112</u>	<u>125</u>	<u>(7)</u>	<u>100</u>
Net interest income . . . . .	2,126	2,625	2,321	2,065	9,137
Fully taxable-equivalent adjustment . . . . .	63	63	67	74	267
Net interest income (fully taxable-equivalent basis) . . .	<u>\$2,189</u>	<u>\$2,688</u>	<u>\$2,388</u>	<u>\$2,139</u>	<u>\$ 9,404</u>
Net interest yield (fully taxable-equivalent basis) . . . . .	<u>1.15%</u>	<u>1.44%</u>	<u>1.24%</u>	<u>1.13%</u>	<u>1.24%</u>
	<u>1Q 2003</u>	<u>2Q 2003</u>	<u>3Q 2003</u>	<u>4Q 2003</u>	<u>Full year 2003</u>
	(dollars in millions)				
Contractual amounts of net interest income . . . . .	\$3,056	\$3,088	\$3,353	\$3,493	\$12,990
Deferred item amortization expense, net <sup>(1)</sup>					
Asset-related amortization expense, net . . . . .	(238)	(540)	(280)	(364)	(1,422)
Debt-related amortization expense, net . . . . .	<u>(257)</u>	<u>(241)</u>	<u>(216)</u>	<u>(265)</u>	<u>(979)</u>
Amortization expense, net . . . . .	(495)	(781)	(496)	(629)	(2,401)
Income (expense) related to derivatives					
Amortization of deferred balances in AOCI, net <sup>(2)</sup> . .	(446)	(363)	(341)	(332)	(1,482)
Accrual of periodic settlements of derivatives <sup>(3)(4)</sup> . .	306	241	(74)	(82)	391
Total income (expense) related to derivatives . . . . .	<u>(140)</u>	<u>(122)</u>	<u>(415)</u>	<u>(414)</u>	<u>(1,091)</u>
Net interest income . . . . .	2,421	2,185	2,442	2,450	9,498
Fully taxable-equivalent adjustment . . . . .	41	64	60	62	227
Net interest income (fully taxable-equivalent basis) . . .	<u>\$2,462</u>	<u>\$2,249</u>	<u>\$2,502</u>	<u>\$2,512</u>	<u>\$ 9,725</u>
Net interest yield (fully taxable-equivalent basis) . . . . .	<u>1.40%</u>	<u>1.26%</u>	<u>1.27%</u>	<u>1.26%</u>	<u>1.30%</u>

(1) Amortization relates to premiums, discounts, deferred fees and other basis adjustments. Basis adjustments are modifications to the carrying value of our financial instruments.

(2) Represents changes in fair values of derivatives in cash flow hedge relationships that were previously deferred in AOCI and have been reclassified to earnings as the associated hedged forecasted issuances of debt and forecasted mortgage purchase transactions affect earnings.

(3) Reflects the accrual of periodic cash settlements in accordance with the contractual terms of all derivatives in qualifying hedge accounting relationships.

(4) Data for 2003 not available at the level of detail provided for 2004.

The various drivers of Net interest income and yields are described in detail below.

*Investment asset mix.* The purchase, sale and liquidation of assets within the Retained portfolio and the Cash and investments portfolio, which we collectively refer to as our portfolios, has a significant impact

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on our overall net interest yield. As the composition of the portfolios changes between higher or lower yielding assets, the overall asset yield on these portfolios fluctuates. Generally, during periods of relatively low interest rates, as experienced in 2003 and 2004, the yield on portfolio assets will decline as higher-yielding assets liquidate and new assets are acquired at lower rates. The composition of the Retained portfolio and the Cash and investments portfolio is discussed later in the “CONSOLIDATED BALANCE SHEETS ANALYSIS.”

*Amortization of premiums and discounts.* When we purchase mortgage-related securities, the price we pay for these assets generally does not equal the securities’ unpaid principal balance. We pay more than the unpaid principal balance (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 unpaid principal balance (referred to as a discount) when the coupon on the security is less than the current market yield for that security.

Purchase premiums and discounts are amortized over the estimated life of the purchased assets as adjustments 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, which are applied retrospectively to the date of purchase of the underlying mortgage-related security, when the effective interest-rate changes due to differences between actual and previously estimated prepayments and changes in estimated future prepayments.

As interest rates declined during the first half of 2003, we paid higher premiums to acquire mortgage-related securities. This resulted in a shift in the Retained portfolio to an increasing premium position in 2003. Mortgage interest rates fluctuated throughout 2004; however, at year end, these rates were comparable to rates at December 31, 2003. As a result, the Retained portfolio continued to be in a net premium position at December 31, 2004. The net balance of unamortized premiums, discounts, deferred fees and other basis adjustments related to all mortgage-related securities in the Retained portfolio (both those classified as available-for-sale and trading) equaled \$3,965 million and \$4,729 million at December 31, 2004 and 2003, respectively.

*Interest expense related to amounts Due to Participation Certificate investors.* As a result of the payment remittance cycle associated with PCs and certain Structured Securities, interest expense related to amounts Due to PC investors tends to increase during periods of rising prepayments and decrease during periods of declining prepayments. We invest the proceeds from prepayments on mortgage loans underlying PCs and Structured Securities in short-term investments until related payments are Due to PC investors. The interest earned on these investments is reported as a component of interest income on Cash and investments.

As described above, mortgage interest rates were relatively stable during 2004 in contrast to declining mortgage interest rates during the first half of 2003. Consequently, the volume of liquidations associated with outstanding PCs and Structured Securities peaked during 2003, causing interest expense Due to Participation Certificate investors to be at a higher level during 2003 compared to 2004 and 2002. Liquidations associated with outstanding PCs and Structured Securities (excluding liquidations associated with PCs in our Cash and investment portfolio) totaled \$224,283 million and \$471,591 million during 2004 and 2003, respectively.

*Debt funding mix and derivatives activity.* We communicate our anticipated issuances of both long-term and short-term debt securities by publishing an annual financing calendar along with periodic updates in the form of Quarterly Funding Announcements. We consider our commitments to issue debt securities with certain maturity characteristics as well as the maturity characteristics of our existing debt outstanding and other funding requirements when we evaluate our existing derivative portfolio. We adjust the composition of that derivative portfolio to manage our interest-rate risk, including the relative duration and convexity of our assets and liabilities.

As discussed in the analysis of Net interest income results for full year 2004, we moved a significant amount of our pay-fixed swaps that were previously in hedge accounting relationships to no hedge designation effective at the beginning of the second quarter of 2004, and we also moved a significant amount of our receive-fixed swaps to no hedge designation in the fourth quarter of 2004. For periods

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following these moves, the interest income or expense associated with these swaps is included in Derivative gains (losses).

Due to declining interest rates in 2002 and the first half of 2003, the expected lives of assets held in the Retained portfolio decreased, requiring us to reduce the duration of our long-term debt funding from an asset/liability management perspective. As a result, 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. Conversely, a pay-fixed swap requires us to make a fixed interest payment in exchange for a variable rate payment. In the third quarter of 2003, we entered into additional pay-fixed swaps to extend the duration of our debt portfolio as interest rates increased. During 2004, our debt securities became more heavily weighted toward long-term debt. The average balance of long-term debt increased approximately 11 percent while the average balance of short-term debt decreased by approximately 10 percent.

*Amortization of hedging gains and losses.* Historically, certain derivative contracts were in hedge accounting relationships, which resulted in basis adjustments to hedged items. These basis adjustments are accounted for and are similar to premiums and discounts, as described above. However, as of December 31, 2004, the majority of our pay-fixed and receive-fixed swaps are no longer in hedge accounting relationships, as discussed in the analysis of 2004 full-year Net interest income results above. For more information, see “Non-Interest Income (Loss) — Derivative Gains (Losses).”

Certain derivative contracts (primarily pay-fixed swaps) have been accounted for as cash flow hedges of the variability of interest payments on forecasted debt issuances, while other derivative contracts (primarily receive-fixed swaps) have been accounted for as fair value hedges of existing debt. In both cases, termination of the hedge accounting relationship, including the actions we took in 2004 related to pay-fixed and receive-fixed swaps, resulted in the associated deferred hedging gain or loss being amortized into Net interest income over the life of the hedged item. Amortization related to terminated cash flow hedges is generally included in Income (expense) related to derivatives or, if the deferred gain or loss is related to a closed cash flow hedge linked to long-term debt, in Interest expense on long-term debt. The amortization related to terminated fair value hedges is also included in Interest expense on long-term debt.

The impact of these drivers on Net interest income, discussed above, during the quarterly periods of 2004 and 2003 is discussed below.

#### *4Q04 vs. 3Q04*

Net interest income and net interest yield, both of which are presented on a fully taxable-equivalent basis, decreased \$249 million and 11 basis points, respectively, during the fourth quarter of 2004 compared to the third quarter of 2004. The decline in Net interest income was primarily due to an increase in our short-term funding costs resulting from increases in short-term interest rates during the fourth quarter and the movement of a significant amount of our receive-fixed swaps to no hedge designation in November 2004. The decline in net interest yield was primarily related to the increase in our short-term funding costs.

#### *3Q04 vs. 2Q04*

Net interest income and net interest yield, both of which are presented on a fully taxable-equivalent basis, decreased \$300 million and 20 basis points, respectively, during the third quarter of 2004 compared to the second quarter of 2004. The decline in Net interest income was primarily due to increased amortization expense related to net premiums and other security-related basis adjustments as a result of a decline in long-term market interest rates from the second quarter of 2004. Additionally, our short-term funding costs increased as a result of increases in short-term interest rates during the third quarter. The decline in net interest yield was due to lower yields on Retained portfolio assets and an increase in short-term funding costs.

#### *2Q04 vs. 1Q04*

Net interest income and net interest yield, both of which are presented on a fully taxable-equivalent basis, increased \$499 million and 29 basis points, respectively, during the second quarter of 2004 compared to the first quarter of 2004. The increase in Net interest income resulted from lower amortization expense related to

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net premiums and other security-related basis adjustments and the impact of moving a significant amount of our pay-fixed swaps to no hedge designation, effective at the beginning of the second quarter. The reduction in amortization expense related to net premiums and other security-related basis adjustments resulted from an increase in long-term market interest rates from the first quarter of 2004. The increase in net interest yield was driven by the reduction in amortization expense and the movement of the pay-fixed swaps as described above.

#### *1Q04 vs. 4Q03*

Net interest income and net interest yield, both of which are presented on a fully taxable-equivalent basis, decreased \$323 million and 11 basis points, respectively, during the first quarter of 2004 compared to the fourth quarter of 2003. Net interest income declined as lower interest income on our interest-earning assets and higher amortization expense related to net premiums and other security-related basis adjustments was partially offset by higher interest income related to the accrual of periodic settlements on derivatives in hedge accounting relationships. The decline in interest income on our interest-earning assets resulted primarily from a \$32 billion decline in the related average balance from the fourth quarter of 2003. The higher amortization expense related to net premiums and other security-related basis adjustments was driven by a decline in market interest rates from the fourth quarter of 2003. Net interest yield declined as a result of the higher amortization expense related to net premiums and other security-related basis adjustments, partially offset by the higher interest income related to the accrual of periodic settlements on derivatives in hedge accounting relationships.

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

#### *4Q03 vs. 3Q03*

Net interest income, on a fully taxable-equivalent basis, increased by \$10 million during the fourth quarter of 2003 as compared to the third quarter of 2003. Net interest yield, on a fully taxable-equivalent basis, decreased by 1 basis point for the same periods. The increase to Net interest income was due to increased interest income recognized on the Retained portfolio as its average balance increased by 5 percent quarter-over-quarter. This increase to net interest income was offset by increased long-term debt expense related to the funding of the Retained portfolio growth. Net interest yield remained relatively flat as improved funding costs were offset by lower asset yields.

#### *3Q03 vs. 2Q03*

Net interest income and net interest yield, both of which are presented on a fully taxable-equivalent basis, increased by \$253 million and 1 basis point, respectively, during the third quarter of 2003 compared to the second quarter of 2003. These increases were driven by lower amortization expense resulting from adjustments to the amortization of the related deferred premiums in the Retained portfolio as mortgage rates and estimates of weighted average mortgage lives increased. Net interest income also benefited from decreases in long-term debt expense and net growth in the Retained portfolio. Interest expense on derivative contracts increased with purchases of additional pay-fixed swaps, which were acquired in a rising rate environment and designated in hedge accounting relationships. Net interest yield remained relatively flat as the decline in our debt costs was offset by the decline in asset yields and an increase in expense related to derivatives.

#### *2Q03 vs. 1Q03*

Net interest income and net interest yield, both of which are presented on an fully taxable-equivalent basis, decreased by \$213 million and 14 basis points, respectively, during the second quarter of 2003 compared to the first quarter of 2003. These decreases were driven by increases in amortization expense related to deferred premiums on mortgage investment purchases. As discussed above in “*Amortization of premiums and discounts*,” the deferred amount related to the total Retained portfolio was in an increasing net premium position and liquidations increased in the quarter. Also, increased liquidations on PCs outstanding generated timing differences between amounts due from servicers and amounts due to PC investors resulting in increased interest expense. These negative effects were partially offset by lower long-term debt expense due to large debt

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retirements completed in the second quarter. Net interest yield declined as amortization expenses and lower asset yields outpaced lower funding costs.

*1Q03 vs. 4Q02*

Net interest income and net interest yield, both of which are presented on a fully taxable-equivalent basis, increased by \$9 million and decreased by 1 basis point, respectively, during the first quarter of 2003 compared to the fourth quarter of 2002. The increase in net interest income related to a decrease in short-term debt expense as a result of declining interest rates and higher interest income related to derivatives due to an increase in volume of receive-fixed swaps. Partially offsetting these increases was higher amortization expense related to net deferred premiums on mortgage investment purchases. In addition, lower yields were recognized on the investment portfolio as short-term rates remained low. During the first quarter of 2003, we refined the assumptions and calculations for the amortization of deferred fees recorded as discounts on assets in our Retained portfolio. The effect on Net interest income of refining these assumptions, which was treated as a change in estimate (and which also impacted Management and guarantee income), was the recognition of \$31 million of additional amortization income during the first quarter of 2003. Although yields on assets were declining faster than debt costs, the margin reduction was offset by the rate impact of lower derivative expenses.

**Non-Interest Income (Loss)**

Table 17 summarizes our Non-interest income (loss) for 2004, 2003 and 2002.

**Table 17 — Non-Interest Income (Loss)**

	2004 vs. 2003			2003 vs. 2002	
	Year Ended December 31,		Change	Year Ended	Change
	2004	2003		December 31, 2002	
	(dollars in millions)				
Non-interest income (loss)					
Management and guarantee income . . . . .	\$ 1,382	\$1,653	\$ (271)	\$ 1,527	\$ 126
Gains (losses) on "Guarantee asset for Participation Certificates, at fair value" . . . . .	(1,135)	(1,461)	326	(2,176)	715
Income on "Guarantee obligation for Participation Certificates" . . . . .	732	925	(193)	592	333
Derivative gains (losses) . . . . .	(4,475)	39	(4,514)	5,302	(5,263)
Hedge accounting gains (losses) . . . . .	743	644	99	187	457
Gains (losses) on investment activity . . . . .	(348)	(1,114)	766	1,799	(2,913)
Gains (losses) on debt retirement . . . . .	(327)	(1,775)	1,448	(674)	(1,101)
Resecuritization fees . . . . .	159	352	(193)	276	76
Other income . . . . .	230	493	(263)	321	172
Total non-interest income (loss) . . . . .	<u>\$ (3,039)</u>	<u>\$ (244)</u>	<u>\$ (2,795)</u>	<u>\$ 7,154</u>	<u>\$ (7,398)</u>

**Management and Guarantee Income**

*Management and guarantee income primarily represents the contractual guarantee fees we receive on mortgage-related securities issued and guaranteed by us that are held by third party investors. For securities we hold, the associated components of guarantee income are included in Net interest income. Management and guarantee income also includes amortization of pre-2003 deferred fees, including credit fees and buy-down fees on PCs and Structured Securities that have not been previously sold under SFAS 125/140 or that have not been previously subject to financial guarantee accounting under FIN 45.*

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Table 18 provides summary information about Management and guarantee income for 2004, 2003 and 2002. The total management and guarantee rate consists of the contractual management and guarantee fee rate, as adjusted for amortization of certain pre-2003 deferred fees, including credit fees and buy-down fees.

**Table 18 — Management and Guarantee Income**

	Year Ended December 31,					
	2004		2003		2002	
	Amount	Rate	Amount	Rate	Amount	Rate
	(dollars in millions, rate in basis points)					
Contractual management and guarantee fees . . . . .	\$1,303	16.5	\$1,229	17.3	\$1,335	19.4
Amortization of deferred fees <sup>(1)(2)</sup> . . . . .	79	1.0	424	6.0	192	2.8
Total management and guarantee income . . . . .	<u>\$1,382</u>	<u>17.5</u>	<u>\$1,653</u>	<u>23.3</u>	<u>\$1,527</u>	<u>22.2</u>
Unamortized balance of credit and buy-down fees included in Other Liabilities, at period end . . . . .	\$ 215		\$ 329		\$ 804	

- (1) We reclassified amounts from certain expenses related to uncollectible interest on PCs held by third parties from Management and guarantee income to (Provision) benefit for credit losses to conform with the 2004 presentation. This resulted in a \$15 million and an \$11 million increase in Management and guarantee income during 2003 and 2002, respectively.
- (2) In accordance with SFAS 91, deferred items are amortized over the estimated lives of the underlying securities using the retrospective effective interest method. This method of amortization results in periodic adjustments when the effective interest rate changes due to differences between actual and estimated prepayments and changes in estimated future prepayments. Catch-up adjustments are made to the unamortized balances of the deferred items to reflect the application of the updated effective yield as if it had been in effect since acquisition.

Management and guarantee income decreased by \$271 million, or 16 percent, to \$1,382 million in 2004 from \$1,653 million in 2003. This decrease in Total management and guarantee income was primarily driven by an 81 percent decrease in amortization of pre-2003 deferred fees. Contributing to this decrease was the effect of the change in our accounting treatment of certain fees beginning in 2003 and a model change implemented in the first quarter of 2003, both of which are discussed in more detail below.

The management and guarantee rate related to the amortization of deferred fees decreased from 6.0 basis points in 2003 to 1.0 basis point in 2004. The rate of amortization is determined based on the estimated lives of the mortgage loans underlying our PCs using the effective interest method (as established by SFAS 91). Periodic adjustments to deferred fees amortization are made to reflect differences between actual and previously estimated mortgage prepayments and changes in estimated future prepayments. The primary drivers of the decrease in amortization of deferred fees in 2004 were: (a) a reduction in the unamortized balances being amortized through Management and guarantee income; (b) 2003 amortization methodology changes; and (c) higher interest rates in 2004 resulting in longer estimated lives of the loans underlying our PCs.

Management and guarantee income includes amortization of pre-2003 deferred fees, including credit fees and buy-down fees on our PCs that have not previously been subject to guarantee accounting under FIN 45 or have not previously been sold under SFAS 125/140. The existing unamortized balance of pre-2003 deferred fees related to Outstanding PCs equaled approximately \$215 million, \$329 million and \$804 million as of December 31, 2004, 2003 and 2002, respectively, and will ultimately be reduced to zero over time. Beginning in 2003, credit and buy-down fees on PCs issued through our Guarantor and MultiLender Programs have been deferred as a component of our Guarantee obligation for Participation Certificates, rather than recorded in Other liabilities on our consolidated balance sheets as was the practice prior to 2003 before the adoption of FIN 45. These fees are amortized into income as a component of Income on “Guarantee obligation for Participation Certificates,” as described more fully in “Table 22 — Income on Guarantee Obligation for 2004 and 2003.” For all periods presented, deferred balances related to credit and buy-down fees associated with PC transactions that qualify as sales (*i.e.*, non-Guarantor or non-MultiLender Program transactions) do not affect Management and guarantee income nor Income on “Guarantee obligation for Participation Certificates.” Instead, these deferred balances are included in the determination of the gain or loss on the sale of mortgage loans, which we report as Gains (losses) on investment activity.

In the first quarter of 2003, we improved our methodology for estimating the expected weighted average lives of mortgages with related deferred fees, including credit fees and buy-down fees. The improvements we

made included enhancements to the prepayment models we use to determine the expected weighted average lives of mortgage loans underlying our PCs, which in turn are used to calculate the recognition of deferred fees based on the effective interest method. These improvements to our models were treated as a change in estimate in accordance with Accounting Principles Board Opinion No. 20, "Accounting Changes," or APB 20, and resulted in the recognition of \$110 million (1.5 basis points) of additional amortization income in Management and guarantee income in the first quarter of 2003.

The decrease in amortization of deferred fees in 2004 as compared with 2003 also resulted from higher mortgage interest rates in 2004 compared to 2003 and the associated impact on prepayment speeds used in our amortization models, which increased the expected weighted average lives of outstanding PCs and slowed the pace of amortization.

The contractual management and guarantee fee rate recognized in 2004 decreased to 16.5 basis points compared with 17.3 basis points in 2003. The portfolio turnover we experienced in 2004 reduced our contractual guarantee fee rates because newly issued PCs tended to have lower contractual guarantee fee rates than the previously outstanding PCs, that were liquidated during 2004. This rate decline was partly driven by the impact of our market adjusted pricing feature on new business purchases, which is discussed in more detail below. Also, the contractual guarantee fee rate for 2004 declined because a greater proportion of our overall credit guarantee compensation was received in the form of upfront fees paid to us by seller/servicers. Beginning in 2003, these upfront fees are amortized into income as a component of Income on "Guarantee obligation for Participation Certificates" or are included in the determination of the gain or loss on the sale of mortgage loans.

We expanded the use of our market adjusted pricing feature in late 2003 to offset the then-prevailing weakness in prices of our PCs outstanding. This pricing provision adjusts guarantee fees upward or downward to compensate for the strength or weakness of our PC prices relative to competing securities. This pricing feature had an increased impact on new business guarantee fees generated in late 2003 and throughout all of 2004. Toward the end of 2004, our PC prices strengthened compared to the second half of 2003. The financial impact of prior and current market adjusted pricing is generally recognized over the life of the PC, unless the security is transferred to a third party in a transaction that qualifies as a sale under SFAS 140. Thus, the impact will continue to be recognized in Contractual management and guarantee fees even though the prices of our PCs have improved and similar adjustments on new purchases have decreased.

Total Management and guarantee income increased in 2003 by \$126 million, or 8 percent, to \$1,653 million from \$1,527 million in 2002. This increase was driven by an increase in average outstanding PCs and an increase in the average total management and guarantee rate recognized in 2003, including amortization of deferred fees. The total management and guarantee rate in 2003 was 23.3 basis points compared with 22.2 basis points in 2002. The increase was driven by accelerated amortization of deferred fees, partially offset by lower contractual management and guarantee fee rates on new business. Increased amortization of deferred fees resulted from the decline in mortgage interest rates during the first half of 2003 and the related increase in mortgage prepayments, as well as the first quarter 2003 model change.



Table 19 summarizes Management and guarantee income and rates for each quarter in 2004 and 2003.

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

	1Q 2004		2Q 2004		3Q 2004		4Q 2004	
	Amount	Rate	Amount	Rate	Amount	Rate	Amount	Rate
	(dollars in millions, rate in basis points)							
Contractual management and guarantee fees . . . . .	\$320	16.7	\$322	16.6	\$324	16.3	\$337	16.3
Amortization of deferred fees <sup>(1)</sup> . . . . .	64	3.4	(71)	(3.7)	56	2.8	30	1.4
Total management and guarantee income . . . . .	<u>\$384</u>	<u>20.1</u>	<u>\$251</u>	<u>12.9</u>	<u>\$380</u>	<u>19.1</u>	<u>\$367</u>	<u>17.7</u>
	1Q 2003		2Q 2003		3Q 2003		4Q 2003	
	Amount	Rate	Amount	Rate	Amount	Rate	Amount	Rate
	(dollars in millions, rate in basis points)							
Contractual management and guarantee fees . . . . .	\$314	17.3	\$311	17.4	\$295	17.3	\$309	17.1
Amortization of deferred fees <sup>(1)(2)</sup> . . . . .	248	13.7	168	9.5	(55)	(3.2)	63	3.5
Total management and guarantee income <sup>(2)</sup> . . . . .	<u>\$562</u>	<u>31.0</u>	<u>\$479</u>	<u>26.9</u>	<u>\$240</u>	<u>14.1</u>	<u>\$372</u>	<u>20.6</u>

- (1) In accordance with SFAS 91, deferred items are amortized over the estimated lives of the underlying securities using the retrospective effective interest method. This method of amortization results in periodic adjustments when the effective interest rate changes due to differences between actual and estimated prepayments and changes in estimated future prepayments. Catch-up adjustments are made to the unamortized balances of the deferred items to reflect the application of the updated effective yield as if it had been in effect since acquisition.
- (2) We reclassified amounts from certain expenses related to uncollectible interest on PCs held by third parties from Management and guarantee income to (Provision) benefit for credit losses to conform with the 2004 presentation. This resulted in increases of \$4 million, \$3 million, \$5 million and \$3 million for 1Q 2003, 2Q 2003, 3Q 2003 and 4Q 2003, respectively, in Management and guarantee income.

As described above, the total management and guarantee rate represents the contractual management and guarantee fee rate as adjusted for amortization of pre-2003 deferred fees, including credit fees and buy-down fees. The amortization component of Management and guarantee income representing the recognition of deferred fees is based on the effective interest method required by SFAS 91, which requires estimating the expected weighted average lives of mortgages with related deferred fees. The use of the effective interest method requires periodic adjustments to the amortization of deferred fees. This can cause significant volatility in quarterly income, as both a current period amortization and a cumulative catch-up adjustment are recognized in a given period as the effective constant yield changes over time. This volatility is driven primarily by variances between actual and anticipated prepayments, which affect the internal rate of return applied in determining the effective constant yield.

*4Q04 vs. 3Q04*

Management and guarantee income decreased by \$13 million, or 3 percent, to \$367 million in the fourth quarter of 2004 from \$380 million in the third quarter of 2004. This decrease was primarily driven by a slight increase in the 30-year mortgage rate during the fourth quarter and the associated impact on estimated prepayment speeds used in our amortization models. This decrease was partially offset by an increase in contractual management and guarantee fees, that was primarily driven by an increase in average outstanding PCs.

*3Q04 vs. 2Q04*

Management and guarantee income increased by \$129 million, or 51 percent, to \$380 million in the third quarter of 2004 from \$251 million in the second quarter of 2004, primarily due to an increase in the amortization of deferred fees. The change in amortization related income was driven by an approximate 53 basis point decline in the 30-year mortgage rate during the third quarter and the associated higher estimated prepayment speeds used in our amortization models which accelerated recognition of deferred fees.

*2Q04 vs. 1Q04*

Management and guarantee income decreased by \$133 million, or 35 percent, to \$251 million in the second quarter of 2004 from \$384 million in the first quarter of 2004. This decline was driven by an approximate 85 basis points increase in the 30-year mortgage rate during the quarter and associated slower

estimated prepayment speeds used in our amortization models. This estimated decline in prepayment speeds caused slower amortization and resulted in net amortization expense for the second quarter of 2004.

#### *1Q04 vs. 4Q03*

Management and guarantee income increased by \$12 million, or 3 percent, to \$384 million in the first quarter of 2004 from \$372 million in the fourth quarter of 2003. This increase in guarantee income was primarily driven by an increase in average outstanding PCs that more than offset the decline in the contractual guarantee fee rates caused by generally lower rates on new guarantees and the liquidation of seasoned loans with higher guarantee fee rates.

#### *4Q03 vs. 3Q03*

Management and guarantee income increased by \$132 million, or 55 percent, to \$372 million in the fourth quarter of 2003 from \$240 million in the third quarter of 2003. This increase was driven primarily by an increase in the portion of Management and guarantee income representing the amortization of deferred fees. The change in amortization recognition was driven by a return to income amortization after the downward adjustment made to amortization in the third quarter, together with a decrease in the expected weighted average lives of mortgages underlying our PCs. The change in the contractual guarantee fee portion of Management and guarantee income reflected an increase in average outstanding PCs.

#### *3Q03 vs. 2Q03*

Management and guarantee income decreased by \$239 million, or 50 percent, to \$240 million in the third quarter of 2003 from \$479 million in the second quarter of 2003. This decrease was driven primarily by amortization expenses that were recorded due to an increase of approximately 70 basis points in the 30-year mortgage rate during the quarter. The change in the contractual guarantee fee portion of Management and guarantee income was relatively small and reflected the decrease in average outstanding PCs.

#### *2Q03 vs. 1Q03*

Management and guarantee income decreased by \$83 million, or 15 percent, to \$479 million in the second quarter of 2003 from \$562 million in the first quarter of 2003. This decrease primarily reflects the effect of the \$110 million model-related adjustment made in the first quarter of 2003 discussed above. The change in the cash flow portion of Management and guarantee income was relatively small, reflective of the decrease in average outstanding PCs.

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

*Gains (losses) on Guarantee asset for Participation Certificates, at fair value, represents the change in fair value of the guarantee asset. Guarantee assets are recognized in connection with transfers of PCs and Structured Securities that are accounted for as sales under SFAS 125/140. Additionally, beginning on January 1, 2003, we began recognizing guarantee assets for PCs issued through our Guarantor Programs and for certain Structured Securities that we issue to third parties in exchange for non-agency mortgage-backed securities, as well as for that portion of PCs issued through MultiLender Program transactions that are not accounted for as sales under SFAS 125/140. This change in accounting, which was triggered by our adoption of FIN 45, resulted in a significant increase in guarantee assets that are recognized on our consolidated balance sheets. Consequently, the size of our guarantee asset subject to this mark to fair value adjustment was larger in 2004 and 2003 compared with 2002.*

The change in fair value of the guarantee asset reflects:

- The portion of cash received that is considered a return of our recorded investment in the guarantee asset; and
- Changes in the fair value of expected future cash inflows.

*Factors Affecting the Fair Value of the Guarantee Asset.* With the passage of time, actual expected cash flows are received and are no longer included in the valuation of the guarantee asset. Cash flows received, which are recorded as Management and guarantee income, represent a reduction of our investment in the

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guarantee asset. As depicted in “Table 20 — Attribution of Gains (Losses) on Guarantee Asset for Participation Certificates, at Fair Value,” cash flows received on the guarantee asset are allocated between interest income (imputed income on the asset based on the discount rate used in the calculation of the fair value of the guarantee asset) and return of investment (the portion of actual cash flows that represents a reduction of the guarantee asset receivable). The realization of cash flows results in a corresponding reduction in the valuation of the guarantee asset.

The change in the fair value of future expected cash flows is the second component of the change in the guarantee asset value. The value of expected cash flows is driven by changes in the expected interest rates and related discount rates that affect the estimated life of the mortgages underlying the Outstanding PCs and Structured Securities and other economic factors that influence the amount and timing of the future cash flows. Changes in the estimated lives of the underlying mortgages affect the value of the guarantee asset because our right to receive guarantee fees ceases when borrowers prepay the underlying mortgages.

The portion of the gains and losses on the guarantee asset attributable to these two factors is shown in “Table 20 — Attribution of Gains (Losses) on Guarantee Asset for Participation Certificates, at Fair Value,” below. See “Table 36 — Changes in Guarantee Asset for Participation Certificates, at Fair Value” in “CONSOLIDATED BALANCE SHEETS ANALYSIS — Guarantee Asset for Participation Certificates” for additional information about the guarantee asset.

**Table 20 — Attribution of Gains (Losses) on Guarantee Asset for Participation Certificates, at Fair Value**

	Year Ended December 31,		
	2004	2003	2002
	(dollars in millions)		
Total cash flows received <sup>(1)</sup> . . . . .	\$(1,086)	\$ (891)	\$ (820)
Portion of cash flows received related to imputed interest . . . . .	257	244	259
Return of investment in guarantee asset . . . . .	(829)	(647)	(561)
Change in fair value of future cash flows . . . . .	(306)	(814)	(1,615)
Gains (losses) on “Guarantee asset for Participation Certificates, at fair value” . . . . .	<u>\$(1,135)</u>	<u>\$(1,461)</u>	<u>\$(2,176)</u>

(1) Represents guarantee fees received on Outstanding PCs and Structured Securities issued under FAS 140 or FIN 45 for which there is a guarantee asset established.

Losses on the guarantee asset decreased \$326 million, or 22 percent, to \$(1,135) million in 2004 compared to \$(1,461) million in 2003 and decreased \$715 million, or 33 percent, to \$(1,461) million in 2003 compared to \$(2,176) million in 2002. The decreased losses were primarily due to a smaller overall decline in mortgage interest rates in 2004 compared to 2003, which tends to affect actual and expected prepayments. This prepayment experience affects our estimation of future guarantee fee cash flows and consequently, the fair value of the guarantee asset. Return of investment for each year was consistent with the growth of the outstanding PCs and Structured Securities, as shown in “Table 8 — Freddie Mac’s Total Mortgage Portfolio Based on Unpaid Principal Balances” in “OUR RETAINED AND TOTAL MORTGAGE PORTFOLIOS.”

“Table 21 — Quarterly and Full Year Gains (Losses) on Guarantee Asset for Participation Certificates, at Fair Value” summarizes the 2004 and 2003 quarterly and full year gains and losses on the guarantee asset.

**Table 21 — Quarterly and Full Year Gains (Losses) on Guarantee Asset for Participation Certificates, at Fair Value**

	<u>1Q 2004</u>	<u>2Q 2004</u>	<u>3Q 2004</u>	<u>4Q 2004</u>	<u>Full Year 2004</u>
	(dollars in millions)				
Return of investment in guarantee asset . . . . .	\$ (199)	\$ (200)	\$ (207)	\$ (223)	\$ (829)
Changes in fair value of future cash flows . . . . .	<u>(444)</u>	<u>771</u>	<u>(639)</u>	<u>6</u>	<u>(306)</u>
Gains (losses) on “Guarantee asset for Participation Certificates at fair value” . . . . .	<u>\$ (643)</u>	<u>\$ 571</u>	<u>\$ (846)</u>	<u>\$ (217)</u>	<u>\$ (1,135)</u>
Guarantee asset for Participation Certificates, at fair value, at period end . . . . .	\$3,583	\$4,724	\$4,184	\$4,516	\$ 4,516
	<u>1Q 2003</u>	<u>2Q 2003</u>	<u>3Q 2003</u>	<u>4Q 2003</u>	<u>Full Year 2003</u>
	(dollars in millions)				
Return of investment in guarantee asset . . . . .	\$ (153)	\$ (154)	\$ (160)	\$ (180)	\$ (647)
Changes in fair value of future cash flows . . . . .	<u>(415)</u>	<u>(938)</u>	<u>418</u>	<u>121</u>	<u>(814)</u>
Gains (losses) on “Guarantee asset for Participation Certificates, at fair value” . . . . .	<u>\$ (568)</u>	<u>\$ (1,092)</u>	<u>\$ 258</u>	<u>\$ (59)</u>	<u>\$ (1,461)</u>
Guarantee asset for Participation Certificates, at fair value, at period end . . . . .	\$2,424	\$ 2,076	\$3,030	\$3,686	\$ 3,686

For all periods presented, quarterly fluctuations in gains (losses) on the guarantee asset were driven by changes in interest rates that affected the expected lives of the mortgages underlying Outstanding PCs and Structured Securities, our expectations of prepayments and corresponding discount rates and the return of investment.

We experienced declines in the fair value of our guarantee asset during the first and third quarters of 2004 because the decline in 30-year mortgage interest rates increased our expectation of prepayments and reduced the value of our guarantee asset. Conversely, increases in 30-year mortgage interest rates during the second quarter of 2004 slowed the pace of expected prepayments and increased the fair value of the guarantee asset. Interest rates for 30-year mortgages were relatively flat during the fourth quarter of 2004. In the fourth quarter, the fair value of our guarantee asset declined as we collected Management and guarantee income related to our guarantee asset, as described above.

Through the first two quarters of 2003, our average single-family portfolio mortgage coupon rate was significantly higher than prevailing 30-year mortgage rates, which increased our expectation of prepayments and reduced the fair value of our guarantee asset. In the third quarter of 2003, mortgage interest rates increased, which slowed the pace of liquidations and increased the fair value of the guarantee asset. The fourth quarter of 2003 was primarily driven by the return of investment, as described above. Rates on 30-year mortgages dropped slightly during the fourth quarter of 2003, which also contributed to the decline in the fair value of the guarantee asset.

**Income on Guarantee Obligation**

*With the adoption of FIN 45 on January 1, 2003, we changed the way we account for Income on “Guarantee obligation for Participation Certificates.” Beginning in 2003, we began recording guarantee obligations for PCs issued through our Guarantor Program and for certain Structured Securities that we issue to third parties in exchange for non-agency mortgage-backed securities, as well as for that portion of PCs issued through MultiLender Program transactions that are not accounted for as sales under SFAS 125/140. Previously, we recorded a guarantee obligation only upon the transfer of PCs or Structured Securities that qualified for sale accounting pursuant to SFAS 125/140. (We continue to record guarantee obligations for*

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these sales.) Consequently, the size of our guarantee obligation subject to this accounting was larger in 2004 and 2003 as compared with 2002. Compensation for this obligation is received in the form of upfront fees (credit and buy-down fees) and contractual guarantee fees received over time. Credit and buy-down fees received prior to 2003 were included in Other liabilities on our consolidated balance sheets and amortized into income as a component of Management and guarantee fee income. In 2003, we began amortizing these items and the initial recorded value of our guarantee obligation into Income on “Guarantee obligation for Participation Certificates” based on actual payment experience on the underlying mortgage loans, which we refer to as the Declining Unpaid Principal Balance Method. Prior to 2003, we marked our guarantee obligation to fair value at the end of each period.

Table 22 summarizes the income for the years ended December 31, 2004 and 2003 on guarantee obligation. In 2002, we accounted for the guarantee obligation at fair value. See “Table 23 — Attribution of Change — Guarantee Obligation for 2002” for an attribution of the changes in fair value of the guarantee obligation in 2002.

**Table 22 — Income on Guarantee Obligation for 2004 and 2003**

	<u>Year Ended</u> <u>December 31, 2004</u>	<u>Year Ended</u> <u>December 31, 2003</u>
	(dollars in millions)	
Amortization income related to:		
Credit and buy-down fees received . . . . .	\$ 128	\$ 57
Initial fair value of contractual guarantee fees <sup>(1)</sup> . . . . .	<u>604</u>	<u>868</u>
Income on “Guarantee obligation for Participation Certificates” . . . . .	<u>\$ 732</u>	<u>\$ 925</u>
Guarantee obligation for Participation Certificates . . . . .	\$4,065	\$2,904
Liquidation rate for outstanding PCs and Structured Securities <sup>(2)</sup> . . . . .	29%	63%

(1) The initial fair value of contractual guarantee fees is the equivalent of our Guarantee asset for Participation Certificates, at fair value.  
(2) Related to outstanding PCs and Structured Securities (including other PCs and Structured Securities held in our Cash and investments portfolio).

Income on “Guarantee obligation for Participation Certificates” totaled \$732 million, \$925 million and \$592 million in 2004, 2003 and 2002, respectively.

In 2004, our Guarantee obligation for Participation Certificates on our consolidated balance sheets increased, but our Income on “Guarantee obligation for Participation Certificates” decreased from \$925 million to \$732 million because liquidations slowed during 2004 compared to 2003. The full-year annualized liquidation rate for our Outstanding PCs and Structured Securities was 29 percent in 2004 as compared to 63 percent in 2003, which resulted in lower amortization under the Declining Unpaid Principal Balance Method in 2004 compared to 2003.

Amortization of credit fees and buy downs increased \$71 million during 2004 due to increased balances and a full year of amortization. See “Table 24 — Quarterly and Annual Income on Guarantee Obligation for 2004 and 2003” for more information. In 2003, an increase in the balance of guarantee obligation, combined with a 63 percent annualized liquidation rate on outstanding PCs and Structured Securities, resulted in \$925 million of income recognized on the amortization of our guarantee obligation.

Prior to January 1, 2003, we marked our guarantee obligation to fair value through earnings and, after that date, we began amortizing the initial balance of such guarantee obligations through Income on “Guarantee obligation for Participation Certificates” based on the Declining Unpaid Principal Balance Method. Accordingly, the 2002 Income on “Guarantee obligation for Participation Certificates” must be analyzed separately (see “Table 23 — Attribution of Change — Guarantee Obligation for 2002”).

Table 23 summarizes the attribution of changes in the fair value of the guarantee obligation for 2002. The guarantee obligation for 2002 was established at its initial fair value, which is determined by estimating the amount and timing of cash flows related to the guarantee obligation. Factors in determining the fair value of the guarantee obligation include expectations about house price appreciation, interest rates, default rates, loan prepayment rates and other economic factors that influence expected credit losses and expected income

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earned on mortgage principal and interest payments held in our cash and investments portfolio pending remittance to PC investors. See “Table 37 — Changes in Guarantee Obligation for Participation Certificates” in “CONSOLIDATED BALANCE SHEETS ANALYSIS — Guarantee Obligation for Participation Certificates” for additional information about the guarantee obligation.

**Table 23 — Attribution of Change — Guarantee Obligation for 2002 (2004 and 2003 Income on Guarantee Obligation is described in Table 22)**

	<u>2002</u>
	<u>Fair Value</u>
	(dollars in millions)
Total cash flows paid.....	\$422
Portion of cash flows paid related to imputed interest .....	(64)
Cash paid representing reduction of guarantee obligations .....	358
Changes in fair value of future cash flows .....	234
Income on “Guarantee obligation for Participation Certificates”.....	<u>\$592</u>

Table 24 summarizes the 2004 and 2003 quarterly and annual income on guarantee obligation.

**Table 24 — Quarterly and Annual Income on Guarantee Obligation for 2004 and 2003**

	<u>1Q 2004</u>	<u>2Q 2004</u>	<u>3Q 2004</u>	<u>4Q 2004</u>	<u>Year Ended December 31, 2004</u>
	(dollars in millions)				
Amortization income related to:					
Credit and buy-down fees received .....	\$ 23	\$ 37	\$ 28	\$ 40	\$ 128
Initial fair value of contractual guarantee fees .....	<u>128</u>	<u>194</u>	<u>129</u>	<u>153</u>	<u>604</u>
Income on “Guarantee obligation for Participation Certificates”.....	<u>\$ 151</u>	<u>\$ 231</u>	<u>\$ 157</u>	<u>\$ 193</u>	<u>\$ 732</u>
Guarantee obligation for Participation Certificates .....	\$3,241	\$3,557	\$3,727	\$4,065	\$4,065
Liquidation rate for Outstanding PCs and Structured Securities <sup>(1)</sup> .....	30%	36%	22%	25%	29%
	<u>1Q 2003</u>	<u>2Q 2003</u>	<u>3Q 2003</u>	<u>4Q 2003</u>	<u>Year Ended December 31, 2003</u>
	(dollars in millions)				
Amortization income related to:					
Credit and buy-down fees received .....	\$ —	\$ 10	\$ 25	\$ 22	\$ 57
Initial fair value of contractual guarantee fees .....	<u>235</u>	<u>255</u>	<u>276</u>	<u>102</u>	<u>868</u>
Income on “Guarantee obligation for Participation Certificates”.....	<u>\$ 235</u>	<u>\$ 265</u>	<u>\$ 301</u>	<u>\$ 124</u>	<u>\$ 925</u>
Guarantee obligation for Participation Certificates .....	\$1,655	\$1,956	\$2,385	\$2,904	\$2,904
Liquidation rate for Outstanding PCs and Structured Securities <sup>(1)</sup> .....	65%	81%	80%	31%	63%

(1) Related to Outstanding PCs and Structured Securities (including other PCs and Structured Securities held in our Cash and investments portfolio.)

Quarterly fluctuations in Guarantee obligation for Participation Certificates during 2004 and 2003 are the result of two factors: (a) the increase in the balance of our guarantee obligation subsequent to our adoption of FIN 45 on January 1, 2003 and (b) fluctuations in the rate of amortization under the Declining Unpaid Principal Balance Method, which is driven by the liquidation rate for outstanding PCs and Structured Securities. During this period, the annualized liquidation rate reached a high of 81 percent in the second quarter of 2003 and fell to a low of 22 percent in the third quarter of 2004.

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## **Derivative Gains (Losses)**

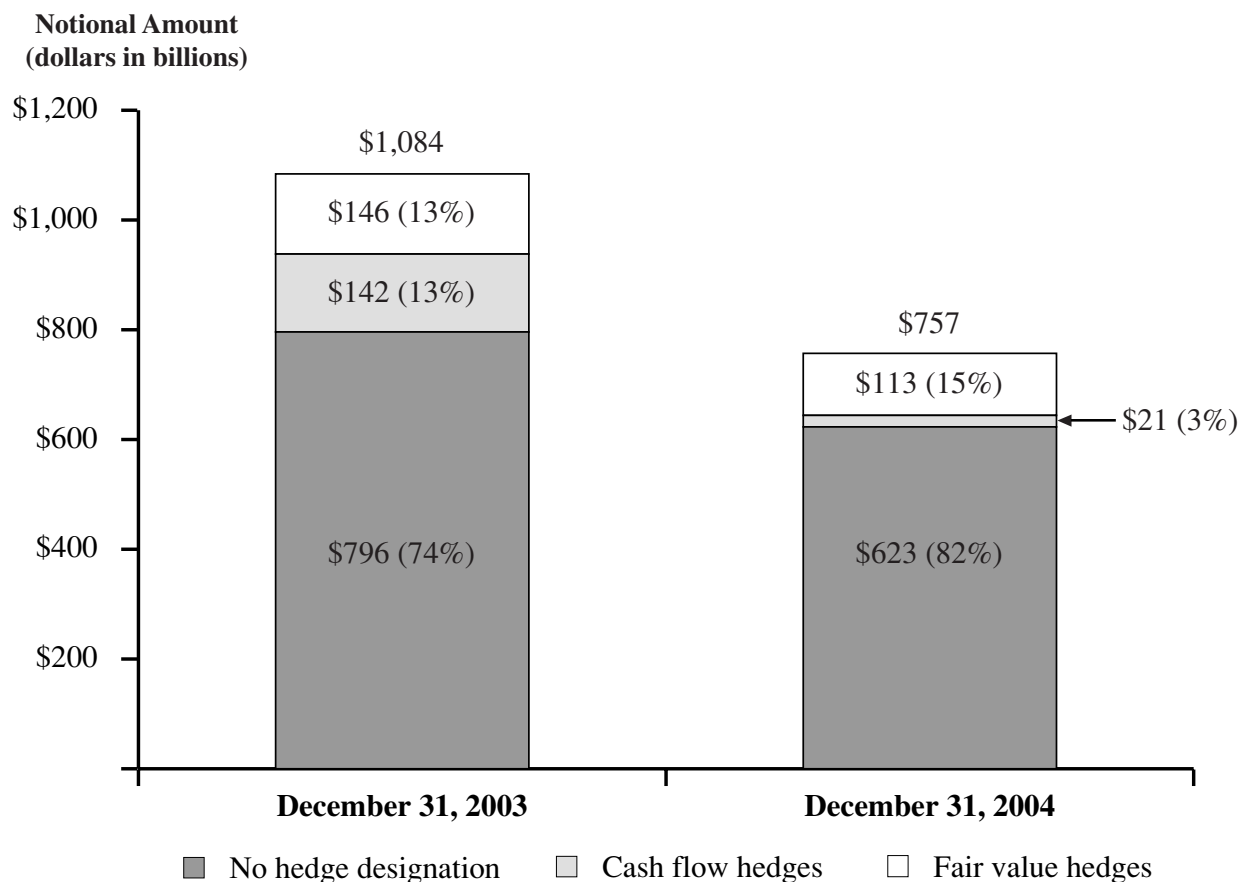
*Derivative gains (losses) represents the change in fair value of derivatives not accounted for in hedge accounting relationships because the derivatives did not qualify for, or we did not elect to pursue, hedge accounting, resulting in fair value changes being recorded to earnings. Derivative gains (losses) also includes the accrual of periodic settlements for derivatives that are not in hedge accounting relationships. Although derivatives are an important aspect of our management of interest-rate risk, they will generally increase the volatility of reported net income, particularly when they are not accounted for in hedge accounting relationships.*

We generally use interest-rate swaps to mitigate contractual funding mismatches between our assets and liabilities. A receive-fixed swap results in our receipt of a fixed interest-rate payment from our counterparty in exchange for a variable rate payment to the counterparty. 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 the right to prepay their mortgages prior to contractual maturity, and this prepayment option is sensitive to changes in interest rates.

Derivatives that are not in qualifying hedge accounting relationships generally increase the volatility of reported Non-interest income (loss) because they are marked to fair value through earnings without the offsetting change in value of the economically hedged exposures also being recognized in earnings. The fair value of receive- and pay-fixed interest-rate swaps is primarily driven by changes in interest rates. Generally, receive-fixed swaps increase in value and pay-fixed swaps decrease in value when interest rates decrease (and the opposite being true when interest rates increase). The fair value of purchased call and put swaptions is sensitive to changes in interest rates in a directionally similar manner to receive- and pay-fixed swaps, respectively. Swaption values are also driven by the market's expectation of potential changes in future interest rates (referred to as "implied volatility"). Swaptions generally become more valuable as implied volatility increases and less valuable as implied volatility decreases. Recognized losses on these purchased options in any given period are limited to the premium paid to purchase the option plus any unrealized gains previously recorded.

Table 25 provides a summary of our derivatives by hedge accounting designation at December 31, 2003 and 2004, respectively.

**Table 25 — Derivatives by Hedge Accounting Designation**



The notional balance of our derivative portfolio declined to \$756.8 billion at December 31, 2004 from \$1,083.9 billion at December 31, 2003, driven by a reduction in the notional balance of option-based derivatives, interest-rate swaps and commitments. Several factors contributed to the reduction in the notional amounts of our derivatives during 2004. The asset mix in the Retained portfolio has moved toward a greater proportion of non-agency, floating-rate mortgage-related securities, which generally require lower interest-rate protection than fixed-rate products. Also, the gradual increase in market interest rates and the flattening of the yield curve in 2004 have reduced the interest-rate risk of our existing fixed-rate investments, thereby lowering our need for option-based derivatives to manage the related risk. During 2004, we also offset a portion of the optionality risk in the Retained portfolio by increasing the amount of our callable debt outstanding.

The notional balance of option-based derivatives declined by \$127.2 billion as a result of adjusting the options portfolio for risk management purposes in response to changes in market conditions and mortgage portfolio composition. The notional balance of interest-rate swaps declined by \$108.9 billion primarily as a result of the termination of certain offsetting positions prior to their contractual maturity. The notional balance of commitments declined by \$56.6 billion, primarily as the result of a reduction in commitments related to the Cash and investments portfolio as we ceased the PC market-making and support activities conducted through our Securities Sales & Trading Group business unit during the fourth quarter of 2004.

Effective as of the beginning of the second quarter of 2004, we determined that substantially all pay-fixed interest-rate swaps and other derivatives that previously had been in cash flow hedge accounting relationships no longer met the hedge accounting requirements of SFAS 133. Consequently, we discontinued hedge accounting treatment for these relationships for financial reporting purposes at that time resulting in pay-fixed

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swaps with a notional balance of approximately \$108 billion being moved from the cash flow hedge designation to no hedge designation. We also voluntarily discontinued hedge accounting treatment for a significant amount of our receive-fixed interest-rate swaps effective November 1, 2004, resulting in receive-fixed interest-rate swaps with a notional balance of approximately \$50 billion being moved from a fair value hedge designation to no hedge designation. We believe that the voluntary discontinuance of hedge accounting treatment for receive-fixed swaps will assist us in addressing the period-to-period volatility of the value of our no hedge designation derivatives, and will help us reduce the operational complexity and related control remediation efforts that would otherwise be needed to ensure ongoing compliance with the requirements for obtaining and maintaining hedge accounting treatment. We may consider implementing new hedge accounting strategies in the future.

Table 26 provides a quarterly summary of our period-end notional amounts of receive- and pay-fixed swaps by hedge accounting categories for 2004 and 2003.

**Table 26 — Notional Amounts of Receive- and Pay-Fixed Swaps<sup>(1)</sup>**

Description	March 31, 2004		June 30, 2004		September 30, 2004		December 31, 2004	
	Notional	% of Total	Notional	% of Total	Notional	% of Total	Notional	% of Total
	(dollars in billions)							
Receive-fixed swaps:								
Fair value hedge . . . . .	\$113.0	99%	\$ 97.6	99%	\$127.2	98%	\$58.0	69%
No hedge designation <sup>(2)</sup> . . . . .	0.8	1	0.7	1	2.7	2	25.6	31
Total . . . . .	<u>\$113.8</u>	<u>100%</u>	<u>\$ 98.3</u>	<u>100%</u>	<u>\$129.9</u>	<u>100%</u>	<u>\$83.6</u>	<u>100%</u>
Pay-fixed swaps:								
Cash flow hedge . . . . .	\$107.8	78%	\$ —	—%	\$ —	—%	\$ —	—%
No hedge designation <sup>(2)</sup> . . . . .	29.7	22	156.1	100	150.1	100	95.0	100
Total . . . . .	<u>\$137.5</u>	<u>100%</u>	<u>\$156.1</u>	<u>100%</u>	<u>\$150.1</u>	<u>100%</u>	<u>\$95.0</u>	<u>100%</u>
Description	March 31, 2003		June 30, 2003		September 30, 2003		December 31, 2003	
	Notional	% of Total	Notional	% of Total	Notional	% of Total	Notional	% of Total
	(dollars in billions)							
Receive-fixed swaps:								
Fair value hedge . . . . .	\$ 89.1	63%	\$ 92.2	79%	\$ 81.5	72%	\$ 93.5	87%
No hedge designation <sup>(2)</sup> . . . . .	52.6	37	24.0	21	31.5	28	13.8	13
Total . . . . .	<u>\$141.7</u>	<u>100%</u>	<u>\$116.2</u>	<u>100%</u>	<u>\$113.0</u>	<u>100%</u>	<u>\$107.3</u>	<u>100%</u>
Pay-fixed swaps:								
Cash flow hedge . . . . .	\$ 90.0	76%	\$ 98.1	62%	\$149.8	72%	\$132.0	74%
No hedge designation <sup>(2)</sup> . . . . .	28.9	24	60.5	38	57.8	28	47.1	26
Total . . . . .	<u>\$118.9</u>	<u>100%</u>	<u>\$158.6</u>	<u>100%</u>	<u>\$207.6</u>	<u>100%</u>	<u>\$179.1</u>	<u>100%</u>

(1) Excludes swaps held as part of our external Money Manager program. As previously disclosed in our Information Statement Supplement dated October 4, 2004, we ceased our PC market-making and support activities accomplished through our external Money Manager program during the fourth quarter of 2004.

(2) For more information concerning all of our derivatives that are classified as no hedge designation, see “Table 27 — Derivatives Not in Hedge Accounting Relationships.”

Table 27 provides a quarterly and full year summary of the period-end notional amounts and gains and losses related to swaps, swaptions and other derivatives that we used to manage interest-rate risk but were not accounted for in hedge accounting relationships for 2004 and 2003.

**Table 27 — Derivatives Not in Hedge Accounting Relationships**

	1Q 2004		2Q 2004		3Q 2004		4Q 2004		Year Ended December 31, 2004
	Notional	Derivative Gains (Losses)	Notional	Derivative Gains (Losses)	Notional	Derivative Gains (Losses)	Notional	Derivative Gains (Losses)	Derivative Gains (Losses)
	(dollars in billions)								
Call swaptions . . . . .	\$223.5	\$2.7	\$226.4	\$ (5.0)	\$207.1	\$ 3.1	\$189.9	\$ (0.4)	\$ 0.4
Put swaptions . . . . .	128.7	(1.2)	88.7	1.0	70.8	(1.1)	25.2	(0.1)	(1.4)
Receive-fixed swaps	0.8	(0.1)	0.7	(0.1)	2.7	—	25.6	(0.2)	(0.4)
Pay-fixed swaps . . . . .	29.7	(1.2)	156.1	5.7	150.1	(5.0)	95.0	(0.4)	(0.9)
Other <sup>(1)</sup> . . . . .	442.6	0.1	379.8	(0.6)	436.3	—	286.8	—	(0.5)
Subtotal . . . . .	825.3	0.3	851.7	1.0	867.0	(3.0)	622.5	(1.1)	(2.8)
Accrual of periodic settlements:									
Receive-fixed swaps . . . . .		—		—		—		0.1	0.1
Pay-fixed swaps . . . . .		(0.2)		(0.6)		(0.6)		(0.4)	(1.8)
Subtotal . . . . .		(0.2)		(0.6)		(0.6)		(0.3)	(1.7)
Total . . . . .	<u>\$825.3</u>	<u>\$0.1</u>	<u>\$851.7</u>	<u>\$ 0.4</u>	<u>\$867.0</u>	<u>\$ (3.6)</u>	<u>\$622.5</u>	<u>\$ (1.4)</u>	<u>\$(4.5)</u>
	(dollars in billions)								
	1Q 2003		2Q 2003		3Q 2003		4Q 2003		Year Ended December 31, 2003
	Notional	Derivative Gains (Losses)	Notional	Derivative Gains (Losses)	Notional	Derivative Gains (Losses)	Notional	Derivative Gains (Losses)	Derivative Gains (Losses)
Call swaptions . . . . .	\$153.4	\$0.3	\$167.8	\$3.1	\$173.8	\$ (3.1)	\$216.9	\$ (0.9)	\$ (0.6)
Put swaptions . . . . .	134.5	(0.3)	155.6	(0.3)	146.3	0.3	123.1	—	(0.3)
Receive-fixed swaps <sup>(2)</sup> . . . . .	52.6	0.2	24.0	0.6	31.5	(0.5)	13.8	(0.5)	(0.2)
Pay-fixed swaps . . . . .	28.9	0.2	60.5	(0.4)	57.8	2.1	47.1	0.9	2.8
Other <sup>(1)(2)(3)</sup> . . . . .	553.6	0.6	572.7	0.7	487.7	(1.5)	395.4	(0.5)	(0.7)
Subtotal . . . . .	923.0	1.0	980.6	3.7	897.1	(2.7)	796.3	(1.0)	1.0
Accrual of periodic settlements . . . . .		(0.1)		(0.2)		(0.4)		(0.3)	(1.0)
Total . . . . .	<u>\$923.0</u>	<u>\$0.9</u>	<u>\$980.6</u>	<u>\$3.5</u>	<u>\$897.1</u>	<u>\$ (3.1)</u>	<u>\$796.3</u>	<u>\$ (1.3)</u>	<u>\$ —</u>

- (1) Other consists of basis swaps, certain option-based contracts, futures, foreign-currency swaps, commitments, derivatives held as part of our external Money Manager program and other derivatives not accounted for in hedge accounting relationships, including a prepayment management agreement and credit derivatives.
- (2) We reclassified the notional amounts of certain foreign-currency swaps from Receive-fixed swaps to Other to conform with the 2004 presentation.
- (3) Subsequent to the issuance of our Information Statement dated September 24, 2004, we increased the December 31, 2003 notional amounts of commitments and swap guarantee derivatives that are subject to the requirements of SFAS 133 and SFAS 149 and are not in hedge accounting relationships by \$200 million and \$31 million, respectively. The net effect of these changes was an increase to the notional amount for no hedge designation to \$796.3 billion from \$796.0 billion at December 31, 2003. Also, subsequent to the issuance of our Information Statement Supplement dated March 31, 2005, we revised the notional amounts of written options and swap guarantee derivatives that are not in hedge accounting relationships for the following periods: (a) reduced 1Q 2003 notional amount of written options by \$708 million, (b) reduced 1Q 2004 notional amount of written options by \$216 million, (c) reduced 4Q 2004 notional amount of written options by \$134 million and increased 4Q 2004 notional amount of swap guarantee derivatives by \$13 million. The net effect of these changes were decreases to the notional amounts for no hedge designation to \$923.0 billion from \$923.7 billion at March 31, 2003, to \$825.3 billion from \$825.5 billion at March 31, 2004 and to \$622.5 billion from \$622.6 billion at December 31, 2004. The net effect of these changes on fair value and on Derivative gains (losses) was immaterial.

Derivative gains (losses) totaled (\$4,475) million, \$39 million, and \$5,302 million in 2004, 2003 and 2002, respectively. As discussed previously, this financial statement caption is affected by the change in the fair value of derivatives as well as the accrual of periodic settlements in accordance with the contractual terms of all derivatives not in hedge accounting relationships. There was significant volatility in the quarterly results due to changes in the fair values of our derivatives and changes in the composition of our portfolio of derivatives not in hedge accounting relationships. In addition, the notional balance of our pay-fixed swaps not

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in hedge accounting relationships increased significantly during the second quarter of 2004, and the notional balance of our receive-fixed swaps not in hedge accounting relationships increased significantly during the fourth quarter of 2004.

Changes in the fair value of our pay-fixed and receive-fixed interest-rate swaps are primarily driven by changes in interest rates. Generally, the fair value of our interest-rate swaps is affected by changes in long-term spot swap rates or, if our interest-rate swaps are forward-starting, long-term forward swap rates. Forward-starting swaps represent interest-rate swap agreements scheduled to begin on a future date. During 2004, significant portions of our swaps not in hedge accounting relationships were forward-starting.

Both spot and forward swap rates were volatile during the year causing significant changes in the fair values of our interest rate swaps. Generally, these rates moved in tandem, however, in the fourth quarter of 2004 forward rates declined, ending the year lower than the prior year end, whereas spot rates increased, ending the year at roughly the same level as the prior year end.

During 2004, net losses on our pay-fixed swap portfolio were driven by the overall decline in forward rates. As shown in Table 27, our pay-fixed swap positions experienced net gains of \$5.7 billion during the second quarter of 2004 as spot rates increased from the prior quarter end. However, our pay-fixed swap positions experienced losses of (\$5.0) billion in the third quarter of 2004 as spot rates decreased from the prior quarter end. In the fourth quarter of 2004, we experienced net losses on our forward starting pay-fixed swaps as forward rates declined, partially offset by the effect of an increase in spot rates which affect our current starting swaps. Our receive-fixed swap positions, which generally lose value with increases in interest rates, experienced net losses during 2004 related primarily to increases in spot rates during the last two months of the fourth quarter.

In addition, during 2004, there were net losses on our call and put swaption positions as the fair values of these positions were driven by changes in swap rates and the decline in implied volatilities of interest rates during the year. Our net swaption position resulted in net gains during the first and third quarters of 2004 driven by gains in call swaptions due to the decline in swap rates from the prior quarter ends. Our net swaption position resulted in net losses of (\$4.0) billion during the second quarter of 2004 driven by losses in call swaptions as swap rates increased from the prior quarter end and implied volatilities of interest rates declined. In the fourth quarter of 2004, our net swaption position resulted in net losses as implied volatilities of interest rates declined.

The movement of the pay-fixed and receive-fixed swaps to no hedge designation during 2004 was the primary driver of the increase in the accrual of periodic settlements (presented in Table 27 above) recorded in derivative gains (losses) as compared to 2003. Had these pay-fixed and receive-fixed swaps remained in hedge accounting relationships, the related accrual of periodic settlements would have been reported as a component of Net interest income (loss). The increase in the notional balance of our pay-fixed swaps not in hedge accounting relationships contributed to the \$0.4 billion increase in the net expense associated with the accrual of periodic settlements in the second quarter of 2004 as compared to the first quarter of 2004. This expense continued to be high in the third and fourth quarters of 2004, but began to be partially offset by the accrual of periodic settlements related to the receive-fixed swaps, which were moved to no hedge designation during the fourth quarter of 2004.

Derivative gains (losses) fluctuated significantly during 2003 due to the decrease in interest rates during the first half of 2003 versus an increase in interest rates during the third quarter of 2003. During the second quarter of 2003, derivative gains of \$3.5 billion were primarily driven by a \$3.1 billion gain in the value of call swaptions, which was due to interest rate declines during the quarter. As interest rates increased during the third quarter of 2003, our call swaptions declined in value by (\$3.1) billion and we incurred (\$1.4) billion of losses on commitments to purchase or sell mortgages and mortgage-related securities. These losses were partially offset by \$2.1 billion in gains on pay-fixed swaps.

During 2002, derivative gains (losses) were largest in the third quarter when the gains totaled \$6.3 billion. This third quarter gain in 2002 was driven by a \$4.8 billion gain on call swaptions, net of losses on put swaptions and a \$1.3 billion gain on receive-fixed swaps, net of losses on pay-fixed swaps. The decrease in interest rates in the third quarter of 2002 increased the fair value of the interest-rate swaps underlying the call

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swaptions, which combined with the increase in the implied volatility of interest rates, resulted in a significant increase in the value of the call swaptions. While increases in implied volatility also have a favorable effect on the value of put swaptions, the decrease in fair value of the underlying pay-fixed interest-rate swaps due to the decrease in interest rates resulted in a net decrease in the fair value of these swaptions during 2002.

### Hedge Accounting Gains (Losses)

*For those derivatives that are accounted for in a hedge accounting relationship, 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 accounting relationships primarily consist of derivatives linked to either existing debt in a fair value hedge accounting relationship or the variability of interest payments on the forecasted issuances of debt securities in a cash flow hedge accounting relationship.*

Hedge accounting gains were \$743 million, \$644 million and \$187 million in 2004, 2003 and 2002, respectively. Hedge ineffectiveness in these years related primarily to our fair value hedge accounting relationships. Hedge accounting gains (losses) will vary from period to period based on the notional amount of derivatives accounted for in hedge accounting relationships and the extent to which differences in the characteristics or terms of the derivative and the hedged item result in fair value or cash flow changes that are not exactly offset. For example, a significant portion of derivatives in our fair value hedges is forward starting and valued using forward rates while the hedged debt is valued using spot rates. Therefore, the difference between the spot rate and the forward rate generally produces ineffectiveness in these fair value hedges, which is recognized in this caption.

### 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.*

Table 28 summarizes the components of Gains (losses) on investment activity for 2004, 2003 and 2002.

**Table 28 — Gains (Losses) on Investment Activity**

	Year Ended December 31,		
	2004	2003	2002
	(dollars in millions)		
Gains (losses) on trading securities <sup>(1)</sup> . . . . .	\$(1,071)	\$(1,606)	\$ 921
Gains (losses) on PC residuals, at fair value . . . . .	58	(144)	(438)
Gains (losses) on sale of mortgage loans and available-for-sale securities <sup>(1)</sup> . . . . .	793	1,551	1,958
Security impairments:			
Mortgage-related interest-only security impairments . . . . .	(66)	(524)	(568)
Other security impairments . . . . .	(60)	(212)	(82)
Total security impairments <sup>(2)</sup> . . . . .	(126)	(736)	(650)
Lower-of-cost-or-market valuation adjustments . . . . .	(2)	(179)	8
Total gains (losses) on investment activity . . . . .	<u>\$ (348)</u>	<u>\$(1,114)</u>	<u>\$1,799</u>

(1) We reclassified \$524 million for full year 2003 from Gains (losses) on sale of mortgage loans and available-for-sale securities to Gains (losses) on trading securities to conform with the 2004 presentation.

(2) Includes impairments on securities classified as available-for-sale and trading. Impairments relating to securities within the scope of Emerging Issues Task Force Issue 99-20, "Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets," are calculated and recorded for both available-for-sale and trading securities.

*Gains (Losses) on Trading Securities* were (\$1,071) million, (\$1,606) million and \$921 million in 2004, 2003 and 2002, respectively. Gains (losses) on securities we hold that are classified for accounting purposes as trading represent changes in the fair value of our trading positions, which include trading securities held, certain 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. Historically, our trading positions arose primarily in connection with our Securities

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Sales & Trading Group business unit, which ceased operations in the fourth quarter of 2004. To a lesser degree, our trading positions also included certain securities held in the Retained portfolio and in the Cash and investments portfolio. Our securities classified as trading, excluding Participation Certificates residuals and guarantee assets, totaled \$11.8 billion and \$52.3 billion at December 31, 2004 and 2003, respectively.

Entering 2003, our trading portfolio consisted of mortgage-related securities that were in unrealized gain positions because the average coupon rates of the securities were relatively high. The portfolio experienced losses because these securities experienced significant prepayments during the first half of 2003 as interest rates fell. In addition, during the third and fourth quarters of 2003 the portfolio experienced losses as rising interest rates decreased the value of investments. In 2002, trading gains benefited from the decline in interest rates during the year.

*Gains (Losses) on PC Residuals* were \$58 million, (\$144) million and (\$438) million in 2004, 2003 and 2002, respectively. PC residuals relate to certain PCs and Structured Securities we hold and represent the fair value of the future cash flows of guarantee contracts that specifically correspond to such PCs or Structured Securities. Our estimates of the related cash flows are impacted by several factors including changes in interest rates, which affect the expected lives of the related PCs and Structured Securities, and changes in our default experience and loss severity trends related to the underlying guarantee contracts. PC residuals that are classified as trading securities are marked to fair value as a component of Gains (losses) on investment activity.

In 2004, we experienced a net increase in the fair value of PC residuals due to smaller decreases in interest rates as compared to 2003 and reductions in expected default costs related to the mortgage collateral underlying PCs held in the Retained portfolio due to continued house price appreciation. In 2003, losses on PC residuals decreased compared with 2002 due to a smaller overall decline in mortgage interest rates experienced during the year. In addition, the proportion of PCs and Structured Securities we held that had a recognized PC residual associated with them increased to 72 percent in 2003 from 38 percent in 2002 due to the adoption of FIN 45, together with an increase in the amount of Retained portfolio purchase activity. 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.

*Gains (Losses) on Sale of Mortgage Loans and Available-for-Sale Securities* were \$793 million, \$1,551 million and \$1,958 million in 2004, 2003 and 2002, respectively. Net gains declined during 2004 from 2003 levels primarily due to a decrease in the volume of transfers of PCs and Structured Securities that qualified as sales under SFAS 125/140. We issued 49 percent fewer PCs and Structured Securities (in terms of unpaid principal balance) during 2004 than we issued during 2003, with roughly the same proportion of these issuances resulting in a gain (loss) on sale of the underlying mortgage loans during each year.

The increased gains on the sale of mortgage loans and available-for-sale securities during 2003 compared to 2002 were primarily attributable to the increasing volume of sales of PCs and Structured Securities in these years, as well as sales of Treasury and agency debt securities originally purchased for asset/liability management purposes during 2003.

*Security Impairments* were (\$126) million, (\$736) million and (\$650) million in 2004, 2003 and 2002, respectively. 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 2004, 2003 and 2002 were primarily related to certain investments in mortgage-related interest-only securities and manufactured housing securities.

Impairment losses on mortgage-related interest-only securities totaled (\$66) million, (\$524) million and (\$568) million during 2004, 2003 and 2002, respectively. GAAP requires the cost basis of a mortgage-related interest-only security to be written down to fair value when there is both a decline in fair value below the carrying amount and an adverse change in expected cash flows. Decreasing interest rates cause our estimates of the lives of these securities to shorten. As a result, the expected cash flows from mortgage-related interest-only securities decrease along with the fair value of these securities.

Impairments related to our mortgage-related interest-only securities were lower during 2004 than in prior years because (a) the interest-rate environment in 2004 was less volatile than in prior years, causing the fair

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value of these securities to remain more stable, (b) the carrying value of our mortgage-related interest-only securities was reduced by impairments taken in prior years and (c) the balance subject to impairment declined because we purchased fewer of these securities during 2004 compared to prior years. During the first half of 2003, interest rates continued to decline from 2002 levels resulting in an increase in prepayments and, in turn, a higher level of impairment losses than in the prior year. In 2003, interest rates decreased sharply during the first and second quarters; as a result, the large majority of the 2003 mortgage-related interest-only securities impairment losses were recognized in those quarters. As interest rates began to rise in the third and fourth quarters of 2003, impairment losses recognized were greatly reduced. The large mortgage-related interest-only security impairment losses during 2002 relate to the decline in interest rates.

Impairments recorded on non-interest-only securities totaled (\$60) million, (\$212) million and (\$82) million in 2004, 2003 and 2002, respectively, including impairments on manufactured housing securities totaling (\$44) million, (\$208) million and (\$67) million during the same periods as a result of the comparatively low credit quality of these securities. See “CONSOLIDATED BALANCE SHEETS ANALYSIS — Cash and Investments” for more information about our non-agency, mortgage-related securities at December 31, 2004 and 2003. Also see “NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES” to our consolidated financial statements.

*Lower-of-Cost-or-Market Valuation Adjustments* were (\$2) million, (\$179) million and \$8 million in 2004, 2003 and 2002, respectively. We record mortgage loans classified as held-for-sale at the lower-of-amortized-cost or market valuation with changes in the valuation of our held-for-sale portfolio recorded to this caption. Losses related to the lower of amortized cost or market value adjustments were insignificant during 2004 and 2002. The sharp decline in mortgage interest rates in the second quarter of 2003 resulted in an increase in mortgage loans purchased as the market experienced heavy refinancing activity. A sharp increase in mortgage interest rates during the third quarter of 2003 reduced the value of our held-for-sale mortgage loan portfolio, resulting in lower of amortized cost or market valuation adjustments that totaled (\$178) million.

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

*We record gains and losses on debt repurchases that are accounted for as extinguishments of debt based on the difference between the principal amount of the debt securities repurchased (adjusted for deferred premiums, discounts, and hedging gains and losses) and current market prices, and the write-off of related deferred debt issuance costs.*

We incurred pre-tax losses of (\$327) million, (\$1,775) million and (\$674) million on the repurchase of approximately \$14.5 billion, \$27.3 billion and \$20.3 billion in principal amount of debt outstanding in 2004, 2003 and 2002, respectively. The most significant debt repurchases occurred in the second quarter of 2003, resulting in pre-tax losses of (\$1,266) million, when we repurchased an aggregate of \$17.1 billion of U.S. dollar and Euro-denominated debt securities, most of which followed the announcement of changes in our senior management. We executed these particular repurchases to support the liquidity and price performance of these securities. The gains (losses) on debt extinguishments include amounts previously deferred under SFAS 133 hedge accounting related to the repurchased debt securities.

#### **Resecuritization Fees**

*Resecuritization fees are revenues we earn primarily in connection with the issuance of Structured Securities for which we make a REMIC election, where the underlying collateral is provided by third parties. These fees are also generated in connection with the creation of interest-only and principal-only strips as well as other Structured Securities.*

Resecuritization fees totaled \$159 million, \$352 million and \$276 million in 2004, 2003 and 2002, respectively. A steep yield curve generally increases the value of structured cash flows, which results in greater value differences between PCs and Structured Securities as well as a corresponding increase in the volume of new Structured Securities being issued. As the yield curve flattened during 2004 and investor demand for Structured Securities decreased, we experienced a 28 percent decline in the volume of Structured Securitization activities based on unpaid principal balances compared to 2003. In addition, we decreased our average

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fees to perform resecuritizations during 2004 in response to competitive pressures and to support the price of our PCs, which represent most of the collateral that we resecuritize. Investors' demand for Structured Securities remained high during 2003 and 2002 largely due to the comparatively steep yield curve during those periods.

### 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. In 2004 and 2003, other income also includes the correction of certain prior year accounting errors.*

Other income totaled \$230 million, \$493 million and \$321 million in 2004, 2003 and 2002, respectively. Absent the fluctuations related to the correction of certain prior year accounting errors in the first quarters of 2004 and 2003 (discussed in more detail below), Other income would have been \$172 million and \$279 million in 2004 and 2003, respectively. We experienced a modest decline in fees earned associated with Loan Prospector®, our automated loan-underwriting tool, which was driven by lower usage of this tool.

In the process of reviewing our accounting policies and practices for 2004 and 2003, we identified certain errors not material to the financial statements that resulted in a cumulative net understatement of income in previously reported periods. During 2004, we identified approximately \$58 million of income, net (\$38 million after-tax) of such errors affecting 2003 and prior periods that we recorded in the first quarter of 2004 as a component of Other income. During 2003, we identified approximately \$214 million of income, net (\$139 million after-tax) attributable to such errors affecting 2002 and prior periods that we recorded in the first quarter of 2003 as a component of Other income.

### Non-Interest Expense

Table 29 summarizes Non-interest expense for 2004, 2003 and 2002.

**Table 29 — Non-Interest Expense**

	2004 vs. 2003			2003 vs. 2002	
	Year Ended December 31,		Change	Year Ended December 31,	
	2004	2003		2002	Change
	(dollars in millions)				
Non-interest expense					
Salaries and employee benefits . . . . .	\$ (758)	\$ (624)	\$ (134)	\$ (593)	\$ (31)
Professional services . . . . .	(588)	(311)	(277)	(155)	(156)
Occupancy expense . . . . .	(60)	(52)	(8)	(42)	(10)
Other administrative expenses . . . . .	(144)	(194)	50	(184)	(10)
Total administrative expenses . . . . .	(1,550)	(1,181)	(369)	(974)	(207)
(Provision) benefit for credit losses . . . . .	(143)	5	(148)	(122)	127
REO operations income (expense) . . . . .	3	(7)	10	(4)	(3)
Housing tax credit partnerships . . . . .	(281)	(200)	(81)	(160)	(40)
Minority interests in earnings of consolidated subsidiaries . . . . .	(129)	(157)	28	(184)	27
Other expenses . . . . .	(271)	(696)	425	(432)	(264)
Total non-interest expense . . . . .	<u>\$ (2,371)</u>	<u>\$ (2,236)</u>	<u>\$ (135)</u>	<u>\$ (1,876)</u>	<u>\$ (360)</u>

### Administrative Expenses

*Salaries and employee benefits, Professional services, Occupancy expense and certain other administrative expenses are collectively referred to as administrative expenses. Administrative expenses are generally incurred to conduct daily operations and support functions. Also, other administrative expenses include*

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amortization expense related to previously capitalized software development costs, net of reductions for current period capitalized software development costs.

Table 30 summarizes Administrative expenses for 2004, 2003 and 2002.

**Table 30 — Administrative Expenses**

	Year Ended December 31,		
	2004	2003	2002
	(dollars in millions)		
Administrative expenses:			
Salaries and employee benefits .....	\$ 758	\$ 624	\$593
Professional services <sup>(1)</sup> .....	588	311	155
Occupancy expense .....	60	52	42
Other administrative expenses <sup>(1)(2)</sup> .....	144	194	184
Total administrative expenses .....	<u>\$1,550</u>	<u>\$1,181</u>	<u>\$974</u>

(1) We reclassified certain expenses from Other administrative expenses to Professional services for 2003 and 2002 to conform with the 2004 presentation.

(2) Other charitable contributions are included in Other administrative expenses for 2004, 2003 and 2002. See “Table 31 — Other Expenses” for the special charitable contributions made in 2002.

Administrative expenses totaled \$1,550 million, \$1,181 million and \$974 million in 2004, 2003 and 2002, respectively. Salaries and employee benefits rose in each year primarily because we increased the number of employees. In addition, employee incentive compensation costs increased by approximately \$50 million in 2004 over 2003 levels as a result of the increased number of employees and efforts to retain key employees during the restatement period and to attract new employees. We also incurred approximately \$18 million of employee severance and related costs and approximately \$5 million of other expenses related to ceasing the PC market making and support activities of our Securities Sales & Trading Group business unit during the fourth quarter of 2004. The increase in Professional services expense in 2004 was primarily driven by our ongoing financial reporting and internal control remediation activities.

The increase in Salaries and employee benefits, Professional services and Other administrative expenses in 2003 compared to 2002 was primarily driven by costs associated with the restatement. During 2003, we incurred expenses associated with the restatement totaling \$172 million, which consisted of approximately \$149 million of professional services expenses due to increased accounting, auditing, consulting and legal services; \$15 million of compensation costs; and \$8 million of other costs.

Other administrative expenses are presented net of certain expenses deferred relating to capitalized software development activities. The reduction to Other administrative expenses with respect to capitalized software development was \$157 million, \$79 million and \$57 million in 2004, 2003 and 2002, respectively. These amounts were offset by related amortization expenses and impairments of \$63 million, \$37 million and \$22 million in 2004, 2003 and 2002, respectively, also recorded in Other administrative expenses. Capitalized software development costs are amortized over periods of three years or less.

**(Provision) Benefit for Credit Losses and Real Estate Owned, or REO, Operations Income (Expense)**

*We collectively refer to our Reserve for losses on mortgage loans held-for-investment and Reserve for guarantee losses on Participation Certificates as our Loan Loss Reserves. The Provision for credit losses includes our provision for losses incurred on our mortgage loans held-for-investment, which are a component of our Retained Portfolio; our provision for incurred losses related to (1) Outstanding PCs and (2) that portion of Structured Securities held by third parties that are backed by non-Freddie Mac mortgage-related securities, which are off-balance sheet obligations; and our provision for uncollectible interest on single-family loans underlying PCs held by third parties. REO operations income (expense) includes certain costs associated with the acquisition of real estate at the time of foreclosure, 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 a provision for valuation losses occurring between acquisition and disposition.*

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The (Provision) benefit for credit losses may be expense or income, depending on whether the Loan Loss Reserves balance needs to be increased or decreased based on the inherent losses associated with our portfolio at any time. The (Provision) benefit for credit losses increased to (\$143) million in 2004 compared to a benefit of \$5 million in 2003. The (Provision) benefit for credit losses was (\$122) million in 2002. The balance of the Loan Loss Reserves totaled \$264 million and \$299 million at December 31, 2004 and 2003, respectively.

The (Provision) benefit for credit losses increased in 2004 due to increases in the estimated incurred losses in the single-family portfolio at December 31, 2004 compared to December 31, 2003, driven by lower REO fair values and resulting in higher estimated losses on a per property basis in certain areas. However, this was partially offset by a decrease in the estimated incurred losses in the Multifamily mortgage portfolio, driven primarily by an increase in the estimated fair value of multifamily properties in certain areas. The benefit for credit losses in 2003, as compared to the expense in 2002, resulted from loss mitigation strategies, strong house price appreciation and recoveries in the single-family portfolio. In addition, the 2002 provision reflected an increase in expected losses on multifamily mortgage loans.

REO operations income (expense) totaled \$3 million, (\$7) million, and \$(4) million in 2004, 2003 and 2002, respectively. The 2004 increase in income was largely driven by a gain of \$7 million on the sale of a multifamily property.

Our total credit losses, defined as “Real estate owned operations income (expense)” plus “net charge-offs,” rose slightly in 2004 but were still low, totaling approximately 1.1 basis points of the average Total mortgage portfolio (after excluding non-Freddie Mac securities). In 2005 we expect credit losses to increase from their recent levels, but to be low relative to historic levels.

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

*Housing tax credit partnerships represent our share of the losses generated from our investments in partnerships that develop or rehabilitate low-income, multifamily rental properties. We generally hold interests in individual partnerships for fifteen years. Although these partnerships generate losses, we realize a return on our investment through reductions in Income tax expense that result from tax credits and the deductibility of the losses. The tax credits related to our investments in these partnerships are generally recognized over a ten-year period.*

Our share of losses generated from our investment in Housing tax credit partnerships totaled (\$281) million, (\$200) million and (\$160) million in 2004, 2003 and 2002, respectively. The year-over-year increases in this expense primarily reflect our increased investment in such partnerships. The related tax benefits, which are reported as a reduction in Income tax expense, totaled \$378 million, \$302 million and \$220 million in 2004, 2003 and 2002, 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 (\$129) million, (\$157) million and (\$184) million in 2004, 2003 and 2002, respectively. The majority of this amount for each of 2004, 2003 and 2002 relates to dividends on the preferred stock issued by our two majority-owned real estate investment trust, or REIT, subsidiaries. These dividends are recorded using an effective interest method and, therefore, will continue to decline over time as our recorded investment in the REITs decreases.

#### **Other Expenses**

*Other expenses generally include those non-administrative expenses that are direct and incremental to revenue producing activities (e.g., Loan Prospector® — related expenses) or are otherwise not related to operational support activities.*

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Table 31 summarizes Other expenses for 2004, 2003, and 2002.

**Table 31 — Other Expenses**

	<u>Year Ended December 31,</u>		
	<u>2004</u>	<u>2003</u>	<u>2002</u>
	(dollars in millions)		
Other expenses:			
OFHEO civil money penalty . . . . .	\$ —	\$125	\$ —
Loss contingency expense . . . . .	—	75	—
Selected affordable housing transaction fees . . . . .	41	124	—
Amortization of credit enhancements . . . . .	86	134	—
Realized losses on certain guarantees . . . . .	33	60	—
Loan Prospector®-related expenses . . . . .	56	99	86
Special charitable contributions <sup>(1)</sup> . . . . .	—	—	225
Disposition of certain technology-related assets . . . . .	—	—	52
Other <sup>(2)</sup> . . . . .	<u>55</u>	<u>79</u>	<u>69</u>
Total Other expenses . . . . .	<u>\$271</u>	<u>\$696</u>	<u>\$432</u>

- (1) Special charitable contributions represents a cash contribution to the Freddie Mac Foundation and corporate giving programs announced in the fourth quarter of 2002. The contribution to the Freddie Mac Foundation is expected to provide operating funds for the Foundation for six to eight years from the contribution date.
- (2) We reclassified certain expenses from Other administrative expenses as included in Administrative expenses (see “Table 30 — Administrative Expenses” for additional information) to Other for 2003 and 2002 to conform with the 2004 presentation.

Total Other expenses totaled \$271 million, \$696 million and \$432 million in 2004, 2003 and 2002, respectively.

Total Other expenses in 2003 included two charges that totaled \$200 million. First, we paid a \$125 million civil money penalty in connection with the OFHEO consent order, which was accrued in the second quarter of 2003. Second, we recognized in the second quarter of 2003 a \$75 million expense for a loss contingency reserve related to legal proceedings arising from the restatement. See “NOTE 13: LEGAL CONTINGENCIES” to our consolidated financial statements for additional information. We also entered into certain multifamily affordable housing transactions during the third and fourth quarters of 2003 that contained a number of contractual incentives, including the payment of fees totaling \$124 million in the third and fourth quarters of 2003 and \$41 million in the first quarter of 2004.

Total Other expenses also include the amortization of credit enhancements, realized losses related to certain guarantees as well as other costs associated with our ongoing activities. Beginning in 2003, credit enhancements are included in Other assets and amortized into Other expenses over time. Amortization expense related to credit enhancements declined \$48 million in 2004 from 2003 levels primarily as a result of declines in our liquidation rates during 2004 compared to 2003. In 2002, credit enhancements were included in the carrying value of the guarantee asset and changes in their carrying value were included in Gains (losses) on “Guarantee asset for Participation Certificates, at fair value.”

Beginning in 2003, due to the adoption of FIN 45, we began recording guarantee assets and guarantee obligations at fair value at inception on (i) PCs issued through our Guarantor Program, (ii) that portion of PCs issued through MultiLender Program transactions that did not qualify as a sale under SFAS 125/140 and (iii) certain Structured Securities that we issue to third parties in exchange for non-agency mortgage-backed securities. Consequently, we immediately recognize any excess of the related guarantee obligation over the guarantee asset and Other assets (that relate to recognized credit enhancements described above) as realized losses on certain guarantees. Such realized losses decreased \$27 million to \$33 million in 2004 from \$60 million in 2003 primarily as a result of interest-rate fluctuations that affect our determination of the initial fair value of the guarantee asset, credit-enhancement asset and guarantee obligation. In 2002, we did not recognize guarantee assets and obligations related to PCs issued through our Guarantor Program or for that portion of PCs transferred to third parties in MultiLender Program transactions that did not qualify as sales under SFAS 125/140. Consequently, we did not recognize a similar expense in 2002.

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Other expenses in 2002 included special charitable contributions of \$225 million representing cash contributions to the Freddie Mac Foundation and corporate giving programs announced in the fourth quarter of 2002. The contribution to the Freddie Mac Foundation is expected to provide operating funds for the Foundation for six to eight years from the date of the contribution. Other charitable contributions of approximately \$6 million, \$6 million, and \$35 million for 2004, 2003, and 2002, respectively, are included within Other administrative expenses.

In 2002, Other expenses includes a \$52 million loss recognized in the fourth quarter of 2002 related to the disposition of certain technology-related assets.

### **Income Tax Expense**

*Income tax expense includes (a) deferred tax expense, which represents the net change in the deferred tax asset or liability balance during the year plus any change in a valuation allowance, and (b) current tax expense, which represents the amount of tax currently payable to, or receivable from, a tax authority plus amounts accrued for expected tax deficiencies (including both tax and interest). Income tax expense excludes the tax effects related to adjustments recorded to AOCI.*

Income tax expense was (\$790) million, (\$2,202) million and (\$4,713) million in 2004, 2003 and 2002, respectively. The effective tax rates for 2004, 2003 and 2002 were 21 percent, 31 percent and 32 percent, respectively. The decrease in the effective tax rate over the past three years, particularly in 2004, is primarily due to the decline in pre-tax income in relation to year-over-year increases in tax credits related to our investments in housing tax credit partnerships and interest earned on tax-exempt securities. In addition, our effective tax rate for 2004 benefited from a \$110 million reduction to our tax reserves as a result of our reaching a closing agreement with the Internal Revenue Service, or IRS, relating to the tax treatment of dividends paid on step-down preferred stock issued by our two REIT subsidiaries. For more information regarding this tax reserve adjustment, see "SUBSEQUENT ACCOUNTING REVISIONS." These effects were partially offset by a non-tax deductible (\$125) million OFHEO civil money penalty and a (\$75) million loss contingency reserve related to legal proceedings arising from the restatement, that were recorded in the second quarter of 2003. Our effective tax rate for 2002 benefited from a reduction to our tax reserve related to favorable U.S. Tax Court rulings.

## CONSOLIDATED BALANCE SHEETS ANALYSIS

Table 32 provides summary consolidated balance sheets at December 31, 2004 and 2003.

**Table 32 — Summary Consolidated Balance Sheets**

	December 31,	
	2004	2003
	(dollars in millions)	
Retained portfolio .....	\$664,468	\$660,357
Cash and investments .....	97,280	109,078
Derivative assets, at fair value .....	15,257	16,180
Guarantee asset for Participation Certificates, at fair value .....	4,516	3,686
Other items included in total assets .....	13,763	14,148
Total assets .....	<u>\$795,284</u>	<u>\$803,449</u>
Total debt securities, net .....	\$731,697	\$739,613
Guarantee obligation for Participation Certificates .....	4,065	2,904
Derivative liabilities, at fair value .....	226	357
Other items included in total liabilities .....	26,371	27,159
Total liabilities .....	<u>762,359</u>	<u>770,033</u>
Minority interests in consolidated subsidiaries .....	1,509	1,929
Total stockholders' equity .....	<u>31,416</u>	<u>31,487</u>
Total liabilities and stockholders' equity .....	<u>\$795,284</u>	<u>\$803,449</u>

Our total assets remained relatively flat as of December 31, 2004 compared to December 31, 2003, declining by \$8.2 billion, or 1 percent. This decrease was primarily driven by an \$11.8 billion reduction in our Cash and investments portfolio. During the same period, total liabilities, plus minority interests in consolidated subsidiaries, decreased by \$8.1 billion, which was driven by decreases in total debt securities. 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 PCs and Structured Securities and other agency and non-agency mortgage-related securities.*

The carrying value of the Retained portfolio increased by \$4.1 billion, or 1 percent, to \$664.5 billion as of December 31, 2004 from \$660.4 billion at December 31, 2003. The Retained portfolio unpaid principal balance (which excludes premiums, discounts, deferred fees and other basis adjustments, the Reserve for losses on mortgage loans held-for-investment, and unrealized gains or losses on mortgage-related securities and PC residuals) increased by 1 percent during 2004. Mortgage-related investment opportunities in fixed-rate products were generally not attractive in 2004. Strong demand from other investors, coupled with lower mortgage loan originations, generally resulted in unattractive mortgage-to-debt option-adjusted spreads. While fixed-rate investment opportunities were relatively less attractive than in 2003, this was mitigated by lower liquidation rates compared to 2003 and purchases of floating rate, non-agency mortgage-related securities.

Table 33 provides additional detail regarding the mortgage loans and mortgage-related securities that comprised our Retained portfolio at December 31, 2004 and 2003.

**Table 33 — Credit Characteristics of Mortgages and Mortgage-Related Securities in the Retained Portfolio**

	December 31, 2004			December 31, 2003		
	Amount	% AAA Rated	% of Total Retained Portfolio <sup>(1)</sup>	Amount	% AAA Rated	% of Total Retained Portfolio <sup>(1)</sup>
	(dollars in millions)					
Mortgage loans . . . . .	\$ 61,360	N/A	9%	\$ 60,270	N/A	9%
PCs and Structured Securities <sup>(2)</sup> . . . . .	356,698	N/A	55	393,135	N/A	61
Non-Freddie Mac mortgage-related securities:						
Agency mortgage-related securities: <sup>(3)</sup>						
Fannie Mae . . . . .	58,004	N/A	9	74,529	N/A	12
Ginnie Mae . . . . .	1,711	N/A	—	2,760	N/A	—
Total agency mortgage-related securities . . . . .	59,715	N/A	9	77,289	N/A	12
Non-agency mortgage-related securities: <sup>(4)</sup>						
Single-family and other mortgage-related securities <sup>(5)</sup> . . . . .	123,411	99.2%	19	72,161	99.8%	11
Commercial mortgage backed securities <sup>(6)</sup> . . . . .	41,184	100.0	6	33,055	99.3	5
Mortgage revenue bonds <sup>(7)</sup> . . . . .	9,077	71.5	2	7,772	77.1	2
Manufactured housing <sup>(8)</sup> . . . . .	1,491	33.4	—	1,784	42.0	—
Total non-agency mortgage-related securities . . . . .	175,163	97.4%	27	114,772	97.3%	18
Total unpaid principal balance of Retained portfolio . . . . .	652,936		100%	645,466		100%
Premiums, discounts, deferred fees and other basis adjustments . . . . .	4,039			4,793		
Net unrealized gains on mortgage-related securities, pre-tax . . . . .	6,762			9,601		
Participation Certificate residuals at fair value . . . . .	845			671		
Reserve for losses on mortgage loans held-for-investment . . . . .	(114)			(174)		
Total Retained portfolio per consolidated balance sheets . . . . .	<u>\$664,468</u>			<u>\$660,357</u>		

- (1) Based on unpaid principal balance.
- (2) With respect to our PCs and Structured Securities, we guarantee the payment of principal and interest and are subject to the credit risk associated with the underlying mortgage loan collateral (or non-agency mortgage-related security collateral, where applicable).
- (3) Agency mortgage-related securities are generally not separately rated by credit rating agencies, but are viewed as having a level of credit quality at least equivalent to non-agency mortgage securities rated “AAA” or equivalent.
- (4) Credit rating of most non-agency mortgage-related securities is designated by at least two nationally recognized credit rating agencies.
- (5) The “other” component of this line item consists of multifamily mortgage-related securities not structured in a commercial mortgage backed security.
- (6) Consists of pools of mortgages collateralized by multifamily, manufactured housing parks, and commercial (office, retail, industrial, and a smaller percentage of hotel or other) properties.
- (7) Consists of obligations of states and political subdivisions.
- (8) 43 percent and 84 percent of mortgage-related securities backed by manufactured housing were rated BBB– or above at December 31, 2004 and 2003, respectively. For the same periods, 96 percent and 90 percent of these securities are supported by credit-enhancements such as deal structure through subordination and bond insurance.

The non-agency mortgage-related securities portion of the Retained portfolio grew from December 31, 2003 to December 31, 2004 in both unpaid principal balance and as a percentage of the total Retained portfolio. This growth is a result of the strong supply of non-agency mortgage-related securities, particularly floating rate products, combined with the fact that investment opportunities in agency fixed-rate products have

not been as attractive to us because strong demand from other investors, and lower mortgage loan originations, have generally resulted in unattractive mortgage-to-debt option-adjusted spreads.

## Cash and Investments

*Cash and investments include 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 or credit guarantee business opportunities and manage interest-rate risk exposure.*

The carrying value of our Cash and investments portfolio decreased by \$11.8 billion, or 11 percent, to \$97.3 billion at December 31, 2004 from \$109.1 billion at December 31, 2003. At December 31, 2003, Cash and investments included certain mortgage-related securities that were not included in the Retained portfolio since they were acquired in conjunction with the PC market-making and support activities conducted through our Securities Sales & Trading Group business unit and external Money Manager program, both of which ceased operations during the fourth quarter of 2004. Consequently, we held no mortgage-related securities in the Cash and investments portfolio at December 31, 2004, compared to \$32.8 billion at December 31, 2003. The Net proceeds from purchases and sales of trading securities reported in our consolidated statement of cash flows for 2004 of approximately \$39.0 billion was primarily driven by the disposition of securities classified as trading from the Cash and investments portfolio.

Table 34 provides additional detail regarding the non-mortgage-related securities and mortgage-related securities that comprised our Cash and investments portfolio at December 31, 2004 and 2003.

**Table 34 — Cash and Investments**

	December 31, 2004			December 31, 2003		
	Ending Balance at Fair Value	Average Maturity (Months)	% of Portfolio A Rated or Better <sup>(1)</sup>	Ending Balance at Fair Value	Average Maturity (Months)	% of Portfolio A Rated or Better <sup>(1)</sup>
	(dollars in millions)					
Cash and cash equivalents . . . . .	\$35,253	<3	N/A	\$ 23,142	<3	N/A
Investments:						
Non-mortgage-related securities:						
Asset-backed securities <sup>(2)</sup> . . . . .	21,733	N/A	100.0%	16,596	N/A	100.0%
Corporate debt securities . . . . .	—	—	—	4,924	36	59.8
Obligations of states and municipalities . . . . .	8,097	303	99.7	9,494	323	100.0
Commercial paper . . . . .	—	—	—	150	1	100.0
Preferred stock . . . . .	—	—	—	64	55	100.0
Subtotal . . . . .	29,830		99.9%	31,228		93.8%
Other non-mortgage-related securities held for PC market-making and support activities <sup>(3)</sup> . . . . .	—			1,314		
Other mortgage-related securities held for PC market-making and support activities <sup>(3)(4)</sup> . . . . .	—			32,812		
Securities purchased under agreements to resell and Federal funds sold . . . . .	32,197	<3	N/A	20,582	<3	N/A
Cash and investments . . . . .	<u>\$97,280</u>			<u>\$109,078</u>		

(1) Credit ratings for most securities are designated by at least two nationally recognized credit rating agencies.  
(2) Consists primarily of securities that can be prepaid prior to their contractual maturity without penalty.  
(3) As previously disclosed in our Information Statement Supplement dated October 4, 2004, we ceased our PC market-making and support activities accomplished through our Securities Sales & Trading Group business unit and our external Money Manager program during the fourth quarter of 2004.  
(4) The majority of these securities were agency mortgage-related securities.

As noted in Table 34, the balance of our total Cash and investments declined \$11.8 billion during 2004. Our Investments balance decreased \$35.5 billion during 2004 due in large part to ceasing of the PC market-

making and support activities of our Securities Sales & Trading Group business unit and the discontinuation of our external Money Manager program. In contrast, our balances of Cash and cash equivalents and Securities purchased under agreements to resell and Federal funds sold increased by a combined \$23.7 billion during 2004 because of the investment of a portion of the proceeds realized from liquidating the securities held by our Securities Sales & Trading Group.

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

#### **Derivative Assets and Liabilities, at Fair Value**

*All derivatives are reported at fair value. For derivatives that are in cash flow hedge accounting relationships, the change in fair value is recorded to AOCI for the effective portion of the hedge and to Hedge accounting gains (losses) for the ineffective portion of the hedge. For derivatives that are in fair value hedge accounting relationships, the change in fair value is recorded to Hedge accounting gains (losses), along with the change in fair value of the hedged item. Changes in fair value of derivatives not accounted for in hedge accounting relationships are recorded to Derivative gains (losses). We use derivatives to manage our interest-rate and other market risk exposures. However, hedge accounting has not been applied to many derivative transactions since a significant number of transactions did not meet hedge accounting requirements or we elected not to pursue hedge accounting.*

Table 35 summarizes the notional balance and related fair value by product type at December 31, 2004 and 2003.

**Table 35 — Total Derivative Portfolio**

	December 31,			
	2004		2003	
	Derivative Notional or Contractual Amount <sup>(1)</sup>	Fair Value <sup>(2)</sup>	Derivative Notional or Contractual Amount <sup>(1)</sup>	Fair Value <sup>(2)</sup>
	(dollars in millions)			
Interest-rate swaps:				
Pay-fixed . . . . .	\$ 95,043	\$(2,879)	\$ 179,751	\$(3,821)
Receive-fixed . . . . .	83,602	2,394	107,417	1,992
Basis (floating to floating) . . . . .	94	1	424	2
Total interest-rate swaps . . . . .	<u>178,739</u>	<u>(484)</u>	<u>287,592</u>	<u>(1,827)</u>
Option-based:				
Call swaptions . . . . .	189,945	4,988	217,338	7,170
Put swaptions . . . . .	25,175	267	123,611	2,096
Other option-based derivatives <sup>(3)(4)</sup> . . . . .	18,981	2	20,379	28
Total option-based . . . . .	<u>234,101</u>	<u>5,257</u>	<u>361,328</u>	<u>9,294</u>
Futures . . . . .	129,110	(33)	130,798	181
Foreign-currency swaps . . . . .	56,850	10,303	46,512	8,400
Subtotal . . . . .	598,800	15,043	826,230	16,048
Prepayment management agreement . . . . .	113,692	—	152,548	—
Commitments <sup>(4)</sup> . . . . .	32,952	(9)	89,520	(230)
Credit derivatives . . . . .	10,926	(2)	15,542	5
Swap guarantee derivatives <sup>(4)(5)</sup> . . . . .	408	(1)	31	—
Total <sup>(4)</sup> . . . . .	<u>\$756,778</u>	<u>\$15,031</u>	<u>\$1,083,871</u>	<u>\$15,823</u>

- (1) Notional or contractual amounts are used to calculate the periodic amounts to be received and paid and generally do not represent actual amounts to be exchanged or directly reflect our exposure to institutional credit risk. Notional or contractual amounts are not recorded as assets or liabilities in our consolidated balance sheets.
- (2) The fair value by derivative type presented on this table is shown prior to netting by counterparty. The fair value of derivatives presented on the consolidated balance sheets, however, is netted by counterparty as permitted by GAAP, and is reported in the Derivative assets, at fair value and Derivative liabilities, at fair value captions. The fair value for futures are directly derived from quoted market prices. Fair values of other derivatives are derived primarily from valuation models with incorporation of market-based inputs.
- (3) Primarily represents written options.
- (4) Subsequent to the issuance of our Information Statement dated September 24, 2004, we increased the December 31, 2003 notional amounts of commitments and swap guarantee derivatives that are subject to the requirements of SFAS 133 and SFAS 149 and are not in hedge accounting relationships by \$200 million and \$31 million, respectively. The net effect of these changes was an increase to the notional amount of our total derivative portfolio at that date to \$1,083,871 million from \$1,083,640 million. Also, subsequent to the issuance of our Information Statement Supplement dated March 31, 2005, we revised the December 31, 2004 notional amounts of written options and swap guarantee derivatives that are not in hedge accounting relationships by (\$134) million and \$13 million, respectively. The net effect of these changes was a decrease to the notional amount of our total derivative portfolio at that date to \$756,778 million from \$756,899 million. The net effect of these changes on fair value was immaterial.
- (5) Represents certain interest-rate swaps where we have guaranteed a third party's performance under the swap. Swap guarantees entered into after June 30, 2003 are treated as derivatives in accordance with SFAS 149. See "RISK MANAGEMENT — Interest-Rate Risk and Other Market Risks — Use of Derivatives and Interest-Rate Risk Management — Types of Derivatives" for more information.

The balance of derivatives in a gain position (reported as Derivative assets, at fair value) decreased by \$0.9 billion, or 6 percent, to \$15.3 billion as of December 31, 2004 from \$16.2 billion as of December 31, 2003, while the balance of derivatives in a loss position (reported as Derivative liabilities, at fair value) remained relatively flat at \$0.2 billion and \$0.4 billion as of December 31, 2004 and 2003, respectively. The carrying value of our derivative assets and liabilities at each consolidated balance sheet date is equal to the fair value of the derivatives that we held on those dates, which is affected by changes in market conditions such as the level and expected volatility of interest rates. The composition of the derivatives we hold will change from period to period as a result of derivative purchases, terminations prior to contractual maturity and expiration of the derivative at its contractual maturity.

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The notional balance of our derivative portfolio declined to \$756.8 billion at December 31, 2004 from \$1,083.9 billion at December 31, 2003, driven by a reduction in the notional balance of option-based derivatives, interest-rate swaps and commitments. The following factors contributed to the reduction in the notional amounts of our derivatives during 2004. The asset mix in the Retained portfolio has moved toward a greater proportion of non-agency, floating-rate mortgage-related securities, which generally require lower interest-rate protection than fixed-rate products. Also, the gradual increase in market interest rates and the flattening of the yield curve in 2004 has reduced the interest-rate risk of our existing fixed-rate investments, thereby lowering our need for option-based derivatives to manage the related risk. During 2004, we also offset the optionality risk in the Retained portfolio by increasing the amount of our callable debt outstanding.

The notional balance of option-based derivatives declined by \$127.2 billion, as a result of adjusting the option portfolio for risk management purposes in response to changes in market conditions and mortgage portfolio composition. The notional balance of interest-rate swaps declined by \$108.9 billion, as a result of the termination of certain offsetting positions prior to their contractual maturity. The notional balance of commitments declined by \$56.6 billion, primarily as the result of a reduction in commitments related to the Cash and investments portfolio as we ceased the PC market-making and support activities conducted through our Securities Sales & Trading Group business unit and external Money Manager Program during the fourth quarter of 2004.

As noted previously, changes in fair values either are recorded in current income or, to the extent our accounting hedge relationships are effective, may be deferred in AOCI or offset by basis adjustments to the related hedged item. As a result, the increases or decreases in fair value by derivative categories, described above, will not correspond directly to Derivative gains (losses) or Hedge accounting gains (losses) on our consolidated statements of income.

#### Guarantee Asset for Participation Certificates

*The Guarantee asset for Participation Certificates represents the fair value of future cash inflows related to our guarantee of PCs and Structured Securities transferred to third parties in transactions that qualify as sales under SFAS 125/140 or that were subject to the requirements of FIN 45.*

The guarantee asset balances increased by \$0.8 billion, or 23 percent, to \$4.5 billion at December 31, 2004 from \$3.7 billion at December 31, 2003. The changes in the guarantee asset balances during 2004 and 2003 are summarized in Table 36.

**Table 36 — Changes in Guarantee Asset for Participation Certificates, at Fair Value**

	<u>2004</u>	<u>2003</u>
	(dollars in millions)	
Beginning Balance, at January 1 .....	\$3,686	\$2,445
Adjustment for change in accounting <sup>(1)</sup> .....	—	(128)
Additions, net of repurchases <sup>(2)</sup> .....	1,965	2,830
Gains (losses) on “Guarantee asset for Participation Certificates, at fair value” <sup>(3)</sup> .....	<u>(1,135)</u>	<u>(1,461)</u>
Ending balance, at December 31 .....	<u>\$4,516</u>	<u>\$3,686</u>

(1) As of January 1, 2003, the fair value of those credit enhancements previously recognized as a component of guarantee assets were reclassified to Other assets.

(2) Subsequent to the issuance of our Information Statement dated September 24, 2004, we reclassified \$7 million from Gains (losses) on “Guarantee asset for Participation Certificates, at fair value” to Additions, net of repurchases.

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

In 2004 and 2003, the primary business drivers affecting the net increase in our guarantee asset balance were our business volumes and changes in mortgage interest rates. Additions, net of repurchases declined from 2003 primarily because we issued 49 percent fewer PCs and Structured Securities (based on unpaid principal balances) in 2004. Gains (losses) on guarantee asset decreased from 2003 due primarily to a smaller overall decline in mortgage interest rates. Other factors contributing to the change in the fair value of the guarantee asset are discussed in “CONSOLIDATED RESULTS OF OPERATIONS — Net Interest Income.”

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## 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 decreased by \$7.9 billion, or 1 percent, to \$731.7 billion at December 31, 2004 from \$739.6 billion at December 31, 2003. This decrease corresponds to the decrease in total assets during 2004. During 2004, debt due within one year declined by \$13.0 billion, partially offset by a \$5.0 billion increase in debt due after one year. We adjust our mix of long-term and short-term debt to reflect our funding and portfolio duration objectives.

## Guarantee Obligation for Participation Certificates

The Guarantee obligation for Participation Certificates represents the unamortized balance of our obligation to guarantee the payment of principal and interest of PCs and Structured Securities, an obligation initially established at fair value in transactions that qualify as sales under SFAS 125/140 or that were subject to the requirements of FIN 45.

The Guarantee obligation for Participation Certificates increased by \$1.2 billion to \$4.1 billion as of December 31, 2004 from \$2.9 billion as of December 31, 2003. The changes in the guarantee obligation balances during 2004 and 2003 are summarized in Table 37.

**Table 37 — Changes in Guarantee Obligation for Participation Certificates**

	<u>2004</u>	<u>2003</u>
	(dollars in millions)	
Beginning balance, at January 1 . . . . .	\$2,904	\$1,427
Adjustment for change in accounting <sup>(1)</sup> . . . . .	—	(110)
Transfer-out to the loan loss reserve during the period <sup>(2)</sup> . . . . .	(13)	(19)
Additions, net of repurchases:		
Fair value of newly-issued guarantee obligations <sup>(3)</sup> . . . . .	1,174	1,684
Deferred gains on newly-executed guarantees . . . . .	732	847
Amortization income related to: <sup>(4)</sup>		
Credit and buy-down fees received . . . . .	(128)	(57)
Initial fair value of contractual guarantee fees . . . . .	<u>(604)</u>	<u>(868)</u>
Income on “Guarantee obligation for Participation Certificates” . . . . .	<u>(732)</u>	<u>(925)</u>
Ending balance, at December 31 . . . . .	<u>\$4,065</u>	<u>\$2,904</u>

(1) Represents the reclassification of the incurred losses included in the “Guarantee obligation for Participation Certificates” at January 1, 2003 in conjunction with the implementation of FIN 45.

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

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

(4) Includes amortization of deferred revenue recognized for our guarantee obligation.

In 2004 and 2003, the primary drivers affecting the net increase in the guarantee obligation balance were our business volume and changes in the mortgage interest rates resulting in fluctuations in liquidation rates from period to period. Additions, net of repurchases declined from 2003 primarily because we issued 49 percent fewer PCs and Structured Securities in 2004 (in terms of unpaid principal balances). Amortization of guarantee obligations increased due to lower liquidation rates in 2004 compared to 2003. Other factors contributing to the change in the amortization of the guarantee obligation are discussed in “CONSOLIDATED RESULTS OF OPERATIONS — Net Interest Income.”

## Total Stockholders’ Equity

Total stockholders’ equity decreased by \$0.1 billion to \$31.4 billion at December 31, 2004 from \$31.5 billion at December 31, 2003.

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Table 38 summarizes the components of Total stockholders' equity.

**Table 38 — Total Stockholders' Equity**

	December 31,	
	2004	2003
	(dollars in millions)	
Preferred stock .....	\$ 4,609	\$ 4,609
Common stock .....	152	152
Additional paid-in capital .....	873	814
Retained earnings .....	30,728	28,837
AOCI related to:		
Available-for-sale securities .....	4,339	6,349
Cash flow hedge relationships <sup>(1)</sup> .....	(7,924)	(7,837)
Minimum pension liability .....	(8)	(10)
Total AOCI .....	(3,593)	(1,498)
Treasury stock .....	(1,353)	(1,427)
Total stockholders' equity .....	<u>\$31,416</u>	<u>\$31,487</u>

(1) Derivatives that meet specific criteria are accounted for as cash flow hedges under SFAS 133. Changes in the effective portion of the fair value of these open derivatives contracts are recorded in AOCI. Net deferred gains and losses on closed cash flow hedges (*i.e.*, where the derivative is either terminated or redesignated) are also classified in AOCI, until the related forecasted transaction is determined to be probable of not occurring or it affects earnings.

Retained earnings increased \$1.9 billion driven by net income reduced by preferred and common stock dividends declared. AOCI declined by \$2.1 billion. AOCI consists primarily of net deferred losses on cash flow hedge relationships, which totaled approximately (\$7.9) billion and (\$7.8) billion at December 31, 2004 and 2003, respectively, and net unrealized gains related to available-for-sale securities, which totaled approximately \$4.3 billion and \$6.3 billion as of December 31, 2004 and 2003, respectively.

The net deferred losses on cash flow hedge relationships are composed of the period-end mark to fair value (net of taxes) of existing derivative contracts in cash flow hedge relationships and balances related to closed cash flow hedges. As described in "CONSOLIDATED RESULTS OF OPERATIONS — Non-Interest Income (Loss) — Derivative Gains (Losses)," we discontinued applying hedge accounting treatment for a significant amount of our pay-fixed and receive-fixed swaps during 2004. As a result, the December 31, 2004 balance in AOCI is primarily composed of deferred losses related to closed cash flow hedge relationships that will be amortized into Income (expense) related to derivatives, a component of Net interest income, over time. Fluctuations in prevailing market interest rates will have no impact on the balance of AOCI relating to closed cash flow hedges. We estimate that approximately \$1.6 billion (net of taxes) of the \$7.9 billion of hedging losses (of which \$7.9 billion are related to closed cash flow hedges and less than \$0.1 billion are net unrealized losses on open cash flow hedges) in AOCI at December 31, 2004 will be reclassified into earnings during 2005.

Table 39 presents the scheduled amortization of the net deferred losses in AOCI at December 31, 2004, related to closed cash flow hedges, into income over future periods based on certain assumptions that may differ from our expectations of future events or from actual future events. For purposes of this table, a number of hypothetical assumptions were made. It is likely that actual amortization in any given future period will differ from the scheduled amortization, perhaps materially, as we make decisions or changes in market conditions occur that differ from these assumptions. For example, the scheduled amortization for cash flow hedges related to future debt issuances is based on the assumption that we will not repurchase debt and that no other factors affecting debt issuance probabilities will change. In addition, for purchase and sale commitments in cash flow hedge relationships, the scheduled amortization assumes no changes in prepayment activities or other factors affecting the timing of reclassifications.

**Table 39 — Scheduled Amortization of Net Deferred Losses in AOCI to Income Related to Closed Cash Flow Hedge Relationships**

<u>Period of Scheduled Amortization to Income</u>	<u>December 31, 2004</u>	
	<u>Amount</u>	<u>Amount</u>
	<u>(Pre-tax)</u>	<u>(After-tax)</u>
	(dollars in millions)	
2005 .....	\$ (2,477)	\$ (1,610)
2006 .....	(1,967)	(1,279)
2007 .....	(1,461)	(949)
2008 .....	(1,326)	(862)
2009 .....	(1,103)	(717)
2010 to 2014 .....	(2,858)	(1,858)
Thereafter .....	(960)	(624)
Net deferred losses in AOCI related to closed cash flow hedge relationships . . . .	\$ (12,152)	\$ (7,899)
Net deferred losses in AOCI related to open cash flow hedge relationships . . . . .	(38)	(25)
Total AOCI related to cash flow hedge relationships .....	<u>\$ (12,190)</u>	<u>\$ (7,924)</u>

The net unrealized gains related to available-for-sale securities decreased by approximately \$2.0 billion, after-tax, at December 31, 2004 compared to December 31, 2003. During 2004, higher yielding securities that were generally in an unrealized gain position were liquidated or sold. The unpaid principal balance of the mortgage-related and non-mortgage-related securities we held in our Retained portfolio and Cash and investments portfolio that were classified as available-for-sale totaled \$610.1 billion and \$598.5 billion at December 31, 2004 and 2003, respectively.

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

Table 40 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 statutory tax rate (35 percent).

**Table 40 — Average Consolidated Balance Sheets and Rate/Volume Analysis**

	Year Ended December 31,								
	2004			2003			2002		
	Average Balance <sup>(1)(2)</sup>	Interest Income (Expense)	Average Rate <sup>(3)(4)</sup>	Average Balance <sup>(1)(2)</sup>	Interest Income (Expense)	Average Rate <sup>(3)(4)</sup>	Average Balance <sup>(1)(2)</sup>	Interest Income (Expense)	Average Rate <sup>(3)(4)</sup>
	(dollars in millions)								
<b>Interest-earning assets:</b>									
Mortgage loans <sup>(5)</sup>	\$ 61,566	\$ 4,007	6.51%	\$ 63,396	\$ 4,251	6.70%	\$ 61,077	\$ 4,290	7.02%
Mortgage-related securities in the Retained portfolio <sup>(6)</sup>	590,118	28,460	4.82	544,396	29,051	5.34	470,450	30,039	6.39
Total Retained portfolio	651,684	32,467	4.98	607,792	33,302	5.48	531,527	34,329	6.46
Investments <sup>(7)</sup>	81,833	2,716	3.29	94,768	3,246	3.40	91,794	3,693	3.99
Securities purchased under agreements to resell and Federal funds sold	29,996	420	1.40	49,085	550	1.12	29,032	454	1.56
<b>Total interest-earning assets</b>	<u>763,513</u>	<u>35,603</u>	4.66	<u>751,645</u>	<u>37,098</u>	4.93	<u>652,353</u>	<u>38,476</u>	5.89
<b>Interest-bearing liabilities:</b>									
Short-term debt	205,072	(2,908)	(1.39)	226,850	(2,785)	(1.21)	209,551	(4,303)	(2.03)
Long-term debt <sup>(8)</sup>	530,816	(22,950)	(4.32)	478,028	(22,083)	(4.62)	406,802	(21,337)	(5.24)
Total debt securities	735,888	(25,858)	(3.50)	704,878	(24,868)	(3.52)	616,353	(25,640)	(4.15)
Due to Participation Certificate investors	12,401	(708)	(5.71)	26,234	(1,641)	(6.26)	18,110	(1,236)	(6.82)
<b>Total interest-bearing liabilities</b>	<u>748,289</u>	<u>(26,566)</u>	(3.54)	<u>731,112</u>	<u>(26,509)</u>	(3.62)	<u>634,463</u>	<u>(26,876)</u>	(4.23)
Income (expense) related to derivatives <sup>(9)</sup>		100	0.01		(1,091)	(0.15)		(2,075)	(0.32)
Impact of net non-interest bearing funding	15,224	—	0.07	20,533	—	0.10	17,890	—	0.13
<b>Total funding of interest-earning assets</b>	<u>\$763,513</u>	<u>\$(26,466)</u>	(3.46)	<u>\$751,645</u>	<u>\$(27,600)</u>	(3.67)	<u>\$652,353</u>	<u>\$(28,951)</u>	(4.43)
<b>Net interest income/yield</b>	<u>\$ 9,137</u>	1.20		<u>\$ 9,498</u>	1.27		<u>\$ 9,525</u>	1.46	
Fully taxable-equivalent adjustment <sup>(10)</sup>	267	0.03		227	0.03		252	0.04	
<b>Net interest income/yield (fully taxable-equivalent basis)</b>	<u>\$ 9,404</u>	1.24		<u>\$ 9,725</u>	1.30%		<u>\$ 9,777</u>	1.50%	

	2004 vs. 2003 Variance			2003 vs. 2002 Variance		
	Due to			Due to		
	Rate <sup>(11)</sup>	Volume <sup>(11)</sup>	Total Change	Rate <sup>(11)</sup>	Volume <sup>(11)</sup>	Total Change
	(dollars in millions)					
<b>Interest-earning assets:</b>						
Mortgages loans	\$ (123)	\$ (121)	\$ (244)	\$ (199)	\$ 160	\$ (39)
Mortgage-related securities in the Retained portfolio	(2,921)	2,330	(591)	(5,330)	4,342	(988)
Total Retained portfolio	(3,044)	2,209	(835)	(5,529)	4,502	(1,027)
Investments	(98)	(432)	(530)	(563)	116	(447)
Securities purchased under agreements to resell and Federal funds sold	116	(246)	(130)	(155)	251	96
<b>Total interest-earning assets</b>	<u>\$(3,026)</u>	<u>\$ 1,531</u>	<u>\$(1,495)</u>	<u>\$(6,247)</u>	<u>\$ 4,869</u>	<u>\$(1,378)</u>
<b>Interest-bearing liabilities:</b>						
Short-term debt	\$ (406)	\$ 283	\$ (123)	\$ 1,849	\$ (331)	\$ 1,518
Long-term debt	1,472	(2,339)	(867)	2,725	(3,471)	(746)
Total debt securities	1,066	(2,056)	(990)	4,574	(3,802)	772
Due to Participation Certificate investors	133	800	933	110	(515)	(405)
<b>Total interest-bearing liabilities</b>	<u>1,199</u>	<u>(1,256)</u>	<u>(57)</u>	<u>4,684</u>	<u>(4,317)</u>	<u>367</u>
Income (expense) related to derivatives	1,191	—	1,191	984	—	984
<b>Total funding of interest-earning assets</b>	<u>\$ 2,390</u>	<u>\$(1,256)</u>	<u>\$ 1,134</u>	<u>\$ 5,668</u>	<u>\$(4,317)</u>	<u>\$ 1,351</u>
<b>Net interest income</b>	<u>\$ (636)</u>	<u>\$ 275</u>	<u>\$ (361)</u>	<u>\$ (579)</u>	<u>\$ 552</u>	<u>\$ (27)</u>
Fully taxable-equivalent adjustment	38	2	40	9	(34)	(25)
<b>Net interest income/yield (fully taxable-equivalent basis)</b>	<u>\$ (598)</u>	<u>\$ 277</u>	<u>\$(321)</u>	<u>\$(570)</u>	<u>\$ 518</u>	<u>\$(52)</u>

- (1) Excludes mortgage loans and mortgage-related securities traded, but not yet settled.
- (2) For securities classified as available-for-sale, we calculate average balances based on their unpaid principal balance plus their associated deferred fees and costs (e.g., premiums and discounts), but exclude the effects of other-than-temporary impairments. For securities in the Retained portfolio classified as trading, we calculate average balances excluding their mark-to-fair-value adjustments. For securities in the Cash and investments portfolio classified as trading, we calculate average balances based on their fair values.
- (3) May not sum due to rounding.
- (4) Average rates for securities classified as available-for-sale are 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.
- (5) Non-accrual loans are included in average balances.
- (6) Rates calculated on a fully taxable-equivalent basis were 4.86%, 5.37% and 6.43% for the years ended December 31, 2004, 2003 and 2002, respectively, based upon related income of \$28,688 million, \$29,246 million and \$30,253 million, respectively.
- (7) 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.
- (8) Includes current portion of long-term debt.
- (9) Includes amortization of deferred balances related to certain cash flow hedges and the accrual of periodic cash settlements in accordance with the contractual terms of all derivatives in qualifying hedge accounting relationships. See "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES" to our consolidated financial statements for more information.
- (10) Represents the adjustment necessary to calculate the tax-exempt income and yield on a tax equivalent basis. We analyze Net interest income, and the related Net interest yield, on a taxable-equivalent basis. Analysis on a taxable-equivalent basis allows the comparison of ratios related to tax-exempt or tax-advantaged securities to those of fully taxable securities with higher yields.
- (11) 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 in Table 41 present our estimates of the fair value of our recorded assets and liabilities and off-balance sheet financial instruments at December 31, 2004 and 2003.

**Table 41 — Consolidated Fair Value Balance Sheets<sup>(1)</sup>**

	December 31, 2004		December 31, 2003	
	Carrying Amount <sup>(2)</sup>	Fair Value	Carrying Amount <sup>(2)</sup>	Fair Value
	(dollars in billions)			
<b>Assets</b>				
Mortgage loans .....	\$ 61.3	\$ 63.3	\$ 60.2	\$ 62.5
Mortgage-related securities <sup>(3)</sup> .....	603.2	603.4	600.2	600.4
Retained portfolio .....	664.5	666.7	660.4	662.9
Cash and cash equivalents .....	35.3	35.3	23.1	23.1
Investments .....	29.8	29.8	65.4	65.4
Securities purchased under agreements to resell and Federal funds sold .....	32.2	32.2	20.6	20.6
Derivative assets .....	15.3	15.3	16.2	16.2
Guarantee asset for Participation Certificates .....	4.5	5.0	3.7	4.5
Other assets .....	13.7	13.3	14.0	13.2
Total assets .....	\$795.3	\$797.6	\$803.4	\$805.9
<b>Liabilities and minority interest</b>				
Total debt securities, net .....	\$731.7	\$737.0	\$739.6	\$749.8
Guarantee obligation for Participation Certificates .....	4.1	2.1	2.9	2.4
Derivative liabilities .....	0.2	0.2	0.4	0.4
Reserve for guarantee losses on Participation Certificates ...	0.2	—	0.1	—
Other liabilities <sup>(4)</sup> .....	26.2	25.7	27.0	23.9
Minority interests in consolidated subsidiaries .....	1.5	1.7	1.9	2.1
Total liabilities and minority interest .....	763.9	766.7	771.9	778.6
<b>Net assets attributable to stockholders</b>				
Preferred stockholders .....	4.6	4.1	4.6	4.4
Common stockholders .....	26.8	26.8	26.9	22.9
Total net assets .....	31.4	30.9	31.5	27.3
Total liabilities and net assets .....	\$795.3	\$797.6	\$803.4	\$805.9

(1) The consolidated fair value balance sheets do not purport to present our net realizable, liquidation or market value as a whole. Furthermore, amounts we ultimately realize from disposition of assets or settlement of liabilities may vary significantly from the fair values presented.

(2) Carrying amounts equal the amounts reported on our GAAP consolidated balance sheets.

(3) The fair value of Mortgage-related securities reported in this table exceeds the carrying value because the fair value includes PC residuals related to Participation Certificates held in the Retained portfolio that are not recognized under GAAP because such PCs were issued prior to the implementation of FIN 45.

(4) Fair values include estimated income taxes on the difference between the consolidated fair value pre-tax net assets and the consolidated GAAP pre-tax net assets.

The fair value information on the consolidated fair value balance sheets includes the estimated fair values of all items recorded in the consolidated balance sheets prepared in accordance with GAAP, as well as all off-balance sheet financial instruments that represent our assets or liabilities that are not recorded in the GAAP consolidated balance sheets. These off-balance sheet items predominantly consist of the unrecognized guarantee assets and obligations associated with a portion of our 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 consolidated financial statements and insurance contracts on manufactured housing investments. See “CRITICAL ACCOUNTING POLICIES AND ESTIMATES” and “OFF-BALANCE SHEET ARRANGEMENTS” as well as “NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES” and “NOTE 16: FAIR VALUE DISCLOSURES” to the consolidated financial statements for more information on fair values.

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

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

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

#### *Core spread income*

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

#### *Return on risk positions*

The types of interest-rate risk to which we are exposed as a result of our Retained portfolio activities include duration and convexity risk, yield curve risk, volatility risk and basis risk. It is our business policy to actively manage, or hedge, the majority of these risks to keep interest-rate risk exposure within prescribed limits. We do not, however, hedge all interest-rate risk that exists at the time a mortgage is purchased or that arises over its life. Therefore, in the normal course of business, we consistently have limited net exposures to these risks. See “RISK MANAGEMENT — Interest-Rate Risk and Other Market Risks” for more information. Return on risk positions are fair value estimates of the return on all such market risks that we actively hedge, or represents the estimated net gain or loss in fair value of net assets attributable to common stockholders resulting from all net exposures related to these managed risks.

#### *Effect of changes in option-adjusted spread (mortgage-to-debt spread)*

One risk that we do not attempt to hedge or actively manage is mortgage-to-debt spread risk, which is the net option-adjusted spread between mortgage and agency debt sectors. Because we generally hold a substantial portion of our mortgage assets for the long term, we do not believe that periodic fluctuations in mortgage-to-debt net option-adjusted spreads will significantly affect the long-term return of the retained portfolio. The effect of changes in option-adjusted spreads is a fair value estimate of the net unrealized gain or loss in fair value of net assets attributable to common stockholders that results from net option-adjusted spread fluctuations occurring during the period.

#### *Core guarantee fees, net*

Core guarantee fees, net is a fair value estimate of the current period accrual of income from the difference between fees we receive related to the credit guarantee business and associated costs and obligations. Both contractual guarantee fees collected over the life of the credit guarantee portfolio and credit-related delivery fees collected up-front when pools are formed are included. Associated costs are default and capital costs. Core guarantee fees, net represents an estimate of the long-term expected annual income of the credit guarantee portfolio, based on current portfolio characteristics and market conditions.

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

Change in fair value of guarantee portfolio represents the estimated impact on the fair value of the credit guarantee business of additions to the portfolio (net difference between the fair values of the guarantee asset and guarantee obligation recorded when pools are formed) plus the effect of changes in interest rates and other market factors (e.g., impact of the passage of time on cash flow discounting and changes in projections of the future credit outlook) on the fair value of the existing credit guarantee portfolio.

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

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

#### *Fee income*

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

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

We believe fair value measures provide an important view of our business economics and risks because fair value takes a consistent approach to the representation of all financial assets and liabilities, rather than an approach that combines historical cost and fair value techniques, as is the case with our GAAP-based consolidated financial statements. The consolidated fair value balance sheet is an important component of our risk management processes as we use daily estimates of the changes in fair value to calculate our PMVS and duration gap measures.

At December 31, 2004, the fair value of net assets (net of tax effect) was \$30.9 billion, a \$3.6 billion, or 13 percent, increase from December 31, 2003. For the same period, the fair value of net assets attributable to common stockholders (representing the fair value balance sheet total net assets less the fair value of net assets attributable to preferred stockholders) was \$26.8 billion, a \$3.9 billion, or 17 percent, increase from December 31, 2003. The fair value of net assets attributable to common stockholders, before common dividends and capital transactions, increased by \$4.7 billion, or 21 percent, from December 31, 2003, a return that exceeds our long-term expectations.

The primary contributors to the increase in fair value of net assets in 2004 were core spread income from the Retained portfolio, fee-based income (including guarantee fees and credit fees related to our PCs and Structured Securities) and a gain in the fair value of our guarantees related to our outstanding PCs and Structured Securities. The fair value increase also included gains resulting from tighter mortgage-to-debt option-adjusted spreads. In 2004, we made improvements to our fair value estimation methodologies, including refinements that better capture available market data relevant to determining the fair value of our debt. The implementation of these improvements resulted in net increases in the fair value of total net assets of approximately \$0.6 billion (after-tax).

The most significant change occurred in the fourth quarter of 2004 when we began using newly available market prices received from broker/dealers and reliable third-party providers for the valuation of a greater portion of our debt instruments. Previously, the calculation of the fair value of these instruments was based primarily on an internal model using available market inputs. The effect of the change was an increase of approximately \$0.4 billion (after-tax) to the fair value of net assets.

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## VOLUME STATISTICS

Table 42 summarizes purchases into our Total mortgage portfolio and securitization activity for the periods presented. See “OUR RETAINED AND TOTAL MORTGAGE PORTFOLIOS” for more information about the Total mortgage portfolio.

**Table 42 — Volume Statistics<sup>(1)</sup>**

	Year Ended December 31,					
	2004	2003		2002		
	(dollars in millions)					
New business purchases <sup>(2)(3)</sup>						
Mortgage purchases						
Single-family:						
30-year fixed-rate <sup>(4)</sup>	\$220,905	60%	\$377,847	53%	\$315,375	58%
15-year fixed-rate	72,754	20	239,684	34	153,346	28
ARMs/Floating-Rate <sup>(5)</sup>	50,969	14	52,556	7	44,917	8
Balloon/Resets	9,658	3	29,714	4	18,531	4
FHA/VA <sup>(6)</sup>	319	—	1,417	—	845	—
RHS	207	—	265	—	180	—
Total single-family	354,812	97	701,483	98	533,194	98
Multifamily:						
Conventional	12,712	3	15,292	2	10,654	2
Total multifamily	12,712	3	15,292	2	10,654	2
Total mortgage purchases	\$367,524	100%	\$716,775	100%	\$543,848	100%
Non-Freddie Mac mortgage-related securities purchased for Structured Securities:						
Alternative collateral deals <sup>(7)</sup>						
Prime and other	\$ 7,205		\$ 3,918		\$ 14,507	
Structured Securities backed by Ginnie Mae Certificates	85		539		265	
Total Non-Freddie Mac mortgage-related securities purchased for Structured Securities	\$ 7,290		\$ 4,457		\$ 14,772	
Non-Freddie Mac mortgage-related securities purchased into the Retained portfolio:						
Fannie Mae	\$ 4,038		\$ 47,806		\$ 45,798	
Ginnie Mae	—		166		820	
Total agency mortgage-related securities	4,038		47,972		46,618	
Single-family and other mortgage-related securities	102,914		54,109		36,004	
Commercial mortgage backed securities	10,878		10,588		8,282	
Mortgage revenue bonds	1,944		963		863	
Manufactured housing	—		—		318	
Total non-agency mortgage-related securities	115,736		65,660		45,467	
Total Non-Freddie Mac mortgage-related securities purchased into the Retained portfolio	\$119,774		\$113,632		\$ 92,085	
Total new business purchases	\$494,588		\$834,864		\$650,705	
Mortgage purchases with credit enhancements <sup>(8)(9)</sup>	19%		16%		20%	
Percentage of refinance mortgage purchases	60		81		74	
Average loan-to-value of single-family purchases:						
Refinance mortgages	67		66		67	
Purchase money mortgages	78		79		79	
Mortgage liquidations <sup>(10)</sup>	\$401,029		\$719,608		\$464,960	
Mortgage liquidation rate	28%		55%		40%	
Securities Settlements:						
Single-family PCs	\$360,933		\$705,450		\$543,716	
Multifamily PCs	4,175		8,337		3,596	
Total	\$365,108		\$713,787		\$547,312	
Resecuritization activity <sup>(11)</sup>	\$215,430		\$298,118		\$331,672	
Freddie Mac securities repurchased into the Retained portfolio <sup>(12)</sup>	\$ 96,235		\$266,989		\$192,817	

- (1) Based on unpaid principal balances.
- (2) Based on our Total mortgage portfolio. Excludes mortgage loans and mortgage-related securities traded, but not yet settled.
- (3) Includes certain mortgage-related securities that have been transferred from the Investments caption on the consolidated balance sheets.
- (4) Also includes 40 and 20 year fixed-rate mortgages.
- (5) Includes ARMs with 1-, 3-, 5-, 7- and 10-year initial fixed-rate periods.
- (6) Excludes FHA/VA loans that may be collateral for alternative collateral deals.
- (7) Prior to 2004, alternative collateral deals included Structured Securities backed by non-agency securities, which were primarily backed by subprime mortgage loans; and to a lesser extent, FHA/VA loans and home equity loans. Beginning in 2004, alternative collateral deals included Structured Securities backed by non-agency securities, which were backed by a mixture of subprime and other (i.e., prime) mortgage loans.
- (8) Credit enhancements include loans for which the lender or a third party has retained a portion of the 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.
- (9) Excludes Structured Securities backed by Ginnie Mae Certificates.
- (10) Excludes the effect of sales of non-Freddie Mac mortgage-related securities. Subsequent to the issuance of our Information Statement dated September 24, 2004, we reclassified certain amounts related to credit impairments, increasing the dollar amount of liquidations for 2003 and 2002.
- (11) Includes activity where we have resecuritized PCs and other previously issued Structured Securities related to multi-class Structured Securities, primarily REMICs, as well as principal-only strips and other Structured Securities, backed by non-Freddie Mac mortgage-related collateral. These amounts exclude resecuritized PCs into single-class securities.
- (12) Excludes the repurchase of PCs and Structured Securities held by us in connection with our PC market-making and support activities that historically have been reflected in the Investments caption on the consolidated balance sheets. As previously disclosed in our Information Statement Supplement dated September 24, 2004, we ceased our PC market-making and support activities accomplished through our Securities Sales & Trading Group business unit and our external Money Manager program during the fourth quarter of 2004.

Our Total new business purchases, which consist of mortgage loans and non-Freddie Mac mortgage-related securities that are purchased for our Retained portfolio, as well as to become collateral for issued PCs and Structured Securities, totaled \$494,588 million, \$834,864 million and \$650,705 million during 2004, 2003 and 2002, respectively. Our Total new business purchases during 2003 were the highest in our history.

Interest rates for fixed-rate mortgages declined during 2002 and through the first half of 2003, resulting in a surge of mortgage refinancing activity during both of these years. In the latter half of 2003, interest rates for fixed-rate mortgages rose from the low point reached in mid-2002, but still ended the year at relatively low levels compared to historical standards. During 2004, interest rates were less volatile than in prior years.

Total mortgage purchases were \$367,524 million, \$716,775 million and \$543,848 million during 2004, 2003 and 2002, respectively. Mortgage lenders tend to deliver more fixed-rate residential mortgages to the GSEs as compared to ARM/floating-rate products. 30-year and 15-year fixed-rate mortgages represented 80 percent, 87 percent and 86 percent of our Total mortgage purchases for 2004, 2003 and 2002. Fixed-rate mortgage volume peaked in 2002 because declining interest rates increased the number of borrowers that qualified for and chose this mortgage product. ARMs/Floating-Rate and Balloon/Resets mortgages represented 17 percent, 11 percent and 12 percent of our Total mortgage purchases for 2004, 2003 and 2002, respectively, highlighting borrowers increasing preference for ARMs/Floating-Rate products.

Total non-Freddie Mac mortgage-related securities purchased were \$127,064 million, \$118,089 million and \$106,857 million during 2004, 2003 and 2002, respectively. During 2004, the mix of purchases changed significantly compared to 2003 and 2002. Specifically, we purchased significantly more non-agency single-family and other mortgage-related securities due to a number of factors described in “CONSOLIDATED BALANCE SHEETS ANALYSIS — Retained Portfolio,” partially offset by a reduction in the purchase of Fannie Mae securities. In addition, during 2003 and 2004, part of our strategy to support PC price performance included the purchase and sale of other agency securities.

The liquidation rate on the Total mortgage portfolio totaled 28 percent, 55 percent and 40 percent for the years ended December 31, 2004, 2003 and 2002, respectively. The relatively higher liquidation rates in 2003 and 2002 compared to 2004 reflect accelerated borrower prepayments due to low fixed interest rates during 2002 and the first half of 2003.

The percentage of purchases with credit enhancements totaled 19 percent, 16 percent and 20 percent for the years ended December 31, 2004, 2003 and 2002, respectively. Credit enhancements primarily include third-party, primary loan-level mortgage insurance, third-party pool issuance or other arrangements in which the third party has retained a portion of the default risk by pledging collateral or agreeing to accept losses on loans that default. The drop in purchases with credit enhancements in 2003 compared to 2004 and 2002 was due primarily to a decline in the number of loans purchased that are covered by primary mortgage insurance, or PMI, which is not required for mortgage loans with low loan-to-value ratios. Purchases in 2003 had the lowest weighted average loan-to-value ratio for the three years presented (*i.e.*, 68 percent for 2003 compared to 71 percent and 70 percent for 2004 and 2002, respectively) because the percentage of refinance mortgage purchases was highest in 2003 of the three years presented (*i.e.*, 81 percent for 2003 compared to 60 percent and 74 percent for 2004 and 2002, respectively). Loan-to-value ratios tend to be lower for refinance mortgages as compared to purchase money mortgages due to the strong house price appreciation experienced in recent years. Our future ability and desire to utilize credit enhancements will depend on our 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 Risks — *Mortgage Credit Risk — Mortgage Credit Risk Management Strategies*” for more information.

We generate a significant portion of our mortgage purchase volume through several key mortgage lenders that have entered into special business arrangements with us. See “BUSINESS — Credit Guarantee Activities” for information about these relationships and consequent risks.

For a discussion of Resecuritization Activity, see “CONSOLIDATED RESULTS OF OPERATIONS — Resecuritization Fees.”

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Table 43 summarizes the characteristics of the single-family loan purchases defined as “New business purchases” in “Table 42 — Volume Statistics” by original loan-to-value ratio range, credit score, loan purpose, property type and occupancy type. See “RISK MANAGEMENT — Credit Risks — *Mortgage Credit Risk*” for definitions of those risk characteristics.

**Table 43 — Characteristics of Purchases into the Single-Family Mortgage Portfolio<sup>(1)</sup>**

<u>Original Loan-to-Value Ratio Range<sup>(2)</sup></u>	<u>Year Ended December 31,</u>		
	<u>2004</u>	<u>2003</u>	<u>2002</u>
0% to 60% . . . . .	23%	29%	25%
Above 60% to 70% . . . . .	16	19	16
Above 70% to 80% . . . . .	46	40	43
Above 80% to 90% . . . . .	8	7	9
Above 90% to 95% . . . . .	6	4	6
Above 95% . . . . .	<u>1</u>	<u>1</u>	<u>1</u>
Total . . . . .	<u>100%</u>	<u>100%</u>	<u>100%</u>
Weighted average original loan-to-value ratio . . . . .	71%	68%	70%
<u>Credit Score<sup>(3)</sup></u>			
740 and above . . . . .	41%	49%	44%
700 to 739 . . . . .	24	23	24
660 to 699 . . . . .	20	17	18
620 to 659 . . . . .	11	8	9
Less than 620 . . . . .	4	3	4
Not Available . . . . .	—	—	<u>1</u>
Total . . . . .	<u>100%</u>	<u>100%</u>	<u>100%</u>
Weighted average credit score . . . . .	719	729	722
<u>Loan Purpose<sup>(3)</sup></u>			
Purchase . . . . .	40%	19%	26%
Cash-out refinance . . . . .	27	26	29
Other refinance . . . . .	<u>33</u>	<u>55</u>	<u>45</u>
Total . . . . .	<u>100%</u>	<u>100%</u>	<u>100%</u>
<u>Property Type<sup>(3)</sup></u>			
1 unit . . . . .	97%	98%	98%
2-4 units . . . . .	<u>3</u>	<u>2</u>	<u>2</u>
Total . . . . .	<u>100%</u>	<u>100%</u>	<u>100%</u>
<u>Occupancy Type<sup>(3)</sup></u>			
Primary residence . . . . .	92%	95%	94%
Second/vacation home . . . . .	4	3	3
Investment . . . . .	<u>4</u>	<u>2</u>	<u>3</u>
Total . . . . .	<u>100%</u>	<u>100%</u>	<u>100%</u>

- (1) Based on purchase activity related to the single-family mortgage portfolio (excluding non-Freddie Mac mortgage-related securities, alternative collateral deals and that portion of Structured Securities that is backed by Ginnie Mae Certificates), which totaled \$355 billion, \$701 billion and \$533 billion at December 31, 2004, 2003 and 2002, respectively.
- (2) Our charter requires that mortgage loans we purchase with loan-to-value ratios above 80 percent have mortgage insurance for the portion of the mortgage loan balance and that exceeds 80 percent of the property’s value or other credit protections.
- (3) See “RISK MANAGEMENT — Credit Risks — *Mortgage Credit Risk*” for more information.

Single-family mortgage loans purchased with loan-to-value ratios above 80 percent accounted for 15 percent, 12 percent and 16 percent for the years ended December 31, 2004, 2003 and 2002, respectively. In addition, the weighted average loan-to-value ratio of the mortgage loans purchased decreased from 70 percent for the year ended December 31, 2002 to 68 percent for the year ended December 31, 2003 and increased to 71 percent for the year ended December 31, 2004. The lower loan-to-value ratios in 2002 and 2003 as

compared to 2004 are primarily the result of house-price appreciation combined with the surge in refinance activity in these years as a result of the reduction in interest rates.

The proportion of mortgage loans purchased resulting from refinancing transactions decreased from a total of 81 and 74 percent for the years ended December 31, 2003 and 2002, respectively, to 60 percent for the year ended December 31, 2004. This decrease in refinance activity is a result of the higher interest rates experienced during the second half of 2003 and 2004.

The quality of mortgage loans purchased continued to be strong. The strong credit quality of borrowers is evidenced by the high average credit scores of mortgage loans purchased of 719, 729 and 722 for the years ended December 31, 2004, 2003 and 2002, respectively. Credit scores are ranked on a scale of approximately 300 to 850 points. The slight decrease in the average credit score in 2004 resulted from a decline in the proportion of refinance mortgage loans, which generally have higher credit scores than purchase mortgage loans. The proportion of one-unit properties in our mortgage loan purchase volume remained stable over the past three years, accounting for 97 percent for the year ended December 31, 2004, a slight decrease from 98 percent for the years ended December 31, 2003 and 2002. The proportion of primary and secondary residences in our mortgage loan purchase volume remained stable over the past three years, accounting for 96 percent, 98 percent and 97 percent in 2004, 2003 and 2002, respectively.

## LIQUIDITY AND CAPITAL RESOURCES

### Liquidity

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

- issuances of long-term and short-term debt;
- receipts of principal and interest on securities we hold or mortgages we have securitized and sold;
- sales of securities we hold, particularly those in the Cash and investments portfolio;
- borrowings against mortgage-related securities and other investment securities we hold;
- other cash flows from operating activities including guarantee activities; and
- issuances of common and preferred stock.

We measure our cash flow position on a daily basis, netting uses of cash (principally, the settlement of mortgage and non-mortgage investment security purchases, principal and interest payments on debt and mortgage securities, net payments on derivative instruments and other operating cash flows) with sources of cash (principally, the settlement of debt borrowings and principal and interest receipts on mortgage and non-mortgage investment securities held in portfolio and mortgages we have securitized and sold). The net cash position is managed over a rolling forecasted period of 90 days, so that the amount of debt funding needed to cover expected negative balances does not adversely affect our overall funding levels. We maintain alternative sources of liquidity to allow normal operations for 90 days and comply with the principles of sound liquidity management set forth by the Basel Committee on Banking Supervision. See “BUSINESS — Regulatory and Governmental Matters — Other Regulatory Matters” for additional information on the Basel Committee on Banking Supervision. We ensure that three months’ worth of liquidity is maintained (based on internal models) assuming we have no access to new-issue public debt markets. This daily management of our liquidity is in accordance with the Liquidity Management and Contingency Planning voluntary commitment. See “VOLUNTARY COMMITMENTS” for further information.

To refinance maturing debt, we depend on the continuing willingness of investors to purchase our debt securities (for more information regarding the maturity profile of our outstanding debt securities, see “Table 44 — Total Capitalization”). Our inability to prepare timely consolidated financial statements, as discussed in “RISK MANAGEMENT — Operational Risks,” or any change in legislative or regulatory exemptions as described in “BUSINESS — Regulatory and Governmental Matters,” could adversely affect our access to some debt investors, thereby potentially increasing our debt funding costs. However, because of our financial performance and our regular and significant participation as an issuer in the funding markets, our sources of liquidity have remained adequate to meet our needs and we anticipate that they will continue to do so. Our ability to issue common stock, preferred stock or subordinated debt may be limited until we have returned to timely financial reporting.

Under our charter, the Secretary of the Treasury has discretionary authority to purchase our obligations up to a maximum of \$2.25 billion principal balance outstanding at any one time. However, we do not rely on this authority as a source of liquidity to meet our obligations. See “BUSINESS — Regulatory and Governmental Matters” for more information.

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 of or a net use of cash. For example, depending on the prevailing interest-rate environment, interest-rate swap agreements could cause us either to make interest payments to counterparties or to receive interest payments from counterparties. Purchased options require us to pay a premium while written options allow us to receive a premium.

Also, the legal proceedings discussed in “NOTE 13: LEGAL CONTINGENCIES” to the consolidated financial statements may result in a use of cash.

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### Total Capitalization

Table 44 sets forth our capitalization at the dates presented. We engage in transactions and issue or repurchase debt obligations on an ongoing basis, all of which cause our total capitalization to change. Therefore, on any date after December 31, 2004, our total capitalization will differ (perhaps substantially) from the figures contained in this capitalization table.

**Table 44 — Total Capitalization**

	December 31,	
	2004	2003
	(dollars in millions)	
Total debt securities, net:		
Senior debt, due within one year:		
Short-term debt securities . . . . .	\$196,639	\$212,035
Current portion of long-term debt . . . . .	<u>85,664</u>	<u>83,227</u>
Senior debt, due within one year . . . . .	282,303	295,262
Senior debt, due after one year . . . . .	443,772	438,738
Subordinated debt, due after one year <sup>(1)</sup> . . . . .	<u>5,622</u>	<u>5,613</u>
Senior and subordinated debt, due after one year . . . . .	<u>449,394</u>	<u>444,351</u>
Total debt securities, net . . . . .	731,697	739,613
Total stockholders' equity . . . . .	<u>31,416</u>	<u>31,487</u>
Total capitalization . . . . .	<u>\$763,113</u>	<u>\$771,100</u>

(1) The year-over-year increase in the balance of subordinated borrowings results from principal accretion related to zero-coupon subordinated debt.

See "NOTE 8: DEBT SECURITIES AND SUBORDINATED BORROWINGS" and "NOTE 9: STOCKHOLDERS' EQUITY" to the consolidated financial statements for further information.

### Debt Securities

We finance our purchases of mortgage loans, mortgage-related securities and non-mortgage-related securities held in our Retained portfolio and Cash and investments portfolio primarily through the issuance of both long-term and short-term debt. Table 45 below summarizes the par value of our debt security issuances based on settlement dates during 2004 and 2003. We seek to maintain consistent, active funding programs that promote investor confidence and high-quality coverage by market makers. By diversifying our investor base and the types of debt securities we offer, we enhance our ability to maintain continuous access to the debt markets under a variety of conditions.

**Table 45 — Debt Security Issuances by Product<sup>(1)</sup>**

	Year Ended December 31,	
	2004	2003
	(dollars in millions)	
Short-term debt:		
Short-term Reference Bills <sup>®</sup> and discount notes <sup>(2)</sup> . . . . .	\$793,462	\$ 779,004
Medium-term Notes <sup>(2)</sup> . . . . .	<u>191</u>	<u>5,610</u>
Total short-term debt . . . . .	793,653	784,614
Long-term debt:		
Medium-term Notes . . . . .	150,859	213,924
U.S. dollar denominated Reference Notes <sup>®</sup> . . . . .	40,000	54,000
€Reference Notes <sup>®</sup> . . . . .	<u>8,680</u>	<u>4,347</u>
Total long-term debt . . . . .	<u>199,539</u>	<u>272,271</u>
Total debt securities issued . . . . .	<u>\$993,192</u>	<u>\$1,056,885</u>

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

(2) Amounts for 2003 have been revised to present additional detail and to conform with the 2004 presentation.

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**Short-Term Debt.** We raise funds to meet our operating cash needs primarily through the issuance of Reference Bills® securities and other discount notes, which are short-term instruments with maturities of one year or less that are sold on a discounted basis, paying only principal at maturity. Our Reference Bills® program consists of large issues of short-term debt that we auction to dealers through the Internet on a regular schedule. We currently auction Reference Bills® securities with one-, three- and six-month maturities weekly. We auction Reference Bills® securities with 12-month maturities every four weeks. We issue discount notes with maturities ranging from one day to one year in response to investor demand and our cash needs.

Short-term debt also includes certain Medium-term Notes that have original maturities of one year or less.

**Long-Term Debt.** We issue long-term debt primarily through our Medium-term Notes program and our Reference Notes® securities program. Medium-term Notes have a variety of structures, including callable and non-callable fixed-rate securities, zero coupon securities and variable-rate securities. Reference Notes® securities are regularly issued non-callable fixed-rate securities.

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

**Reference Notes®.** Through our Reference Notes® securities program, we sell large issues of long-term debt that provide investors worldwide with a high-quality, liquid investment vehicle. Some of our Reference Notes® securities are sold through Internet auctions. Newly issued Reference Notes® securities have maturities ranging from two through ten years. We primarily issue securities denominated in U.S. dollars, although we also issue securities denominated in various other currencies, particularly Euros. We hedge our exposure to changes in foreign currency exchange rates by entering into swap transactions that effectively convert foreign-denominated obligations to U.S. dollar denominated obligations. See “RISK MANAGEMENT — Interest-Rate Risk and Other Market Risks — *Sources of Interest-Rate Risk and Other Market Risks*” for more information.

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

**Subordinated Debt.** In October 2000, we announced plans to initiate periodic issuances of subordinated debt securities, which we refer to as Freddie SUBS® securities, as part of a series of voluntary commitments regarding our financial operations and disclosures designed to further strengthen our transparency, capital adequacy and market discipline. The Freddie SUBS® program is in addition to the subordinated debt issued prior to October 2000. During 2001 and 2002, we completed a total of four offerings of Freddie SUBS® that provided approximately \$5.5 billion in net proceeds. During 2004 and 2003, we did not issue any Freddie SUBS®. Our ability to issue subordinated debt may be limited until we return to timely financial reporting. See “VOLUNTARY COMMITMENTS” for additional information.

**Financing Calendars.** Annually, we publish financing calendars for the upcoming year, which are 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. All Reference Notes® securities, €Reference Notes® securities and Reference Bills® securities issued during 2004 and the first five months of 2005 were issued in accordance with our previously announced financing calendars.

Our financing calendars underscore our goal of aligning our interests with investors while also ensuring that we have the flexibility to offer the marketplace securities of the appropriate size and maturity. In addition, we have supplemented our calendars by publishing the “Quarterly Funding Announcement,” or QFA, which promotes additional transparency and predictability by detailing our expected funding activity for the upcoming quarter. We also publish detailed funding summaries on a monthly basis, which outline our funding activity for the previous month. The QFA and the monthly funding summaries are available on our website, [www.FreddieMac.com](http://www.FreddieMac.com). (We are providing this Internet address solely for the information of interested persons. We do not intend this Internet address to be an active link and are not using references to this

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Internet address here or elsewhere in this Information Statement to incorporate additional information into this Information Statement.)

By adhering to our financing calendars, we are able to provide our debt investors with a predictable source of investment opportunities. However, there is no assurance that we will be able to continue to adhere to our financing calendars in the future. In order to continue our debt offerings as scheduled and properly manage our asset/liability mix, we regularly conduct repurchases of outstanding debt securities. Our repurchase operations support the transparency, liquidity and predictability of Reference Notes® securities, €Reference Notes® securities and callable debt securities. During 2004 and 2003, we repurchased approximately \$9.0 billion and \$24.8 billion, respectively, of our outstanding Reference Notes® securities and €Reference Notes® securities. In addition, primarily as a response to declining interest rates, we called approximately \$120.0 billion and \$153.0 billion of our higher-rate long-term callable debt during 2004 and 2003, respectively. From time to time, we may also enter into transactions in which we exchange newly issued debt securities for similar outstanding debt securities held by investors. These transactions are not accounted for as repurchases, but rather as debt exchanges.

**Credit Ratings.** Our ability to access the capital markets and other sources of funding, as well as our cost of funds, are highly dependent upon our credit ratings. Table 46 indicates our credit ratings at May 23, 2005.

**Table 46 — Freddie Mac Credit Ratings**

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

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

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

In addition to the ratings described in Table 46, Standard & Poor's, or S&P, provides a "Risk-To-The-Government" rating that measures our ability to meet our debt obligations and the value of our franchise in the absence of any implied government support. Our "Risk-To-The-Government" rating was AA- at May 23, 2005. Moody's also provides a "Bank Financial Strength" rating that represents Moody's opinion of our intrinsic safety and soundness and, as such, excludes certain external credit risks and credit support elements. Ratings under this measure range from A, the highest, to E. Our "Bank Financial Strength" rating was A- at May 23, 2005.

### *Equity Securities*

During the first five months of 2005 and all of 2004 and 2003, we did not issue, redeem or repurchase any equity securities, other than transfers of previously issued treasury stock under our stock compensation plans. During 2002, we redeemed \$287 million of 6.125 percent preferred stock issued in November 1996, and effectively replaced it with a 5.81 percent perpetual non-cumulative preferred stock issuance with a redemption value of \$300 million, resulting in additional net cash proceeds to us of approximately \$13 million. We repurchased approximately 9.1 million common shares during 2002 for approximately \$555 million.

### *Cash and Investments Portfolio*

We maintain a Cash and investments portfolio that is important to our financial management and our ability to provide liquidity and stability to the mortgage market. At December 31, 2004, the investments in this portfolio consisted of liquid non-mortgage-related securities that could be sold or financed to:

- protect against temporary disruptions in our ability to obtain funding for our business operations;
- manage recurring cash flows and meet other cash management needs;

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- temporarily deploy capital until the capital can be redeployed into Retained portfolio investments or credit guarantee business opportunities;
- 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.

The non-mortgage-related securities in the Cash and investments portfolio consist principally of asset-backed securities and other marketable assets that can be readily converted to cash. During 2004, we adjusted the investment strategy for the Cash and investments portfolio and, as a result, this portfolio did not hold corporate debt securities or preferred stock at December 31, 2004. 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 Risks — *Institutional Credit Risk*” for more information.

At December 31, 2003, the Cash and investments portfolio included certain mortgage-related securities that were not included in the Retained portfolio since they were acquired in conjunction with the PC market-making and support activities conducted through our Securities Sales & Trading Group business unit and external Money Manager program, both of which ceased operations during the fourth quarter of 2004. Consequently, we held no mortgage-related securities in the Cash and investments portfolio at December 31, 2004, compared to \$32.8 billion at December 31, 2003. In addition, our Securities Sales & Trading Group business unit and external Money Manager program held approximately \$8.3 billion of securities purchased under agreements to resell at December 31, 2003, which we subsequently disposed of during 2004. For additional information on our Cash and investments portfolio, see “CONSOLIDATED BALANCE SHEETS ANALYSIS — Cash and Investments.”

### **Contractual Obligations**

“Table 47 — Specified Contractual Obligations by Year (at December 31, 2004)” includes aggregated information about the listed categories of our contractual obligations. These contractual obligations affect our short- and long-term liquidity and capital resource needs. Table 47 includes information about undiscounted future cash payments due under these contractual obligations, aggregated by type of contractual obligation, including the contractual maturity profile of our consolidated debt securities and other liabilities reported on our consolidated balance sheets and our operating leases at December 31, 2004. The timing of actual future payments may differ from those presented in this table due to a number of factors, including discretionary debt repurchases. Our contractual obligations include other purchase obligations that are enforceable and legally binding. For purposes of the table, purchase obligations are included through the termination date specified in the respective agreements, even if the contract is renewable. Many of the purchase agreements for goods or services include clauses that would allow us to cancel the agreement prior to the expiration of the contract within a specified notice period; however, the table includes such obligations without regard to such termination clauses (unless actual notice of our intention to terminate the agreement has been communicated to the counterparty).

Table 47 excludes guarantee obligations, which represent our obligations to stand ready to perform under our guarantees of the payment of principal and interest of PCs and Structured Securities, as the amount and timing of payments under these arrangements are generally contingent upon the occurrence of future events. The liabilities on our consolidated balance sheets associated with our guarantee obligations are included in the caption Guarantee obligation for Participation Certificates. See “NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES” to the consolidated financial statements for additional information about our guarantee obligations.

The funding policy for our tax-qualified defined benefit pension plan, or Pension Plan, is generally to contribute an amount equal to at least the minimum required contribution, if any, but no more than the maximum amount deductible for federal income tax purposes each year. Based on a preliminary analysis, we currently believe that under applicable law no minimum contribution will be required and no tax-deductible contribution will be permitted for 2005. Therefore, we do not currently expect to contribute to our Pension

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Plan in 2005. For additional information regarding our retirement benefit obligations see “NOTE 15: EMPLOYEE BENEFITS” to the consolidated financial statements.

With the exception of purchase commitments that are accounted for as derivatives, derivative transactions that may require cash settlement in future periods are not reflected on Table 47. See “Table 54 — Derivative Fair Values and Maturities,” which describes the notional amount and fair value for each derivative type and the maturity profile of the positions in “RISK MANAGEMENT — Interest-Rate Risk and Other Market Risks.”

Dividend payments on preferred stock are not reflected on Table 47, since all classes of preferred stock are non-cumulative. See “NOTE 9: STOCKHOLDERS’ EQUITY” to the consolidated financial statements for additional information.

**Table 47 — Specified Contractual Obligations by Year (at December 31, 2004)**

	<u>Total</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>Thereafter</u>
	(dollars in millions)						
Long-term debt securities <sup>(1)</sup> . . . . .	\$551,707	\$ 83,625	\$83,447	\$64,838	\$46,092	\$55,574	\$218,131
Short-term debt securities <sup>(1)(2)</sup> . . . . .	196,639	196,639	—	—	—	—	—
Other liabilities reflected on our consolidated balance sheets:							
Due to Participation Certificate investors . . . . .	13,654	13,654	—	—	—	—	—
Accrued interest payable <sup>(3)</sup> . . . . .	7,329	7,329	—	—	—	—	—
Other contractual liabilities <sup>(4)(5)</sup> . . . . .	3,482	1,625	842	629	162	80	144
Purchase obligations:							
Purchase commitments <sup>(6)</sup> . . . . .	23,394	23,394	—	—	—	—	—
Other purchase obligations . . . . .	139	81	23	19	15	—	1
Operating lease obligations . . . . .	106	17	17	16	10	9	37
Total specified contractual obligations . . . . .	<u>\$796,450</u>	<u>\$326,364</u>	<u>\$84,329</u>	<u>\$65,502</u>	<u>\$46,279</u>	<u>\$55,663</u>	<u>\$218,313</u>

- (1) The amounts presented for long-term debt securities exclude net premiums, discounts, and foreign-currency-related and hedging-related basis adjustments of \$16,649 million at December 31, 2004. Callable debt is included in this table at its contractual maturity. For additional information about long-term and short-term debt securities, see “NOTE 8: DEBT SECURITIES AND SUBORDINATED BORROWINGS” to the consolidated financial statements.
- (2) Includes unamortized discounts and premiums.
- (3) Accrued interest payable primarily represents the accrual of interest on our short-term and long-term debt securities, as well as the accrual of periodic cash settlements in accordance with the contractual terms of all derivatives, netted by counterparty as permitted by GAAP.
- (4) Other contractual liabilities primarily represent future cash payments due under our contractual obligations to make delayed equity contributions to low-income housing tax credit, or LIHTC, partnerships that are unconditional and legally binding.
- (5) Accrued obligations related to our defined benefit pension plans and executive deferred compensation plan are included in the Total and 2005 columns. However, the timing of payments due under these obligations is uncertain. See “NOTE 15: EMPLOYEE BENEFITS” to the consolidated financial statements for additional information.
- (6) Purchase commitments represent our obligations to purchase mortgage loans and mortgage-related securities from third parties. The majority of purchase commitments included in this caption are accounted for as derivatives in accordance with SFAS 133.

## Capital Resources

We manage our capital resources to provide attractive returns on our common equity, while maintaining sufficient capital to satisfy regulatory capital requirements and assuring that capital is available to absorb unforeseen losses that might arise in fulfilling our obligations and conducting our business programs.

Table 48 summarizes the components of our Core capital as of the dates presented. Core capital excludes AOCI consistent with our regulatory capital requirements, which are described under “*Capital Adequacy*” below.

**Table 48 — Summary of Core Capital**

	December 31,	
	2004	2003
	(dollars in millions)	
Common stock, at par value . . . . .	\$ 152	\$ 152
Preferred stock, at redemption value . . . . .	4,609	4,609
Additional paid-in capital . . . . .	873	814
Retained earnings . . . . .	30,728	28,837
Treasury stock, at cost . . . . .	(1,353)	(1,427)
Core capital . . . . .	<u>\$35,009</u>	<u>\$32,985</u>

### *Capital Transactions*

During 2004 and 2003, we added approximately \$2.0 billion and \$4.0 billion, respectively, to Core capital primarily from Net income, partially offset by the payment of common and preferred stock dividends.

Our Board of Directors approved a dividend per common share of \$0.35 for first quarter 2005, an increase of 17 percent over the quarterly dividend in 2004. The dividend per common share was \$0.30 for each quarter in 2004, an increase of 15 percent over the \$0.26 quarterly dividend paid each quarter during 2003. We paid a quarterly dividend per common share of \$0.22 in 2002. Dividends declared and paid in any quarter will be determined by our Board of Directors after considering our capital position and earnings and growth prospects, among other factors.

In addition, under the capital monitoring framework established by OFHEO in January 2004, we are required to obtain prior written approval from the Director of OFHEO before engaging in certain capital transactions, including the repurchase of any shares of common stock, redemption of any preferred stock or payment of preferred stock dividends above stated contractual rates. We also must submit a written report to the Director of OFHEO after the declaration, but before the payment, of any dividend on our common stock. The report must contain certain information on the amount of the dividend, the rationale for the payment and the impact on our capital surplus.

As we return to timely financial reporting, in periods when we are adequately capitalized and attractive investment opportunities are not available, we will consult with OFHEO and consider options to return capital to our stockholders through dividends or common stock repurchases. The amount of capital available to distribute to our stockholders will be affected primarily by our capital position and earnings and growth prospects, among other factors.

All repurchases of our common stock have been made as part of the stock repurchase plan approved by our Board of Directors on September 5, 1997. This plan allows repurchases of common stock not to exceed five percent of shares outstanding as of September 5, 1997, which was approximately 34 million shares. At December 31, 2004, approximately 13 million common shares remained available for repurchase under this plan. During 2003, 2004 and the first five months of 2005, we did not repurchase any common shares. We repurchased approximately 9.1 million shares of common stock during 2002 for approximately \$555 million. In addition, we may not be able to issue or redeem preferred stock or subordinated debt until we resume timely financial reporting and therefore, changes in Core capital will generally be limited to net income and dividends. See “BUSINESS — Regulatory and Governmental Matters — OFHEO” for a discussion of the framework established by OFHEO for monitoring our capital. In addition, we periodically reissue treasury

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

For a summary of our preferred stock outstanding at December 31, 2004 and information on redemption dates for our preferred stock issuances, see “NOTE 9: STOCKHOLDERS’ EQUITY” to the consolidated financial statements.

### *Capital Adequacy*

We regularly assess the adequacy of our capital to confirm 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 with the intention to hold capital that exceeds all regulatory requirements.

The risk-based capital standard determines the amount of capital that we must hold to absorb projected losses resulting from future adverse interest-rate and credit-risk conditions specified by the GSE Act, plus 30 percent mandated by the GSE Act to cover management and operations risk. The risk-based capital standard is based on stress test results calculated under two interest-rate scenarios prescribed by the GSE Act, one in which 10-year Treasury yields rise by as much as 75 percent (up-rate scenario) and one in which they fall by as much as 50 percent (down-rate scenario). The credit component of the stress tests simulates the performance of our mortgage portfolio based on loss rates for the Benchmark Region. The criteria for the Benchmark Region are set forth by the GSE Act and are intended to capture the region that experienced the highest historical rates of default and severity of mortgage losses for two consecutive origination years. The risk-based capital requirement is the amount of Total capital needed to absorb the stress test losses in the most adverse scenario, plus 30 percent of that amount to cover management and operations risk. Total capital includes Core capital and general reserves for mortgage and foreclosure losses and any other amounts available to absorb losses that OFHEO includes by regulation. Core capital consists of the par value of outstanding common stock (common stock issued less common stock held in treasury), the par value of outstanding perpetual noncumulative preferred stock, additional paid-in capital and retained earnings as determined in accordance with GAAP.

The minimum capital standard requires us to hold an amount of Core capital that is generally the sum of 2.50 percent of aggregate on-balance sheet assets, as determined in accordance with GAAP, and approximately 0.45 percent of outstanding mortgage-related securities guaranteed by us and other aggregate off-balance sheet obligations. As discussed below, in 2004 OFHEO implemented a framework for monitoring our capital adequacy which includes a targeted capital surplus of 30 percent of our minimum capital requirement.

The critical capital standard requires us to hold an amount of Core capital that is generally the sum of 1.25 percent of aggregate on-balance sheet assets, as determined in accordance with GAAP, and approximately 0.25 percent of outstanding mortgage-related securities guaranteed by us and other aggregate off-balance sheet obligations.

We evaluate ongoing capital compliance under changing market conditions through regular assessments of the impact of these conditions on the level of our minimum capital surplus and our actions. We measure the effects of key drivers, including the level of interest rates, the slope of the yield curve and changes in implied market volatilities. Our assessment process is designed to ensure that we maintain a significant minimum capital surplus across a wide range of economic scenarios. We also monitor the level and variability of our capital surplus relative to our targeted 30 percent surplus under the capital monitoring framework temporarily mandated by OFHEO. Our estimated surplus in excess of the 30 percent target surplus was approximately \$3.6 billion at December 31, 2004. Our sensitivity analysis currently indicates that our actual surplus would exceed the targeted surplus across a wide range of economic scenarios. We also evaluate ongoing compliance with the risk-based capital requirement through regular intra-quarter analysis and reporting. We monitor the effects of interest rate changes and risk management actions on the level of risk-based capital surplus.

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Table 49 summarizes our regulatory capital requirements and surpluses at December 31, 2004 and 2003. Amounts for 2004 are as currently reported to OFHEO. See “NOTE 10: REGULATORY CAPITAL” to the consolidated financial statements for further information.

**Table 49 — Regulatory Capital Requirements**

	December 31,	
	2004	2003
	(dollars in millions)	
<i>Minimum capital requirement</i> <sup>(1)</sup> .....	\$24,131	\$23,774
Core capital <sup>(1)(2)</sup> .....	35,009	32,985
Minimum capital surplus <sup>(1)</sup> .....	10,878	9,211
<i>Critical capital requirement</i> <sup>(1)</sup> .....	12,308	12,097
Core capital <sup>(1)(2)</sup> .....	35,009	32,985
Critical capital surplus <sup>(1)</sup> .....	22,701	20,888
<i>Risk-based capital requirement</i> <sup>(3)</sup> .....	11,108	5,426
Total capital <sup>(3)(4)</sup> .....	34,691	33,436
Risk-based capital surplus <sup>(3)</sup> .....	23,583	28,010

- (1) OFHEO is the authoritative source of the capital calculations that underlie our capital classifications. For 2004, we amended the minimum and critical capital requirements, core capital and surplus amounts previously reported to OFHEO to incorporate adjustments reflected in our consolidated financial statements. The 2004 minimum and critical capital requirements, core capital and surplus amounts are estimates and have been revised to reflect changes related to a closing agreement entered into with the IRS concerning our REIT subsidiaries. See “NOTE 14: INCOME TAXES” to the consolidated financial statements for further information.
- (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 noncumulative 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 issuance of our 2004 and 2003 financial results. OFHEO determined not to recalculate the risk-based capital amounts given that the minimum capital requirement remained the determining requirement for our classification as adequately capitalized.
- (4) Total capital includes Core capital and general reserves for mortgage and foreclosure losses.

## OFF-BALANCE SHEET ARRANGEMENTS

### Off-Balance Sheet Transactions

In the ordinary course of business, we fulfill our statutory purposes by engaging in various transactions. These transactions enable us to:

- maintain the lowest possible cost of financing for our mortgage investments;
- bring efficiency to the mortgage market;
- manage interest-rate risk, credit risk and other business and market risks; and
- enhance our liquidity and capital resources.

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

### *Guaranty of PCs and Structured Securities*

As discussed in "BUSINESS — Credit Guarantee Activities," we participate in the secondary mortgage market by issuing PCs and Structured Securities to third party investors. PCs represent undivided interests in pools of mortgage loans that are backed by either single-family or multifamily mortgage loans. Structured Securities represent undivided interests in PCs or other mortgage-related securities issued by either Ginnie Mae or non-agency issuers. In each case, we guarantee the payment of principal and interest on issued PCs or Structured Securities. In these transactions, mortgage-related assets that back PCs and Structured Securities held by third parties are not reflected as our assets under GAAP, unless we retained an interest in PCs that back Structured Securities that were issued as part of a sale transaction.

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

Our PCs and Structured Securities are an integral part of our mortgage purchase program and any decline in the price performance of or demand for our PCs could have a material adverse effect on the profitability of our new credit guarantee business.

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

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

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In addition to the issuance and transfer of PCs to third parties, we also sell PCs from our Retained portfolio in resecuritized form. More specifically, we issue single- and multi-class Structured Securities that are backed by securities held in our Retained portfolio and subsequently transfer such Structured Securities to third parties in exchange for cash, or for PCs and other mortgage-related securities delivered to us by third party dealers who sell such Structured Securities to mortgage security investors. We generally earn resecuritization fees in connection with the creation of Structured Securities and can earn an ongoing management and guarantee fee for certain issued Structured Securities. Our principal exposure on Structured Securities relates only to that portion of resecuritized assets that are represented by non-Freddie Mac mortgage-related securities.

See “Table 10 — Freddie Mac Single-Class and Multi-Class PCs and Other Structured Securities Based on Unpaid Principal Balances” for our total PCs and Structured Securities outstanding (held by third parties) at December 31, 2004 and 2003. Our outstanding PCs and Structured Securities also include:

- Structured Securities backed by Ginnie Mae Certificates;
- multifamily mortgage loans for which we provide our guarantee of the payment of principal and interest, and that are originated and held by state and municipal agencies to support tax-exempt multifamily housing revenue bonds (see “NOTE 4: FINANCIAL GUARANTEES” to the consolidated financial statements);
- tax-exempt multifamily housing revenue bonds that support pass-through certificates issued by third parties for which we provide our guarantee of the payment of principal and interest;
- Freddie Mac pass-through certificates which are backed by tax-exempt housing revenue bonds and related taxable bonds and/or loans; and
- mortgage loans held by third parties for which we provide a credit guarantee.

For our purchase and securitization activity for 2004 and 2003, see “Table 42 — Volume Statistics”.

The accounting policies we apply to our credit guarantee activities significantly affect the volatility of our reported earnings through the initial recognition of the fair value of guarantee assets and guarantee obligations in connection with sales of PCs and Structured Securities, the recognition of subsequent gains or losses from the change in fair value of guarantee assets and PC residuals generated from such sales and the repurchase and sale of PCs into and out of our Retained portfolio and our Cash and investments portfolio. See “CONSOLIDATED RESULTS OF OPERATIONS — Non-Interest Income (Loss) — Management and Guarantee Income” for an analysis of management and guarantee income and other affected consolidated statements of income captions related to our credit guarantee activities. See “CONSOLIDATED BALANCE SHEETS ANALYSIS” for discussion of our guarantee assets and guarantee obligations. The accounting and financial results for our securitization transactions (including gains and losses on transfers of PCs and Structured Securities that are accounted for as sales and periodic cash flows on transfers of securitized interests and corresponding retained interests) and the significant assumptions used to determine the gains or losses from such transfers that are accounted for as sales are discussed in “NOTE 2: TRANSFERS OF SECURITIZED INTERESTS IN MORTGAGE-RELATED ASSETS” to the consolidated financial statements. The maximum potential amount of future principal payments we could be required to make in connection with the unpaid principal balance of all PCs and Structured Securities held by third parties totaled \$852 billion and \$752 billion at December 31, 2004 and 2003, respectively. See “NOTE 4: FINANCIAL GUARANTEES” to the consolidated financial statements for additional information.

#### **Other**

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

We are a party to numerous entities that are considered to be variable interest entities, or VIEs, under FASB Interpretation No. 46 (Revised December 2003), “Consolidation of Variable Interest Entities”, or

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FIN 46-R. These VIEs include low-income multifamily housing tax credit partnerships, certain Structured Securities trusts (T-Series transactions or alternative collateral deals), and certain asset-backed investment entities. See “NOTE 3: VARIABLE INTEREST ENTITIES” to the consolidated financial statements for additional information related to our significant variable interests in these VIEs.

As part of our credit guarantee business, we routinely enter into forward purchase and sale commitments for mortgage loans and mortgage-related securities. Pursuant to SFAS 133, a portion of these commitments are accounted for as derivatives under GAAP, with their fair value reported as either Derivative assets, at fair value or Derivative liabilities, at fair value on the consolidated balance sheets. See “RISK MANAGEMENT — Interest-Rate Risk and Other Market Risks — *Derivative Tables*” for further information. Certain non-derivative commitments are related to commitments arising from mortgage swap transactions and commitments to purchase certain multifamily mortgage loans that will be classified as held-for-investment under GAAP. These non-derivative commitments totaled \$183.0 billion and \$178.4 billion at December 31, 2004 and 2003, respectively. Such commitments were not accounted for as derivatives in accordance with SFAS 133 and were not recorded on our consolidated balance sheets at fair value.

We have individually negotiated several arrangements providing for a mortgage lender’s commitment to sell a high proportion of its conforming mortgage origination volume to us. We are exposed to the risk that we could lose purchase volume to the extent these agreements are terminated or modified without replacement from other lenders.



## RISK MANAGEMENT

Our business of purchasing mortgages and mortgage-related securities, funding these purchases and guaranteeing the payment of principal and interest on the mortgage-related securities we issue exposes us to three broad categories of risk: operational risks, market risk, and credit risk. Managing these risks is a critical function for us as our effectiveness influences our ability to accomplish our mission as well as the level and stability of our earnings and long-term value. Our strategies for managing operational risks, market risk, and credit risk are based upon the principle that risk should be understood, measured and managed directly by our business areas, with appropriate, independent oversight.

### Risk Oversight

We oversee business area management of operational, market and credit risks through our Enterprise Risk Oversight group led by the Chief Enterprise Risk Officer, who reports directly to the Chief Executive Officer. The Chief Enterprise Risk Officer provides advice to senior management on key risk management issues and provides reporting on risk matters to the Audit Committee of the Board of Directors. Within the Enterprise Risk Oversight function, the Operational Risk Oversight group, the Market Risk Oversight group and the Credit Risk Oversight group each provide independent oversight. Oversight of our financial reporting processes and internal controls occurs through the Chief Financial Officer. The Chief Financial Officer provides overall guidance on the internal controls framework and communicates an assessment of internal controls to senior management and the Audit Committee of the Board of Directors on a regular basis. The Chief Financial Officer has established an internal controls organization to oversee the adequacy of internal controls across the enterprise.

Our Internal Audit and Corporate Compliance Divisions play key roles in our risk oversight process. Internal Audit assesses whether our risk management, control and governance processes are adequate and functioning effectively. Corporate Compliance helps ensure that we comply with statutory and regulatory requirements, and related corporate policies that govern our business activities. Internal Audit reports to the Audit Committee. The Chief Compliance Officer reports directly to the Chief Executive Officer and provides reports on compliance matters to the Audit Committee.

The Board of Directors oversees risk management through the Audit Committee, the Finance and Capital Deployment Committee and the Mission and Sourcing Committee. An independent director chairs each of these Committees.

### Operational Risks

#### *Summary*

Operational risks represent the potential for financial loss resulting from failed or inadequate controls with respect to process, technology, people or external events. Operational risks are present in all of our business processes, including financial reporting. While we have made strides in remediating internal control weaknesses with respect to financial reporting, we have a significant number of internal control issues that have not been fully remediated and considerable challenges remain. Some of these control issues represent “material weaknesses” in our internal controls over financial reporting. We have detailed these material weaknesses and remediation activities in — “*Internal Controls over Financial Reporting*”. We have focused intense effort in 2004 on identifying and remediating control design issues; however, we may discover new control weaknesses as we complete our controls effectiveness testing effort which is currently underway.

Our process for managing operational risks is to identify, measure, remediate, and monitor all key sources of operational risks. To improve our ability to manage operational risks, we have undertaken a number of corporate initiatives. In 2004 we implemented corporate-wide ethics training; an enhanced employee hotline process for reporting concerns, including those relating to our financial reporting processes; a revised corporate disclosure policy; an enhanced Disclosure Committee; and a New Products Committee. We believe these initiatives have strengthened our entity-level control, and emphasized a “tone from the top” of strong integrity and ethical behavior.

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A major corporate reorganization in early 2005 resulted in a functional organization structure with responsibilities for operations and technology under a new executive vice president position. We also completed a full integration of all financial accounting functions under the Chief Financial Officer to enable greater accountability and role clarity.

Finally, we have undertaken a key initiative to improve our capabilities to better measure our operational risks. We have defined an operational risks framework that we believe is consistent with the Basel II Advanced Measurement Approach scheduled to be adopted by large U.S. banks. See “BUSINESS — Regulatory and Governmental Matters — Other Regulatory Matters.” The framework includes common risk language, the operational loss event, tracking key risk indicators and control self-assessments. We believe that the implementation of this framework improves our operational risks management capabilities. We are in the early stage of a multi-year effort to fully implement the components of this framework.

### *Sources of Operational Risks*

**Process Risk.** Process risk includes transaction execution, modeling, and vendor management risk.

Transaction execution risk is mitigated through comprehensive product development processes, suitable approval authorities, data quality standards and identification and execution of control procedures. While we are exposed to the risk of loss from failure to develop or follow appropriate processes for our business transactions, process risk management enables us to fulfill our commitment to introduce new products and programs to improve homeownership opportunities for low- and moderate-income borrowers and to meet our customers’ needs. We have strengthened our controls over the new product process with the creation of a New Products Committee, designed to clearly identify the requirements for implementing all new product ideas.

We make significant use of business and financial models. In 2004, we strengthened our processes to validate assumptions, model code and theory. We have enhanced our oversight processes, including establishing a corporate function to focus on the key models used in management decisions and financial reporting. While controls over model risk have been enhanced, significant efforts remain with respect to controls over model applications. We plan to further remediate model oversight issues during 2005.

Vendor management is critical for us because we currently outsource to external parties certain key functions. These functions include processing functions for trade capture, market risk management analytics, asset valuation (Blackrock Financial Management, Inc.), and processing functions for mortgage loan underwriting (Electronic Data Systems Corporation). We may enter into similar outsourcing relationships in the same or other business areas in the future. If one or more of these key external parties were not able to perform their functions for a period of time or at an acceptable service level, there is a risk that our financial condition or results of operations would be adversely affected, perhaps materially. Our use of vendors also exposes us to the risk of a loss of intellectual property or a breach of confidentiality or other harm. We endeavor to mitigate these risks through detailed vendor requirements, active vendor management, legal contracts, business continuity planning, and third party review of vendors. In addition, to ensure the integrity of data used in financial reporting, we have implemented quality assurance processes valuations and processes performed by Blackrock.

**Technology Risk.** Technology risk includes the risk of inadequate or failed systems, inappropriate systems implementation and inadequate system security that allows unauthorized access to computer systems. We monitor computer security measures and applications and we use corporate information access policies and periodic access reviews to verify that only authorized personnel have access to our systems. We identified material weaknesses related to system security, change management and information technology application and general controls during our control reviews in 2004. These weaknesses related not only to financial reporting systems, but other business applications as well. Remediation efforts to correct these weaknesses began in 2004 and will continue through 2005. See “*Internal Controls over Financial Reporting*” for more information concerning internal control issues related to our systems.

We are making significant investments to build new financial reporting systems and to move to more effective and efficient business processing systems. During the transition period, however, we are more reliant on end-user computing systems than we prefer. End-user computing systems increase the risk of errors in

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some of our core operational processes and increase our reliance on monitoring controls. In addition, changes in management controls for these systems required significant enhancement in 2004. We are mitigating this risk by improving our documentation and moving responsibility for key end-user systems to the Information Technology Group. See “— *Internal Controls over Financial Reporting*” for more information concerning end-user system issues and mitigation activities.

**People Risk.** People risk includes the risk of inadequate or unqualified staffing, as well as the risk of employee errors and internal fraud. We mitigate this risk at the entity-level through the use of professional recruiting staff, employee screening and targeted retention actions. At the business-unit level this risk is mitigated by employee training and development activities and supervisory review of staff. People risk was generally a significant risk during 2003 and, to a lesser extent, during 2004, with large staff additions in both the accounting and information technology areas to address financial reporting processes and control remediation. During 2003 and 2004, we also made extensive use of consultants. In the fourth quarter of 2004 the use of consultants began to decline significantly. This trend has continued in 2005, and while people risk is still elevated, it has begun to decline.

**External Event Risk.** We are exposed to the risk that a catastrophic event, such as a terrorist event or natural disaster, could result in a significant business disruption and an inability to process transactions through normal business processes. To mitigate this risk, we maintain and test a business continuity plan and have established backup facilities for critical business processes and systems away from, although in the same metropolitan area as, our main offices. In 2004, we began an effort to determine the feasibility of establishing an alternate site for critical business processes that has a separate power grid, labor pool and geographic location. We are in the early phases of this effort.

We are also exposed to the risk that our sellers or servicers misrepresent the mortgages they sell to us, or sell or service these mortgages in a manner inconsistent with our selling requirements or servicing guidelines, and as a result, adversely affect our income or asset values. We rely on a variety of preventative and detective controls to mitigate this risk. In particular, we use quality control reports and reviews, on-site audits and investigations of situations involving possible fraud to identify problems. We also require sellers and servicers to represent and warrant to us that the loans they sell to us or service for us meet our standards. We impose minimum net worth, insurance and other eligibility requirements to help ensure that our sellers and servicers have the capability and incentive to meet our standards. See “Credit Risks” and “BUSINESS — Predatory Lending” for more information on how we manage the risk of sellers and servicers.

### ***Internal Controls over Financial Reporting***

Improving internal controls over financial reporting and addressing material weaknesses were top priorities in 2004 and continue to be in 2005. As we are working to strengthen our control environment we focused on managing the operational risks related to inaccurate or incomplete financial reporting to our stakeholders. Throughout 2004, there were a number of material weaknesses and other control deficiencies in our internal controls over financial reporting that required our attention. They were:

- significant integration issues among numerous core business, accounting, and external service provider operations and over-reliance on end-user computing systems for certain major activities;
- inadequate controls over data input and systems limitations in financial processes;
- inadequate supervisory review of the preparation of journal entries in certain accounting units;
- end-user computing solutions with both insufficient documentation and change controls;
- inadequate staffing and systems to support the appropriate scope of independent price verification of financial instruments used in the preparation of financial statements;
- lack of formal change management and oversight processes over certain models used to support financial reporting;
- insufficient monitoring controls within financial operations and related reporting functions;

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- insufficient documentation controls regarding roles and responsibilities related to certain data correction activities;
- technology implementation control deficiencies, including changes in management processes that allow access to production environments by developers; and
- access by some business end-users to production databases.

In order to compensate for these material weaknesses we have had to perform extensive verification and validation procedures to ensure our financial statements are fairly presented in accordance with GAAP. This work began with the completion of process documentation for our controls over financial reporting and an internal review to assess the design of internal controls over these processes. Our objective was to assess the quality of the controls design and to initiate substantive actions to improve any design weaknesses. This effort identified additional material weaknesses in our controls design related to:

- lack of documentation and evaluation of information technology general and application controls;
- weaknesses in certain processes surrounding the accounting for security impairment; and
- weaknesses in management's processes for identifying deficiencies in controls over financial reporting.

We undertook considerable work in 2004 to address the risks of the material weaknesses in our financial reporting processes. This work resulted in the risks related to many weaknesses either being fully remediated or reduced. However, as of the end of 2004, we still had several material weaknesses within our financial reporting controls. These weaknesses must be monitored closely and compensating procedures must be executed to ensure there is no material impact to our financial reporting. We continue to place considerable management emphasis on the development and execution of plans to reduce and eventually eliminate the risk associated with these remaining weaknesses. The remaining material weaknesses as of December 31, 2004 include:

- end-user computing controls;
- monitoring controls within financial operations;
- information technology general and application controls;
- management risk and control self-assessment process; and
- integration between Operations and Finance.

In 2004 the focus was on improving the controls design and in addressing design weaknesses in our financial reporting controls. We plan to remediate the existing material weaknesses described above by the end of 2005, except for the material weakness related to integration between Operations and Finance. For this weakness, we will apply risk reduction techniques in 2005, but do not expect to remediate fully until 2006. Further, we are addressing other control deficiencies that are not material weaknesses, as they still represent risks in our control environment.

The next step in our plan is to test the operating effectiveness of the controls over financial reporting. Controls testing will provide evidence that the controls are working as designed, or will indicate where we have deficiencies. Additionally, we are pursuing actions to fully document and test our entity-level controls and controls over third party vendors. Entity-level controls include components such as: our Code of Conduct, employee hotline, anti-fraud program and compliance program. Third party controls are those controls that ensure the information and services we receive from third party vendors are well controlled and meet our quality requirements.

There are continued risks to our financial reporting timeline as we strive to fully remediate the remaining material weaknesses and enhance our internal control environment. As we execute testing we may also encounter additional material weaknesses that we need to address. We manage these timeline and scope risks through a centralized internal controls and program management office with significant involvement of key executives.

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## Interest-Rate Risk and Other Market Risks

We are exposed to the risk that changes in interest rates or in other market factors will adversely affect our cash flows, the fair value of net assets and/or future earnings. We take an active and disciplined approach to the management of these risks. Our disciplined approach to risk management is essential to generating fair value growth for stockholders in a wide range of interest-rate environments. Our interest-rate risk exposure results primarily from mortgage loans and mortgage-related securities held in our Retained portfolio and the liabilities funding this portfolio. To a lesser extent, we are also exposed to interest-rate risk through our credit guarantee activities.

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

The purpose of the Market Risk Oversight group is to provide independent oversight of market risk, including interest-rate risk, and to enhance our market risk measurement and management capabilities so that they are consistent with industry best practice. Market Risk Oversight fulfills its mission by reporting to senior management concerning the key investment strategies and market risks taken throughout the corporation, the consistency of market risk positions with stated strategies and the appropriateness of limits and policies related to risk exposure. The Models and Methods group, also a part of the Enterprise Risk Oversight function, is responsible for independently assessing the design and adequacy of all key models, including prepayment models.

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

**Retained Portfolio.** Our Retained portfolio activities expose us to interest-rate risk and other market risks. This exposure results primarily from the uncertainty as to when borrowers will pay the outstanding principal balance of mortgage loans and mortgage-related securities held in the Retained portfolio, known as prepayment risk, and the resulting potential mismatch in the timing of our receipt of cash flows on our assets versus the timing of our obligation to make payments on our liabilities. For the vast majority of our mortgage-related investments, the mortgage borrower has the option to make unscheduled payments of additional principal or to completely pay off a mortgage loan at any time before its scheduled maturity date (without having to pay prepayment penalties) or to hold the mortgage to its stated maturity. The borrower's option makes the timing and amount of mortgage prepayments (and thus the timing and amount of mortgage cash flows received by us) very sensitive to changes in interest rates, among other factors.

The Retained portfolio comprises mortgage investments with a range of different characteristics, including different stated maturities, underlying collateral, principal and interest payment structures and prepayment patterns. To manage the interest-rate risk associated with this wide range of mortgage-related investments, we employ a risk management strategy that seeks to substantially match the duration characteristics of our assets and liabilities. We use various instruments, including short-term debt, callable and non-callable long-term debt and interest-rate derivatives, to mitigate the risk that mortgage investments may prepay faster or slower than expected.

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

- **Duration Risk.** Duration is a measure of a financial instrument's price sensitivity to changes in interest rates. We actively manage duration risk through asset selection and structuring (that is, by identifying or structuring mortgage-related securities with attractive prepayment and other characteristics), by issuing a broad range of both callable and non-callable debt instruments and by transacting in interest-rate derivatives.

We monitor duration against limits and reporting thresholds established by senior management and the Board of Directors. Our interest-rate sensitivity is estimated and reported through our PMVS and duration gap measures. These measures are estimated on a daily basis and publicly reported on a monthly basis. See "*Measurement of Interest-Rate Risk*" below.

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Although duration risk has been maintained at relatively low levels as indicated by our PMVS and duration gap estimates (see “*Measurement of Interest-Rate Risk — PMVS and Duration Gap*”), fair value gains or losses will generally occur as market conditions change. For example, fair value gains or losses occur when our duration gap is positive or negative and the level of interest rates or shape of the yield curve changes.

- **Convexity Risk.** Convexity is a measure of how much duration changes as interest rates change. Convexity risk primarily results from mortgage prepayment risk. We actively mitigate this risk by maintaining a high percentage of callable debt and option-based derivatives relative to the fixed-rate mortgage assets held in the Retained portfolio.

We do not, however, hedge all prepayment option risk that exists at the time a mortgage is purchased or that arises over its life. For the portion of risk not hedged at the time of purchase, we undertake frequent rebalancing actions in order to keep our interest-rate risk exposure within our internal limits (see “*Use of Derivatives and Interest-Rate Risk Management — Use of Derivatives — Adjust Funding Mix*” below). Although convexity risks have been maintained at relatively low levels as indicated by our PMVS estimate (see “*Measurement of Interest-Rate Risk — PMVS and Duration Gap*”), fair value gains or losses will generally occur as market conditions change. For example, because we do not hedge all of the prepayment risk inherent in our mortgage investment portfolio, fair value gains or losses occur from changes in the relationship between interest-rate volatility expected at the time a mortgage loan is acquired and the volatility actually experienced (see “*Volatility Risk*” below for more information).

- **Yield Curve Risk.** Yield curve risk is the risk that non-parallel shifts in the yield curve (such as a flattening or steepening) will adversely affect our cash flows, fair value of net assets and/or future earnings. Changes in the shape, or slope, of the yield curve often arise due to changes in the market’s expectation of future interest rates at different points along the yield curve, including expectations regarding action by the Federal Reserve Board. For this reason, we evaluate our exposure to yield curve risk by examining potential reshaping scenarios at various points along the yield curve. Our yield curve risk under a specified yield curve scenario is reflected in our PMVS-Yield Curve, or PMVS-YC, disclosure.
- **Volatility Risk.** Volatility risk is the risk that changes in the market’s expectation of the magnitude of future variations in interest rates will adversely affect our cash flows, fair value of net assets and/or future earnings. The market’s expectation about the future volatility of interest rates, or implied volatility, is a key determinant of the value of an interest-rate option. Higher expected volatility implies a greater likelihood that the expected life of a mortgage asset will either extend or contract. For example, higher interest-rate volatility implies a higher likelihood that interest rates will decline to levels that make mortgage prepayments attractive to homeowners, thereby making their prepayment option more valuable and making our mortgage assets subject to their prepayment option less valuable. We manage volatility risk through asset selection and by maintaining a consistently high percentage of option-embedded liabilities (e.g., callable debt) and option-based derivatives relative to our mortgage assets. We monitor volatility risk by measuring exposure levels on a daily basis and we maintain internal limits on the amount of volatility risk exposure.
- **Basis Risk.** Basis risk is the risk that interest rates in different market sectors will not move in tandem and will adversely affect our cash flows, fair value of net assets and/or future earnings. This risk arises principally because we hedge mortgage-related investments with LIBOR- and Treasury-based interest-rate derivatives. We do not actively manage the basis risk arising from funding Retained portfolio investments with our debt securities, also referred to as mortgage-to-debt option-adjusted spread risk. See “*CONSOLIDATED FAIR VALUE BALANCE SHEETS — Key Components of Changes in Fair Value of Net Assets — Effect of changes in option-adjusted spread (mortgage-to-debt spread)*” for additional information. We also incur basis risk when we use LIBOR- or Treasury-based instruments in our risk management activities. We monitor the fair value fluctuations associated with these basis risks and manage this exposure

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by adjusting our mix of LIBOR- and Treasury-based instruments and our debt in response to changes in the expected interest-rate relationships in these different markets. We monitor basis risk on a daily basis and maintain internal limits on the amount of basis risk exposure.

- **Prepayment Model Risk.** Prepayment model risk is the risk that actual mortgage prepayment behavior will differ from the prepayment behaviors we forecast using our proprietary internal models and will adversely affect our cash flows, fair value of net assets and/or future earnings. These models are used to determine the estimated duration and convexity of mortgage assets for our PMVS and duration gap measures. To mitigate prepayment model risk, we perform extensive monthly testing of actual results against model results and sensitivity analysis to facilitate informed asset selection and risk management decisions. However, expected returns can be affected by differences between prepayments forecasted by the models and actual prepayments.
- **Foreign Currency Risk.** Foreign currency risk is the risk that fluctuations in currency exchange rates (e.g., foreign currencies to the U.S. dollar) will adversely affect our cash flows, fair value of net assets and/or future earnings. Our exposure to foreign currency risk arises primarily because we issue debt denominated in currencies other than the U.S. dollar, our functional currency. In the case of our €Reference Notes® securities program, we are obligated to make periodic interest and principal payments in Euros. We mitigate the risk associated with fluctuations in currency exchange rates by entering into swap transactions that effectively convert foreign-denominated obligations into U.S. dollar denominated obligations.

**Credit Guarantee Activities.** Changes in interest rates and credit expectations cause fluctuations in the fair value of our existing credit guarantee portfolio. We do not hedge these changes in the fair value of our existing credit guarantee portfolio, other than the interest-rate exposure related to net buy-ups. We also hedge expected gains or losses resulting from our mortgage security program cycles. Timing differences caused by mortgage security program cycles can lead to significant interest expense, particularly in a rapidly declining interest-rate environment. If the interest rate paid to a PC investor is higher than the reinvestment rate on payments received from mortgage borrowers, we bear the cost difference, recognized as interest expense, for the time period between when the borrower pays us and when we reduce the PC balance.

While year-to-year changes in the fair value of the guarantee portfolio may have a significant impact on the fair value of net assets, we believe that changes in the fair value of our existing guarantee portfolio are not a good indication of long-term fair value expectations because such changes do not reflect the strong probability that, over time, replacement business will largely replenish guarantee fee income lost because of prepayments.

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

**Use of Derivatives.** To manage interest-rate and other market risks, we use derivatives primarily to:

- hedge forecasted issuances of debt and synthetically create callable and non-callable funding;
- hedge foreign-currency exposure associated with certain debt issuances; and
- regularly adjust or rebalance our funding mix in order to more closely match changes in the interest-rate characteristics of our mortgage assets.

*Hedge Forecasted Debt Issuances and Create Synthetic Funding.* We typically commit to purchase mortgage investments on an opportunistic basis for a future settlement date that often ranges from two weeks to three months after the date of the commitment. To facilitate larger and more predictable debt issuances that contribute to lower funding costs, we use interest-rate derivatives to hedge the anticipated debt issuances associated with these periodic mortgage purchases. In doing so, we economically hedge the interest-rate risk exposure from the time the mortgage is committed to be purchased to the time the debt is issued. We typically fund mortgage investments with a combination of callable and non-callable debt of various maturities in order to better match the cash-flow and optionality characteristics of the mortgage investments. Through the use of interest-rate derivatives, we can synthetically create the substantive economic equivalent of these various funding structures. For example, the combination of a series of short-term debt issuances over a defined

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longer-term period and a pay-fixed swap with the same maturity is the substantive economic equivalent of a long-term debt instrument of comparable maturity. Similarly, the combination of non-callable debt and a swaption, or option to enter into a receive-fixed swap, with the same maturity as the non-callable debt, is the substantive economic equivalent of callable debt. The ability to either issue debt or synthetically create its substantive economic equivalent through derivatives increases funding flexibility, allows us to better match asset and liability cash flows and often reduces the overall funding cost.

*Hedge Foreign-Currency Exposure.* We also use derivatives to hedge foreign-currency exposure associated with foreign currency denominated debt issuances, such as our €Reference Notes<sup>®</sup> securities program, as discussed above in “*Sources of Interest-Rate Risk and Other Market Risks — Retained Portfolio — Foreign Currency Risk.*” Through the use of derivatives, we are able to mitigate nearly all currency risk at the time of debt issuance.

*Adjust Funding Mix.* As market conditions dictate, we undertake rebalancing actions in order to keep our interest-rate risk exposure within management limits. As interest rates decline, mortgage prepayments tend to increase and the expected life of mortgages tends to decrease. In this environment, we typically enter into receive-fixed swaps or purchase Treasury-based derivatives to adjust the duration of our funding to offset the declining mortgage duration. As interest rates increase, prepayments tend to decrease and lengthen the expected life of mortgages. In this case, we typically enter into pay-fixed swaps or sell Treasury-based derivatives in order to adjust the duration of our funding to offset increasing mortgage duration.

**Types of Derivatives.** We use derivatives that are common in the financial markets to conduct our risk management activities. The majority of our derivative positions fall into the following four categories:

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

In addition to swaps, futures and options, our derivative positions include certain purchase and sale commitments and other contractual agreements including swap guarantee derivatives and credit risk-sharing agreements discussed further below.

*Forward Purchase and Sale Commitments.* We routinely enter into forward purchase and sale commitments for mortgage loans and mortgage-related securities. Most of these commitments are derivatives subject to the requirements of SFAS 133 and accordingly must be recorded at fair value on our consolidated balance sheets.

*Prepayment Management Agreement.* Practices of seller/servicers may affect prepayment levels on mortgages that underlie PCs. As a result, mortgages underlying some PCs may be prepaid faster than similar mortgages underlying other PCs, adversely affecting our management and guarantee income and the performance of our mortgage-related securities. We have taken steps to achieve prepayment experience on PCs that is consistent with market norms. Beginning in 2002, we required that certain mortgage pools delivered to us between 2001 and 2003, which we considered to pose elevated risk of prepayment, be covered by a prepayment management agreement to partially compensate us for the adverse financial impacts caused by disproportionately higher mortgage prepayments. We also offered an incentive through an adjusted guarantee fee level on certain mortgage deliveries when the prepayment experience of the mortgage pools is within defined ranges. This type of agreement is accounted for as a derivative in accordance with SFAS 133 and classified as no hedge designation, with changes in fair value recorded as Derivative gains (losses) on the consolidated statements of income. This type of agreement is reflected at fair value on our consolidated balance sheets in the Derivative assets, at fair value, or Derivative liabilities, at fair value, caption. At December 31, 2004 and 2003, approximately \$113.7 billion and \$152.5 billion, respectively, of the mortgages underlying PCs included in our Total mortgage portfolio (see “Table 8 — Freddie Mac’s Total Mortgage Portfolio Based on Unpaid Principal Balances”) were subject to this type of agreement. Amounts due to us under this type of agreement are reported as a component of our Management and guarantee income.

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*Swap Guarantee Derivatives.* We guarantee the payment of principal and interest on (a) multifamily mortgage loans that are originated and held by state and municipal housing finance agencies to support tax-exempt multifamily housing revenue bonds, (b) tax-exempt multifamily housing revenue bonds that support pass-through certificates issued by third parties, and (c) Freddie Mac pass-through certificates which are backed by tax-exempt multifamily housing revenue bonds and related taxable bonds and/or loans. In connection with these guarantees we have also guaranteed the sponsor's or the borrower's performance as a counterparty on any related interest-rate swaps used to mitigate interest-rate risk. Guarantees of these interest-rate swaps entered into after June 30, 2003 are treated as derivatives in accordance with SFAS 149 and are reported as swap guarantee derivatives. The notional amount of these swap guarantees was \$408 million and \$31 million at December 31, 2004 and 2003, respectively.

**Summary of Derivative Positions.** The fair value of our derivatives was a net asset balance of \$15.0 billion and \$15.8 billion at December 31, 2004 and 2003, respectively. In our consolidated balance sheets, derivative instruments are presented in Derivative assets, at fair value or Derivative liabilities, at fair value. See "Table 35 — Total Derivative Portfolio" for a summary of notional amounts and fair values by product type.

### *Derivative-Related Risks*

Our use of derivatives exposes us to derivative market liquidity risk and counterparty credit risk. We are subject to derivative market liquidity risk, described below, arising from possible difficulties in entering into and exiting out of derivatives to meet our needs. Counterparty credit risk arises from the possibility that the counterparty will not be able to meet its contractual obligations.

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

To mitigate the risk that we may be unable to enter into or replace derivatives transactions at reasonable cost, we limit our duration and convexity exposure to each counterparty. At December 31, 2004, the largest single notional balance of our 25 approved OTC counterparties listed in "Table 50 — Derivative Counterparty Credit Exposure" was \$60.9 billion, or 13 percent, of the total notional balance of our OTC interest-rate swaps, option-based derivatives and foreign currency swaps.

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

We actively manage our exposure to counterparty credit risk. We use several tools to manage and minimize counterparty credit risk including:

- review of external rating analyses;
- strict standards for approving new derivative counterparties;
- ongoing monitoring of our positions with each counterparty by type of derivative;
- diversification of counterparties (discussed under "Derivative Market Liquidity Risk");

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

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

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

*Master Netting and Collateral Agreements.* We use master netting and collateral agreements to reduce our credit risk exposure to our active OTC derivative counterparties for interest-rate swaps, option-based derivatives and foreign-currency swaps. Master netting agreements provide for the netting of amounts receivable and payable from an individual counterparty, which reduces our exposure to a single counterparty in the event of default. For example, if we have a gain position on one derivative and a loss position on another derivative with the same counterparty, then the gain can be netted with the loss to determine the amount of our net exposure to the counterparty. On a daily basis, the market value of each counterparty's derivatives outstanding is calculated to determine the amount of our net credit exposure, which is equal to derivatives in a net gain position by counterparty after giving consideration to collateral posted. Our collateral agreements require most counterparties to post collateral for the amount of our net exposure to them above the applicable threshold. Collateral posting thresholds are generally tied to a counterparty's credit rating. Derivative exposures and collateral amounts are monitored on a daily basis using both internal pricing models and dealer price quotes. Our derivative counterparties typically transfer collateral within one to three business days based on the values of the related derivatives. As described further below, this time lag in posting collateral can affect our net uncollateralized exposure to derivative counterparties.

The collateral posted by counterparties serves to protect us against the risk of counterparty credit losses. Collateral posted by a derivative counterparty is typically in the form of cash, U.S. Treasury securities, agency securities or other mortgage-related securities. In the event a counterparty defaults on its obligations under the derivatives agreement and the default is not remedied in the manner prescribed in the agreement, we have the right under the agreement to direct the custodian bank to transfer the collateral to us or, in the case of non-cash collateral, to sell the collateral and transfer the proceeds to us.

Table 50 summarizes our exposure to counterparty credit risk in our derivatives. This table is useful in understanding our credit risk related to our derivative portfolio.

**Table 50 — Derivative Counterparty Credit Exposure**

December 31, 2004						
Rating <sup>(1)</sup>	Number of Counterparties <sup>(2)</sup>	Notional Amount	Total Exposure at Fair Value <sup>(3)</sup>	Exposure, Net of Collateral <sup>(4)</sup>	Weighted Average Contractual Maturity (in years)	Collateral Posting Threshold <sup>(5)</sup>
(dollars in millions)						
AAA <sup>(6)</sup>	2	\$ 3,041	\$ 498	\$498	2.5	Mutually agreed upon
AA+	1	597	399	32	23.9	\$10 million or less
AA	5	110,692	3,096	25	4.4	\$10 million or less
AA-	7	135,041	5,199	36	5.2	\$10 million or less
A+	6	153,867	6,505	—	5.1	\$1 million or less
A	3	56,530	1,478	8	5.1	\$1 million or less
A-	1	210	11	2	7.0	\$1 million or less
Subtotal <sup>(7)</sup>	25	459,978	17,186	601	5.0	
Other derivatives <sup>(8)</sup>		138,822	—	—		
Prepayment management agreement <sup>(9)</sup>		113,692	—	—		
Commitments <sup>(10)</sup>		32,952	40	40		
Credit derivatives <sup>(11)</sup>		10,926	—	—		
Swap guarantee derivatives <sup>(9)</sup>		408	—	—		
Total derivatives		<u>\$756,778</u>	<u>\$17,226</u>	<u>\$641</u>		

December 31, 2003						
Rating <sup>(1)</sup>	Number of Counterparties <sup>(2)</sup>	Notional Amount	Total Exposure at Fair Value <sup>(3)</sup>	Exposure, Net of Collateral <sup>(4)</sup>	Weighted Average Contractual Maturity (in years)	Collateral Posting Threshold <sup>(5)</sup>
(dollars in millions)						
AAA	2	\$ 2,825	\$ 283	\$283	3.6	Mutually agreed upon
AA+	1	604	303	5	24.7	\$10 million or less
AA	4	119,409	1,610	29	4.6	\$10 million or less
AA-	7	237,048	7,091	250	4.1	\$10 million or less
A+	6	236,944	5,922	133	5.4	\$1 million or less
A	3	87,001	2,143	95	5.2	\$1 million or less
A-	4	1,018	19	1	3.3	\$1 million or less
Subtotal <sup>(7)</sup>	27	684,849	17,371	796	4.8	
Other derivatives <sup>(8)</sup>		141,381	—	—		
Prepayment management agreement <sup>(9)</sup>		152,548	—	—		
Commitments <sup>(10)</sup>		89,520	101	101		
Credit derivatives <sup>(11)</sup>		15,542	7	7		
Swap guarantee derivatives <sup>(9)</sup>		31	—	—		
Total derivatives		<u>\$1,083,871</u>	<u>\$17,479</u>	<u>\$904</u>		

- (1) We use the lower of S&P and Moody's ratings to manage collateral requirements. In this table, the rating of the legal entity (or the guarantor of the legal entity) is stated in terms of the S&P equivalent.
- (2) Based on legal entities. Affiliated legal entities are reported separately.
- (3) For each counterparty, this amount includes derivatives with a net positive fair value (recorded as Derivative assets, at fair value) including the related accrued interest receivable/payable (net) (recorded in Accounts and other receivables, net and Accrued interest payable).
- (4) Total Exposure at Fair Value less collateral held as determined at the counterparty level.
- (5) Counterparties are required to post collateral when their exposure exceeds agreed-upon collateral posting thresholds. These thresholds are typically based on the counterparty's credit rating and are individually negotiated.
- (6) At December 31, 2004, two of our derivative counterparties were rated AAA. In early 2005, one of these counterparties was downgraded to AA+. With respect to this downgraded counterparty, there was no Total Exposure at Fair Value at December 31, 2004 as the fair value of the underlying derivatives were in a net liability position at that date.
- (7) Consists of OTC derivative agreements for interest-rate swaps, option-based derivatives, excluding written options, and foreign-currency swaps. Written options do not present counterparty credit exposure, because we receive a one-time up-front premium in exchange for giving the holder the right to execute a contract under specified terms, which generally puts us in a liability position.
- (8) Consists primarily of exchange-traded contracts, which do not measurably increase our exposure to counterparty credit risk because changes in value of open exchange-traded contracts are settled daily through a financial clearinghouse established by each exchange.
- (9) See "Use of Derivatives and Interest-Rate Risk Management — Types of Derivatives" for additional information concerning the nature of the prepayment management agreement and swap guarantee derivatives.
- (10) Consists of OTC derivative agreements for forward purchase and sale commitments.
- (11) See "Credit Risks — Mortgage Credit Risk — Mortgage Credit Risk Management Strategies" for additional information about credit derivatives.

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Over time, our exposure to certain counterparties for OTC interest-rate swaps, option-based derivatives and foreign-currency swaps varies depending on changes in fair values which are affected by changes in period-end interest rates, the implied volatility of interest rates, foreign-currency exchange rates and the amount of derivatives held. Our uncollateralized exposure to counterparties for OTC interest-rate swaps, option-based derivatives and foreign-currency swaps, after applying netting agreements and collateral, decreased to \$601 million as of December 31, 2004 from \$796 million as of December 31, 2003. This decrease in uncollateralized exposure was due to the following three factors:

- decreases in the differences between fair value estimates used by our derivative counterparties in determining the value of collateral to be posted and the estimates of derivative fair values used in our financial reporting;
- smaller market movements during the time period between when a derivative was marked to fair value and the date we received the related collateral. Our derivative counterparties typically post collateral one to three business days after we request collateral; and
- decreases in the exposure below the posting thresholds of our derivative counterparties.

As indicated in Table 50, approximately 97 percent of our counterparty credit exposure for OTC interest-rate swaps, option-based derivatives and foreign currency swaps was collateralized at December 31, 2004. In the extremely unlikely event that all of our counterparties for these derivatives were to have defaulted simultaneously on December 31, 2004, our maximum loss for accounting purposes would have been approximately \$601 million. As discussed below, in “*Derivative Portfolio Stress-Testing*,” however, our economic loss, as measured by our potential additional uncollateralized exposure, may be higher than the \$601 million uncollateralized exposure of our derivatives if we were not able to replace the defaulted derivatives in a timely fashion.

*OTC Forward Purchase and Sale Commitments Treated as Derivatives.* Since the typical maturity for our OTC commitments is less than one year, we do not require master netting and collateral agreements for the counterparties of these commitments. Therefore, as indicated in Table 50, the exposure to OTC commitments counterparties of \$40 million and \$101 million as of December 31, 2004 and 2003, respectively, was uncollateralized. The decrease in uncollateralized exposure was due to a significant decrease in the volume of unsettled commitments as of December 31, 2004, which contributed to the reduction of notional amounts for OTC commitments treated as derivatives.

Similar to counterparties for OTC interest-rate swaps, option-based derivatives and foreign-currency swaps, we monitor the credit fundamentals of our OTC commitments counterparties on an ongoing basis to ensure that they continue to meet our internal risk-management standards.

*Derivative Portfolio Stress-Testing.* Market values of derivatives can change significantly when market conditions change. As a result, we monitor the risk that our uncollateralized exposure to each of our OTC counterparties for interest-rate swaps, option-based derivatives and foreign-currency swaps will increase under certain adverse market conditions. We perform severe market stress tests on a daily basis to evaluate the potential additional uncollateralized exposure we have to each of these derivative counterparties. The market stress test assumes changes in the level, slope and implied volatility of interest rates and changes in foreign-currency exchange rates over a brief time period. The market stress test also assumes high OTC counterparty default rates coupled with low recovery rates to calculate our potential exposure to each OTC counterparty.

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

#### ***Derivative Tables***

Table 51 shows the notional amount for each of our hedge accounting categories under SFAS 133 and the corresponding impact of those positions on our consolidated financial statements. The application and effectiveness of our hedging strategies can materially affect Stockholders’ equity and the timing of our

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recognition of earnings. See “NOTE 12: DERIVATIVES” to the consolidated financial statements for more information concerning our hedging activity.

**Table 51 — Summary of the Effect of Derivatives on Selected Consolidated Financial Statement Captions**

Description	Consolidated Balance Sheets					
	December 31, 2004			December 31, 2003		
	Notional Amount	Fair Value (Pre-Tax) <sup>(1)</sup>	AOCI (Net of Tax) <sup>(2)</sup>	Notional Amount	Fair Value (Pre-Tax) <sup>(1)</sup>	AOCI (Net of Tax) <sup>(2)</sup>
	(dollars in millions)					
Fair value hedges-open	\$113,101	\$12,317	\$ —	\$ 145,690	\$10,185	\$ —
Cash flow hedges-open	21,214	228	(25)	141,903	(2,808)	(1,927)
No hedge designation <sup>(3)</sup>	622,463	2,486	—	796,278	8,446	—
Subtotal	756,778	15,031	(25)	1,083,871	15,823	(1,927)
Balance related to closed cash flow hedges	—	—	(7,899)	—	—	(5,910)
Total	<u>\$756,778</u>	<u>\$15,031</u>	<u>\$(7,924)</u>	<u>\$1,083,871</u>	<u>\$15,823</u>	<u>\$(7,837)</u>

Description	Consolidated Statements of Income					
	Year Ended December 31, 2004		Year Ended December 31, 2003		Year Ended December 31, 2002	
	Hedge Accounting Gains (Losses) <sup>(4)</sup>	Derivative Gains (Losses) <sup>(5)</sup>	Hedge Accounting Gains (Losses) <sup>(4)</sup>	Derivative Gains (Losses) <sup>(5)</sup>	Hedge Accounting Gains (Losses) <sup>(4)</sup>	Derivative Gains (Losses) <sup>(5)</sup>
	(dollars in millions)					
Fair value hedges-open	\$742	\$ —	\$697	\$—	\$241	\$ —
Cash flow hedges-open	1	2	(53)	29	(54)	116
No hedge designation <sup>(3)</sup>	—	(4,477)	—	10	—	5,186
Total	<u>\$743</u>	<u>\$(4,475)</u>	<u>\$644</u>	<u>\$39</u>	<u>\$187</u>	<u>\$5,302</u>

- (1) The fair values of derivatives (netted by counterparty as permitted by GAAP) are presented as Derivative assets, at fair value, and Derivative liabilities, at fair value, on our consolidated balance sheets. The fair values for futures are directly derived from quoted market prices. Fair values of other derivatives are derived primarily from valuation models with incorporation of market-based inputs.
- (2) Derivatives that meet specific criteria are accounted for as cash flow hedges under SFAS 133. Changes in the effective portion of the fair value of these open derivatives contracts are recorded in AOCI, net of taxes. Net deferred gains and losses on closed cash flow hedges (*i.e.*, where the derivative is either terminated or redesignated) are also classified in AOCI, net of taxes, until the related forecasted transaction is determined to be probable of not occurring or affects earnings.
- (3) A significant portion of our derivatives is not designated in hedge accounting relationships and is reported as no hedge designation. For most derivatives not qualifying as an accounting hedge, fair value gains and losses are reported as Derivative gains (losses) on our consolidated statements of income. For purchase and sale commitments of securities classified as trading under SFAS 115 (with notional balances of approximately \$0 billion, \$78 billion and \$147 billion at December 31, 2004, 2003 and 2002, respectively), fair value gains and losses are reported as Gains (losses) on investment activity on our consolidated statements of income and therefore, those fair value gains and losses are not included above.
- (4) Hedge accounting gains (losses) arise when the fair value change of a derivative does not exactly offset the fair value change of the hedged item. For further information, see “NOTE 12: DERIVATIVES” to the consolidated financial statements.
- (5) Includes gains or losses reclassified from AOCI, net of taxes, as a result of the termination of cash flow hedge designations because we determined that the related forecasted transaction is probable of not occurring.

*Effect on Consolidated Financial Statements.* As Table 51 shows, a significant portion of our derivatives was not designated in hedge accounting relationships at December 31, 2004 and 2003. Derivatives that are not in qualifying hedge accounting relationships generally increase the volatility of reported Net income because they are marked to fair value through earnings without the offsetting change in value of the economically hedged exposures also being recognized in earnings. For information about our hedging activities, see “CONSOLIDATED RESULTS OF OPERATIONS — Non-Interest Income (Loss) — Derivative Gains (Losses).”

To qualify for cash flow hedge accounting treatment, hedged forecasted transactions must be considered probable of occurring. In addition, SFAS 133 imposes a variety of operational requirements that must be met. At December 31, 2004, \$21,214 million notional amount of derivative contracts was designated in cash flow hedge relationships, including \$1,576 million notional amount of foreign-currency swaps and \$19,638 million notional amount of commitments. The current fair value of the derivatives included in cash flow hedge relationships is recorded on the consolidated balance sheets as Derivative assets, at fair value, or Derivative liabilities, at fair value. For derivatives that receive cash flow hedge accounting treatment under SFAS 133, the effective portion of the change in fair value of the derivative asset or derivative liability is presented in the Stockholders’ equity section of our consolidated balance sheets in AOCI, net of taxes. The effective portion of

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the derivative generally offsets, on a cumulative basis, the cumulative change in the present value of the hedged cash flows.

As of December 31, 2004, the net cumulative change in the fair value of all derivatives designated in cash flow hedge relationships that were still open or for which the forecasted transactions had not yet occurred since SFAS 133 was implemented on January 1, 2001 (net of amounts previously reclassified to earnings through December 31, 2004) was a loss of approximately \$7.9 billion on an after-tax basis. This amount was related almost entirely to \$7.9 billion of deferred losses on closed cash flow hedge relationships. The majority of the closed cash flow hedges related to the hedging of the variability of cash flows from forecasted issuances of debt with various derivatives. Closed cash flow hedges involve derivatives that have been terminated or are no longer designated in cash flow hedge relationships. Fluctuations in prevailing market interest rates have no impact on the deferred portion of AOCI, net of taxes, relating to losses on closed cash flow hedges. Therefore, the \$7.9 billion in deferred losses related to closed cash flow hedges will be recognized as a reduction of earnings as the originally hedged forecasted transactions affect earnings, unless it becomes probable that the forecasted transaction will not occur. If it is probable that the forecasted transaction will not occur, then the entire deferred amount associated with the forecasted transaction will be reclassified into earnings immediately. See “Table 39 — Scheduled Amortization of Net Deferred Losses in AOCI to Income Related to Closed Cash Flow Hedge Relationships” for more information on expected reclassifications to income of net deferred losses related to closed cash flow hedges during future periods.

Table 52 summarizes the notional amounts for each type of derivative, including our new contracts, maturities and terminations during the year. This information indicates the level and type of derivative activity undertaken during the year and reflects our use of different derivative products in the execution of our risk management strategies. The notional amounts of our derivatives are a reference point to determine the payments owed between us and our counterparties under the contracts. The notional amount of a derivative is not an indication of the fair value of the position or of the cash flows related to the position. In most market environments, derivatives have fair values that are a small percentage of their notional amount.

**Table 52 — Changes in Derivative Notional Amounts**

	Year Ended December 31, 2004			
	Derivative Notional Amount <sup>(1)</sup>			
	Beginning Balance	New Contracts	Maturities/Terminations <sup>(2)</sup>	Ending Balance
	(dollars in millions)			
Interest-rate swaps:				
Pay-fixed	\$179,751	\$163,369	\$ (248,077)	\$ 95,043
Receive-fixed	107,417	230,194	(254,009)	83,602
Basis (floating to floating)	424	—	(330)	94
Total interest-rate swaps	<u>287,592</u>	<u>393,563</u>	<u>(502,416)</u>	<u>178,739</u>
Option-based:				
Call swaptions	217,338	45,555	(72,948)	189,945
Put swaptions	123,611	32,911	(131,347)	25,175
Other option-based derivatives <sup>(3)</sup>	20,379	17,923	(19,321)	18,981
Total option-based	<u>361,328</u>	<u>96,389</u>	<u>(223,616)</u>	<u>234,101</u>
Futures	130,798	489,176	(490,864)	129,110
Foreign-currency swaps	46,512	19,428	(9,090)	56,850
Subtotal	<u>\$826,230</u>	<u>\$998,556</u>	<u>\$ (1,225,986)</u>	<u>\$598,800</u>
Prepayment management agreement				113,692
Commitments				32,952
Credit derivatives				10,926
Swap guarantee derivatives				408
Total				<u>\$756,778</u>
	Year Ended December 31, 2003			
	Derivative Notional Amount <sup>(1)</sup>			
	Beginning Balance	New Contracts	Maturities/Terminations <sup>(2)</sup>	Ending Balance
	(dollars in millions)			
Interest-rate swaps:				
Pay-fixed	\$135,758	\$ 228,727	\$ (184,734)	\$ 179,751
Receive-fixed	149,397	162,363	(204,343)	107,417
Basis (floating to floating)	4,941	136	(4,653)	424
Total interest-rate swaps	<u>290,096</u>	<u>391,226</u>	<u>(393,730)</u>	<u>287,592</u>
Option-based:				
Call swaptions	131,679	125,839	(40,180)	217,338
Put swaptions	129,881	93,237	(99,507)	123,611
Other option-based derivatives <sup>(3)(4)</sup>	27,522	26,519	(33,662)	20,379
Total option-based	<u>289,082</u>	<u>245,595</u>	<u>(173,349)</u>	<u>361,328</u>
Futures	228,411	444,830	(542,443)	130,798
Foreign-currency swaps	43,687	23,193	(20,368)	46,512
Subtotal <sup>(4)</sup>	<u>\$851,276</u>	<u>\$1,104,844</u>	<u>\$ (1,129,890)</u>	<u>\$ 826,230</u>
Prepayment management agreement				152,548
Commitments				89,520
Credit derivatives				15,542
Swap guarantee derivatives				31
Total				<u>\$1,083,871</u>

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

(2) Includes foreign currency translation adjustments to notional amounts as of the date presented.

(3) Primarily represents written options.

(4) Subsequent to the issuance of our Information Statement dated September 24, 2004, we decreased the beginning balance of Other option-based derivatives for the year ended December 31, 2003 by \$585 million. The effect of this change was a decrease to the beginning balance at that date to \$851,276 million from \$851,861 million. We also increased new contracts of Other option-based derivatives by \$585 million. The effect of this change was an increase to new contracts at that date to \$1,104,844 million from \$1,104,259 million.

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The total notional amount of our derivatives (excluding the prepayment management agreement, commitments, credit derivatives and swap guarantee derivatives) decreased by \$227.4 billion from December 31, 2003 to December 31, 2004. See “CONSOLIDATED BALANCE SHEETS ANALYSIS — Derivative Assets and Liabilities, at Fair Value” for information on the factors driving the decrease in notional amounts during 2004.

Table 53 summarizes the change in derivative fair values for the periods presented. See “Table 54 — Derivative Fair Values and Maturities” for a breakdown of our derivative fair values by derivative type. Also see “CRITICAL ACCOUNTING POLICIES AND ESTIMATES — Fair Value Measurement” for a discussion of how changes in fair values affect our financial results under GAAP.

**Table 53 — Changes in Derivative Fair Values**

	Year Ended December 31,	
	2004	2003
	(dollars in millions)	
Beginning balance — Net asset (liability) .....	\$15,823	\$ 9,426
Net change in:		
Futures <sup>(1)</sup> .....	(214)	(609)
Commitments .....	221	(483)
Credit derivatives .....	(7)	1
Swap guarantee derivatives .....	(1)	—
Other derivatives: <sup>(2)</sup>		
Changes in fair value .....	(627)	6,572
Fair value of new contracts entered into during the period <sup>(3)</sup> .....	1,733	4,841
Contracts realized or otherwise settled during the period .....	(1,897)	(3,925)
Ending balance — Net asset (liability) .....	<u>\$15,031</u>	<u>\$15,823</u>

(1) The fair value changes for futures are determined by the individual exchanges on which they are traded, and not by us.

(2) Includes fair value changes for OTC interest-rate swaps, option-based derivatives and foreign-currency swaps.

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



Table 54 shows the notional amount and fair value for each derivative type and the maturity profile of the positions. The fair values of the derivative positions are presented on a product-by-product basis, without netting by counterparty. The fair value of a longer-term derivative generally will vary more over time than a comparable derivative with a shorter maturity. A positive fair value in Table 54 for a derivative product category is the estimated amount, prior to netting by counterparty, that we would be entitled to receive if we terminated those transactions. A negative fair value is the estimated amount, prior to netting by counterparty, that we would owe if we terminated the derivatives in that product category.

**Table 54 — Derivative Fair Values and Maturities**

	December 31, 2004					
	Notional Amount	Total Fair Value <sup>(1)</sup>	Fair Value <sup>(2)</sup>			
			Less than 1 Year	1 to 3 Years	Greater than 3 and up to 5 Years	In Excess of 5 Years
			(dollars in millions)			
Interest-rate swaps:						
Pay-fixed .....	\$ 95,043	\$(2,879)	\$ 20	\$ (21)	\$ (20)	\$(2,858)
Receive-fixed .....	83,602	2,394	40	319	170	1,865
Basis (floating to floating) .....	94	1	—	—	—	1
Total interest-rate swaps .....	<u>178,739</u>	<u>(484)</u>	<u>60</u>	<u>298</u>	<u>150</u>	<u>(992)</u>
Option-based:						
Call swaptions .....	189,945	4,988	237	1,997	1,158	1,596
Put swaptions .....	25,175	267	207	56	—	4
Other option-based derivatives .....	18,981	2	—	4	2	(4)
Total option-based .....	<u>234,101</u>	<u>5,257</u>	<u>444</u>	<u>2,057</u>	<u>1,160</u>	<u>1,596</u>
Futures .....	129,110	(33)	(33)	—	—	—
Foreign-currency swaps .....	56,850	10,303	3,370	2,116	1,026	3,791
Prepayment management agreement .....	113,692	—	—	—	—	—
Commitments .....	32,952	(9)	(9)	—	—	—
Swap guarantee derivatives .....	408	(1)	—	—	—	(1)
Subtotal .....	<u>745,852</u>	<u>15,033</u>	<u>\$3,832</u>	<u>\$4,471</u>	<u>\$2,336</u>	<u>\$ 4,394</u>
Credit derivatives .....	10,926	(2)				
Total .....	<u>\$756,778</u>	<u>\$15,031</u>				

- (1) The fair value by derivative type presented on this table is shown prior to netting by counterparty. The fair value of derivatives presented on the consolidated balance sheets, however, is netted by counterparty as permitted by GAAP, and is reported in the Derivative assets, at fair value, and Derivative liabilities, at fair value captions.
- (2) Fair value is categorized based on the years from December 31, 2004 until the contractual maturity of the derivative.

See “CONSOLIDATED RESULTS OF OPERATIONS” and “CONSOLIDATED BALANCE SHEETS ANALYSIS” for more information regarding how these changes in fair value affect our financial results.

Table 55 provides a summary of the contractual terms of our pay-fixed and receive-fixed swaps. This table provides information about the effect of interest-rate swaps on net interest yield if the derivative is in a fair value or cash flow hedge relationship. If the derivative is classified as no hedge designation, the derivative does not affect our net interest yield, but rather is reported in Derivative gains (losses) on our consolidated statements of income.

**Table 55 — Contractual Terms of Pay-Fixed and Receive-Fixed Swaps**

	December 31, 2004					
	Pay-Fixed/ Receive-Variable			Receive-Fixed/ Pay-Variable		
	Notional	Pay Rate	Receive Rate <sup>(1)</sup>	Notional	Pay Rate <sup>(1)</sup>	Receive Rate
	(dollars in millions)					
<b>Swaps</b>						
Maturity less than 1 year.....	\$ 4,282	2.34%	2.19%	\$11,032	3.48%	2.17%
Maturity 1 to 3 years .....	4,703	3.84	2.38	24,581	3.92	2.20
Maturity greater than 3 and up to 5 years...	15,147	3.99	2.37	15,751	3.67	2.22
Maturity in excess of 5 years .....	27,205	4.91	2.30	32,238	5.19	2.22
Subtotal .....	<u>51,337</u>			<u>83,602</u>		
<b>Forward-starting swaps<sup>(2)</sup></b>						
Maturity greater than 3 and up to 5 years...	1,625	3.73	—	—	—	—
Maturity in excess of 5 years .....	42,081	6.20	—	—	—	—
Subtotal .....	<u>43,706</u>			<u>—</u>		
Total .....	<u>\$95,043</u>			<u>\$83,602</u>		
	December 31, 2003					
	Pay-Fixed/ Receive-Variable			Receive-Fixed/ Pay-Variable		
	Notional	Pay Rate	Receive Rate <sup>(1)</sup>	Notional	Pay Rate <sup>(1)</sup>	Receive Rate
	(dollars in millions)					
<b>Swaps</b>						
Maturity less than 1 year.....	\$ 4,900	5.76%	1.18%	\$ 21,106	1.40%	2.38%
Maturity 1 to 3 years .....	31,073	2.69	1.17	18,247	1.73	3.88
Maturity greater than 3 and up to 5 years...	15,967	3.63	1.17	11,249	1.99	3.99
Maturity in excess of 5 years .....	65,395	4.91	1.17	24,202	1.66	5.64
Subtotal .....	<u>117,335</u>			<u>74,804</u>		
<b>Forward-starting swaps<sup>(2)</sup></b>						
Maturity 1 to 3 years .....	—	—	—	8,520	—	2.83
Maturity greater than 3 and up to 5 years...	220	4.49	—	3,260	—	3.21
Maturity in excess of 5 years .....	62,196	6.11	—	20,833	—	5.07
Subtotal .....	<u>62,416</u>			<u>32,613</u>		
Total .....	<u>\$179,751</u>			<u>\$107,417</u>		

- (1) The weighted-average rate payable and receivable is as of the date indicated. Because the rates of the swaps are floating, these rates will change as prevailing interest rates change. The variable legs of these swaps are generally based on LIBOR or Euro Interbank Offered Rate.  
(2) Represents interest-rate swap agreements scheduled to begin on a future date. Generally, the interest rate associated with the variable leg of the swap is set when the first payment cycle begins and is periodically reset thereafter.

### **Measurement of Interest-Rate Risk**

We measure our exposure to key interest-rate risks every day against both internal management limits and limits set by the Board of Directors. Throughout 2004 our interest-rate risk remained low and well below management and Board limits.

**PMVS and Duration Gap.** Our interest-rate sensitivity disclosures provide a set of management estimates that convey a useful assessment of the amount of our interest-rate risk at a given point in time. This section describes our primary interest-rate risk measures: PMVS and duration gap. PMVS is measured in two ways, one measuring the estimated sensitivity of our portfolio market value (as defined below) to parallel moves in interest rates (PMVS-L) and the other to nonparallel movements (PMVS-YC). We calculate PMVS-L and PMVS-YC every business day. PMVS-L and PMVS-YC are based on the assumption of instantaneous yield curve shifts; therefore neither measure includes the effect on fair value of any rebalancing actions that we would typically take to reduce our risk exposure.

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- PMVS-L shows the estimated loss in pre-tax portfolio market value, expressed as a percentage of our after-tax fair value of net assets attributable to common stockholders (measured as fair value of net assets less the fair value of preferred stock) from an immediate adverse 50 basis point parallel shift in the level of LIBOR rates (that is, when the yield at each point on the LIBOR yield curve increases or decreases by 50 basis points). We believe the use of an immediate 50 basis point shift in the LIBOR yield curve is a conservative estimate of interest-rate risk. The periodic disclosure in our Monthly Volume Summary report, which is available on our website at [www.FreddieMac.com](http://www.FreddieMac.com), reflects the average of the daily PMVS-L estimates for a given reporting period (a month, quarter or year). (We are providing this Internet address solely for the information of interested persons. We do not intend this Internet address to be an active link and are not using references to this Internet address here or elsewhere in this Information Statement to incorporate additional information into this Information Statement.)
- PMVS-YC shows the estimated loss in pre-tax portfolio market value, expressed as a percentage of our after-tax fair value of net assets attributable to common stockholders, from an immediate adverse 25 basis point change in the slope (up and down) of the LIBOR yield curve. The 25 basis point change in slope for the PMVS-YC measure is obtained by shifting the two-year and ten-year LIBOR rates by an equal amount (12.5 basis points), but in opposite directions. LIBOR rate shifts between the two-year and ten-year points are interpolated. The periodic disclosure in our Monthly Volume Summary report, which is available on our website at [www.FreddieMac.com](http://www.FreddieMac.com), reflects the average of the daily PMVS-YC estimates for a given reporting period (a month, quarter or year).
- Duration gap estimates the net sensitivity of the fair value of our financial instruments to movements in interest rates. Duration gap is presented in units expressed as months. On a daily basis, we estimate the fair value and effective duration of our financial assets and liabilities, including derivatives. The fair value of each instrument is multiplied by its duration to determine the instrument's duration dollars. Duration dollars are then aggregated to estimate the portfolio's net duration dollar exposure. To calculate duration gap, the net duration dollar exposure is divided by the fair value of total interest-earning assets and expressed in months. A duration gap of zero implies that the change in value of assets from an instantaneous rate move will be accompanied by an equal and offsetting move in the value of debt and derivatives thus leaving the net fair value of equity unchanged. However, because duration does not capture convexity exposure (the amount by which duration itself changes as rates move), actual changes in fair value from interest-rate changes may differ from those implied by duration gap alone. For that reason, management believes duration gap is most useful when used in conjunction with PMVS. The periodic duration gap disclosure in our Monthly Volume Summary report, which is available on our website at [www.FreddieMac.com](http://www.FreddieMac.com), reflects the average of the daily duration gap estimates for a given reporting period (a month, quarter or year).

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

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

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portfolio market value or duration gap because of the minimal impact they would have on both PMVS and duration gap.

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

While PMVS and duration gap estimate the exposure of the fair value of net assets attributable to common stockholders to changes in interest rates, they do not capture the potential impact of certain other market risks, such as changes in volatility, basis, prepayment model, mortgage-to-debt spread and foreign currency risk. The impact of these other market risks can be significant. See “*Sources of Interest-Rate Risk and Other Market Risks*” for further information.

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

*PMVS Results.* Table 56 provides estimated point-in-time PMVS-L and PMVS-YC results at December 31, 2004 and 2003. To supplement the PMVS-L results based on an assumed 50 basis point shift in the LIBOR yield curve, Table 56 also provides year-end PMVS-L estimates assuming an immediate 100 basis point shift in the LIBOR yield curve. Because we do not hedge all prepayment option risk, the duration of our mortgage assets changes more rapidly as changes in interest rates increase. Accordingly, as shown in Table 56, the PMVS-L results based on a 100 basis point shift in the LIBOR curve are disproportionately higher than the PMVS-L results based on a 50 basis point shift in the LIBOR curve. We disclose the average daily, quarterly and annual PMVS-L and PMVS-YC results in our Monthly Volume Summary report.

**Table 56 — Portfolio Market Value Sensitivity Assuming Shifts of the LIBOR Yield Curve**

	<u>Portfolio Market Value Sensitivity</u>			<u>Potential Pre-Tax Loss in Portfolio Market Value (millions)</u>		
	<u>PMVS-YC</u>	<u>PMVS-L</u>		<u>PMVS-YC</u>	<u>PMVS-L</u>	
	<u>25 bp</u>	<u>50 bp</u>	<u>100 bp</u>	<u>25 bp</u>	<u>50 bp</u>	<u>100 bp</u>
<b>At:</b>						
December 31, 2004 .....	0%	3%	8%	\$25	\$725	\$2,083
December 31, 2003 .....	0%	2%	9%	\$20	\$559	\$2,171

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

Table 57 shows that the low PMVS-L risk levels for the periods presented would generally have been substantially higher if we had not used derivatives to manage our interest-rate risk exposure.

**Table 57 — Derivative Impact on PMVS**

	<u>Before Derivatives</u>	<u>After Derivatives</u>	<u>Effect of Derivatives</u>
<b>At December 31, 2004</b>			
PMVS-L (50bp) .....	7%	3%	(4)%
PMVS-YC (25bp) .....	1%	0%	(1)%
<b>At December 31, 2003</b>			
PMVS-L (50bp) .....	6%	2%	(4)%
PMVS-YC (25bp) .....	0%	0%	0%

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*Duration Gap Results.* We disclose the average daily, quarterly and annual duration gap in our Monthly Volume Summary report. Table 58 provides estimated average duration gap results for December 2004 and 2003.

**Table 58 — Duration Gap**

<u>Average for the Month of December,</u>	<u>Duration Gap</u> (in months)
2004 .....	(1)
2003 .....	0

## Credit Risks

Our Total mortgage portfolio is subject to credit risks. See “Table 8 — Freddie Mac’s Total Mortgage Portfolio Based on Unpaid Principal Balances” for more information on the composition of our Total mortgage portfolio. We are subject primarily to two types of credit risk — mortgage credit risk and institutional credit risk. Mortgage credit risk is the risk that a borrower will fail to make timely payments on a mortgage owned or guaranteed by us. Institutional credit risk is the risk that a counterparty that has entered into a business contract or arrangement with us will fail to meet its obligations. A portion of the revenue that Freddie Mac earns from management and guarantee fees is designed to compensate the firm for taking on credit risk.

### *Oversight of Credit Risks*

The purpose of the Credit Risk Oversight group is to provide independent oversight of the corporate-wide credit risk management functions, including asset selection, portfolio management, loss mitigation, and institutional counterparty risk. In particular, Credit Risk Oversight is responsible for providing senior management with regular, independent evaluations of whether credit risks are effectively identified, measured, managed, and controlled. The Models and Methods Oversight group, a part of the Enterprise Risk Oversight function, is responsible for independently assessing the design and adequacy of all key credit risk models.

### *Mortgage Credit Risk*

Defaults by mortgage borrowers result in losses if we are unable to collect amounts due through the sale of the underlying properties, restructuring the mortgage loans or by using other loss mitigation strategies. The discussion below describes our mortgage credit risk management strategies and summarizes our credit performance.

**Mortgage Credit Risk Management Strategies.** Our strategies for managing mortgage credit risk focus on five primary areas:

- underwriting requirements and quality control standards;
- credit enhancements;
- portfolio diversification;
- loss mitigation activities; and
- other risk management activities.

*Underwriting Requirements and Quality Control Standards.* All mortgages that we purchase have an inherent risk of default. Through our underwriting and quality control processes, we seek to understand the underlying risk in a given mortgage we securitize or purchase for our Retained portfolio to ensure that we adequately price for the risk we assume. Our current business model relies on a process of delegated underwriting for the single-family mortgages we purchase or securitize. That is, we provide originators with a series of guidelines to follow in the underwriting of a mortgage and they represent and warrant to us that the mortgages sold to us meet these guidelines. We subsequently review a sample of these loans and if we determine that any loan is not in compliance with our underwriting standards, we may require the seller/

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servicer to repurchase that mortgage or make us whole in the event of a default. To assist us in purchasing mortgages that can be sold to us, we provide originators with automated underwriting software tools, such as Loan Prospector® and other quantitative credit risk management tools to evaluate and purchase single-family mortgages and monitor the related mortgage credit risk. Loan Prospector® combines information on the key indicators of mortgage default risk, such as loan-to-value ratios, credit scores and other mortgage and borrower characteristics to generate credit risk classifications. These statistically-based risk assessment tools increase our ability to distinguish among single-family loans based on their risk, return and importance to our mission. On a negotiated basis, we may allow seller/servicers to underwrite mortgages for sale to us using other proprietary automated underwriting systems.

For 2004 and 2003, Loan Prospector® was used to evaluate approximately 61 percent and 64 percent, respectively, of our single-family purchase volume prior to purchase. As part of our post-purchase quality control review process, we use Loan Prospector® to evaluate the credit quality of virtually all single-family mortgages that were not evaluated by Loan Prospector® prior to purchase. Loan Prospector® risk classifications influence both the price we charge to guarantee loans and the sample of loans we review in quality control. As such, Loan Prospector® provides an effective credit risk management tool.

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

*Credit Enhancements.* For most of the mortgage loans in our Total mortgage portfolio (other than non-Freddie Mac mortgage-related securities and that portion of issued Structured Securities that is backed by Ginnie Mae Certificates), we retain the primary risk of loss in the event of default by the borrower on the underlying mortgage. Our charter requires that, to be eligible for purchase, single-family mortgages with loan-to-value ratios above 80 percent at the time of purchase be covered by (a) primary mortgage insurance or (b) certain other credit protections. In addition, for some mortgage loans, we elect to share the default risk by transferring a portion of that risk to various third parties through a variety of other credit enhancement vehicles. Mortgage loans covered by primary mortgage insurance and these other credit protections are referred to as credit-enhanced mortgages. Proceeds received from these credit enhancements are applied to offset credit losses and to Net interest income for that portion that represents forgone interest not previously recognized related to individual mortgage loans that default.

Table 59 shows the credit-enhanced portion of our Total mortgage portfolio (excluding non-Freddie Mac mortgage-related securities and Structured Securities issued by us that are backed by Ginnie Mae Certificates).

**Table 59 — Credit-Enhanced Percentage of the Total Mortgage Portfolio<sup>(1)</sup>**

	<u>December 31,</u>		
	<u>2004</u>	<u>2003</u>	<u>2002</u>
Credit-enhanced <sup>(2)</sup> .....	19%	21%	27%

(1) Non-Freddie Mac mortgage-related securities are excluded from this table because they do not expose us to primary risk of loss in the event of a default by the borrower on the underlying mortgage. That portion of Structured Securities backed by Ginnie Mae Certificates is excluded because the incremental credit risk to which it exposes us is considered de minimis. See “Table 33 — Credit Characteristics of Mortgages and Mortgage-Related Securities in the Retained Portfolio” for additional information about our non-Freddie Mac mortgage-related securities.

(2) Credit enhancements primarily include third party primary loan-level mortgage insurance, third party pool insurance and other arrangements in which the lender or a third party has retained a portion of the default risk by pledging collateral or agreeing to accept losses on loans that default. In many cases, the lender’s or third party’s risk is limited to a specific level of losses at the time the credit enhancement becomes effective.

The percentage of our Total mortgage portfolio (excluding Structured Securities backed by Ginnie Mae Certificates and non-Freddie Mac mortgage-related securities held by us) with credit-enhancements decreased from 2002 to 2004. This decrease was primarily due to a high level of refinance loans acquired in 2003 and 2004, which tend to have lower loan-to-value ratios and, therefore, generally do not require credit

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enhancements. Our ability and desire to expand the portion of our Total mortgage portfolio with credit enhancements will depend on our evaluation of the credit quality of new business purchase opportunities, our portfolio risk profile and the future availability of effective credit enhancements at prices that permit an attractive return.

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

After primary mortgage insurance, the most prevalent type of credit enhancement that we use is pool insurance. With pool insurance, a mortgage insurer provides insurance on a pool of loans up to a stated aggregate loss limit. Our pool insurance contracts cover losses ranging between approximately 0.69 percent and 5.00 percent of the aggregate unpaid principal balance of the pooled loans at the time of purchase. In addition to a pool-level loss coverage limit, some pool insurance contracts may have limits on coverage at the loan level. For pool insurance contracts that expire before the completion of the contractual term of the mortgage loan, we seek to ensure that the contracts cover the period of time during which we believe the mortgage loans are most likely to default.

Other forms of credit enhancements on single-family mortgage loans include collateral (including cash or high-quality marketable securities) pledged by a lender, government guarantees, and recourse agreements (under which we may require a lender to repurchase loans that default). In some instances, our agreements with insurers limit the insurance to a stated aggregate loss.

For multifamily mortgages, we occasionally utilize credit enhancements to mitigate risk. The types of credit enhancements used for multifamily mortgage loans include recourse, third-party guarantees or letters of credit, subordinated participations in mortgage loans or structured pools, and cross-default and cross-collateralization provisions. With a cross-default provision, if the loan on a property goes into default, we have the right to declare specified other mortgage loans of the same borrower or certain of its affiliates to be in default and to foreclose those other mortgages. With a cross-collateralization provision, we have the additional right to apply excess proceeds from the foreclosure of one mortgage to amounts owed to us by the same borrower or certain of its affiliates relating to other multifamily mortgage loans we own. We also receive similar credit enhancements for Multifamily PC guarantor swaps; for tax-exempt multifamily housing revenue bonds that support pass-through certificates issued by third parties for which we provide our guarantee of the payment of principal and interest; for Freddie Mac pass-through certificates that are backed by tax-exempt multifamily housing revenue bonds and related taxable bonds and/or loans, and for multifamily mortgage loans that are originated and held by state and municipal agencies to support tax-exempt multifamily housing revenue bonds for which we provide our guarantee of the payment of principal and interest. For information about our maximum coverage in regards to these credit enhancements, see "NOTE 4: FINANCIAL GUARANTEES" to the consolidated financial statements.

While the use of credit enhancements reduces our exposure to mortgage credit risk, it increases our exposure to institutional credit risk. See "*Institutional Credit Risk*" for more information.

*Portfolio Diversification.* A key characteristic of our credit risk portfolio is broad diversification along a number of critical risk dimensions. We continually monitor a variety of mortgage loan characteristics such as product mix, loan-to-value ratios and geographic concentration, which may affect the default experience on our overall mortgage portfolio, and may seek to reinsure a portion of our portfolio if we observe unacceptable levels of concentration.

*Product Mix.* Table 60 presents the distribution of underlying mortgage assets for total PCs and Structured Securities issued and outstanding.

**Table 60 — Freddie Mac Issued and Outstanding PCs and Structured Securities<sup>(1)</sup>**

	December 31,			
	2004		2003	
	Total Issued PCs and Structured Securities	Outstanding PCs and Structured Securities <sup>(2)</sup>	Total Issued PCs and Structured Securities	Outstanding PCs and Structured Securities <sup>(2)</sup>
	(dollars in millions)			
Freddie Mac issued PCs and Structured Securities				
Single-family:				
Conventional:				
30-year fixed-rate <sup>(3)</sup> .....	\$ 689,945	\$509,923	\$ 649,719	\$449,281
15-year fixed-rate .....	347,135	224,627	355,800	197,677
ARMs/floating-rate <sup>(4)</sup> .....	102,273	59,089	81,184	39,868
Seconds <sup>(5)</sup> .....	—	—	2	2
FHA/VA .....	1,350	1,340	2,098	2,058
RHS and other federal guarantee loans	178	178	164	164
Alternative collateral deals <sup>(6)</sup> .....	16,560	8,125	17,486	11,478
Balloons/resets <sup>(7)</sup> .....	32,966	31,075	34,788	31,818
Structured Securities backed by Ginnie Mae Certificates <sup>(8)</sup> .....	3,015	2,628	4,729	4,059
Total single-family .....	<u>1,193,422</u>	<u>836,985</u>	<u>1,145,970</u>	<u>736,405</u>
Multifamily:				
Conventional .....	15,546	15,285	16,098	15,759
Total .....	<u>\$1,208,968</u>	<u>\$852,270</u>	<u>\$1,162,068</u>	<u>\$752,164</u>

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

(2) Represents PCs and Structured Securities held by third parties.

(3) Also includes 20-year and 40-year fixed-rate mortgages.

(4) Includes ARM's with 1-, 3-, 5-, 7- and 10-year initial fixed-rate periods.

(5) Represents mortgage loans on properties that are subordinate to the superior mortgage lien.

(6) Prior to 2004, alternative collateral deals included Structured Securities backed by non-agency securities, which were primarily backed by subprime mortgage loans; and to a lesser extent, FHA / VA loans and home equity loans. Beginning in 2004, alternative collateral deals included Structured Securities backed by non-agency securities, which were backed by a mixture of subprime and other (*i.e.*, prime) mortgage loans. The alternative collateral deal portion of outstanding PCs and Structured Securities consisted of \$1,587 million and \$2,572 million of fixed-rate, \$1,165 million and \$2,723 million of ARM's/floating rate, \$5,286 million and \$6,040 million of FHA/VA, \$17 million and \$5 million of the Rural Housing Service and other federal guarantee loans, and \$70 million and \$138 million of seconds at December 31, 2004 and 2003, respectively.

(7) Mortgages whose terms require lump sum principal payments on contractually determined future dates unless the borrower qualifies for and elects an extension of the maturity date at an adjusted interest rate.

(8) Ginnie Mae Certificates which underlie the Structured Securities are backed by FHA/VA loans.



Table 61 presents the distribution of unsecuritized whole mortgage loans held in our Retained portfolio.

**Table 61 — Mortgage Loans Held in the Retained Portfolio<sup>(1)</sup>**

	December 31,	
	2004	2003
	(dollars in millions)	
<b>Single-family:</b>		
Conventional		
Fixed-rate <sup>(2)</sup> .....	\$21,409	\$24,902
Adjustable-rate <sup>(2)</sup> .....	990	1,245
Seconds .....	—	1
Total Conventional .....	22,399	26,148
FHA/VA — Fixed-rate .....	344	513
RHS and other federal guarantee loans .....	646	613
Total single-family .....	23,389	\$27,274
<b>Multifamily Mortgages:</b>		
Conventional .....	37,968	\$32,993
FHA/RHS .....	3	3
Total multifamily .....	37,971	32,996
<b>Total mortgages</b> .....	<u>\$61,360</u>	<u>\$60,270</u>

(1) Based on unpaid principal balances. Excludes mortgage loans traded, but not yet settled.

(2) We reclassified \$374 million of mortgage loans from Single-family Conventional Fixed-rate to Single-family Conventional Adjustable-rate for the year ended December 31, 2003 to conform with the 2004 presentation.

Product mix affects the credit risk profile of our Total mortgage portfolio. In general, 15-year fixed-rate mortgages exhibit the lowest default rate among the types of single-family mortgage loans we securitize and purchase, due to the accelerated rate of principal amortization on these mortgages and the credit profiles of borrowers who seek and qualify for them. The next lowest rate of default is associated with 30-year fixed-rate mortgages. Balloon/reset mortgages and ARMs typically default at a higher rate than fixed-rate mortgages, although default rates for different types of ARMs may vary. While ARMs are typically originated with interest rates that are initially lower than those available for fixed-rate mortgages, their interest rates also change over time based on changes in an index or reference interest rate. As a result, the borrower's payments may rise or fall, within limits, as interest rates change. As payment amounts increase, the risk of default also increases. In the low interest rate environment experienced during 2002, 2003 and 2004, this trend was reversed with ARMs exhibiting lower default rates than fixed-rate mortgages.

During 2004, there was a rapid proliferation of alternative product types, including initial interest-only loans (loans where the borrower pays only interest for a period of time before the loan begins to amortize), negative amortization loans (loans where the borrower's payment is capped and as a result the loan balance may actually increase due to the difference between the capped payment and the fully indexed payment), and Alternative A products (primarily loans originated based on stated income or asset information or where the borrower provides no supporting documentation of income, assets or employment). While each of these products has been on the market for some time, their prevalence increased in 2004. These products are designed to address a variety of borrower needs, including affordability issues and documentation issues. Each of these products is expected to default more often than our traditional product types. To date, we have purchased a limited amount of these products through our securitization programs, although we expect our participation in these products to grow over the coming years. We will monitor the growth of these products in our portfolio, and if appropriate, may seek credit enhancements to manage the incremental risk.

The subprime segment of the mortgage market primarily serves borrowers with lower quality credit payment histories. These mortgages typically carry a higher risk of default. Our participation in this market helps to increase the availability of mortgage credit and reduce the costs of homeownership for a broader spectrum of borrowers.

We participate in the subprime market segment in two ways. First, our Retained portfolio makes investments in non-Freddie Mac mortgage-related securities that were originated in this market segment. Substantially all of these securities were rated "AAA" by one or more rating agencies at the time of purchase.

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These investments are included in the single-family and other mortgage-related securities portion of our non-Freddie Mac mortgage-related securities portfolio shown in “Table 33 — Credit Characteristics of Mortgages and Mortgage-Related Securities in the Retained Portfolio.” Second, we guarantee securities backed by subprime mortgages. (These securities comprise a portion of our “alternative collateral deals.”) These securities have previously been credit enhanced and at the time of our purchase most of these securities were “shadow rated” at least “BBB” (based on the S&P rating scale) by at least one nationally recognized credit rating agency which assessed the risks of the securities without regard to the benefits of our guarantee. In addition to the non-Freddie Mac mortgage-related securities discussed above, our Retained portfolio makes investments in some of the Structured Securities issued in these transactions.

The distribution of the single-family loans underlying our Total mortgage portfolio (excluding non-Freddie Mac mortgage-related securities, alternative collateral deals and that portion of Structured Securities that is backed by Ginnie Mae Certificates) by original and estimated current loan-to-value ratio ranges, credit scores, loan purpose, property type and occupancy type is shown in Table 62.

**Table 62 — Characteristics of Single-Family Mortgage Loan Portfolio<sup>(1)</sup>**

<u>Original LTV Ratio Range<sup>(2)</sup></u>	<u>December 31,</u>		
	<u>2004</u>	<u>2003</u>	<u>2002</u>
Less than 60% . . . . .	26%	26%	21%
Above 60% to 70% . . . . .	17	17	15
Above 70% to 80% . . . . .	42	41	43
Above 80% to 90% . . . . .	9	9	11
Above 90% to 95% . . . . .	5	6	8
Above 95% . . . . .	1	1	2
Total . . . . .	<u>100%</u>	<u>100%</u>	<u>100%</u>
Weighted average original loan-to-value ratio . . . . .	70%	70%	72%
<u>Estimated Current LTV Ratio Range<sup>(3)</sup></u>			
Less than 60% . . . . .	53%	44%	45%
Above 60% to 70% . . . . .	19	20	19
Above 70% to 80% . . . . .	18	23	22
Above 80% to 90% . . . . .	7	9	9
Above 90% to 95% . . . . .	2	3	3
Above 95% . . . . .	1	1	2
Total . . . . .	<u>100%</u>	<u>100%</u>	<u>100%</u>
Weighted average estimated current LTV ratio . . . . .	57%	61%	61%
<u>Credit Score</u>			
740 and above . . . . .	44%	44%	39%
700 to 739 . . . . .	23	23	23
660 to 699 . . . . .	18	17	18
620 to 659 . . . . .	9	9	10
Less than 620 . . . . .	4	4	4
Not Available . . . . .	2	3	6
Total . . . . .	<u>100%</u>	<u>100%</u>	<u>100%</u>
Weighted average credit score . . . . .	723	723	718
<u>Loan Purpose</u>			
Purchase . . . . .	28%	25%	34%
Cash-out refinance . . . . .	27	26	25
Other refinance . . . . .	45	49	41
Total . . . . .	<u>100%</u>	<u>100%</u>	<u>100%</u>
<u>Property Type</u>			
1 unit . . . . .	97%	97%	97%
2-4 units . . . . .	3	3	3
Total . . . . .	<u>100%</u>	<u>100%</u>	<u>100%</u>
<u>Occupancy Type</u>			
Primary residence . . . . .	94%	94%	94%
Second/vacation home . . . . .	3	3	3
Investment . . . . .	3	3	3
Total . . . . .	<u>100%</u>	<u>100%</u>	<u>100%</u>

- (1) Based on the single-family mortgage portfolio (excluding non-Freddie Mac mortgage-related securities, alternative collateral deals and that portion of Structured Securities that is backed by Ginnie Mae Certificates), which totaled \$1,197 billion, \$1,151 billion and \$1,084 billion at December 31, 2004, 2003 and 2002, respectively.
- (2) Our charter requires that mortgage loans purchased with loan-to-value ratios above 80 percent be covered by mortgage insurance or other credit enhancements.
- (3) Current market values are estimated by adjusting the value of the property at origination based on changes in the market value of house prices since origination.

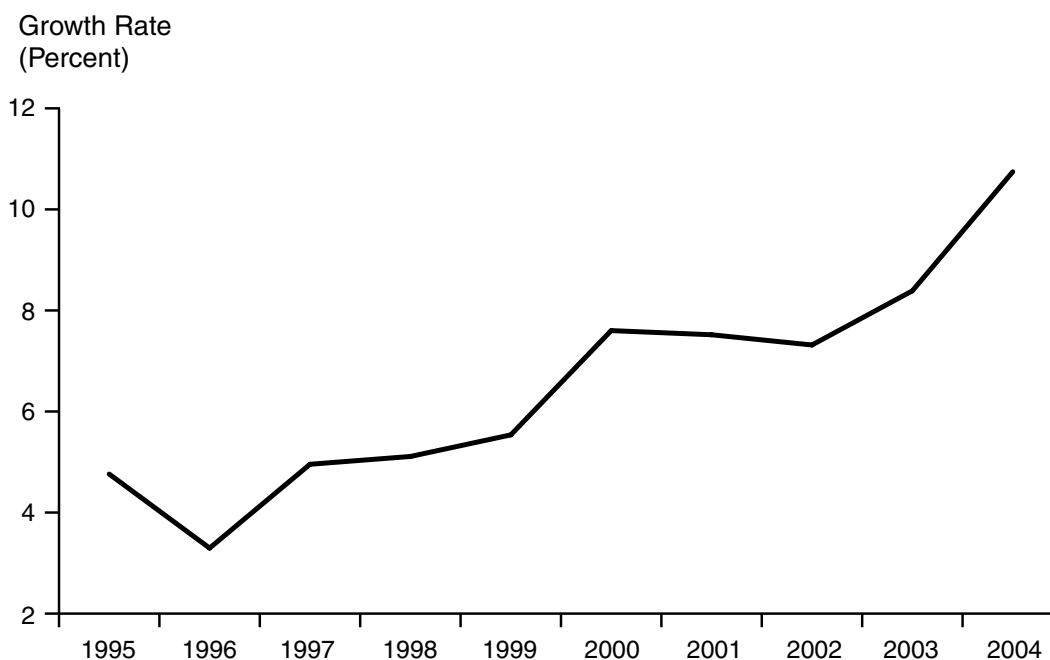
*Loan-to-Value Ratios.* Our principal safeguard against credit losses for mortgage loans in our single-family, non-credit-enhanced portfolio is provided by the borrowers' equity in the underlying properties. The weighted average original loan-to-value ratio decreased to 70 percent for the years ended December 31, 2004

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and 2003 from 72 percent for the year ended December 31, 2002. Mortgage loans with higher loan-to-value ratios (and therefore lower levels of borrower equity) at the time of purchase are also protected by credit enhancements, since our charter requires that loans with loan-to-value ratios above 80 percent at the time of purchase be covered by mortgage insurance or certain other credit protections.

The likelihood of single-family mortgage default depends not only on the initial credit quality of the loan, but also on events that occur after origination. Accordingly, we monitor changes in house prices across the country and the impact of these house price changes on the underlying loan-to-value ratio of mortgages in our portfolio.

**Figure 1 — Annual House Price Appreciation**



As shown in Figure 1, house prices have risen significantly over the last ten years, and have grown very dramatically over the last three years. This house price appreciation has positively influenced the values of properties underlying the mortgages in our portfolio. The weighted average estimated current loan-to-value ratio of our single-family non-credit-enhanced portfolio decreased to 57 percent for the year ended December 31, 2004 from 61 percent for each of the years ended December 31, 2003 and 2002. The decrease is primarily the result of unusually strong house price appreciation. Despite these positive national trends, we remain vigilant in identifying possible weaknesses in regional geographic markets, particularly with respect to new loans originated in an environment of strong house prices, and may seek to reinsure a portion of this risk should we determine that the possibility of such weaknesses warrants action. Historical experience has shown that defaults are less likely to occur on mortgages with lower estimated current loan-to-value ratios. Furthermore, in the event of a default, higher levels of borrower equity in a property reduce the total amount of loss, thereby mitigating credit losses.

*Credit Score.* Credit scores are a useful measure for assessing the credit quality of a borrower. Credit scores are numbers reported by the credit repositories, based on statistical models, that summarize an individual's credit record and predict the likelihood that a borrower will repay future obligations as expected. FICO® scores, or FICO, developed by Fair, Isaac and Co., Inc., are the most commonly used credit scores today.

FICO scores are ranked on a scale of approximately 300 to 850 points. Statistically, consumers with higher credit scores are more likely to repay their debts as expected than those with lower scores. The weighted average credit score for the Total mortgage portfolio (based on the credit score at origination) remained high at 723 at both December 31, 2004 and 2003 and a slight increase from 718 at December 31,

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2002, indicating strong credit quality borrowers. In particular, the percentage of the mortgage loans with an available FICO score of 740 or greater in the Total mortgage portfolio has remained at 44 percent at December 31, 2004 and 2003 and increased from 39 percent at December 31, 2002.

*Loan Purpose.* Mortgage loan purpose indicates how the borrower intends to use the funds from a mortgage loan. The three general categories are: purchase, cash-out refinance, or other refinance. In a purchase transaction, funds are used to acquire a property. In a cash-out refinance transaction, in addition to paying off an existing first mortgage lien, the borrowers obtain additional funds that may be used for other purposes, including paying off subordinate mortgage liens and providing unrestricted cash proceeds to the borrower. In other refinance transactions, the funds are used to pay off an existing first mortgage lien and may be used in limited amounts for certain specified purposes; such refinances are generally referred to as “no cash-out” or “rate and term” refinances. Other refinance transactions also include refinance mortgages for which the delivery data provided was not sufficient for us to determine whether the mortgage was a cash-out or a no cash-out refinance transaction. From a risk perspective, purchase transactions have the lowest likelihood of default (all else being equal), followed by no-cash out refinances, then cash out refinances. As a practical matter, however, no-cash out refinances tend to have lower loan-to-value ratios and higher credit scores than purchase transactions and as such, have better overall performance than purchase transactions. While a reduction in interest rates in 2003 increased the proportion of refinance mortgage loans in the Total mortgage portfolio from a total of 66 percent at December 31, 2002 to 75 percent at December 31, 2003, an increase in interest rates in 2004 slightly decreased the proportion of refinance mortgage loans in the Total mortgage portfolio to a total of 72 percent at December 31, 2004.

*Property Type.* Single-family mortgage loans are defined as mortgages secured by housing with up to four living units. Mortgages on one-unit properties tend to have lower credit risk than mortgages on multiple-unit properties. The proportion of one-unit properties in the Total mortgage portfolio remained the same over the past three years, accounting for 97 percent at December 31, 2004, 2003 and 2002.

*Occupancy Type.* Borrowers may purchase a home as a primary residence, second/vacation home or investment property that is typically a rental property. Mortgage loans on properties occupied by the borrower as a primary or secondary residence tend to have a lower credit risk than mortgages on investment properties. The proportion of primary and secondary residences in the Total mortgage portfolio remained the same over the past three years, accounting for 97 percent at December 31, 2004, 2003 and 2002.

*Geographic Concentration.* Since our business model involves purchasing mortgages from every geographic region in the U.S., we maintain a geographically diverse mortgage portfolio. This diversification provides protection from changing local and economic conditions. See “NOTE 17: CONCENTRATION OF CREDIT AND OTHER RISKS” to our consolidated financial statements for more information concerning the distribution of our Total mortgage portfolio (excluding non-Freddie Mac mortgage-related securities and that portion of Structured Securities that is backed by Ginnie Mae Certificates) by geographic region. Our Total mortgage portfolio’s geographic distribution was relatively stable from 2003 to 2004, and remains broadly diversified across these regions.

*Loss Mitigation Activities.* Within our credit portfolio, we expect and price for some mortgage loans to become non-performing due to changes in general economic conditions, changes in the financial status of individual borrowers or other factors.

Table 63 summarizes our non-performing assets. The increase in our non-performing assets from 2000 through 2003 was primarily driven by higher delinquencies associated with our alternative collateral deals. While these delinquencies result in higher levels of non-performing assets, we have limited loss exposure due to the credit enhancements associated with these securities. Prior to 2004, alternative collateral deals consisted only of Structured Securities backed by non-agency securities, which were primarily backed by subprime mortgage loans; and to a lesser extent, FHA/VA loans and home equity loans. Beginning in 2004, however, certain alternative collateral deals were backed by prime mortgage loans.

**Table 63 — Non-Performing Assets**

	December 31,				
	2004	2003	2002	2001	2000
	(dollars in millions)				
Troubled debt restructurings, or TDRs <sup>(1)</sup> .....	\$2,297	\$ 2,370	\$2,164	\$1,617	\$1,389
Serious delinquencies <sup>(2)</sup> .....	6,318	7,470	6,830	5,070	3,546
Non-accrual loans <sup>(3)</sup> .....	27	21	47	44	9
Subtotal <sup>(4)</sup> .....	8,642	9,861	9,041	6,731	4,944
REO, net <sup>(5)</sup> .....	741	795	594	447	358
Total .....	<u>\$9,383</u>	<u>\$10,656</u>	<u>\$9,635</u>	<u>\$7,178</u>	<u>\$5,302</u>

- (1) Includes previously delinquent loans whose terms have been modified. Some of these loans may be performing as a result of the modified terms. TDRs are considered part of our impaired loan population. Figures presented are based on unpaid principal balances of mortgage loans. See "NOTE 6: LOAN LOSS RESERVES" to the consolidated financial statements for additional information on impaired loans.
- (2) Includes single-family loans 90 days or more delinquent. For multifamily loans, the population includes all loans 60 days or more delinquent, but less than 90 days delinquent. Also included within this population are multifamily loans greater than 90 days past due but where principal and interest are being paid to us under the terms of a credit enhancement agreement. Also includes seriously delinquent loans in alternative collateral deals which totaled \$2,234 million, \$2,793 million, \$2,290 million, \$1,052 million and \$529 million at December 31, 2004, 2003, 2002, 2001 and 2000, respectively. See the discussion related to alternative collateral deal delinquencies following "Table 65 — Delinquency Performance."
- (3) Non-accrual mortgage loans are loans for which interest income is recognized only on a cash basis and only includes multifamily loans that are 90 days or more delinquent. Balance represents 2, 2, 3, 5 and 10 properties at December 31, 2004, 2003, 2002, 2001 and 2000, respectively. No single-family mortgage loans are classified as non-accrual. For single-family mortgages we recognize interest income on an accrual basis for all such loans, regardless of delinquency. We establish reserves for uncollectible interest that are estimated using statistical models which quantify accrued but unpaid interest at the consolidated balance sheet date. Mortgage loans placed on non-accrual status are considered part of our impaired loan population.
- (4) For the year ended December 31, 2004, \$443 million was included in net interest income and management and guarantee income related to these mortgage loans (excluding interest income related to alternative collateral deals). The amount of forgone net interest income and additional management and guarantee income that we would have recorded had these loans been current is \$65 million for the year ended December 31, 2004.
- (5) For more information about REO balances, see "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES" and "NOTE 7: REAL ESTATE OWNED" to the consolidated financial statements.

Loss mitigation activities are a key component of our strategy for managing and resolving troubled assets and lowering credit losses. Our loss mitigation strategy emphasizes early intervention in delinquent mortgages and alternatives to foreclosure. Foreclosure alternatives are intended to reduce the number of delinquent mortgages that proceed to foreclosure and, ultimately, mitigate our total credit losses by eliminating a portion of the costs related to foreclosed properties. Table 64 summarizes the number of loans involved in different types of single-family foreclosure alternatives.

**Table 64 — Single-Family Foreclosure Alternatives<sup>(1)</sup>**

	December 31,		
	2004	2003	2002
	(number of loans)		
<b>Foreclosure Alternatives<sup>(2)</sup></b>			
Repayment plans .....	37,406	34,458	32,672
Loan modifications .....	6,789	8,508	7,951
Forbearance agreements .....	2,105	2,226	2,798
Pre-foreclosure sales <sup>(3)</sup> .....	<u>2,010</u>	<u>1,755</u>	<u>1,531</u>
Foreclosure alternatives .....	<u>48,310</u>	<u>46,947</u>	<u>44,952</u>

- (1) Based on the single-family Total mortgage portfolio, excluding non-Freddie Mac mortgage-related securities, alternative collateral deals and that portion of Structured Securities that is backed by non-Freddie Mac mortgage-related securities.
- (2) Some mortgage loans may go through a foreclosure alternative more than once or may go through more than one type of foreclosure alternative. Additionally, the table represents only instances that successfully return the borrower to a current payment status, with the exception of pre-foreclosure sales, where the relationship with the borrower has concluded.
- (3) This amount includes third party sales and other foreclosure alternatives.

The increase in foreclosure alternatives from 2002 through 2004 was primarily driven by an enhanced effort by us and servicers to pursue loss mitigation for homeownership preservation and a favorable interest rate environment that facilitated the foreclosure alternatives. Repayment plans, the most common type of foreclosure alternative, mitigate our credit losses because they assist borrowers in returning to compliance with

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the original terms of their mortgages. Loan modifications, the second most common type of foreclosure alternative, involve changing the terms of a mortgage and therefore are a more favorable alternative to the borrower during a declining interest-rate environment, such as we experienced during 2002 and the first half of 2003. Forbearance agreements, the third most common type of foreclosure alternative, provide a temporary suspension of the foreclosure process to allow additional time for the borrower to return to compliance with the original terms of the borrower's mortgage or to implement another foreclosure alternative.

Other single-family loss mitigation activities include providing default management tools designed to help single-family servicers manage non-performing loans more effectively. These tools include Early Indicator<sup>®</sup>, a system that estimates the probability that delinquent loans will be resolved or advanced through to a loss-producing state. In addition, we provide the servicers with a suite of self-management tools such as Timeline Manager, Workout Manager, Expense Manager and REO Manager. We also use Servicer Performance Profile reports to evaluate and manage the performance of our mortgage servicers based on their management of performing and non-performing loans.

We require multifamily servicers to closely manage mortgage loans they have sold us in order to mitigate potential losses. At least once a year, for loans over \$1 million, servicers must submit an assessment of the mortgaged property to us based on an inspection of the property and a review of the property's financial statements. We also evaluate these assessments internally and may direct the servicer to take specific actions to reduce the likelihood of delinquency or default. If a loan defaults despite this intervention, we then determine whether it is in our best interest to offer a reasonable foreclosure alternative to the borrower. For example, we may modify the terms of a multifamily mortgage loan which gives the borrower an opportunity to bring the loan current and allows the borrower to retain ownership of the property. Since multifamily seller/servicers are an important part of our loss mitigation process, we rate their performance regularly and conduct on-site reviews of their servicing operations to confirm compliance with our standards.

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

In some cases, we also provide financial incentives in the form of lump sum payments to selected seller/servicers if they deliver a specified volume or share of mortgage loans meeting specified credit risk standards over a defined period of time. These financial incentives may also take the form of a fee payable to us by the seller if the mortgages delivered to us do not meet certain credit standards.

We have also entered into risk-sharing agreements that are accounted for as derivatives in accordance with GAAP. In part because the agreements may result in us making payments to the seller/servicer (depending upon actual default experience over the lives of the mortgages), they are considered credit derivatives, rather than financial guarantees under GAAP. Under these agreements, default losses on specific mortgage loans delivered by sellers are compared to default losses on reference pools of mortgage loans with similar characteristics. Based upon the results of that comparison, we remit or receive payments based upon the default performance of the specified mortgage loans. These payments are recorded in Management and guarantee income on the consolidated statements of income. The total notional amount of mortgage loans subject to these agreements was approximately \$10.9 billion and \$15.5 billion at December 31, 2004 and 2003, respectively. These risk-sharing agreements are classified as no hedge designation for purposes of applying SFAS 133, with changes in fair value recorded as Derivative gains (losses) on the consolidated statements of income. The fair value of these risk-sharing agreements is recorded in the Derivative assets, at fair value and Derivative liabilities, at fair value on the consolidated balance sheets, with net amounts of \$(2) million and \$5 million at December 31, 2004 and 2003, respectively.

Although these arrangements are part of our overall credit risk management strategy, we have not treated them as credit enhancements for purposes of describing our Total mortgage portfolio characteristics because

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the financial incentive and credit derivative agreements may result in us making payments to the seller/servicer.

**Credit Performance.** The effectiveness of our credit risk management activities is reflected, in part, in the level of credit losses relative to our Total mortgage portfolio (excluding non-Freddie Mac mortgage-related securities and that portion of Structured Securities that is backed by Ginnie Mae Certificates). To the extent we take on riskier assets, such as A- mortgages, and charge higher guarantee fees, credit losses may rise despite effective credit risk management activities. Therefore, while credit losses are a useful indicator of management activities, they must ultimately be considered relative to the revenue received for assuming the underlying credit risk. Several key statistics associated with potential and actual credit losses are detailed in the tables below.

*Delinquencies.* Table 65 summarizes the delinquency performance of our single-family and multifamily mortgage portfolios. “Table 66 — Single-Family — Non-Credit-Enhanced Delinquencies — By Region” and “Table 67 — Composition of Single-Family Mortgages by Year of Origination — Mortgage Portfolio and Non-Credit-Enhanced Delinquencies” provide a more detailed analysis of single-family delinquencies, by geographic region and year of origination.

**Table 65 — Delinquency Performance<sup>(1)</sup>**

	December 31,		
	2004	2003	2002
<b>Single-family<sup>(2)</sup></b>			
Non-credit-enhanced portfolio			
Delinquency rate <sup>(3)</sup> .....	0.24%	0.27%	0.28%
Total number of delinquent loans .....	19,691	21,063	20,946
Credit-enhanced portfolio <sup>(4)</sup>			
Delinquency rate <sup>(3)</sup> .....	2.75%	2.96%	2.07%
Total number of delinquent loans .....	54,913	66,283	58,768
Total portfolio			
Delinquency rate <sup>(3)</sup> .....	0.73%	0.86%	0.77%
Total number of delinquent loans .....	74,604	87,346	79,714
<b>Multifamily<sup>(4)</sup></b>			
Total portfolio			
Delinquency rate .....	0.06%	0.05%	0.13%
Net carrying value of delinquent loans (in millions) .....	\$ 35	\$ 24	\$ 49

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

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

(3) Includes alternative collateral deals.

(4) Based on net carrying value of mortgages 60 days or more delinquent or in foreclosure.

The single-family total portfolio delinquency rate decreased by 13 basis points from December 31, 2003 to 0.73 percent at December 31, 2004. This decrease was driven by the single-family credit-enhanced delinquency rate, which decreased by 21 basis points from December 31, 2003 to 2.75 percent at December 31, 2004 and a 3 basis point decline in the single-family non-credit-enhanced portfolio. The decrease in the credit-enhanced delinquency rate was primarily associated with reduced delinquencies in our alternative collateral deals, the drop in the unemployment rate and continued house price appreciation. The multifamily delinquency rate was 0.06 percent at December 31, 2004, up from 0.05 percent at December 31, 2003. Multifamily delinquencies include certain mortgage loans where the borrowers are not paying as agreed, but principal and interest are being paid to us under the terms of a credit enhancement agreement.



Table 66 presents delinquency rates for the non-credit-enhanced portion of the single-family loans underlying our Total mortgage portfolio (excluding non-Freddie Mac mortgage-related securities and that portion of Structured Securities that is backed by Ginnie Mae Certificates) by geographic region.

**Table 66 — Single-Family — Non-Credit-Enhanced Delinquencies — By Region<sup>(1)(2)</sup>**

	December 31,		
	2004	2003	2002
Northeast .....	0.24%	0.28%	0.30%
Southeast .....	0.31	0.32	0.34
North central .....	0.27	0.27	0.27
Southwest .....	0.26	0.28	0.28
West .....	0.15	0.19	0.23
Total all regions .....	0.24%	0.27%	0.28%

(1) Based on the number of mortgages 90 days or more delinquent or in foreclosure.

(2) See "NOTE 17: CONCENTRATION OF CREDIT AND OTHER RISKS" to the consolidated financial statements for a description of these regions.

Regional delinquency rates generally declined in 2004. Reductions in the Northeast and West regions were the primary drivers behind the decrease in the overall delinquency rate. These regions' delinquency improvement is a result of improved economies and increased house price appreciation. The non-credit enhanced delinquency rate for the North Central region, which has been adversely impacted by declines in the manufacturing industry, remained unchanged despite the slight increase in the number of delinquent properties.

Table 67 presents the distribution of the single-family loans underlying our Total mortgage portfolio (excluding non-Freddie Mac mortgage-related securities and that portion of Structured Securities that is backed by Ginnie Mae Certificates) and non-credit-enhanced delinquency rates by year of origination.

**Table 67 — Composition of Single-Family Mortgages By Year of Origination — Mortgage Portfolio and Non-Credit-Enhanced Delinquencies**

Year of Origination	December 31,					
	2004		2003		2002	
	Percent of Single-Family Balance <sup>(1)</sup>	Non-Credit-Enhanced Delinquency Rate <sup>(2)</sup>	Percent of Single-Family Balance <sup>(1)</sup>	Non-Credit-Enhanced Delinquency Rate <sup>(2)</sup>	Percent of Single-Family Balance <sup>(1)</sup>	Non-Credit-Enhanced Delinquency Rate <sup>(2)</sup>
Pre-1997 .....	3%	0.65%	6%	0.68%	11%	0.54%
1997 .....	1	0.83	1	0.82	3	0.51
1998 .....	3	0.49	4	0.45	11	0.26
1999 .....	2	0.78	3	0.73	8	0.44
2000 .....	1	1.94	1	1.78	3	0.91
2001 .....	6	0.59	10	0.48	26	0.19
2002 .....	16	0.26	24	0.18	38	0.05
2003 .....	44	0.06	51	0.01	—	—
2004 .....	24	0.03	—	—	—	—
As of December 31 .....	<u>100%</u>	0.24%	<u>100%</u>	0.27%	<u>100%</u>	0.28%

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

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

Our single-family portfolio distribution by origination year was affected by heavy refinance volumes in recent years. At December 31, 2004, 84 percent of our single-family mortgage portfolio consisted of mortgage loans originated in 2002, 2003 or 2004. Mortgage loans originated in 2001 and earlier, which represent approximately 16 percent of our single-family mortgage portfolio, have delinquency rates that are generally higher than the overall portfolio delinquency rate due to the natural aging of the loans and, in some instances, to the weaker credit quality of these loans. For instance, mortgage loans originated in 2000 were generally for purchase transactions, which, as noted earlier, typically involve more risk resulting in weaker credit quality, as opposed to refinancing transactions. As a result, we have experienced higher than average early defaults and delinquency rates on these mortgage loans originated in 2000, but they represent only one percent of the single-family Total mortgage portfolio (excluding non-Freddie Mac mortgage-related securities and that portion of Structured Securities that is backed by Ginnie Mae Certificates).

*Credit Loss Performance.* Some of the loans that are delinquent or in foreclosure result in credit losses. Table 68 provides detail on our credit loss performance, including REO activity, charge-offs and credit losses.

**Table 68 — Credit Loss Performance**

	Year Ended December 31,		
	2004	2003	2002
	(dollars in millions)		
<b>REO</b>			
REO balances:			
Single-family .....	\$ 740	\$ 758	\$ 593
Multifamily .....	1	37	1
Total .....	<u>\$ 741</u>	<u>\$ 795</u>	<u>\$ 594</u>
REO activity (number of properties): <sup>(1)</sup>			
Beginning property inventory .....	9,170	7,222	5,713
Properties acquired .....	18,489	17,750	13,520
Properties disposed .....	<u>(18,055)</u>	<u>(15,802)</u>	<u>(12,011)</u>
Ending property inventory .....	<u>9,604</u>	<u>9,170</u>	<u>7,222</u>
Average holding period (in days) <sup>(2)</sup> .....	177	174	185
REO operations income (expense): <sup>(3)</sup>			
Single-family .....	\$ (1)	\$ (4)	\$ (4)
Multifamily .....	4	(3)	—
Total .....	<u>\$ 3</u>	<u>\$ (7)</u>	<u>\$ (4)</u>
<b>CHARGE-OFFS</b>			
<b>Single-family:</b>			
Foreclosure alternatives, gross .....	\$ (47)	\$ (40)	\$ (46)
Recoveries <sup>(4)</sup> .....	21	17	17
Foreclosure alternatives, net .....	(26)	(23)	(29)
REO acquisitions, gross .....	(253)	(176)	(124)
Recoveries <sup>(3)(4)</sup> .....	139	127	80
REO acquisitions, net .....	(114)	(49)	(44)
Single-family totals:			
Charge-offs, gross .....	(300)	(216)	(170)
Recoveries <sup>(3)(4)</sup> .....	160	144	97
<b>Single-family charge-offs, net</b> .....	<u>(140)</u>	<u>(72)</u>	<u>(73)</u>
<b>Multifamily:</b>			
Charge-offs, gross .....	—	(8)	(1)
Recoveries <sup>(4)</sup> .....	—	1	2
<b>Multifamily charge-offs, net</b> .....	<u>—</u>	<u>(7)</u>	<u>1</u>
<b>Total Charge-offs:</b> <sup>(3)</sup>			
Charge-offs, gross .....	(300)	(224)	(171)
<b>Recoveries:</b>			
Related to primary mortgage insurance .....	85	94	61
Not related to primary mortgage insurance .....	75	51	38
<b>Total recoveries</b> <sup>(3)(4)</sup> .....	<u>160</u>	<u>145</u>	<u>99</u>
<b>Charge-offs, net</b> .....	<u>\$ (140)</u>	<u>\$ (79)</u>	<u>\$ (72)</u>
<b>CREDIT GAINS (LOSSES)<sup>(5)</sup></b>			
Single-family <sup>(3)</sup> .....	\$ (141)	\$ (76)	\$ (77)
Multifamily .....	4	(10)	1
<b>Total</b> <sup>(3)</sup> .....	<u>\$ (137)</u>	<u>\$ (86)</u>	<u>\$ (76)</u>
<b>In basis points:</b> <sup>(6)</sup>			
Single-family <sup>(3)</sup> .....	(1.1)	(0.7)	(0.7)
Multifamily .....	—	(0.1)	—
<b>Total</b> <sup>(3)</sup> .....	<u>(1.1)</u>	<u>(0.8)</u>	<u>(0.7)</u>

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

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

(3) We reclassified income of \$30 million and \$17 million for 2003 and 2002, respectively, from REO operations income (expense) to (Provision) benefit for credit losses to conform with the 2004 presentation. In addition, we reclassified certain expenses related to uncollectible interest on PCs held by third parties from Management and guarantee income to (Provision) benefit for credit losses to conform with the 2004 presentation. As a result of these reclassifications, we decreased charge-offs — single-family, net by \$26 million and \$15 million for 2003 and 2002, respectively.

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

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

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

Overall, we continued to demonstrate strong credit performance during 2004, driven by effective risk management and the sustained strength of the single-family housing market. The following discussion provides additional analysis on key credit loss-related statistics and results.

Net credit losses (REO operations income (expenses) plus charge-offs, net) increased in 2004 as a result of the increase in single-family charge-offs. Single-family credit losses totaled \$141 million, or 1.1 basis points of the average Total mortgage portfolio in 2004. This represents an increase from the historically low levels of single-family credit losses experienced in 2003 (\$76 million or 0.7 basis points) and in 2002 (\$77 million or 0.7 basis points). Our multifamily portfolio produced a credit gain of \$4 million in 2004, compared to a \$10 million loss in 2003, and a \$1 million gain in 2002.

When we foreclose on a property, it may become part of our REO inventory. REO operations income (expense), a component of credit losses, includes the expenses incurred to foreclose, acquire, maintain and sell a property. REO inventory levels increased in 2004 in terms of number of properties held, although the dollar amounts decreased. The single-family REO balance was \$740 million at December 31, 2004, a change from \$758 million and \$593 million at December 31, 2003 and 2002, respectively. Although REO inventories increased, single-family REO income (expense) improved to expense of \$1 million in 2004 from expense of \$4 million in both 2003 and 2002 largely due to house price growth, recoveries from credit enhancements and reimbursements from seller/servicers. REO income arises when the fair market value of the acquired asset exceeds the carrying value of the mortgage loan or when we are able to sell the REO at amounts in excess of its carrying value.

Charge-offs, net, another component of credit losses, include losses and recoveries on mortgages that are transferred to REO or involved in a foreclosure alternative. Single-family charge-offs, net of recoveries, increased to \$140 million in 2004 from \$72 million in 2003 and \$73 million in 2002, largely due to decreases in the fair value of REO properties and increased REO acquisitions in the North Central region which continues to hold the largest share of REO inventory. Charge-offs, net are reflected on our consolidated balance sheets as a reduction in loan loss reserves. See “Table 71 — Loan Loss Reserves Activity” for more information.

Table 69 and Table 70 provide detail by region for two key credit performance statistics, REO activity and charge-offs. Regional REO acquisition and charge-off trends follow a pattern that is similar to that of regional delinquency trends.

**Table 69 — REO Activity — By Region<sup>(1)</sup>**

	Year Ended December 31,		
	2004	2003	2002
	(number of properties)		
<b>REO Inventory</b>			
Beginning property inventory .....	9,170	7,222	5,713
Properties acquired by region:			
Northeast .....	1,500	1,600	1,683
Southeast .....	5,499	5,378	3,533
North central .....	5,787	4,643	3,180
Southwest .....	3,926	3,503	2,435
West .....	<u>1,777</u>	<u>2,626</u>	<u>2,689</u>
Total properties acquired .....	18,489	17,750	13,520
Properties disposed by region:			
Northeast .....	(1,562)	(1,674)	(1,798)
Southeast .....	(5,596)	(4,476)	(3,012)
North central .....	(5,111)	(3,908)	(2,420)
Southwest .....	(3,605)	(3,018)	(2,019)
West .....	<u>(2,181)</u>	<u>(2,726)</u>	<u>(2,762)</u>
Total properties disposed .....	<u>(18,055)</u>	<u>(15,802)</u>	<u>(12,011)</u>
Ending property inventory .....	<u><u>9,604</u></u>	<u><u>9,170</u></u>	<u><u>7,222</u></u>

(1) See “NOTE 17: CONCENTRATION OF CREDIT AND OTHER RISKS” to the consolidated financial statements for a description of these regions.

**Table 70 — Single-Family Charge-offs and Recoveries By Region<sup>(1)(2)</sup>**

	<u>Year Ended December 31,</u>		
	<u>2004</u>	<u>2003<sup>(3)</sup></u>	<u>2002<sup>(3)</sup></u>
	(dollars in millions)		
<b>Northeast</b>			
Charge-offs .....	\$ 24	\$ 21	\$ 27
Recoveries .....	<u>(10)</u>	<u>(10)</u>	<u>(13)</u>
Charge-offs, net .....	<u>14</u>	<u>11</u>	<u>14</u>
<b>Southeast</b>			
Charge-offs .....	84	62	42
Recoveries .....	<u>(49)</u>	<u>(44)</u>	<u>(24)</u>
Charge-offs, net .....	<u>35</u>	<u>18</u>	<u>18</u>
<b>North central</b>			
Charge-offs .....	92	54	31
Recoveries .....	<u>(49)</u>	<u>(35)</u>	<u>(20)</u>
Charge-offs, net .....	<u>43</u>	<u>19</u>	<u>11</u>
<b>Southwest</b>			
Charge-offs .....	66	43	28
Recoveries .....	<u>(35)</u>	<u>(32)</u>	<u>(17)</u>
Charge-offs, net .....	<u>31</u>	<u>11</u>	<u>11</u>
<b>West</b>			
Charge-offs .....	34	36	42
Recoveries .....	<u>(17)</u>	<u>(23)</u>	<u>(23)</u>
Charge-offs, net .....	<u>17</u>	<u>13</u>	<u>19</u>
<b>Total</b>			
Charge-offs .....	300	216	170
Recoveries .....	<u>(160)</u>	<u>(144)</u>	<u>(97)</u>
Charge-offs, net .....	<u>\$ 140</u>	<u>\$ 72</u>	<u>\$ 73</u>

- (1) See “NOTE 17: CONCENTRATION OF CREDIT AND OTHER RISKS” to the consolidated financial statements for a description of these regions.
- (2) Includes recoveries of charge-offs primarily resulting from foreclosure alternatives and REO acquisitions on loans where a share of default risk has been assumed by servicers, mortgage insurers, or other third parties through credit enhancements. Recoveries of charge-offs through credit enhancements are limited in many instances to amounts less than the full amount of the loss.
- (3) We reclassified certain income for the years ended December 31, 2003 and 2002 from REO operations income (expense) to (Provision) benefit for credit losses to conform with the 2004 presentation. In addition, we reclassified certain expenses related to uncollectible interest on PCs held by third parties from Management and guarantee income to (Provision) benefit for credit losses to conform with the 2004 presentation. As a result of these reclassifications, we decreased charge-offs, net by \$26 million and \$15 million for the years ended December 31, 2003 and 2002, respectively.

Table 71 summarizes our loan loss reserves activity.

**Table 71 — Loan Loss Reserves Activity**

	Year Ended December 31,				
	2004	2003	2002	2001	2000
	(dollars in millions)				
<b>Total loan loss reserves<sup>(1)</sup>:</b>					
Beginning balance	\$ 299	\$ 265	\$ 224	\$ 229	\$ 217
Provision (benefit) for credit losses <sup>(2)</sup>	143	(5)	122	33	82
Charge-offs	(300)	(224)	(171)	(129)	(124)
Recoveries <sup>(2)(3)</sup>	160	145	99	101	62
Charge-offs, net <sup>(2)</sup>	(140)	(79)	(72)	(28)	(62)
Adjustment for change in accounting <sup>(4)</sup>	—	110	—	—	—
Transfers-out during the period <sup>(5)</sup>	(20)	(11)	(9)	(10)	(8)
Other transfers, net during the period <sup>(6)</sup>	(18)	19	—	—	—
Ending balance	<u>\$ 264</u>	<u>\$ 299</u>	<u>\$ 265</u>	<u>\$ 224</u>	<u>\$ 229</u>
Charge-offs, net to Total mortgage portfolio <sup>(7)</sup>	1.1bp	0.7bp	0.7bp	0.3bp	0.7bp
Coverage ratio (reserves to charge-offs, net)	1.9	3.8	3.7	8.0	3.7

- (1) Includes Reserves for loans held-for-investment in the Retained portfolio and Reserves for guarantee losses on Participation Certificates. See “NOTE 6: LOAN LOSS RESERVES” to the consolidated financial statements for more details.
- (2) We reclassified certain income for the full years ended December 31, 2003, 2002, 2001 and 2000 from REO operations income (expense) to (Provision) benefit for credit losses to conform with the 2004 presentation. In addition, we reclassified certain expenses related to uncollectible interest on PCs held by third parties from Management and guarantee income to (Provision) benefit for credit losses to conform with the 2004 presentation. This resulted in a \$15 million decrease, \$6 million decrease, \$1 million increase and \$3 million increase in (Provision) benefit for credit losses during 2003, 2002, 2001 and 2000, respectively. As a result of these reclassifications, we increased recoveries by \$26 million, \$15 million, \$9 million and \$5 million for the full years 2003, 2002, 2001 and 2000, respectively.
- (3) Includes recoveries of charge-offs primarily resulting from foreclosure alternatives and REO acquisitions on loans where a share of default risk has been assumed by servicers, mortgage insurers or third parties through credit enhancements. Recoveries of charge-offs through credit enhancements are limited in many instances to amounts less than the full amount of the loss.
- (4) On January 1, 2003, \$110 million of recognized guarantee obligations that was attributable to estimated incurred losses on outstanding PCs or Structured Securities was reclassified to Reserve for guarantee losses on Participation Certificates.
- (5) Represents the reclassification of the reserve amount attributable to uncollectible interest on outstanding PCs and Structured Securities, which is included as an offset to the related receivable balance within Accounts and other receivables, net on the consolidated balance sheets.
- (6) Represents the reclassification of the portions of guarantee obligations recognized upon the sale of PCs or Structured Securities that corresponds to incurred credit losses reclassified to Reserve for guarantee losses on Participation Certificates upon initial recognition of a guarantee obligation. In addition, the 2004 amount includes a reduction of loan loss reserves of \$31 million related to prior period adjustments for which the related income was recorded in Other income.
- (7) Calculated using the average Total mortgage portfolio, excluding non-Freddie Mac mortgage-related securities and that portion of Structured Securities that is backed by Ginnie Mae Certificates.

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

Loan loss reserves are increased through periodic charges to the provision for credit losses and decreased by charges-offs, net of recoveries. We record charge-offs to the loan loss reserves when the loss is specifically identifiable and virtually certain. For mortgages that are transferred to REO or involved in a pre-foreclosure sale, we record losses at the time of transfer or sale. For loans that have been modified, losses are recorded at the time of modification if the modification is a troubled debt restructuring.

As shown in “Table 71 — Loan Loss Reserves Activity,” total loan loss reserves decreased in 2004. This decrease was primarily due to transfers out from the reserves related to uncollectible interest and a reduction of reserves related to prior period adjustments for which the related income was recorded in Other income.

*Credit Risk Sensitivity.* As a part of our voluntary disclosure commitments made in October 2000, we provide public disclosure of credit risk sensitivity results on a quarterly basis on our website. The credit risk

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sensitivity analysis assesses the assumed increase in the present value of expected single-family mortgage portfolio losses over ten years as the result of an estimated instantaneous five percent decline in house prices nationwide, followed by a return to more normal growth in house prices based on historical experience. An internally developed Monte Carlo simulation-based model is used to generate our credit risk sensitivity analyses. The Monte Carlo model uses an interest rate simulation program to generate numerous interest rate paths that, in conjunction with a prepayment model, are used to estimate mortgage cash flows along each path. We use this same model to calculate the expected default cost component of the Guarantee obligation for Participation Certificates and to estimate expected future default costs of mortgage loans and mortgage-related securities. In the credit rate sensitivity analysis, we adjust the house-price assumption used in the base case to estimate the level and sensitivity of potential credit costs resulting from a sudden decline in house prices. See “NOTE 2: TRANSFERS OF SECURITIZED INTERESTS IN MORTGAGE-RELATED ASSETS” to the consolidated financial statements for more information.

The credit risk sensitivity results at December 31, 2004 and 2003 are shown in Table 72. Credit risk sensitivity results as of the end of each quarter in 2004 and the first quarter of 2005 are presented in “VOLUNTARY COMMITMENTS.”

**Table 72 — Credit Risk Sensitivity — Estimated Net Present Value (NPV) of Increase in Credit Losses<sup>(1)</sup>**

	Before Receipt of Credit Enhancements <sup>(2)</sup>		After Receipt of Credit Enhancements <sup>(3)</sup>	
	NPV	NPV Ratio <sup>(4)</sup>	NPV	NPV Ratio <sup>(4)</sup>
	(dollars in millions, except ratios)			
At:				
December 31, 2004 .....	\$794	6.5bps	\$463	3.8bps
December 31, 2003 .....	\$926	7.9bps	\$533	4.6bps

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

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

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

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

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

We are subject to credit risk from institutional counterparties to the extent they do not fulfill their obligations to us under the terms of specific contracts or agreements. Our primary institutional credit risk exposure, other than counterparty credit risk exposure relating to derivatives (which is discussed in “Interest-Rate Risk and Other Market Risks — *Derivative-Related Risks* — Derivative Counterparty Credit Risk”), arises from agreements with the following entities:

- mortgage seller/servicers;
- mortgage loan insurers;
- issuers, guarantors or third party providers of credit enhancements on non-Freddie Mac mortgage-related securities held in our Retained portfolio;
- mortgage investors and originators; and
- issuers, guarantors and insurers of investments held in our Cash and investments portfolio.

**Mortgage Seller/Servicers.** We are exposed to institutional credit risk arising from the insolvency of mortgage seller/servicers that remit to us monthly principal and interest payments on mortgages, provide credit enhancements such as recourse or collateral and represent and warrant that mortgages were originated in compliance with our standards. The servicing fee charged by mortgage servicers varies by mortgage product. We require our single-family servicers to retain a minimum percentage fee for mortgages serviced on our behalf, typically 0.25 percent of the unpaid principal balance of the mortgage loans. However, we do on an exception basis allow lower minimum servicing amounts. The credit risk associated with servicing fees relates

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to whether we could transfer the servicing to an alternate servicer without a loss in the event the current servicer is unable to fulfill its responsibilities.

To protect us against these risks, we require seller/servicers to meet minimum financial capacity standards, insurance and other eligibility requirements. We institute remedial actions against mortgage seller/servicers that fail to comply with our standards. These actions may include transferring mortgage servicing to other qualified servicers or terminating our relationship with the mortgage seller/servicer.

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

**Mortgage Loan Insurers.** We bear institutional credit risk relating to the non-performance of mortgage insurers that insure purchased or guaranteed mortgages (see “*Mortgage Credit Risk — Mortgage Credit Risk Management Strategies — Credit Enhancements*” for more information). We manage this risk by establishing eligibility standards for mortgage insurers and by regularly monitoring our exposure to individual mortgage insurers. We also monitor the mortgage insurers’ credit ratings, as provided by nationally recognized credit rating agencies. In addition, we periodically review the methods used by the credit rating agencies. We also perform periodic on-site reviews of mortgage insurers to confirm compliance with our eligibility requirements and to evaluate their management and control practices. In addition, state insurance authorities regulate mortgage insurers. Substantially all mortgage insurers providing primary mortgage insurance and pool insurance coverage on single-family mortgages purchased during 2004 were rated “AA” or better by S&P. At December 31, 2004, there were seven mortgage insurers (the largest being Mortgage Guarantee Insurance Corporation) that each provided more than five percent of our Total mortgage insurance coverage (including primary mortgage insurance and pool insurance) and together accounted for approximately 99 percent of our overall coverage.

**Non-Freddie Mac Mortgage-Related Securities.** Investments for our Retained portfolio expose us to institutional credit risk on non-Freddie Mac mortgage-related securities to the extent that issuers, guarantors, or third parties providing credit enhancements, become insolvent. See “Table 33 — Credit Characteristics of Mortgages and Mortgage-Related Securities in the Retained Portfolio” for more information concerning our Retained portfolio.

Our non-Freddie Mac mortgage-related securities portfolio consists of both agency and non-agency mortgage securities. Agency mortgage-related securities, which are securities issued or guaranteed by Fannie Mae or Ginnie Mae, present minimal institutional credit risk exposure to us due to the high credit quality of the issuers and guarantors. Agency mortgage-related securities are generally not separately rated by credit rating agencies, but are viewed as having a level of credit quality at least equivalent to non-agency mortgage securities rated AAA (based on the S&P rating scale or an equivalent rating from other nationally recognized rating agencies). At December 31, 2004, we held approximately \$60 billion of agency securities, representing approximately four percent of our Total mortgage portfolio (see “Table 8 — Freddie Mac’s Total Mortgage Portfolio Based on Unpaid Principal Balances” for more information about our Total mortgage portfolio).

Non-agency mortgage securities may expose us to some institutional credit risk, if the nature of the credit enhancement relies on a third party to cover potential losses. However, most of our non-agency mortgage securities rely primarily on subordinated tranches to provide credit loss protection and therefore expose us to very limited counterparty risk. In those instances where we desire further protection, we may choose to mitigate our exposure with bond insurance or by purchasing additional subordination. Bond insurance exposes us to the claims paying ability of the bond insurer. Substantially all of the bond insurers providing coverage for non-agency mortgage securities held by us were rated AAA or equivalent by at least one nationally recognized credit rating agency. At December 31, 2004, we held approximately \$175 billion of non-agency mortgage-related securities. Of this amount, 97 percent were rated AAA or equivalent.

We manage institutional credit risk on non-Freddie Mac mortgage-related securities by only purchasing securities that meet our investment guidelines and performing ongoing analysis to evaluate the creditworthiness of the issuers and servicers of these securities and the bond insurers that guarantee them. To assess the

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creditworthiness of non-agency securities, we may perform additional analysis, including on-site visits, verification of loan documentation, review of underwriting or servicing processes and similar due diligence measures. In addition, management regularly evaluates these investments to determine if any impairment in fair value requires an impairment loss recognition in earnings, warrants divestiture or requires a combination of both. See “NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES” to the consolidated financial statements for more information on impairments.

**Mortgage Investors and Originators.** We are exposed to pre-settlement risk through the purchase, sale and financing of mortgage loans and mortgage-related securities with mortgage investors and originators. This exposure primarily arose in connection with our Securities Sales & Trading Group business unit prior to its cessation of activities in the fourth quarter of 2004. Pre-settlement risk is the risk that a counterparty will not perform under the terms of a transaction due to adverse changes in market value between trade date and settlement date. The probability of such a default is generally remote over the short time horizon between the trade and settlement date. We manage this risk by evaluating the creditworthiness of our counterparties and monitoring and managing our exposures. In some instances, we may require these counterparties to post collateral.

**Cash and Investments Portfolio.** Institutional credit risk also arises from the insolvency of issuers or guarantors of investments held in our Cash and investments portfolio. This portfolio is generally used to meet both anticipated and unanticipated liquidity and working capital requirements (See “LIQUIDITY AND CAPITAL RESOURCES — Liquidity” for more information). Instruments in this portfolio are investment grade at the time of purchase and primarily short-term in nature, thereby significantly mitigating institutional credit risk in this portfolio. We regularly evaluate these investments to determine if any impairment in fair value requires an impairment loss recognition in earnings, warrants divestiture or requires a combination of both.

## QUARTERLY SELECTED FINANCIAL DATA

	2004				
	1Q	2Q	3Q	4Q	Full-Year
	(dollars in millions)				
Net interest income	\$2,126	\$2,625	\$ 2,321	\$2,065	\$ 9,137
Non-interest income (loss)	(26)	1,532	(3,691)	(854)	(3,039)
Non-interest expense	(503)	(548)	(603)	(717)	(2,371)
Income tax (expense) benefit	(285)	(855)	467	(117)	(790)
Net income (loss)	<u>\$1,312</u>	<u>\$2,754</u>	<u>\$(1,506)</u>	<u>\$ 377</u>	<u>\$ 2,937</u>
Basic earnings (loss) per common share <sup>(1)</sup>	\$ 1.83	\$ 3.92	\$ (2.26)	\$ 0.47	\$ 3.96
Diluted earnings (loss) per common share <sup>(1)</sup>	\$ 1.82	\$ 3.91	\$ (2.26)	\$ 0.47	\$ 3.94
	2003				
	1Q	2Q	3Q	4Q	Full-Year
	(dollars in millions)				
Net interest income	\$2,421	\$2,185	\$2,442	\$2,450	\$ 9,498
Non-interest income (loss) <sup>(2)</sup>	1,247	1,830	(2,294)	(1,027)	(244)
Non-interest expense <sup>(2)</sup>	(410)	(613)	(562)	(651)	(2,236)
Income tax (expense) benefit	(991)	(1,096)	126	(241)	(2,202)
Net income (loss)	<u>\$2,267</u>	<u>\$2,306</u>	<u>\$(288)</u>	<u>\$ 531</u>	<u>\$ 4,816</u>
Basic earnings (loss) per common share <sup>(1)</sup>	\$ 3.22	\$ 3.28	\$(0.49)	\$ 0.70	\$ 6.69
Diluted earnings (loss) per common share <sup>(1)</sup>	\$ 3.21	\$ 3.27	\$(0.49)	\$ 0.69	\$ 6.68

(1) Earnings per share is computed independently for each of the quarters presented. Due to the use of weighted-average common shares outstanding when calculating earnings per share, the sum of the four quarters may not equal the full-year amount. Earnings per share amounts may not recalculate using the amounts in this table due to rounding.

(2) Certain expenses related to uncollectible interest on PCs held by third parties were reclassified to (Provision) benefit for credit losses from Management and guarantee income to conform with the 2004 presentation. This resulted in a reclassification of \$4 million, \$3 million, \$5 million and \$3 million for 1Q 2003, 2Q 2003, 3Q 2003 and 4Q 2003, respectively, totaling a \$15 million reduction in the loss reported in Non-interest income (loss) with a corresponding increase in expenses reported in Non-interest expense during 2003.

## SUBSEQUENT ACCOUNTING REVISIONS

As we announced on May 12, 2005, we entered into a closing agreement with the IRS that resolves issues relating to the tax treatment of dividends paid on step-down preferred stock that our two REIT subsidiaries previously issued. The closing agreement resulted in changes to our 2004 financial results previously released in our Information Statement Supplement dated March 31, 2005. Specifically, we recorded a reduction in tax reserves, which are a component of Other assets, and a corresponding reduction in Income tax expense, totaling \$110 million. Of that amount, Income tax expense was reduced by \$94 million, which was the balance of the tax reserve related to this issue at January 1, 2004, and by a reversal of \$16 million of additional tax reserve recorded in 2004. The impact by quarter was an increase (reduction) to Net income of \$101 million, \$16 million, (\$9) million, and \$2 million, affecting the first, second, third and fourth quarters of 2004, respectively. In 2005 and thereafter, we will record tax benefits related to REIT preferred stock dividend payments in the consolidated financial statements consistent with the closing agreement. See "NOTE 14: INCOME TAXES" to the consolidated financial statements for additional information.

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## ADDITIONAL INFORMATION

The following tables provide additional information about select captions on our consolidated balance sheets at December 31, 2004, 2003 and 2002.

**Table 73 — Fair Value of Securities**

	December 31,		
	2004	2003	2002
	(dollars in millions)		
<b>Available-for-sale securities</b>			
<i>Retained portfolio</i>			
<b>Mortgage-related securities issued by:</b>			
Freddie Mac .....	\$352,102	\$384,426	\$327,995
Fannie Mae .....	59,519	76,844	81,930
Ginnie Mae .....	1,762	2,918	5,175
Other .....	168,058	109,409	73,498
Obligations of states and political subdivisions .....	9,020	7,729	7,667
Total mortgage-related securities .....	<u>590,461</u>	<u>581,326</u>	<u>496,265</u>
<i>Cash and investments portfolio</i>			
<b>Non-mortgage-related securities:</b>			
Asset-backed securities .....	21,733	16,596	34,694
Debt securities issued by the U.S. Treasury and other U.S. government corporations and agencies .....	—	—	12,493
Corporate debt securities .....	—	4,924	10,102
Obligations of states and political subdivisions .....	8,097	9,494	6,641
Commercial paper .....	—	150	2,240
Preferred stock .....	—	64	249
Total non-mortgage-related securities .....	<u>29,830</u>	<u>31,228</u>	<u>66,419</u>
<b>Total available-for-sale securities .....</b>	<u><u>\$620,291</u></u>	<u><u>\$612,554</u></u>	<u><u>\$562,684</u></u>
<b>Trading securities</b>			
<i>Retained portfolio</i>			
<b>Mortgage-related securities issued by:</b>			
Freddie Mac .....	\$ 11,398	\$ 17,590	\$ 28,535
Fannie Mae .....	385	586	519
Ginnie Mae .....	59	24	50
Total mortgage-related securities .....	<u>11,842</u>	<u>18,200</u>	<u>29,104</u>
<i>Cash and investments portfolio<sup>(1)</sup></i>			
<b>Mortgage-related securities issued by:</b>			
Freddie Mac .....	—	17,266	20,244
Fannie Mae .....	—	15,052	11,029
Ginnie Mae .....	—	490	1,062
Other .....	—	9	31
Total mortgage-related securities .....	<u>—</u>	<u>32,817</u>	<u>32,366</u>
<b>Non-mortgage-related securities:</b>			
Asset-backed securities .....	—	52	96
Debt securities issued by the U.S. Treasury and other U.S. government corporations and agencies .....	—	479	1,004
Mutual funds .....	—	—	540
Commercial paper .....	—	341	479
Corporate debt securities .....	—	437	229
Debt securities issued by foreign governments .....	—	5	4
Other .....	—	—	57
Total non-mortgage-related securities .....	<u>—</u>	<u>1,314</u>	<u>2,409</u>
<b>Total trading securities .....</b>	<u><u>\$ 11,842</u></u>	<u><u>\$ 52,331</u></u>	<u><u>\$ 63,879</u></u>

(1) The reduction of trading securities within the Cash and investments portfolio in 2004 was attributable to us ceasing the operations of our PC market-making and support activities accomplished through our Securities Sales & Trading Group business unit and external Money Manager program during the fourth quarter of 2004.

For additional information about the securities we hold, see “NOTE 5: RETAINED PORTFOLIO AND CASH AND INVESTMENTS PORTFOLIO” to the consolidated financial statements.

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**Table 74 — Senior Debt, Due Within One Year**

	2004				
	At December 31,		Average Outstanding During the Year		Maximum Balance, Net Outstanding at Any Month End
	Balance, Net	Weighted Average Effective Rate <sup>(1)</sup>	Balance, Net <sup>(2)</sup>	Weighted Average Effective Rate <sup>(3)</sup>	
			(dollars in millions)		
Discount notes . . . . .	\$180,198	2.04%	\$184,834	1.40%	\$212,715
Medium-term notes . . . . .	162	2.51	4,289	1.31	5,320
Securities sold under agreements to repurchase and Federal funds purchased	—	—	801	1.37	3,046
Swap collateral obligations . . . . .	16,279	2.24	13,549	1.36	16,279
Short-term debt securities . . . . .	196,639				
Current portion of long-term debt . . . . .	85,664				
Senior debt, due within one year . . . . .	<u>\$282,303</u>				
			2003		
	At December 31,		Average Outstanding During the Year		Maximum Balance, Net Outstanding at Any Month End
	Balance, Net	Weighted Average Effective Rate <sup>(1)</sup>	Balance, Net <sup>(2)</sup>	Weighted Average Effective Rate <sup>(3)</sup>	
			(dollars in millions)		
Discount notes <sup>(4)</sup> . . . . .	\$188,309	1.12%	\$207,374	1.21%	\$264,370
Medium-term notes . . . . .	5,300	1.18	1,243	1.32	5,300
Securities sold under agreements to repurchase and Federal funds purchased <sup>(5)</sup> . . . . .	1,611	0.96	2,283	0.94	8,296
Swap collateral obligations <sup>(6)</sup> . . . . .	16,082	1.02	11,694	1.13	16,082
Securities sold, not yet purchased . . . . .	733				
Short-term debt securities . . . . .	212,035				
Current portion of long-term debt . . . . .	83,227				
Senior debt, due within one year . . . . .	<u>\$295,262</u>				
			2002		
	At December 31,		Average Outstanding During the Year		Maximum Balance, Net Outstanding at Any Month End
	Balance, Net	Weighted Average Effective Rate <sup>(1)</sup>	Balance, Net <sup>(2)</sup>	Weighted Average Effective Rate <sup>(3)</sup>	
			(dollars in millions)		
Discount notes <sup>(4)</sup> . . . . .	\$163,202	1.61%	\$180,889	2.02%	\$211,393
Medium-term notes <sup>(4)</sup> . . . . .	1,015	2.07	5,528	2.39	8,163
Securities sold under agreements to repurchase and Federal funds purchased	15,262	1.08	13,882	1.39	21,472
Swap collateral obligations <sup>(6)(7)</sup> . . . . .	8,209	1.39	3,278	1.65	8,209
Securities sold, not yet purchased . . . . .	6,356				
Short-term debt securities . . . . .	194,044				
Current portion of long-term debt . . . . .	50,385				
Senior debt, due within one year . . . . .	<u>\$244,429</u>				

- (1) Represents the weighted average effective rate at the end of the period, which includes the amortization of discounts or premiums and issuance costs, but excludes the amortization of foreign-currency-related and hedging-related basis adjustments.
- (2) Includes unamortized discounts or premiums and issuance costs. Issuance costs are reported in the Other assets caption on the consolidated balance sheets.
- (3) Represents the approximate weighted average effective rate during the period, which includes the amortization of discounts or premiums and issuance costs, but excludes the amortization of foreign-currency-related and hedging-related basis adjustments.
- (4) Maximum Balance, Net Outstanding at Any Month End for 2003 and 2002 has been revised to conform with the 2004 presentation.
- (5) Balance, Net and Weighted Average Effective Rate for Average Outstanding During the Year for 2003 have been revised for Securities sold under agreements to repurchase and Federal funds purchased to conform with the 2004 presentation.
- (6) Weighted Average Effective Rate at December 31, 2003 and 2002 have been revised to conform with the 2004 presentation.
- (7) Balance, Net and Weighted Average Effective Rate for Average Outstanding During the Year for 2002 have been revised to conform with the 2004 presentation.

For additional information about our debt securities, see “NOTE 8: DEBT SECURITIES AND SUBORDINATED BORROWINGS” to the consolidated financial statements.

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## VOLUNTARY COMMITMENTS

The following provides updated information on the Voluntary Commitments we made in October 2000. Additional information about our Voluntary Commitments is available on our website ([www.FreddieMac.com/investors](http://www.FreddieMac.com/investors)).

Description	Comments	Status
<p>1. <i>Periodic Issuance of Subordinated Debt:</i></p> <ul style="list-style-type: none"> <li>• We will issue publicly traded and externally rated Freddie SUBS® on a semi-annual basis.</li> <li>• Freddie SUBS® will be issued in an amount such that “Voluntary Commitments’ capital” less 0.45 percent of Outstanding PCs and Structured Securities will equal or exceed four percent of on-balance sheet assets by October 2003. Voluntary Commitments’ capital is defined as the sum of Core capital (effectively equal to Stockholders’ equity less AOCI, net of taxes), loan loss reserves and Freddie SUBS® outstanding.</li> </ul>	<ul style="list-style-type: none"> <li>• At December 31, 2004, the ratio of Voluntary Commitments’ capital less 0.45 percent of Outstanding PCs and Structured Securities to total assets was 4.6 percent.</li> <li>• We cannot determine this ratio as of the end of any period in 2005 with specificity until we release the consolidated financial statements for the relevant period.</li> </ul>	<ul style="list-style-type: none"> <li>• We did not issue any Freddie SUBS® in 2004. As a result of not having current consolidated financial statements, our ability to issue subordinated debt may be limited.</li> <li>• As of December 31, 2004, we met this commitment.</li> <li>• We plan to update our disclosure for this commitment following the release of our 2005 consolidated financial statements for the relevant period.</li> </ul>
<p>2. <i>Liquidity Management and Contingency Planning:</i></p> <ul style="list-style-type: none"> <li>• We will comply with principles of sound liquidity management set forth by the Basel Committee on Banking Supervision and will maintain more than three months’ worth of liquidity (based on internal forecasts) assuming we have no access to new issue public debt markets.</li> <li>• In implementing this commitment, we will maintain at least five percent of on-balance sheet assets in liquid, marketable, non-mortgage securities. We will also maintain additional, liquid mortgage securities for use as collateral in short-term borrowings from dealer counterparties.</li> </ul>	<ul style="list-style-type: none"> <li>• For purposes of this commitment, we will maintain liquidity needed to meet our obligations to pay principal and interest related to our outstanding debt maturities, to pay PC investors the amounts due to them, to purchase mortgage loans and mortgage-related securities that we have committed to purchase as well as to fund operating expenditures. To fund these obligations in the event of market disruption, we could sell some securities from our Retained portfolio and liquidate non-mortgage investments from our Cash and investments portfolio. In addition, we could borrow against mortgage-related securities that are a component of our Retained portfolio by executing transactions in the repurchase agreement market. (Our ability to execute these and other strategies may be adversely affected by market conditions, operational constraints and other factors.)</li> <li>• Assets that meet this definition include Cash and cash equivalents (excluding operating cash accounts, cash posted as collateral by derivative counterparties and certain other balances), various non-mortgage investments such as municipal bonds, asset-backed securities, commercial paper and certain securities purchased under agreements to resell (reverse repos). This commitment no longer considers investments held by our Securities Sales &amp; Trading Group business unit or as part of our external Money Manager program as these operations ceased activity during the fourth quarter of 2004.</li> <li>• We cannot determine the percentage of on-balance sheet assets in liquid, marketable, non-mortgage securities as of the end of any period in 2005 with specificity until we release the consolidated financial statements for the relevant period.</li> </ul>	<ul style="list-style-type: none"> <li>• As of December 31, 2004, we met this commitment.</li> <li>• As of December 31, 2004, we met this commitment.</li> <li>• We plan to update our disclosure for this commitment following the release of our 2005 consolidated financial statements for the relevant period.</li> </ul>

**VOLUNTARY COMMITMENTS (continued)**

Description	Comments	Status																																																
<p><i>3. Interest-Rate Risk Disclosures</i></p> <p>We will provide public disclosure of interest-rate risk sensitivity results on a monthly basis. Specifically, we will disclose the PMVS-L, which shows the expected impact on our portfolio market value from an immediate, adverse 50 basis point parallel shift in the yield curve. We will also disclose the PMVS-YC, which shows the same impact from an immediate, adverse 25 basis point change in the slope of the yield curve.</p>		<p>The full-year average PMVS-L and PMVS-YC for 2004 was 2 and 0 percent, respectively. 2005's monthly average PMVS results and related disclosures are provided in our Monthly Volume Summary, or MVS, which is available on our website, <a href="http://www.FreddieMac.com/investor">www.FreddieMac.com/investor</a>.</p>																																																
<p><i>4. Credit Risk Disclosures:</i></p> <p>We will provide public disclosure of credit risk sensitivity results on a quarterly basis. Compared to a base case in which house prices on average rise at rates consistent with long-term trends, these disclosures show the increase in the present value of expected single-family credit losses to us over a ten-year period assuming an immediate five percent decline in house prices followed by a resumption of the same long-term trend in house-price appreciation as in the base case.</p>	<p>An internally developed Monte Carlo simulation-based model is used to generate our credit risk sensitivity analyses. We use this same model to calculate the expected default cost component of the Guarantee obligation on Participation Certificates and to estimate expected future default costs of mortgage loans and mortgage-related securities. In this analysis, we adjust the house-price assumption used in the base case to estimate the level and sensitivity of potential credit costs associated with our existing single-family mortgage portfolio. See "NOTE 2: TRANSFERS OF SECURITIZED INTERESTS IN MORTGAGE-RELATED ASSETS" to the consolidated financial statements for more information.</p>	<p>Our quarterly credit risk sensitivity estimates are as follows:</p> <table border="1"> <thead> <tr> <th rowspan="3"></th> <th colspan="2">Before Receipt of Credit Enhancements <sup>(1)</sup></th> <th colspan="2">After Receipt of Credit Enhancements <sup>(2)</sup></th> </tr> <tr> <th>NPV <sup>(3)</sup></th> <th>NPV Ratio <sup>(4)</sup></th> <th>NPV <sup>(3)</sup></th> <th>NPV Ratio <sup>(4)</sup></th> </tr> <tr> <th>(dollars in millions)</th> <th></th> <th>(dollars in millions)</th> <th></th> </tr> </thead> <tbody> <tr> <td>As of:</td> <td></td> <td></td> <td></td> <td></td> </tr> <tr> <td>03/31/05</td> <td>\$756</td> <td>6.2 bps</td> <td>\$447</td> <td>3.6 bps</td> </tr> <tr> <td>12/31/04</td> <td>794</td> <td>6.5 bps</td> <td>463</td> <td>3.8 bps</td> </tr> <tr> <td>09/30/04</td> <td>879</td> <td>7.3 bps</td> <td>512</td> <td>4.2 bps</td> </tr> <tr> <td>06/30/04</td> <td>873</td> <td>7.3 bps</td> <td>522</td> <td>4.4 bps</td> </tr> <tr> <td>03/31/04</td> <td>872</td> <td>7.4 bps</td> <td>503</td> <td>4.3 bps</td> </tr> <tr> <td>12/31/03</td> <td>926</td> <td>7.9 bps</td> <td>533</td> <td>4.6 bps</td> </tr> </tbody> </table> <p>(1) Assumes that none of the credit enhancements currently covering our mortgages has any mitigating impact on our credit losses.</p> <p>(2) Assumes we collect amounts due from credit enhancement providers after giving effect to certain assumptions about counterparty default rates.</p> <p>(3) Based on single-family Total mortgage portfolio, excluding Structured Securities backed by non-Freddie Mac mortgage-related securities and Structured Securities backed by Ginnie Mae Certificates.</p> <p>(4) Calculated as the ratio of net present value of increase in credit losses to the total single-family mortgage portfolio, which excludes multi-family mortgages and Structured Securities backed by Ginnie Mae Certificates.</p>		Before Receipt of Credit Enhancements <sup>(1)</sup>		After Receipt of Credit Enhancements <sup>(2)</sup>		NPV <sup>(3)</sup>	NPV Ratio <sup>(4)</sup>	NPV <sup>(3)</sup>	NPV Ratio <sup>(4)</sup>	(dollars in millions)		(dollars in millions)		As of:					03/31/05	\$756	6.2 bps	\$447	3.6 bps	12/31/04	794	6.5 bps	463	3.8 bps	09/30/04	879	7.3 bps	512	4.2 bps	06/30/04	873	7.3 bps	522	4.4 bps	03/31/04	872	7.4 bps	503	4.3 bps	12/31/03	926	7.9 bps	533	4.6 bps
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<p><i>5. Public Disclosure of Annual Rating:</i></p> <p>We will obtain an annual credit rating assessing risk to the government or independent financial strength from a nationally recognized statistical rating organization and will disclose this rating to the public.</p>	<p>We have a "risk-to-the-government" credit rating of "AA-" from S&amp;P. Moody's has assigned us a Bank Financial Strength Rating of "A-." Both of these ratings are maintained on a surveillance basis, which means that the rating agencies are committed to notify the public if the rating is ever affected by a change in our financial condition.</p>	<p>As of May 23, 2005, S&amp;P's risk-to-the-government rating us was "AA-" and Moody's Bank Financial Strength Rating for us was "A-."</p>																																																

*Freddie Mac*

**CONSOLIDATED FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

## REPORT OF INDEPENDENT AUDITORS

To the Board of Directors and Stockholders of Freddie Mac:

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income, of cash flows, and of stockholders' equity present fairly, in all material respects, the financial position of Freddie Mac, a stockholder-owned government-sponsored enterprise (the "company"), and its subsidiaries at December 31, 2004 and 2003, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2004, in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

We have also audited in accordance with auditing standards generally accepted in the United States of America the supplemental consolidated fair value balance sheets of the company as of December 31, 2004 and 2003. As described in "NOTE 16: FAIR VALUE DISCLOSURES," the supplemental consolidated fair value balance sheets have been prepared by management to present relevant financial information that is not provided by the historical-cost consolidated balance sheets and is not intended to be a presentation in conformity with generally accepted accounting principles. In addition, the supplemental consolidated fair value balance sheets do not purport to present the net realizable, liquidation, or market value of the company as a whole. Furthermore, amounts ultimately realized by the company from the disposal of assets or amounts required to settle obligations may vary significantly from the fair values presented. In our opinion, the supplemental consolidated fair value balance sheets referred to above present fairly, in all material respects, the information set forth therein as described in "NOTE 16: FAIR VALUE DISCLOSURES."

As discussed in "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES," the company adopted the provisions of FASB Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others" and FASB Staff Position 45-2 "Whether FASB Interpretation No. 45, 'Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others,' Provides Support for Subsequently Accounting for a Guarantor's Liability at Fair Value," as of January 1, 2003.

*PricewaterhouseCoopers LLP*

McLean, Virginia  
June 1, 2005

*Freddie Mac*



**FREDDIE MAC**  
**CONSOLIDATED STATEMENTS OF INCOME**

	Year Ended December 31,		
	2004	2003	2002
	(dollars in millions, except share-related amounts)		
<i>Interest income</i>			
Mortgage loans	\$ 4,007	\$ 4,251	\$ 4,290
Mortgage-related securities in the Retained portfolio	28,460	29,051	30,039
Cash and investments	3,136	3,796	4,147
Total interest income	<u>35,603</u>	<u>37,098</u>	<u>38,476</u>
<i>Interest expense</i>			
Short-term debt	(2,908)	(2,785)	(4,303)
Long-term debt	(22,950)	(22,083)	(21,337)
Total interest expense on debt securities	(25,858)	(24,868)	(25,640)
Due to Participation Certificate investors	(708)	(1,641)	(1,236)
Total interest expense	(26,566)	(26,509)	(26,876)
Income (expense) related to derivatives	100	(1,091)	(2,075)
<i>Net interest income</i>	<u>9,137</u>	<u>9,498</u>	<u>9,525</u>
<i>Non-interest income (loss)</i>			
Management and guarantee income (includes interest on Guarantee asset for Participation Certificates of \$257, \$244 and \$242)	1,382	1,653	1,527
Gains (losses) on "Guarantee asset for Participation Certificates, at fair value"	(1,135)	(1,461)	(2,176)
Income on "Guarantee obligation for Participation Certificates"	732	925	592
Derivative gains (losses)	(4,475)	39	5,302
Hedge accounting gains (losses)	743	644	187
Gains (losses) on investment activity	(348)	(1,114)	1,799
Gains (losses) on debt retirement	(327)	(1,775)	(674)
Resecuritization fees	159	352	276
Other income	230	493	321
<i>Non-interest income (loss)</i>	<u>(3,039)</u>	<u>(244)</u>	<u>7,154</u>
<i>Non-interest expense</i>			
Salaries and employee benefits	(758)	(624)	(593)
Professional services	(588)	(311)	(155)
Occupancy expense	(60)	(52)	(42)
Other administrative expenses	(144)	(194)	(184)
Total administrative expenses	(1,550)	(1,181)	(974)
(Provision) benefit for credit losses	(143)	5	(122)
REO operations income (expense)	3	(7)	(4)
Housing tax credit partnerships	(281)	(200)	(160)
Minority interests in earnings of consolidated subsidiaries	(129)	(157)	(184)
Other expenses	(271)	(696)	(432)
<i>Non-interest expense</i>	<u>(2,371)</u>	<u>(2,236)</u>	<u>(1,876)</u>
Income before income tax expense	3,727	7,018	14,803
Income tax expense	(790)	(2,202)	(4,713)
<i>Net income</i>	<u>\$ 2,937</u>	<u>\$ 4,816</u>	<u>\$ 10,090</u>
Preferred stock dividends and issuance costs on redeemed preferred stock (including \$0, \$0 and \$5 of issuance costs on redeemed preferred stock)	(210)	(216)	(239)
<i>Net income available to common stockholders</i>	<u>\$ 2,727</u>	<u>\$ 4,600</u>	<u>\$ 9,851</u>
Basic earnings per common share	\$ 3.96	\$ 6.69	\$ 14.22
Diluted earnings per common share	\$ 3.94	\$ 6.68	\$ 14.17
Weighted average common shares outstanding (thousands)			
Basic	689,282	687,094	692,727
Diluted	691,521	688,675	695,116
Dividends per common share	\$ 1.20	\$ 1.04	\$ 0.88

*The accompanying notes are an integral part of these financial statements.*

*Freddie Mac*

**FREDDIE MAC  
CONSOLIDATED BALANCE SHEETS**

	<u>December 31, 2004</u>	<u>December 31, 2003</u>
(dollars in millions)		
<b>Assets</b>		
<i>Retained portfolio</i>		
Mortgage loans:		
Held-for-investment, at amortized cost .....	\$ 58,852	\$ 57,804
Reserve for losses on mortgage loans held-for-investment .....	(114)	(174)
Held-for-sale, at lower of cost or market value .....	2,582	2,530
Mortgage loans, net of reserve .....	<u>61,320</u>	<u>60,160</u>
Mortgage-related securities:		
Available-for-sale, at fair value (includes \$194 and \$282 pledged as collateral that may be repledged) .....	590,461	581,326
Trading, at fair value (includes \$0 and \$32 pledged as collateral that may be repledged) .....	11,842	18,200
Participation Certificate residuals, at fair value .....	845	671
Total mortgage-related securities .....	<u>603,148</u>	<u>600,197</u>
<i>Retained portfolio</i> .....	<u>664,468</u>	<u>660,357</u>
<i>Cash and investments</i>		
Cash and cash equivalents .....	35,253	23,142
Investments:		
Mortgage-related securities:		
Trading, at fair value (includes \$0 and \$6 pledged as collateral that may be repledged) .....	—	32,817
Participation Certificate residuals, at fair value .....	—	(5)
Non-mortgage-related securities:		
Available-for-sale, at fair value .....	29,830	31,228
Trading, at fair value (includes \$0 and \$23 pledged as collateral that may be repledged) .....	—	1,314
Total non-mortgage-related securities .....	<u>29,830</u>	<u>32,542</u>
Total mortgage-related and non-mortgage-related securities .....	29,830	65,354
Securities purchased under agreements to resell and Federal funds sold .....	32,197	20,582
<i>Cash and investments</i> .....	<u>97,280</u>	<u>109,078</u>
Accounts and other receivables, net .....	7,286	8,067
Derivative assets, at fair value .....	15,257	16,180
Guarantee asset for Participation Certificates, at fair value .....	4,516	3,686
Real estate owned, net .....	741	795
Other assets .....	5,736	5,286
<i>Total assets</i> .....	<u>\$795,284</u>	<u>\$803,449</u>
<b>Liabilities and stockholders' equity</b>		
<i>Debt securities, net</i>		
Senior debt:		
Due within one year .....	\$282,303	\$295,262
Due after one year .....	443,772	438,738
Subordinated debt, due after one year .....	5,622	5,613
<i>Total debt securities, net</i> .....	<u>731,697</u>	<u>739,613</u>
Due to Participation Certificate investors .....	13,654	13,205
Accrued interest payable .....	7,329	7,345
Guarantee obligation for Participation Certificates .....	4,065	2,904
Derivative liabilities, at fair value .....	226	357
Reserve for guarantee losses on Participation Certificates .....	150	125
Other liabilities .....	5,238	6,484
<i>Total liabilities</i> .....	<u>762,359</u>	<u>770,033</u>
Commitments and contingencies (Notes 1, 3, 4 and 13) .....		
<i>Minority interests in consolidated subsidiaries</i> .....	1,509	1,929
<i>Stockholders' equity</i>		
Preferred stock, at redemption value .....	4,609	4,609
Common stock, \$0.21 par value, 726,000,000 shares authorized, 725,882,280 shares issued and 690,606,185 shares and 688,573,911 shares outstanding, respectively .....	152	152
Additional paid-in capital .....	873	814
Retained earnings .....	30,728	28,837
Accumulated other comprehensive income (loss), (AOCI) net of taxes, related to:		
Available-for-sale securities .....	4,339	6,349
Cash flow hedge relationships .....	(7,924)	(7,837)
Minimum pension liability .....	(8)	(10)
Total accumulated other comprehensive income (loss), net of taxes .....	<u>(3,593)</u>	<u>(1,498)</u>
Treasury stock, at cost, 35,276,095 shares and 37,308,369 shares, respectively .....	<u>(1,353)</u>	<u>(1,427)</u>
<i>Total stockholders' equity</i> .....	<u>31,416</u>	<u>31,487</u>
<i>Total liabilities and stockholders' equity</i> .....	<u>\$795,284</u>	<u>\$803,449</u>

*The accompanying notes are an integral part of these financial statements.*

*Freddie Mac*

**FREDDIE MAC**  
**CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY**

	Year Ended December 31,					
	2004		2003		2002	
	Shares	Amount	Shares	Amount	Shares	Amount
	(dollars and shares in millions)					
<i>Preferred stock, at redemption value</i>						
Balance, beginning of year	92	\$ 4,609	92	\$ 4,609	92	\$ 4,596
Preferred stock issuances	—	—	—	—	6	300
Preferred stock redemptions	—	—	—	—	(6)	(287)
<i>Preferred stock, end of year</i>	<u>92</u>	<u>4,609</u>	<u>92</u>	<u>4,609</u>	<u>92</u>	<u>4,609</u>
<i>Common stock, par value</i>						
Balance, beginning of year	726	152	726	152	726	152
<i>Common stock, end of year</i>	<u>726</u>	<u>152</u>	<u>726</u>	<u>152</u>	<u>726</u>	<u>152</u>
<i>Additional paid-in capital</i>						
Balance, beginning of year		814		744		671
Stock-based compensation, before tax effect of \$20, \$23 and \$23		56		64		65
Income tax benefit from employee stock option exercises		20		16		16
Preferred stock issuance costs		—		—		(2)
Common stock issuances		(17)		(10)		(6)
<i>Additional paid-in capital, end of year</i>		<u>873</u>		<u>814</u>		<u>744</u>
<i>Retained earnings</i>						
Balance, beginning of year		28,837		24,955		15,710
Net income		2,937		4,816		10,090
Preferred stock dividends declared		(210)		(216)		(234)
Common stock dividends declared		(836)		(718)		(611)
<i>Retained earnings, end of year</i>		<u>30,728</u>		<u>28,837</u>		<u>24,955</u>
<i>AOCI, net of taxes</i>						
Balance, beginning of year		(1,498)		2,340		(557)
Changes in unrealized gains (losses) related to available-for-sale securities, net of reclassification adjustments		(2,010)		(5,868)		8,017
Changes in unrealized gains (losses) related to cash flow hedge relationships, net of reclassification adjustments		(87)		2,040		(5,120)
Change in minimum pension liability		2		(10)		—
<i>AOCI, net of taxes, end of year</i>		<u>(3,593)</u>		<u>(1,498)</u>		<u>2,340</u>
<i>Treasury stock, at cost</i>						
Balance, beginning of year	37	(1,427)	39	(1,470)	31	(948)
Common stock issuances	(2)	74	(2)	43	(1)	33
Common stock repurchases	—	—	—	—	9	(555)
<i>Treasury stock, end of year</i>	<u>35</u>	<u>(1,353)</u>	<u>37</u>	<u>(1,427)</u>	<u>39</u>	<u>(1,470)</u>
<i>Total stockholders' equity</i>		<u>\$31,416</u>		<u>\$31,487</u>		<u>\$31,330</u>
<i>Comprehensive income</i>						
Net income		\$ 2,937		\$ 4,816		\$10,090
Changes in AOCI, net of taxes, net of reclassification adjustments		(2,095)		(3,838)		2,897
<i>Total comprehensive income</i>		<u>\$ 842</u>		<u>\$ 978</u>		<u>\$12,987</u>

*The accompanying notes are an integral part of these financial statements.*

*Freddie Mac*

**FREDDIE MAC**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

	Year Ended December 31,		
	2004	2003	2002
	(dollars in millions)		
<b>Cash flows from operating activities</b>			
Net income	\$ 2,937	\$ 4,816	\$ 10,090
Adjustments to reconcile net income to net cash provided by operating activities:			
Hedge accounting (gains) losses	(743)	(644)	(187)
Unrealized (gains) losses on derivatives not in hedge accounting relationships, net	2,758	(1,079)	(5,941)
Asset related amortization — premiums, discounts and hedging basis adjustments	1,329	995	(404)
Debt related amortization — premiums and discounts on certain debt securities and hedging basis adjustments	3,318	2,318	374
Losses on debt retirement	327	1,775	674
Provision for credit losses	143	(5)	122
(Gains) losses on investment activity	738	2,625	(1,784)
Purchases of held-for-sale mortgages	(31,698)	(82,074)	(55,275)
Sales of held-for-sale mortgages	30,965	84,329	49,035
Repayments of held-for-sale mortgages	162	390	1,097
Net proceeds from purchases and sales of trading securities	38,672	8,935	7,170
Change in accounts and other receivables, net	2,149	4,394	3,238
Change in amounts due to Participation Certificate investors, net	529	(22,369)	7,705
Change in accrued interest payable	(513)	(217)	(1,207)
Change in income taxes payable	756	(1,090)	(484)
Change in Guarantee asset for Participation Certificates, at fair value	(830)	(1,362)	711
Change in Guarantee obligation for Participation Certificates	1,173	1,606	272
Change in Participation Certificate residuals, at fair value	(170)	(389)	326
Change in deferred income taxes	(346)	737	2,690
Other, net	196	219	2,559
<i>Net cash provided by operating activities</i>	<u>51,852</u>	<u>3,910</u>	<u>20,781</u>
<b>Cash flows from investing activities</b>			
Purchases of available-for-sale securities	(276,573)	(446,036)	(451,510)
Proceeds from sales of available-for-sale securities	85,583	143,513	176,928
Proceeds from maturities of available-for-sale securities	178,148	242,044	178,991
Purchases of held-for-investment mortgages	(14,241)	(17,570)	(13,197)
Repayments of held-for-investment mortgages	11,511	15,283	12,999
Proceeds from sales of REO	1,552	1,327	980
Net (increase) decrease in securities purchased under agreements to resell and Federal funds sold	(11,615)	2,461	10,457
Derivative premiums and terminations, net	(193)	3,333	(4,062)
Investments in housing tax credit partnerships	(69)	(32)	(65)
<i>Net cash used for investing activities</i>	<u>(25,897)</u>	<u>(55,677)</u>	<u>(88,479)</u>
<b>Cash flows from financing activities</b>			
Proceeds from issuance of short-term debt	826,020	900,073	2,048,131
Repayments of short-term debt	(841,638)	(881,860)	(2,099,206)
Proceeds from issuance of long-term debt	187,878	258,371	269,386
Repayments of long-term debt	(184,295)	(210,841)	(141,257)
Repayments of minority interest in consolidated subsidiaries	(405)	(376)	(350)
Proceeds from issuance of preferred stock, net of issuance costs	—	—	298
Redemption of preferred stock	—	—	(287)
Proceeds from issuance of common stock	57	33	27
Repurchases of common stock	—	—	(555)
Payment of cash dividends on preferred stock and common stock	(1,046)	(934)	(845)
Repayments of housing tax credit partnerships notes payable	(415)	(349)	(316)
<i>Net cash (used for) provided by financing activities</i>	<u>(13,844)</u>	<u>64,117</u>	<u>75,026</u>
Net increase in cash and cash equivalents	12,111	12,350	7,328
Cash and cash equivalents at beginning of period	23,142	10,792	3,464
<i>Cash and cash equivalents at end of period</i>	<u>\$ 35,253</u>	<u>\$ 23,142</u>	<u>\$ 10,792</u>
<b>Supplemental cash flow information</b>			
Cash paid for:			
Interest	\$ 23,257	\$ 25,562	\$ 26,590
Derivative interest carry	325	578	3,239
Income taxes	363	2,538	2,491
Non-cash investing and financing activities:			
Securitized and retained available-for-sale securities formed from prior period purchases of held-for-sale mortgages	272	1,681	2,910
Transfers from mortgage loans to REO	1,546	1,570	1,127
Investments in housing tax credit partnerships financed by notes payable	1,184	702	896
Transfers from held-for-sale mortgages to held-for-investment mortgages	198	179	209

*The accompanying notes are an integral part of these financial statements.*

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Freddie Mac (the “company”) is a stockholder-owned, government-sponsored enterprise (“GSE”) established by Congress in 1970 to provide a continuous flow of funds for residential mortgages. Freddie Mac’s obligations are the company’s alone and not insured or guaranteed by the United States of America (“U.S.”) or any other agency or instrumentality of the U.S.

Freddie Mac plays a fundamental role in the American housing finance system, linking the domestic mortgage market and the global capital markets. Freddie Mac’s participation in the secondary mortgage market includes providing its credit guarantee for residential mortgages originated by mortgage lenders and investing in mortgage loans and mortgage-related securities held in Freddie Mac’s Retained portfolio. Through its credit guarantee activities, Freddie Mac securitizes mortgage loans by issuing Mortgage Participation Certificates (“PCs”) to third-party investors. Freddie Mac also resecuritizes mortgage-related securities that are issued by Freddie Mac or the Government National Mortgage Association (“Ginnie Mae”), as well as non-agency entities. Securities issued through Freddie Mac’s resecuritization activities are referred to as Structured Securities. Freddie Mac also guarantees multifamily mortgage loans that support housing revenue bonds issued by third parties and it guarantees other mortgage loans held by third parties, which are included in the definition of PCs and Structured Securities. In each case, under U.S. generally accepted accounting principles (“GAAP”), securitized mortgage-related assets that back PCs and Structured Securities that are held by third parties are not reflected as assets of Freddie Mac. However, Freddie Mac does retain an obligation to guarantee the payment of principal and interest on issued PCs and Structured Securities, which usually results in the recognition of a guarantee asset and guarantee obligation on the company’s consolidated balance sheets.

Freddie Mac’s financial reporting and accounting policies conform to GAAP. Certain amounts in prior periods have been reclassified to conform with the current presentation.

#### Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect (a) the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and (b) the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. The use of certain estimates in preparation of the financial statements is described below.

A significant estimate that is prevalent in the company’s financial statements is the estimation of fair value for financial instruments, including derivative instruments, required to be recorded at fair value under GAAP. The measurement of fair value is fundamental to the presentation of Freddie Mac’s financial condition and results of operations and, in many instances, requires management to make complex judgments. In general, Freddie Mac records financial instruments at an estimate of the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. Fair value is generally based on (i) quoted prices, (ii) market parameters obtained from third-party dealers, pricing services or based on direct market observations in active markets or (iii) derived from such prices or parameters, where available. If quoted prices or market parameters are not available, fair value is based on internal valuation models using market data inputs or internally developed assumptions, where appropriate. The use of different pricing models and assumptions could produce materially different estimates of fair value. See “NOTE 16: FAIR VALUE DISCLOSURES” for further discussion of fair value estimates.

Freddie Mac also makes other significant estimates and judgments in:

- determining the expected future cash flows (including the timing and amounts of prepayments) of mortgage-related assets in the Retained portfolio;
- assessing when securities are other-than-temporarily impaired;
- assessing the reserves for credit losses on mortgage loans and guarantee losses on PCs;
- assessing Freddie Mac’s legal and tax contingencies;

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- estimating the expected timing and amounts of future issuances of non-callable debt and redemptions of callable debt; and
- determining other matters that affect the reported amounts and disclosure of contingencies in the financial statements.

In accordance with Statement of Financial Accounting Standards (“SFAS”) No. 5, “Accounting for Contingencies” (“SFAS 5”), contingencies that might result in gains are not recorded prior to realization; whereas, contingencies that might result in losses are accrued currently if it is probable a liability has been incurred and the amount is reasonably estimable. Loss contingencies that are considered reasonably possible are not accrued, but are required to be disclosed. Loss contingencies that are considered to have a remote probability of occurrence are not required to be accrued or disclosed in accordance with SFAS 5.

### **Consolidation and Equity Method of Accounting**

The consolidated financial statements include the accounts of the company and its subsidiaries. All material intercompany transactions have been eliminated in consolidation. For each entity with which Freddie Mac is involved, the company makes a determination as to whether the entity should be considered a subsidiary of the company and included in the company’s consolidated financial statements. Freddie Mac consolidates all subsidiaries in which it holds more than 50 percent of the voting rights and has the ability to exercise control over the entity. Based on its exercise of control over them, the company consolidates its two majority-owned Real Estate Investment Trusts (“REITs”), Home Ownership Funding Corporation I and Home Ownership Funding Corporation II. The company also consolidates the accounts of wholly-owned JB 8000, Inc. (previously Ignition Mortgage Technology Solutions, Inc.). The equity and net earnings attributable to the minority shareholder interests which relate to the company’s consolidated subsidiaries are reported separately in the consolidated balance sheets as Minority interests in consolidated subsidiaries and in the consolidated statements of income as Minority interests in earnings of consolidated subsidiaries, respectively.

In addition to voting interests in an entity, a controlling financial interest may also exist in entities through arrangements that do not involve voting interests. Beginning in 2003, the company evaluated entities deemed to be variable interest entities under the revision to Financial Accounting Standards Board (“FASB”) Interpretation No. 46, “Consolidation of Variable Interest Entities” (“FIN 46-R”). FIN 46-R provides guidance for determining when a company must consolidate the assets, liabilities and activities of a variable interest entity. A variable interest entity is an entity (a) that has a total equity investment at risk that is not sufficient to finance its activities without additional subordinated financial support from other entities or (b) where the group of equity holders does not have the ability to make significant decisions about the entity’s activities, or the obligation to absorb the entity’s expected losses or the right to receive the entity’s expected residual returns, or both. If an entity is a variable interest entity, the company must determine if its variable interest is significant and whether the company is the “primary beneficiary.” Under FIN 46-R, a company is considered the primary beneficiary and must consolidate a variable interest entity when it absorbs a majority of expected losses or expected residual returns, or both. See “NOTE 3: VARIABLE INTEREST ENTITIES” for additional discussion and information regarding the consolidation of variable interest entities.

The company uses the equity method of accounting for companies over which it has the ability to exercise significant influence, but not control. Under the equity method of accounting, Freddie Mac reports its recorded investment as part of Other assets on the consolidated balance sheets and recognizes its share of the entity’s net income or losses in the consolidated statements of income with an offset to the recorded investment on the consolidated balance sheets. Losses are recognized up to the amount of investment recorded.

The company regularly invests as a limited partner in qualified low-income housing tax credit (“LIHTC”) partnerships that are eligible for federal tax credits. These tax credits are reported as reductions in the company’s provision for income taxes pursuant to Emerging Issues Task Force (“EITF”) Issue 94-1, “Accounting for Tax Benefits Resulting from Investments in Affordable Housing Projects” (“EITF 94-1”). Freddie Mac accounts for the investments which are not consolidated using the equity method of accounting, in accordance with Statement of Position (“SOP”) No. 78-9, “Accounting for Investments in Real Estate Ventures” (“SOP 78-9”). For partnerships accounted for under the equity method, Freddie Mac’s recorded investment is reported as part of Other assets on the consolidated balance

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sheets and its share of partnership income or loss is reported in the consolidated statements of income as Non-interest expense — Housing tax credit partnerships. The company's obligations to make delayed equity contributions that are unconditional and legally binding are recorded at their present value in Other liabilities on the consolidated balance sheets. To the extent that the company's cost basis in qualified low-income housing tax credit partnerships is different than the book basis reflected at the partnership level, the basis difference is amortized over the life of the tax credits and included in the company's share of earnings (losses) from housing tax credit partnerships. Freddie Mac periodically reviews these investments for impairment and adjusts them to fair value when a decline in market value below the recorded investment is deemed to be "other than temporary" under GAAP. Impairment losses are included in the consolidated statements of income as part of Non-interest expense — Housing tax credit partnerships.

### **Cash and Cash Equivalents and Statements of Cash Flows**

Freddie Mac accounts for highly liquid investment securities with an original maturity of three months or less and used for cash management purposes as cash equivalents. Cash collateral obtained from counterparties to derivative contracts where Freddie Mac is in an unrealized gain position is recorded as Cash and cash equivalents.

In the consolidated statements of cash flows, cash flows related to the acquisition and termination of derivatives other than forward commitments are generally classified in investing activities, without regard to whether they are designated as a hedge of another item. Cash flows from commitments accounted for as derivatives under SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities" ("SFAS 133") that result in the acquisition or sale of mortgage securities or mortgage loans are classified in either: (a) investing activities for available-for-sale securities or mortgage loans classified as held-for-investment or (b) operating activities for trading securities or mortgage loans classified as held-for-sale. Cash flows related to mortgage loans classified as held-for-sale are classified in operating activities unless the loans have been securitized and retained as available-for-sale PCs within the same reporting period, in which case they are classified as investing activities. The periodic cash flows on certain derivatives, which are recorded in the consolidated statements of income on an accrual basis either in Income (expense) related to derivatives or in Derivative gains (losses), are reported in operating activities. Cash flows related to guarantee fees, including buy-up and buy-down payments ("Buy-Ups" and "Buy-Downs," respectively), are classified as operating activities, along with the cash flows related to the collection and distribution of payments on the mortgage loans underlying PCs. Buy-Ups and Buy-Downs are discussed further below in "Guarantor Swap Transactions Executed Prior to January 1, 2003." Cash flows related to the repayment of the original issue discount on short-term, zero-coupon debt are reported as operating activities.

Freddie Mac reclassified certain amounts from those previously reported on the consolidated statements of cash flows for the years ended December 31, 2003 and 2002. Specifically, for the years ended December 31, 2003 and 2002, Net cash provided by operating activities decreased by \$572 million and \$983 million, respectively, while Net cash used for investing activities decreased by \$432 million and \$86 million, respectively, and Net cash (used for) provided by financing activities increased by \$140 million and \$897 million, respectively. These adjustments are corrections primarily related to certain timing differences on cash paid for interest related to short-term Discount notes and certain accruals related to the acquisition of loans underlying Freddie Mac mortgage-related securities. In addition, Freddie Mac revised previously reported supplemental cash flow disclosures related to Cash paid for Interest for the years ended December 31, 2003 and 2002. This adjustment was made to include cash paid related to original issue discounts on short-term Discount notes in conformity with the current period presentation and resulted in increasing previously reported amounts by \$2,710 million and \$4,596 million for the years ended December 31, 2003 and 2002, respectively.

Freddie Mac often retains Structured Securities created through resecuritizations of mortgage-related securities held by the company. The new Structured Securities the company acquires in these transactions are classified as available-for-sale or trading based upon the predominant classification of the mortgage-related security collateral the company contributed. There were \$428 million and \$322 million of non-cash net transfers to the available-for-sale classification from the trading classification related to resecuritization transactions in 2004 and 2003, respectively.

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## Transfers of Financial Assets that Qualify as Purchases or Sales

Freddie Mac accounts for transfers of financial assets pursuant to the requirements of SFAS No. 140, “Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities” (“SFAS 140”), and, prior to April 1, 2001, SFAS No. 125, “Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities” (“SFAS 125”), collectively referred to as “SFAS 125/140.” If Freddie Mac determines that it surrenders control over assets that it transfers to a third party, Freddie Mac accounts for such transfers as sales to the extent its counterparty provides consideration other than beneficial interests in the transferred assets (e.g., cash). Likewise, if Freddie Mac determines that it obtains control over assets that were transferred to it, it accounts for such transfers as purchases to the extent Freddie Mac provides consideration other than beneficial interests in exchange for the transferred assets. Freddie Mac accounts for cash-based transfers of financial assets that do not qualify as sales as secured borrowings.

If a transfer of financial assets qualifies as a sale, Freddie Mac continues to carry on its consolidated balance sheets any retained interests in securitized financial assets. Such retained interests generally take one of two forms. First, in connection with its right to receive guarantee payments (as further discussed below), Freddie Mac recognizes a retained interest that is classified on its consolidated balance sheets as Guarantee asset for Participation Certificates, at fair value. (This retained interest is referred to below as a “GA”.) Second, Freddie Mac recognizes PCs (or Structured Securities issued by the company using PCs held in its portfolio) that are not transferred to third parties upon the completion of a securitization of mortgage loans (or, in the case of Structured Securities, upon the rescuitization of PCs or Structured Securities held in portfolio). PCs and Structured Securities that are held in portfolio are accounted for pursuant to the requirements of SFAS No. 115, “Accounting for Certain Investments in Debt and Equity Securities” (“SFAS 115”). The carrying amounts of all of such retained interests are determined by allocating the previous carrying amount of the transferred assets between assets sold and the retained interests based upon their relative fair values at the date of transfer.

Upon completion of a transfer of financial assets that qualifies as a sale, Freddie Mac also de-recognizes all assets sold and recognizes all assets obtained and liabilities incurred. In this regard, Freddie Mac recognizes the fair value of its recourse obligation to guarantee the payment of principal and interest of PCs and Structured Securities transferred in sale transactions. The initial fair value of such recourse obligations is intended to reflect the estimated amount that Freddie Mac would be required to pay to a third party of similar credit standing to be relieved of Freddie Mac’s obligations under the guarantee contract. The portion of such recourse obligations that relates to Freddie Mac’s non-contingent obligation to stand ready to perform under its guarantee is recognized as Guarantee obligation for Participation Certificates (or as a “GO”), while the portion of such recourse obligations that relates to incurred losses on securitized assets is recognized for consolidated balance sheet purposes as Reserve for guarantee losses on Participation Certificates. Such recourse obligations serve as a reduction of proceeds in the calculation of the corresponding gain (loss) on the sale of transferred PCs and Structured Securities. The fair value of a recognized recourse obligation is estimated using an expected cash flow approach consistent with Statement of Financial Accounting Concepts No. 7, “Using Cash Flow Information and Present Value in Accounting Measurements” (“CON 7”). These recourse obligations are valued independently of corresponding GAs. The resulting gain (loss) on sale of transferred PCs and Structured Securities is reflected in Freddie Mac’s consolidated statements of income as a component of Gains (losses) on investment activity.

*Subsequent Measurement of Recognized GAs*— Freddie Mac generally views recognized GAs as financial assets that can be prepaid or otherwise settled in a manner that may prevent Freddie Mac from recovering substantially all of its recorded investment. As a result, Freddie Mac generally accounts for GAs like debt instruments classified as trading under SFAS 115. All changes in the fair value of recognized GAs are reflected in earnings as a component of Gains (losses) on “Guarantee asset for Participation Certificates, at fair value.” All guarantee-related compensation that is received over the life of the loan in cash is reflected in earnings as a component of Management and guarantee income. See “NOTE 2: TRANSFERS OF SECURITIZED INTERESTS IN MORTGAGE-RELATED ASSETS” for a discussion of the attribution of GA-related cash flows.

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*Subsequent Measurement of Recognized GOs*— With respect to the subsequent measurement of recognized GOs for the year ended December 31, 2002, Freddie Mac accounts for recognized GOs at fair value. All changes in fair value are reflected in Freddie Mac’s consolidated statements of income as a component of Income on “Guarantee obligation for Participation Certificates.”

With respect to the subsequent measurement of recognized GOs for the years ended December 31, 2004 and 2003, Freddie Mac subsequently measures such liabilities using a systematic and rational method of amortization. More specifically, Freddie Mac amortizes recognized GOs into earnings in proportion to the rate of unpaid principal balance decline of securitized mortgage loans. Periodic amortization of recognized GOs is reflected in earnings as a component of Income on “Guarantee obligation for Participation Certificates.” Freddie Mac subsequently measures its contingent obligation to make guarantee payments pursuant to the provisions of SFAS 5, which requires that credit losses be recognized in earnings when assessed as both probable and estimable. See discussion below in “Recently Adopted Accounting Standards and Accounting Changes” for further discussion concerning the change in methods used by Freddie Mac to subsequently measure recognized GOs.

### **Guarantor Swap Transactions Executed Prior to January 1, 2003**

Guarantor Swaps represent transactions in which third-party institutions transfer mortgage loans to Freddie Mac in exchange for issued PCs that are backed by such mortgage loans. In return for providing its guarantee on such issued PCs, and similar to PCs described above in “Transfers of Financial Assets that Qualify as Purchases or Sales,” Freddie Mac earns a management and guarantee fee (“G-Fee”) that is paid to Freddie Mac over the life of an issued PC. It is also common for Buy-Ups or Buy-Downs to be exchanged between Freddie Mac and its counterparties upon the issuance of a PC. Buy-Ups represent upfront payments that are made by Freddie Mac, which increase the G-Fee that Freddie Mac will receive over the life of the PC in connection with its guarantee. Buy-Downs represent upfront payments that are made to Freddie Mac, which decrease (*i.e.*, partially prepay) the G-Fee that Freddie Mac will receive over the life of the PC in connection with its guarantee. Moreover, Freddie Mac may receive upfront, cash-based payments as additional compensation for its guarantee of mortgage loans with certain credit risk related characteristics (“Credit Fees”). Finally, and as additional consideration received on such exchanges, Freddie Mac may receive various types of seller-provided credit enhancements that correspond to securitized mortgage loans. The accounting for the primary components of Guarantor Swaps executed prior to January 1, 2003 follows.

*Accounting For Guarantee Fees, Buy-Up, Buy Down and Credit Fees*— G-Fees (as adjusted for Buy-Downs received) are recognized as Management and guarantee income on an accrual basis over the corresponding guarantee period in accordance with the provisions of EITF Issue No. 85-20, “Recognition of Fees for Guaranteeing a Loan.”

Buy-Up amounts paid at PC issuance are recognized on the consolidated balance sheets as a GA if the corresponding PCs are held by third parties and are accounted for like a debt security that is classified as trading under SFAS 115. If a Buy-Up was paid in connection with PCs that Freddie Mac holds, the Buy-Up is recognized on the company’s consolidated balance sheets as a component of Participation Certificate residuals, at fair value (“PC residuals”), which is discussed further below.

Buy-Down and Credit Fee amounts that were received at PC issuance prior to January 1, 2003 are deferred on Freddie Mac’s consolidated balance sheets as an adjustment of Other liabilities. These amounts are amortized into Management and guarantee income pursuant to the requirements of SFAS No. 91, “Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases” (“SFAS 91”).

If Freddie Mac were to purchase, and then subsequently sell for GAAP purposes, a PC that was issued prior to January 1, 2003 as part of a Guarantor Swap (and for which a GA and GO were never previously recognized), it would recognize, as a GA, the fair value of its contractual right to receive guarantee fees, and would also recognize, as a GO, the fair value of its obligation to guarantee the payment of principal and interest on such securities. Such assets and liabilities would be subsequently measured in a manner that is consistent with principles described above in “Transfers of Financial Assets that Qualify as Purchases or Sales.”

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*Accounting For Incurred Credit Losses* — Freddie Mac measures its contingent obligation to make guarantee payments pursuant to the provisions of SFAS 5, which requires that credit losses be recognized in earnings when assessed as both probable and estimable.

*Accounting For Credit Enhancements* — Premium payments on purchased pool insurance are recognized as Other Assets, which are amortized into Non-interest expense (a) on a straight-line basis over three-month periods to the extent that premiums paid were quarterly-based or (b) on a level yield basis to the extent that Freddie Mac paid related pool insurance premiums upfront and in full. Otherwise, credit enhancements do not receive recognition at the inception of executed Guarantor Swap transactions.

To the extent that related PCs that correspond to received credit enhancements (and for which a GA and GO were never previously recognized) are purchased and then subsequently sold for GAAP purposes by Freddie Mac, the fair value of received pool insurance or recourse is recognized as a component of GAs, while the fair value of primary mortgage insurance (“PMI”) is recognized as a component of GOs. Such amounts are subsequently measured in a manner that is consistent with principles described above in “Transfers of Financial Assets that Qualify as Purchases or Sales.”

### **Guarantor Swap Transactions Executed on or after January 1, 2003**

Freddie Mac accounts for Guarantor Swaps that were executed on or after January 1, 2003 pursuant to the requirements of FASB Interpretation No. 45, “Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others” (“FIN 45”). As exchange transactions, executed Guarantor Swap transactions are recognized by Freddie Mac at the inception of such transactions on a fair value basis. The accounting for each of the components of Guarantor Swap transactions executed on or after January 1, 2003 follows.

*Accounting For Guarantee Fees* — As consideration received in connection with a guarantee-related exchange transaction, Freddie Mac recognizes the fair value of its contractual right to receive guarantee fees as a GA at the inception of an executed guarantee. Consistent with principles described above, such assets, which are classified as Guarantee asset for Participation Certificates, at fair value, are subsequently measured on a fair value basis. All changes in the fair value of recognized GAs are reflected in earnings as a component of Gains (losses) on “Guarantee asset for Participation Certificates, at fair value.” All guarantee-related compensation that is received over the life of the loan in cash is reflected in earnings as a component of Management and guarantee income.

*Accounting For Guarantee Obligations* — GOs are initially measured as the greater of (a) fair value or (b) the contingent liability amount required by SFAS 5 to be recognized at inception of an executed guarantee. The fair value of a recognized GO is estimated using an expected cash flow approach consistent with CON 7. Such liabilities are valued independently of corresponding GAs that are recognized in connection with such transactions. That portion of Freddie Mac’s estimated guarantee liability that relates to its non-contingent obligation to stand ready to perform under a PC guarantee is recognized as Guarantee obligation for Participation Certificates, while that portion of its estimated guarantee liability that relates to its contingent obligation to make payments under its guarantee is recognized for consolidated balance sheet purposes as Reserve for guarantee losses on Participation Certificates.

Freddie Mac subsequently measures recognized GOs by amortizing such liabilities into earnings in proportion to the rate of the unpaid principal balance decline of securitized mortgage loans. Periodic amortization of recognized GOs is reflected in earnings as a component of Income on “Guarantee obligation for Participation Certificates.” Freddie Mac subsequently measures its contingent obligation to make guarantee payments pursuant to the provisions of SFAS 5, which requires that credit losses be recognized in earnings when assessed as both probable and estimable.

*Accounting For Credit Enhancements* — With respect to those credit enhancements that are received in connection with Guarantor Swaps and other similar exchange transactions of PCs:

- pool insurance is recognized as an Other asset at its fair value;
- recourse and/or indemnifications that are provided by counterparties to Guarantor Swap transactions are recognized at fair value as Other assets; and
- PMI is recognized at inception at fair value as a component of recognized GOs.

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Credit enhancements that are separately recognized as Other assets are amortized into earnings as Non-interest expense. Such assets are specifically amortized over related contract terms at the greater of results calculated by amortizing recognized credit enhancements (a) in proportion to the rate of unpaid principal balance decline of covered mortgage loans or (b) on a straight-line basis over a credit enhancement's contract term.

*Accounting For Inception Differences Between Consideration Received and Guarantee Obligations Incurred* — Because GAs, GOs and credit enhancement-related assets that are recognized at the inception of an executed Guarantor Swap are valued independently of each other, net differences between such recognized assets and liabilities may exist at inception. Net positive differences between such amounts are deferred on Freddie Mac's consolidated balance sheet as a component of Guarantee obligation for Participation Certificates and are hereinafter referred to as "Deferred Guarantee Income". Net negative differences between GAs, GOs and credit enhancement-related assets that are recognized at the inception of executed financial guarantees are expensed immediately to earnings as a component of Non-interest expense — Other expenses.

Deferred Guarantee Income is amortized into earnings at a rate that is commensurate with the observed decline in the unpaid principal balance of securitized mortgage loans. Periodic amortization of recognized Deferred Guarantee Income is reflected in earnings as a component of Income on "Guarantee obligation for Participation Certificates."

*Accounting For Buy-Ups, Buy-Downs and Credit Fees* — Cash payments that are made or received in connection with Buy-Ups and Buy-Downs are recognized as adjustments of recognized Deferred Guarantee Income. Likewise, Credit Fees that Freddie Mac received at inception are also recognized as adjustments of recognized Deferred Guarantee Income.

#### **MultiLender Swap-Based Issuances of PCs**

Freddie Mac issues PCs through its MultiLender Program that are backed by mortgage loans delivered to Freddie Mac by more than one third party. Freddie Mac may itself contribute mortgage loans to MultiLender pools from which PCs are then issued and delivered to third parties (and to Freddie Mac, to the extent that Freddie Mac contributed mortgage loans to a MultiLender pool). Freddie Mac accounts for its contributions of mortgage loans to a MultiLender pool as partial sales of those assets, the sold portion of which is dependent upon the contribution of collateral made by Freddie Mac relative to third parties. The portion of a MultiLender Swap transaction that qualifies as a sale is accounted for in the same manner as transfers described above that are accounted for as sales. The remaining portion of such PC issuances and transfers are accounted for in a manner consistent with the accounting for PCs issued through the Guarantor Program (as described above).

#### **PC-for-Structured Security Swap Transactions**

Freddie Mac issues and transfers Structured Securities to third parties in exchange for PCs and non-Freddie Mac mortgage-related securities. Freddie Mac cannot freely pledge or exchange the securities that are delivered to it by third parties in these exchanges. As a result, Freddie Mac does not view such exchanges as triggering sale accounting recognition under SFAS 125/140. Additionally, Freddie Mac does not account for such exchanges pursuant to the requirements of FIN 45 given that the guarantees on newly-issued Structured Securities constitute guarantees of Freddie Mac's own performance associated with guarantees on PCs or Structured Securities that underlie the newly-issued Structured Securities (guarantees of one's own performance are exempt from the requirements of FIN 45). As a result, Freddie Mac does not recognize any incremental GAs or GOs on such transactions. Rather, Freddie Mac defers and amortizes into income on a straight-line basis that portion of the transaction fee that Freddie Mac receives on such transactions that relates to the estimated fair value of the company's future administrative responsibilities for issued Structured Securities. In cases where Freddie Mac retains portions of the Structured Securities, a portion of this fee is deferred under the requirements of SFAS 91. The balance of transaction fees received, which relates to compensation earned in connection with structuring-related services rendered by Freddie Mac to third parties, is recognized immediately in earnings as Non-interest income — Resecuritization fees.

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## **Purchases of PCs or Structured Securities for Which Recognized GAs and GOs Exist**

The purchase of a PC or Structured Security prompts the extinguishment of a corresponding, recognized GO. Likewise, and where applicable, the purchase of such securities also prompts the extinguishment of the unamortized balance of Deferred Guarantee Income, Buy Downs and Credit Fees.

Freddie Mac records the de-recognition of an extinguished GO against earnings as a component of Gains (losses) on investment activity. Correspondingly, recognized GAs are reduced by an amount equal to the-then fair value of an extinguished GO, an adjustment of which is also reflected in earnings as a component of Gains (losses) on investment activity. All recognized GAs in this case are then reclassified on Freddie Mac's consolidated balance sheets as a component of "Participation Certificate residuals, at fair value" ("PC Residuals").

The unamortized balance of Deferred Guarantee Income, Buy-Downs and Credit Fees received are extinguished as a basis adjustment to the recognized value of purchased PCs. Like purchase discounts, such basis adjustments are subsequently amortized into earnings as Interest income pursuant to the requirements of SFAS 91 using the effective interest method.

## **PC Residuals**

PC residuals relate to certain PCs or Structured Securities held by Freddie Mac and represent the fair value of the expected future cash flows associated with the guarantee contracts that are inherent within such securities.

A PC residual is recognized by Freddie Mac in connection with PCs or Structured Securities held by Freddie Mac that (a) were previously transferred to third parties as part of transactions that were accounted for either as sales pursuant to the provisions of SFAS 125/140 sale or as guarantee transactions that are subject to the provisions of FIN 45 (such that a GA and GO was previously-established for held PCs or Structured Securities), (b) were formed from mortgage loans purchased through Freddie Mac's Cash Window ("Cash Window Purchases") and that were never transferred to third parties, (c) were purchased by Freddie Mac from third parties in contemplation of the related issuance of such PCs through the Guarantor Program or (d) relate to Buy-Ups paid in connection with purchased PCs that had not previously been included as part of a transfer that was accounted for as a sale under SFAS 125/140 or as part of a guarantee transaction that was subject to the provisions of FIN 45.

Like a recognized GA, a PC residual is accounted for like a debt security and is classified as either available-for-sale or trading under SFAS 115. PC residuals relating to PCs or Structured Securities that previously went through either a SFAS 125/140 sale or were accounted for pursuant to FIN 45 are classified as trading under SFAS 115. PC residuals relating to PCs held in portfolio that were formed from Cash Window Purchases and that were never transferred to third parties are generally classified as available-for-sale under SFAS 115. The same treatment applies to PC residuals that correspond to PCs purchased by Freddie Mac from third parties in contemplation of their issuance through the Guarantor Program, except that any portions of these PC residuals that relate to Buy-Ups paid by Freddie Mac are accounted for as trading investments.

All changes in the fair value of PC residuals that are designated as trading are reflected in earnings as a component of Gains (losses) on investment activity. All changes in the fair value of PC residuals that are accounted for as available-for-sale are reflected as a component of Accumulated other comprehensive income (loss), net of taxes ("AOCI"), a component of Stockholders' equity.

Recognized PC residuals consist of a variety of cash flows that are primarily recorded through interest income. See "NOTE 2: TRANSFERS OF SECURITIZED INTERESTS IN MORTGAGE-RELATED ASSETS" for a discussion of the attribution of GA and PC Residual-related cash flows.

## **Due to Participation Certificate Investors**

Timing differences between Freddie Mac's receipt of scheduled and unscheduled principal and interest payments from seller/servicers on mortgages underlying PCs and the subsequent pass through of those payments on PCs owned by third-party investors results in the liability Due to Participation Certificate investors. In those cases, payments from seller/servicers are generally received in a given month, yet the PC

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balance is not reduced for payments of principal until the first day of the next month and Freddie Mac releases the cash (principal and interest) to the PC investor on the fifteenth day of that next month. The company generally invests these principal and interest amounts received in short-term investments from the time Freddie Mac receives the amounts until the time Freddie Mac pays the PC investor. Interest income resulting from investment of principal and interest payments from seller/servicers is reported in interest income over the period earned.

For unscheduled principal prepayment amounts, these timing differences result in an expense accrual upon prepayment of the mortgage as the related PCs continue to bear interest to the PC investor at the PC coupon rate from the date of prepayment until the date the PC security balance is reduced, while generally no interest is received from the mortgage on that prepayment amount during that same time period. The expense recognized upon prepayment is reported in Interest expense — Due to Participation Certificate investors.

Freddie Mac reports PC coupon interest amounts relating to its investment in PCs consistent with the accounting practices generally applied by third party investors in PCs. Accordingly, the PC coupon interest on prepayments of a mortgage pending remittance on PCs held by Freddie Mac is reported as both Interest Income — Mortgage-related securities in the Retained portfolio and Interest expense — Due to Participation Certificate investors. Scheduled and unscheduled principal payments received by Freddie Mac that relate to its investment in PCs are reported as a reduction to its investment in PCs on the consolidated balance sheets.

### **Mortgage Loans**

Mortgage loans that management may sell are classified as held-for-sale. If a decision is made to retain the loan, the loans are transferred to the held-for-investment portfolio. Loans transferred to the held-for-investment portfolio are transferred at lower of cost or market value. Lower-of-cost-or-market value adjustments, in this case, are treated as basis adjustments of such mortgage loans and are subsequently amortized into interest income over the period held.

Held-for-sale mortgages are included in the Retained portfolio and reported at lower of cost or market value, on a portfolio basis, with losses reported in Gains (losses) on investment activity. Consistent with SFAS No. 65, “Accounting for Certain Mortgage Banking Activities” (“SFAS 65”), premiums and discounts on loans classified as held-for-sale are not amortized as interest revenue during the period that such loans are classified as held-for-sale.

For a description of how Freddie Mac determines the fair value of its held-for-sale mortgage loans, see “NOTE 16: FAIR VALUE DISCLOSURES.”

Mortgage loans that management has the ability and intent to hold for the foreseeable future or to maturity are classified as held-for-investment. These mortgage loans are reported at their outstanding principal balances, net of deferred fees and costs (including premiums and discounts). These deferred items are amortized into interest income over the estimated lives of the mortgages using the effective interest method. The company uses actual prepayment experience and estimates of future prepayments to determine the constant yield needed to apply the effective interest method. For purposes of estimating future prepayments, the mortgages are aggregated by similar characteristics such as origination date, coupon and maturity.

The company recognizes interest income on mortgage loans on an accrual basis, except when management believes the collection of principal or interest is doubtful.

### **Reserves for Losses on Mortgage Loans Held-for-Investment and Losses on PCs**

Freddie Mac maintains a Reserve for losses on mortgage loans held-for-investment to provide for credit losses inherent in that portfolio. The Reserve for losses on mortgage loans held-for-investment is determined pursuant to the provisions of SFAS 5 and SFAS No. 114, “Accounting by Creditors for Impairment of a Loan — an Amendment of FASB Statements No. 5 and 15” (“SFAS 114”) as more fully described below. Freddie Mac also maintains a Reserve for guarantee losses on Participation Certificates to provide for losses incurred on mortgages underlying PCs or Structured Securities held by third parties. The Reserve for guarantee losses on Participation Certificates is determined pursuant to the provisions of SFAS 5 and SFAS 114. The Reserve for losses on mortgage loans held-for-investment and Reserve for guarantee losses on Participation Certificates are collectively referred to as “loan loss reserves.” Increases in loan loss reserves are reflected in earnings as a component of the (Provision) benefit for credit losses. Decreases in loan loss reserves

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are reflected through either (a) charging-off such balances (net of recoveries) where realized losses are recorded or (b) a reduction in the (Provision) benefit for credit losses.

Loan loss reserves are also increased upon the sale of PCs and Structured Securities for which Freddie Mac incurred losses on the underlying mortgage loans while such securities were held by Freddie Mac. From an earnings perspective, such incurred losses are recognized as a component of Gains (losses) on investment activity through, where applicable (a) the subsequent measurement of corresponding PC residuals that are classified as trading (and to which such PCs or Structured Securities relate), (b) the recognition of impairment-related losses on such securities (*i.e.*, to the extent that such securities do not have recognized PC residual balances associated with them that are classified as trading) or (c) as a component of gain (loss) on sale of such securities. Upon the sale of such PCs or Structured Securities, incurred losses are classified on the consolidated balance sheets as Reserve for guarantee losses on Participation Certificates.

#### *Single-family loan portfolio*

In accordance with SFAS 5, Freddie Mac estimates 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 mortgage loans at the balance sheet date. The homogeneous pools of single-family mortgage loans are determined based on common underlying characteristics including year of origination, loan-to-value ratio and geographic region. In determining the loan loss reserves for single-family loans, Freddie Mac determines the point within the range of probable losses that represents the best estimate of incurred losses.

The factors used to estimate incurred losses at period-end include:

- actual and estimated loss severity trends for similar loans;
- actual and estimated default experience;
- actual and estimated proceeds from PMI 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.

Freddie Mac frequently validates and updates the models and factors to capture changes in actual loss experience, as well as changes in underwriting practices and in its loss mitigation strategies. Freddie Mac also considers macroeconomic and other factors including:

- regional housing trends;
- applicable home price indices;
- unemployment and employment dislocation trends;
- consumer credit statistics;
- recent changes in credit underwriting practices;
- extent of third party insurance; and
- other measurable factors that influence the quality of the portfolio at the balance sheet date.

Favorable trends in these macroeconomic and other factors produce a reserve requirement toward the lower end of the range; adverse trends in these factors produce a reserve requirement toward the higher end of the range. Management then adjusts the level of loan loss reserves to the level required based on its best assessment of these factors.

#### *Multifamily loan portfolio*

Freddie Mac also estimates a range of incurred credit losses on the multifamily loan portfolio. Management considers all available evidence in determining this range including: adequacy of third-party credit enhancements and an evaluation of the repayment prospects of, and fair value of collateral underlying the individual loans. The review of the repayment prospects and value of collateral underlying individual loans

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occurs within the context of property-specific and market-level risk characteristics including apartment vacancy rates, apartment rental rates, and property sales information, under several scenarios. Management reviews the range of probable losses and selects the point within the range that represents the best estimate of incurred losses. Loans individually evaluated for impairment include loans that become 60 days past due for principal and interest, certain loans with observable collateral deficiencies and loans whose contractual terms were modified due to credit concerns. When loan loss reserves for individual loans are established, consideration is given to all available evidence such as present value of discounted expected future cash flows, fair value of collateral and credit enhancements.

### **Non-performing Loans**

Non-performing loans consist of (a) loans that were previously delinquent whose terms have been modified and, therefore, are now considered part of Freddie Mac's impaired loan population ("troubled debt restructurings" or "TDRs"), (b) serious delinquencies and (c) nonaccrual loans. Serious delinquencies are those single-family loans that are 90 days or more past due, and multifamily loans that are more than 60 days but less than 90 days past due. Also included in this category are multifamily loans greater than 90 days past due but where principal and interest are being paid to Freddie Mac under the terms of a credit enhancement agreement. Non-performing loans generally accrue interest in accordance with their contractual terms unless they are in nonaccrual status. Nonaccrual loans are loans where interest income is recognized on a cash basis, and only include multifamily loans greater than 90 days past due. For nonaccrual loans, any existing accruals are reversed against interest income unless they are both well secured and in the process of collection. For single-family loans greater than 90 days past due, interest income is accrued; however, reserves for uncollectible interest on single-family loans are estimated using statistical models, which quantify accrued but uncollectible interest. Freddie Mac reports this reserve as a reduction to the accrued loan interest balance in Accounts and other receivables, net.

Impaired loans include single-family loans, both performing and non-performing, that are TDRs. Multifamily impaired loans are defined as performing and non-performing TDRs, loans 60 days or more past due (except for certain credit-enhanced loans) and certain mortgage loans with real estate collateral values less than the outstanding unpaid principal balances. See "Table 6.2 — Impaired Loans" in "NOTE 6: LOAN LOSS RESERVES" for further discussion.

Freddie Mac has the option to purchase mortgage loans out of PC pools under certain circumstances, such as to resolve an existing or impending delinquency or default. Freddie Mac's general practice is to purchase the mortgage loans out of pools when the loans are 120 days delinquent. These repurchased loans are recorded on Freddie Mac's consolidated balance sheets at their purchase price (*i.e.*, the mortgage loan's unpaid principal balance), as adjusted for the effects of (a) the related amount of recognized GAs, PC residuals and security premiums and discounts (where applicable) and (b) the extinguishment of a proportionally related amount of recognized Buy-Downs, Credit Fees, GOs and Day One Differences (where applicable). Additionally, that portion of amounts classified in Reserve for guarantee losses on Participation Certificates that relates to a purchased loan is reclassified to Reserve for losses on mortgage loans held-for-investment.

### **Charge-Offs**

The loan loss reserves are reduced for charge-offs when a loss is specifically identified and is virtually certain of occurring. For both single-family and multifamily mortgages where the original terms of the mortgage loan agreement are modified for economic or legal reasons related to the borrower's financial difficulties, losses are recorded at the time of modification in accordance with SFAS 114 and the loans are accounted for as TDRs. For mortgages that are foreclosed upon and thus transferred to Real estate owned, net or involved in a pre-foreclosure sale, losses at the time of transfer or pre-foreclosure sale are charged-off against Reserve for losses on mortgage loans held-for-investment. In the case of real estate owned ("REO") transfers, losses arise when the carrying basis of the loan (including accrued interest) exceeds the fair value of the foreclosed property (after deduction for estimated selling costs and consideration of third-party insurance or other credit enhancements). REO gains arise and are recognized immediately in earnings when the fair market value of the acquired asset (after deduction for estimated disposition costs) exceeds the carrying value

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of the mortgage (including accrued interest). REO gains and losses (subsequent to foreclosure) are included in REO operations income (expense).

### **Investments in Securities**

The company classifies mortgage-related securities and non-mortgage-related securities as available-for-sale or trading, as defined in SFAS 115. Freddie Mac currently does not classify any securities as held to maturity although the company may elect to do so in the future. Securities classified as available-for-sale and trading are reported at fair value with changes in fair value included in AOCI and Gains (losses) on investment activity, respectively. See “NOTE 16: FAIR VALUE DISCLOSURES” for more information on how Freddie Mac determines the fair value of securities.

The company records forward purchases and sales of securities that are specifically exempt from the requirements of SFAS 133 on a trade date basis. Securities underlying forward purchases and sales contracts that are not exempt from the requirements of SFAS 133 are recorded on contractual settlement date.

For most of the company’s investments in securities, interest income is recognized using the retrospective effective interest method in accordance with SFAS 91. Deferred items, including premiums, discounts and other basis adjustments, are amortized into interest income over the estimated lives of the securities. The company uses actual prepayment experience and estimates of future prepayments to determine the constant yield needed to apply the effective interest method. The company recalculates the constant effective yield based on changes in estimated prepayments as a result of changes in interest rates and other factors. When the constant effective yield changes, an adjustment to interest income is made for the amount of amortization that would have been recorded if the new effective yield had been applied since the mortgage assets were acquired.

For certain of the company’s investments in securities, interest income is recognized using the prospective effective interest method in accordance with EITF No. 99-20 “Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets” (“EITF 99-20”). The company specifically applies such guidance to beneficial interests (including undivided interests which are similar to beneficial interests) in securitized financial assets that (a) 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 interest-only strips) or (b) are not of high credit quality at the acquisition date. EITF 99-20 requires that the company recognize as interest income (throughout the life of a retained interest) the excess of all estimated cash flows attributable to these interests over its principal amount using the effective yield method. The company updates its estimates of expected cash flows periodically and recognizes changes in calculated effective yield on a prospective basis.

Freddie Mac reviews securities for other-than-temporary impairment whenever the security’s fair value is less than its amortized cost. Impairment is evaluated considering a number of indicators which include the severity of the decline in fair value, credit ratings and the length of time the investment has been in an unrealized loss position. In addition to these indicators, Freddie Mac recognizes impairment when qualitative factors indicate that the company may not recover the unrealized loss. When evaluating the impairment indicators and qualitative factors, Freddie Mac considers its intent and ability to hold the investment until a point in time at which recovery can be reasonably expected to occur. Impairment losses on manufactured housing securities exclude the effects of separate financial guarantee contracts that are not embedded in the securities since the benefits of such contracts are not recognized until claims become probable of recovery under the contracts. When a security is deemed to be impaired, the cost basis of the security is written down to fair value, with the loss recorded to Gains (losses) on investment activity. The security cost basis is not changed for subsequent recoveries in fair value. For securities within the scope of EITF 99-20, as described above, other-than-temporary impairments are defined as occurring whenever there is an adverse change in estimated cash flows coupled with a decline in fair value below the amortized cost basis.

Gains and losses on the sale of securities are included in Gains (losses) on investment activity, including those gains (losses) reclassified into earnings from AOCI. The company uses the specific identification method for determining the cost of a security in computing the gain or loss.

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## **Repurchase and Resale Agreements**

Freddie Mac enters into repurchase and resale agreements primarily as an investor or to finance its security positions. Freddie Mac also enters into (a) “dollar roll” transactions, which consist of simultaneous agreements with the same counterparty to sell a security and purchase similar securities at a future date at an agreed-upon price and (b) “reverse dollar roll” transactions, which consist of simultaneous agreements with the same counterparty to purchase a security and sell similar securities at a future date at an agreed-upon price. These transactions are accounted for pursuant to SFAS 125/140. In this regard, such transactions are accounted for as purchases and sales when the transferor relinquishes control over transferred securities. These transactions are accounted for as secured financings when the transferor does not relinquish control over transferred securities. Freddie Mac’s policy is to take possession of securities purchased under agreements to resell and reverse dollar roll transactions. The amount of mortgage-related and non-mortgage-related securities pledged and that may be repledged under repurchase agreements and dollar roll transactions is presented parenthetically in the relevant securities captions in the consolidated balance sheets.

## **Debt Securities Issued**

Debt securities issued by Freddie Mac are classified as either Due within one year or Due after one year based on their remaining contractual maturity. The classification of interest expense on debt securities as either short-term or long-term is based on the original contractual maturity of the debt security. Deferred items, including premiums, discounts, issuance costs and hedging-related basis adjustments, are amortized and reported through interest expense using the effective interest method over the period during which the related indebtedness is outstanding or, for callable debt, over the period during which the related indebtedness is expected to be outstanding. For callable debt, changes in the expected call date are reflected prospectively as an adjustment to the effective yield on the debt. Amortization of hedging-related basis adjustments is initiated upon the termination of the related hedge relationship, whereas amortization of premiums, discounts and issuance costs begins at the time of debt issuance. Deferred items, including premiums, discounts and hedging-related basis adjustments are reported as a component of Debt securities, net whereas issuance costs are reported as a component of Other assets. Debt securities denominated in a foreign currency are translated into U.S. dollars using foreign exchange spot rates at the balance sheet dates and any gains/losses are reported in Non-interest income (loss) — Other income.

Contemporaneous exchanges of cash between the company and a creditor in connection with the issuance of a new debt obligation and satisfaction of an existing debt obligation are accounted for as extinguishments with recognition of gains or losses in earnings if the debt instruments have substantially different terms. If the debt instruments do not have substantially different terms, the transaction is accounted for as an exchange rather than an extinguishment. In this case, the fees associated with the new debt obligation, along with the existing unamortized premium, discount or other basis adjustments on the existing debt obligation, are considered a basis adjustment on the new debt obligation and are amortized as an adjustment of interest expense over the remaining term of the new debt obligation.

## **Derivatives**

Generally, derivatives are financial instruments with little or no initial net investment in comparison to their notional amount and whose value is based upon an underlying asset, index, reference rate or other variable. They may be privately negotiated contractual agreements that can be customized to meet specific needs, including certain commitments to purchase and sell mortgage loans, mortgage-related securities and debt securities, or they may be standardized contracts executed through organized exchanges. All derivatives are reported at their fair value on the consolidated balance sheets. The fair value of derivatives is generally reported net by counterparty, provided that a legally enforceable master netting agreement exists. Derivatives in a net asset position are reported as Derivative assets, at fair value. Similarly, derivatives in a net liability position are reported as Derivative liabilities, at fair value.

Currently, the majority of the company’s derivatives are not designated in hedge accounting relationships. For those derivatives not designated as an accounting hedge, fair value gains and losses are reported as Derivative gains (losses) in the consolidated statements of income. For purchase and sale commitments of securities classified as trading under SFAS 115, fair value gains and losses are reported as Gains (losses) on investment activity in the consolidated statements of income.

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Subject to certain qualifying conditions, Freddie Mac may designate a derivative as either a hedge of the cash flows of a variable-rate instrument or forecasted transaction (“cash flow hedge”), a hedge of the fair value of a fixed-rate instrument (“fair value hedge”) or a foreign-currency fair value or cash flow hedge (“foreign currency hedge”). In order to be designated as an accounting hedge, the derivative must initially be expected to be highly effective in offsetting the changes in cash flows or fair value of the hedged item resulting from the hedged risk. In addition, the documentation of the hedging designation must include identification of the hedged item, the hedging instrument, the risk exposure and corresponding risk management objective, how effectiveness will be assessed and how ineffectiveness will be measured.

For a derivative qualifying as a cash flow hedge, Freddie Mac reports changes in the fair value of these instruments in AOCI to the extent the hedge is effective. The remaining ineffective portion, calculated using the hypothetical derivative method, is reported as Hedge accounting gains (losses). This method requires the company to develop a hypothetical derivative whose terms match those of the hedged item and compare estimated changes in the fair value of the hypothetical derivative to changes in the fair value of the hedging derivative. In general, Freddie Mac recognizes the associated amounts reported in AOCI as Income (expense) related to derivatives during the period or periods in which the hedged item affects earnings. If the hedged item relates to a forecasted issuance of debt, Freddie Mac reclassifies the associated amount reported in AOCI into earnings as Net interest income over the periods when the debt is issued and affects earnings. Amounts reported in AOCI related to changes in the fair value of commitments to purchase or sell securities that are designated as cash flow hedges are recognized as interest income for assets held and Gains (losses) on investment activity for assets sold.

If the hedged item in a cash flow hedge is the forecasted issuance of debt, and the occurrence of the forecasted transaction becomes probable of not occurring, the amount in AOCI is reclassified to earnings immediately. If Freddie Mac expects at any time that continued reporting of a net loss in AOCI would lead to recognizing a net loss on the combination of a hedging instrument and the hedged transaction (and related asset acquired or liability incurred) in one or more future periods, the loss is reclassified immediately into earnings for the amount that is not expected to be recovered.

For a derivative qualifying as a fair value hedge, Freddie Mac reports changes in the fair value of the derivative as Hedge accounting gains (losses) along with the changes in the fair value of the hedged item attributable to the risk being hedged. 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, the company discontinues hedge accounting prospectively. Freddie Mac continues to carry the derivative on the consolidated balance sheets at fair value and records further fair value gains and losses in the consolidated statements of income as Derivative gains (losses) until the derivative is terminated or redesignated.

The periodic interest cash flows related to derivative contracts currently accrued, which are derived primarily from interest-rate swap contracts, are classified as Income (expense) related to derivatives for derivatives in hedge relationships and as Derivative gains (losses) for derivatives not in hedge accounting relationships.

Inception gains or losses associated with commitments to purchase mortgage loans are deferred. With respect to those purchase commitments that have been designated as cash flow hedges, inception gains or losses are considered together with that portion of the cumulative change in fair value of such derivative instruments that are recognized in AOCI for the purpose of determining whether a net deferred loss exists that, as described above, should be reclassified to earnings. Additionally, and similar to derivative-related gains that are recognized as a component of AOCI, deferred inception-based gains on mortgage purchase commitments will be reclassified into earnings in the same period or periods during which acquired mortgage loans affect earnings. Specifically, inception gains or losses are:

- Recognized as a component of the gain or loss on sale of corresponding mortgage loans (either in whole loan or securitized form); or
- Recognized as interest income over the life of the corresponding mortgage loans at the point that, where applicable, such mortgage loans are reclassified as held-for-investment.

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## **Real Estate Owned**

REO is carried at the lower of cost or fair value (after deduction for estimated disposition costs). Amounts expected to be received from third-party insurance or other credit enhancements are reported when the claim is filed and are recorded as a component of Accounts and other receivables, net in the consolidated balance sheets. Material development and improvement costs relating to REO are capitalized. Operating expenses on the properties, net of any rental or other income, are included in REO operations income (expense). Estimated declines in REO fair value that result from ongoing valuation of the properties are provided for and charged to REO operations income (expense) when identified. The resulting valuation allowance is treated as a lower of cost or fair value adjustment to the basis of the properties. Any gains and losses on REO dispositions are included in REO operations income (expense).

## **Income Taxes**

Freddie Mac uses the asset and liability method of accounting for income taxes pursuant to SFAS No. 109, "Accounting for Income Taxes" ("SFAS 109"). Under the asset and liability method, deferred tax assets and liabilities are recognized based upon the expected future tax consequences of existing temporary differences between the financial reporting and the tax reporting basis of assets and liabilities using enacted statutory tax rates. To the extent tax laws change, deferred tax assets and liabilities are adjusted, when necessary, in the period that the tax change is enacted. Valuation allowances are recorded to reduce deferred tax assets when it is more likely than not that a tax benefit will not be realized. For all periods presented, no such valuation allowance was deemed necessary by management. Reserves are recorded for income tax and contingent interest where the potential for loss is probable and reasonably estimable in accordance with SFAS 5.

Income tax expense includes (a) deferred tax expense, which represents the net change in the deferred tax asset or liability balance during the year plus any change in a valuation allowance and (b) current tax expense, which represents the amount of tax currently payable to or receivable from a tax authority plus amounts accrued for expected tax deficiencies (including both tax and interest). Income tax expense excludes the tax effects related to adjustments recorded to AOCI.

## **Stock-Based Compensation**

In December 2002, FASB issued SFAS No. 148, "Accounting for Stock-Based Compensation — Transition and Disclosure — An Amendment of FASB Statement No. 123" ("SFAS 148"). This statement provides alternative methods of transition for a voluntary change to the fair value expense recognition method of accounting for stock-based employee compensation under SFAS No. 123, "Accounting for Stock-Based Compensation" ("SFAS 123"). The annual disclosure provisions of SFAS 148 are effective for fiscal years ending after December 15, 2002, and the interim disclosure provisions are effective for interim periods beginning after December 15, 2002.

Freddie Mac initially adopted the fair value compensation expense provisions of SFAS 123 prospectively for awards granted, modified or settled on or after January 1, 2002, in accordance with SFAS 123's original transition provision. However, as permitted by SFAS 148, Freddie Mac elected to adopt SFAS 123 retroactively to January 1, 1995. Accordingly, Freddie Mac records compensation expense equal to the estimated fair value of the stock-based compensation on the grant date, amortized on a straight-line basis over the vesting period, which is generally three to five years for options, restricted stock and restricted stock units and, starting in 2003, three months for the Employee Stock Purchase Plan ("ESPP"). The offset to the recorded compensation expense is an adjustment to Additional paid-in capital in Freddie Mac's consolidated balance sheets.

The fair value of options to purchase shares of Freddie Mac common stock, including options issued pursuant to the ESPP, is estimated using a Black-Scholes option pricing model, taking into account the exercise price and expected life of the option, the market value of the underlying stock and its expected volatility, expected dividends on the stock and the risk-free interest rate for the expected term of the option. The fair value of restricted stock and restricted stock unit awards is based on the grant-date fair value of Freddie Mac's common stock.

As discussed in "NOTE 11: STOCK-BASED COMPENSATION," awards under the company's stock compensation plans, including employee stock options, restricted stock units ("RSUs") and restricted stock, generally provide for dividend-equivalent rights. For employee stock options, the dividend-equivalent feature is

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contemplated in the fair value estimate by using a dividend yield of zero as a Black-Scholes model input. Accordingly, compensation expense for these dividend-equivalents is recognized through amortization expense recognition. For restricted stock and RSUs, the value of the dividend-equivalents is reflected in the market price of a share of common stock. The fair value of restricted stock and RSUs on the grant date is recognized as compensation expense over the vesting period.

Incremental compensation expense related to modification of awards is based on a comparison of the fair value of the modified award with the fair value of the original award before modification (measured using the shorter of the remaining or revised term). Furthermore, the company generally expects to settle its stock-based compensation awards in shares. In the limited cases in which an award may be cash-settled only in the event of a contingency such as involuntary termination, Freddie Mac accounts for the award as an equity award until the contingency becomes probable, when liability accounting is triggered. Under SFAS 123, liabilities are initially measured at intrinsic value with changes in intrinsic value recognized as earnings.

For stock-based compensation granted prior to 1995, Freddie Mac continues to apply the provisions of Accounting Principles Board Opinion (“APB”) No. 25, “Accounting for Stock Issued to Employees” (“APB 25”). Under APB 25, typically no compensation expense is recorded if the option exercise price is equal to the market price of the stock on the date of grant. Freddie Mac recognized compensation expense for restricted stock grants and dividend-equivalent rights associated with stock options. Furthermore, no compensation expense was recognized for the ESPP since it is a qualifying plan under tax regulations.

### **Earnings Per Common Share**

Basic earnings per common share is computed as net income available to common stockholders divided by the weighted average common shares outstanding for the period. Diluted earnings per common share is determined using the weighted average number of common shares during the period, adjusted for the dilutive effect of common stock equivalents. Dilutive common stock equivalents reflect the assumed issuance of additional common shares pursuant to certain of the company’s stock-based compensation plans that could potentially reduce or “dilute” earnings per share, based on the treasury stock method as defined in SFAS No. 128, “Earnings per Share” (“SFAS 128”).

### **Comprehensive Income**

Comprehensive income, as defined in SFAS No. 130, “Reporting Comprehensive Income” (“SFAS 130”), is the change in equity, on a net of tax basis, resulting from transactions and other events and circumstances from non-owner sources during a period. It includes all changes in equity during a period, except those resulting from investments by owners and distributions to owners. For Freddie Mac, comprehensive income is composed of net income plus changes in the unrealized gains and losses on available-for-sale securities, the effective portion of derivatives accounted for as cash flow hedge relationships, and changes in the minimum pension liability.

### **Reportable Segments**

Freddie Mac has one business segment for financial reporting purposes because the company did not meet the criteria for reporting business segments that are prescribed in SFAS No. 131, “Disclosures About Segments of an Enterprise and Related Information” (“SFAS 131”), for any period presented in the consolidated financial statements.

### **Recently Adopted Accounting Standards and Accounting Changes**

*Consolidation of Variable Interest Entities* — In January 2003, the FASB issued FIN 46. FIN 46 provides guidance for determining when a company must consolidate the assets, liabilities and activities of a variable interest entity. In addition, various disclosures are required about variable interest entities when an entity is not the primary beneficiary but holds a “significant variable interest” in a variable interest entity.

In December 2003, the FASB released FIN 46-R. The revision captured much of the guidance to date that had been provided by the FASB for implementation of FIN 46, clarified FIN 46 and revised certain effective dates for implementation. Freddie Mac adopted FIN 46-R for 2003. The implementation had no effect on the company’s consolidated financial statements in 2004 or 2003. In 2004, the company determined that five low-income housing tax credit partnerships, West\*Mac Associates Limited Partnership (“West\*Mac”), the owner and developer of the company’s headquarters, and a reinsurance company should be consolidated pursuant to the requirements of FIN 46-R. Prior to 2004, Freddie Mac consolidated these

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entities in accordance with other applicable requirements under GAAP. Finally, the company also has significant variable interests in certain variable interest entities that are not consolidated because the company is not the primary beneficiary. See “NOTE 3: VARIABLE INTEREST ENTITIES” for more information concerning variable interest entities.

*Accounting For Financial Guarantees* — Effective January 1, 2003, Freddie Mac adopted FIN 45 and FASB Staff Position FIN 45-2, “Whether FASB Interpretation No. 45, ‘Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others,’ Provides Support for Subsequently Accounting for a Guarantor’s Liability at Fair Value” (“FSP FIN 45-2”). FIN 45 requires that Freddie Mac recognize the fair value of the company’s obligation to guarantee the payment of principal and interest on PCs and other mortgage pass-through certificates that are issued by the company that are transferred to third parties. Such guidance also requires that the company recognizes the fair value of any consideration received in connection with the execution of such guarantees, which primarily includes the company’s contractual right to receive guarantee fees. In consideration of FSP FIN 45-2, effective January 1, 2003, Freddie Mac subsequently measures that portion of recognized guarantee obligations that relates to the company’s non-contingent obligation to stand ready to perform using a systematic and rational method of amortization, while the company’s contingent obligation to make payments under executed guarantees is accounted for pursuant to the requirements of SFAS 5. The implementation of FIN 45 and other such accounting changes in 2003 had a significant impact on Freddie Mac’s accounting for PC guarantees. Additionally, on January 1, 2003, Freddie Mac reclassified \$110 million to Reserve for guarantee losses on Participation Certificates representing that portion of recognized guarantee obligations that was attributable to estimated incurred losses on outstanding PCs or Structured Securities on that date.

*Accounting For Credit Enhancements* — Effective January 1, 2003, Freddie Mac no longer measures recognized credit enhancements on a fair value basis subsequent to the initial recognition of the credit enhancement. This change was made in conjunction with the change in the method by which recognized guarantee obligations are subsequently measured for consolidated financial statement purposes. This change necessitated a corresponding modification in the balance sheet classification of those credit enhancements that were previously recognized as a component of GAs and PC residuals since recognized GAs and PC residuals are subsequently measured on a fair value basis. In this regard, effective January 1, 2003, \$189 million related to credit enhancements was reclassified to Other assets (\$128 million from the GA and \$61 million from PC residuals) and, correspondingly, is amortized into earnings as a component of Other expenses at the greater of amounts calculated by amortizing recognized credit enhancements (a) in proportion to the rate of unpaid principal balance decline of covered mortgage loans or (b) on a straight-line basis over a credit enhancement contract term. The implementation of FIN 45 also resulted in a change in when credit enhancements were recognized for consolidated financial statement purposes. Based upon the view expressed in FIN 45 that guarantee transactions constitute exchange transactions, Freddie Mac now recognizes the fair value of credit enhancements as consideration received in connection with Guarantor and MultiLender Swap transactions (and other, similar transactions) as of the issuance date of those PCs that were issued on or after January 1, 2003. Prior to January 1, 2003, Freddie Mac did not recognize credit enhancements for consolidated balance sheet purposes until a PC or Structured Security to which such credit enhancements related was included in a transfer that qualified as a sale under SFAS 125/140.

*Derivative Instruments and Hedging Activities* — On July 1, 2003, Freddie Mac adopted SFAS No. 149 “Amendment of Statement 133 on Derivative Instruments and Hedging Activities” (“SFAS 149”). SFAS 149 amended and clarified the financial accounting and reporting for derivatives to incorporate decisions made by the FASB and the FASB’s Derivative Implementation Group subsequent to the original issuance of SFAS 133 and in connection with other FASB projects. Under SFAS 149, purchase commitments for certain loans to be classified as held-for-investment must be accounted for as derivatives. The implementation of SFAS 149 did not have a material effect on the consolidated financial statements.

In September 2003, the Office of the Chief Accountant of the Securities and Exchange Commission (“SEC”) published interpretive guidance on SFAS 133. To be consistent with the SEC guidance published at that time, Freddie Mac is reporting the income statement effects of derivatives not currently designated in hedge accounting relationships under SFAS 133 in a single line item on the company’s consolidated statements of income, Derivative gains (losses) for all periods presented. Prior to 2003, the accrual for periodic cash settlements in accordance with the contractual terms of derivatives not in hedge accounting

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relationships was recorded in Net interest income as a component of Income (expense) related to derivatives. Therefore, for periods prior to 2003, the impact of the accrual for these periodic derivative cash settlements has been reclassified from Income (expense) related to derivatives to Derivative gains (losses). The effect of this reclassification on the company's consolidated statements of income was to increase Net interest income by \$639 million for 2002 and decrease Non-interest income by the same amounts. These reclassifications had no effect on net income.

### **Recently Issued Accounting Standards**

*Certain Loans or Debt Securities Acquired in a Transfer* — In December 2003, the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants, (“AICPA”), issued SOP No. 03-3, “Accounting for Certain Loans or Debt Securities Acquired in a Transfer” (“SOP 03-3”). SOP 03-3 addresses the accounting for differences between the contractual cash flows and the cash flows expected to be collected from purchased loans or debt securities if those differences are attributable, in part, to credit quality. The scope of SOP 03-3 is limited to purchased loans or debt securities with evidence of deterioration of credit quality since origination acquired by completion of a transfer for which it is probable, at acquisition, that the investor will be unable to collect all contractually required payments receivable. SOP 03-3 requires purchased loans and debt securities to be recorded initially at acquisition cost (typically fair value in an arms-length purchase). SOP 03-3 is effective for certain loans and debt securities acquired after December 31, 2004. The adoption of SOP 03-3 is not expected to be material to the company's financial position or results of operations.

*Other-than-Temporary Impairment* — In September 2004, the FASB voted unanimously to delay certain portions of EITF 03-1, “The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments” (“EITF 03-1”), subject to further consideration. Subsequently, the FASB deferred this consideration pending resolution of other related matters. The deferral applies to both debt and equity securities and specifically applies to impairments caused by interest rate and sector spreads. In addition, the provisions of EITF 03-1 that have been deferred relate to the requirements that a company declare its intent to hold the security to recovery and designate a recovery period in order to avoid recognizing an other-than-temporary impairment charge through earnings. The FASB may address other-than-temporary impairments further in a future project. The FASB's actions to defer the impairment measurement consensus did not change the separate disclosure consensus in EITF 03-1, which remains effective. The incremental disclosures required by EITF 03-1 are included in “NOTE 5: RETAINED PORTFOLIO AND CASH AND INVESTMENTS PORTFOLIO.”

*Stock-Based Compensation* — In December 2004, the FASB issued SFAS No. 123 (Revised 2004), “Share-Based Payment” (“SFAS 123-R”), which replaces the existing SFAS 123 and supercedes APB 25. Also, in March 2005, the SEC issued Staff Accounting Bulletin No. 107 (“SAB 107”) which provides additional guidance on the application of SFAS 123-R. SFAS 123-R requires companies to measure and record compensation expense for stock options and other share-based payments based on the instruments' fair values. SFAS 123-R is effective for interim and annual reporting periods beginning after June 15, 2005. As noted above in “Stock-Based Compensation,” the company has applied the fair value compensation expense provisions of SFAS 123 retroactively to January 1, 1995. The impact of the adoption of SFAS 123-R is not expected to be material to the company's financial position or results of operations.

*Implicit Variable Interests* — In March 2005, the FASB issued FASB Staff Position No. FIN 46(R)-5, “Implicit Variable Interests Under FASB Interpretation No. 46 (Revised December 2003)” (“FSP FIN 46(R)-5”). FSP FIN 46(R)-5 provides guidance on when an indirect relationship could be deemed an implicit variable interest that should be considered in assessing whether or not to consolidate certain entities. Determination as to whether an implicit variable interest exists should be based on whether the company, through its relationship with the related party, will absorb the variability of the variable interest entity. FSP FIN 46(R)-5 is effective for the company beginning April 1, 2005. The impact of adoption is not expected to be material to the company's financial position or results of operations.

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## NOTE 2: TRANSFERS OF SECURITIZED INTERESTS IN MORTGAGE-RELATED ASSETS

### Types of Securitization Transactions Executed By Freddie Mac

Freddie Mac issues two types of mortgage-related securities: Mortgage Participation Certificates (“PCs”) and Structured Securities. PCs represent undivided interests in pools of mortgage loans that are secured by either single-family or multifamily loans. Similarly, Structured Securities represent undivided interests in PCs or other mortgage-related securities that are issued by either Ginnie Mae or non-agency issuers. Freddie Mac guarantees the payment of principal and interest on all issued PCs and Structured Securities.

Freddie Mac issues PCs in several different ways:

- Single-family mortgage loans that are purchased by Freddie Mac through its Cash Window are either retained by Freddie Mac in its Retained portfolio or are sold through auction in the form of issued PCs. Some single-family mortgage loans in the Retained portfolio are securitized and, therefore, are held as investments in the form of PCs. Mortgage loans that are purchased through the Cash Window and not retained by Freddie Mac are pooled together with other single-family mortgage loans that are received in connection with PC swap-based transactions that it executes with various lenders (and which Freddie Mac refers to as “MultiLender Swaps”). In this case, issued PCs that are not delivered to third party lenders in connection with MultiLender Swap transactions are sold by Freddie Mac for cash consideration through an auction.
- Freddie Mac commonly issues PCs to third parties through PC-swap-based transactions where either single-family or multifamily mortgage loans are delivered to Freddie Mac in exchange for PCs backed by such pools of mortgage loans. In this regard, and unlike MultiLender Swap transactions, the pools of mortgage loans formed in this case relate exclusively to mortgage loans that are delivered to Freddie Mac by a single lender.

Freddie Mac sells PCs that are held in its Retained portfolio in resecuritized form as Structured Securities. More specifically, Freddie Mac issues single and multi-class Structured Securities that are backed by PCs and other mortgage-related securities held in portfolio and subsequently transfers such Structured Securities to third parties in exchange for cash consideration. Freddie Mac also commonly issues Structured Securities in exchange for PCs and other mortgage-related securities that are delivered to it by third party dealers who, in turn, sell such Structured Securities to retail and institutional investors.

### Retained Interests Created Through The Securitization Process

Freddie Mac’s retained interests in securitized and resecuritized mortgage-related assets include the following:

- PCs retained by Freddie Mac that are backed by conforming single-family mortgage loans and multifamily mortgage loans for which Freddie Mac paid cash consideration.
- Structured Securities retained by Freddie Mac in connection with the resecuritization of PCs and mortgage-related securities that are issued by Ginnie Mae and non-agency entities.
- Freddie Mac’s contractual right to receive a negotiated fraction of the interest-related cash flows of securitized mortgage loans which relates to compensation due Freddie Mac in connection with its guarantee and administration of payments of principal and interest on issued PCs. This retained, undivided interest is referred to as a GA.
- PC residuals, which relate to certain PCs and Structured Securities held by Freddie Mac and represent the fair value of the expected net future cash flows of guarantee and bond administration cash flows that are contractually distinct from that of such corresponding PCs or Structured Securities.

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### *Unpaid Principal Balances of Issued PCs and Structured Securities*

Table 2.1 below presents the unpaid principal balances of issued PCs and Structured Securities as of December 31, 2004 and 2003.

**Table 2.1 — Issued PCs and Structured Securities Based on Unpaid Principal Balances<sup>(1)(2)</sup>**

	December 31,	
	2004	2003
	(dollars in millions)	
PCs and Structured Securities:		
Held by third parties . . . . .	\$ 852,270	\$ 752,164
Held by Freddie Mac in the:		
Retained portfolio <sup>(3)</sup> . . . . .	356,698	393,135
Cash and investments portfolio <sup>(4)</sup> . . . . .	—	16,769
Total issued PCs and Structured Securities <sup>(5)(6)</sup> . . . . .	<u>\$1,208,968</u>	<u>\$1,162,068</u>

- (1) Excludes mortgage loans and mortgage-related securities traded, but not yet settled.
- (2) Due to the nature of security program remittance cycles of issued PCs and Structured Securities, the unpaid principal balances of the underlying mortgage loans do not equal the unpaid principal balances of issued PCs and Structured Securities. See “NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — Due to Participation Certificate Investors” for more information.
- (3) With respect to mortgage loans purchased through Freddie Mac’s Cash Window that were internally securitized as PCs and held as available-for-sale investments in the Retained portfolio, the company recognized losses of \$1 million and \$178 million for the years ended December 31, 2004 and 2003, respectively, that correspond to permanent lower-of-cost-or-market value adjustments that were recognized in connection with such mortgage loans. Such lower-of-cost-or-market value adjustments were treated as basis adjustments to such issued PCs and, as such, are amortized into interest income over the holding period of such securities.
- (4) Represents PCs and Structured Securities held by Freddie Mac in connection with PC market-making and support activities, which are reflected in Investments on the consolidated balance sheets. In the fourth quarter of 2004, Freddie Mac ceased its PC market-making and support activities accomplished through its Securities Sales & Trading Group business unit and its external Money Manager program.
- (5) As further discussed in “NOTE 4: FINANCIAL GUARANTEES,” these amounts include:
  - \$3,015 million and \$4,729 million of Structured Securities backed by Ginnie Mae Certificates at December 31, 2004 and 2003, respectively.
  - \$5,432 million and \$5,044 million at December 31, 2004 and 2003, respectively, that pertain to Freddie Mac’s guarantee of (a) the payment of principal and interest on (i) tax-exempt multifamily housing revenue bonds that support pass-through certificates issued by third parties; and (ii) multifamily mortgage loans that are originated and held by state and municipal housing finance agencies to support tax-exempt multifamily housing revenue bonds; and (b) Freddie Mac pass-through certificates which are backed by tax-exempt multifamily housing revenue bonds and related taxable bonds and/or loans together with scheduled principal payments on such bonds and/or loans.
  - \$1,806 million and \$2,278 million at December 31, 2004 and 2003, respectively, of single-family mortgage loans held by third parties for which Freddie Mac provided a credit guarantee.
- (6) PCs and Structured Securities exclude \$723,429 million and \$637,491 million at December 31, 2004 and 2003, respectively, of Structured Securities backed by resecuritized PCs and other previously issued Structured Securities. These excluded Structured Securities do not increase Freddie Mac’s credit related exposure and consist of single-class Structured Securities backed by PCs, Real Estate Mortgage Investment Conduits, or REMICs and principal-only strips. The notional balance of interest-only strips of \$105,703 million and \$91,192 million at December 31, 2004 and 2003, respectively, is excluded because this table is based on unpaid principal balances. Also excluded are modifiable and combinable REMIC tranches and interest and principal classes, which collectively total \$1,097,336 million and \$988,600 million at December 31, 2004 and 2003, respectively, where the holder has the option to exchange the security tranches for other pre-defined security tranches.

At December 31, 2004 and 2003, approximately 86 percent and 78 percent, respectively, of issued PCs and Structured Securities (excluding securities issued by Freddie Mac and backed by Ginnie Mae Certificates or non-agency mortgage-related securities and other securities guaranteed by Freddie Mac) had corresponding GAs, GOs or PC residuals recognized on Freddie Mac’s consolidated balance sheets. The percentage of these PCs and Structured Securities that had corresponding GAs, GOs or PC residuals due to the adoption of FIN 45 accounting on January 1, 2003 was 39 percent and 30 percent, at December 31, 2004 and 2003, respectively. As of December 31, 2004 and 2003, 87 percent and 81 percent, respectively, of PCs and Structured Securities held by third parties had a related GA and GO established.

### *Gains and Losses on Transfers of PCs and Structured Securities that are Accounted for as Sales*

Freddie Mac recognized pre-tax gains of approximately \$356 million, \$711 million and \$874 million for the years ended December 31, 2004, 2003 and 2002, respectively, on transfers of PCs and Structured



Securities that were accounted for as sales under SFAS 125/140. In connection with the derivation of such gains (losses), Freddie Mac has:

- developed and consistently applied a methodology for determining the order in which to record extinguishments of GOs and the recognition of retained interests because PCs within an individual CUSIP are fungible in nature;
- de-recognized for financial statement purposes the carrying value of the sold portion of securitized assets as of the end of the month in which a sale has occurred; and
- recorded extinguishments of GOs as of the beginning of the month in which the purchase of corresponding PCs or Structured Securities has occurred.

### **Key Valuation Assumptions Associated with Recognized GAs, GOs, Credit Enhancements and PC Residuals that Correspond to PCs or Structured Securities Backed by Single-Family Mortgages**

Freddie Mac recognizes GAs and GOs for PCs backed by residential mortgage loans and multifamily mortgage loans in conjunction with transfers accounted for as sales under SFAS 125/140 as well as, beginning on January 1, 2003, transactions that do not qualify as sales, but are accounted for as guarantees pursuant to the requirements of FIN 45. At December 31, 2004 and 2003, GAs totaled \$4,516 million and \$3,686 million on Freddie Mac's consolidated balance sheets and of these amounts, approximately \$88 million (or approximately 2 percent) and \$24 million (or less than 1 percent), respectively, related to guarantees of multifamily mortgage loans. Consequently, the following discussion of key valuation assumptions and corresponding sensitivity analysis of recognized GAs, GOs, credit enhancements and PC residuals focuses solely on PCs and Structured Securities backed by single-family mortgage loans.

#### *Recognized GAs*

Fair values of recognized GAs were calculated using an expected cash flow approach. Specifically, Monte Carlo simulations were used to project monthly prepayment and default rates across 300 house price and interest rate scenarios. Through December 31, 2002, Monte Carlo simulations were also used to project monthly loss severity rates because recognized GAs for those periods included the fair value of pool insurance, recourse and indemnifications. As discussed in "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES," Freddie Mac discontinued the inclusion of these credit enhancements as components of recognized GAs effective January 1, 2003 and monthly loss severity rates are no longer included as part of Monte Carlo simulations used to project future cash flows associated with GAs. Monte Carlo projections were used to forecast GA-related future cash flows associated with approximately 360,000, 330,000 and 210,000 groups of mortgage loans for 2004, 2003 and 2002, respectively, that are distinguished based upon differing combinations of various loan attributes (these groups of loans are referred to as "Loan Group"). Freddie Mac then discounted their forecasted cash flows using factors that were derived from modeled forward interest rates (for each scenario path) to which Freddie Mac then applied a trailing average option-adjusted spread of up to 24 months that was based on spot interest-only security prices. The trailing average option-adjusted spreads ranged between 127 and 313 basis points from January 1, 2004 to December 31, 2004, and between 313 and 766 basis points from January 1, 2003 to December 31, 2003.

Based upon the foregoing, Freddie Mac recognized as GAs the average of the present value of the GA-related cash flows generated for each Loan Group for each of the referenced scenarios. Effective January 1, 2003, Freddie Mac modified the composition of GA-related cash flows used to derive fair value as a result of changes to its accounting policies (which are further described in "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES").

#### *Recognized GOs*

GOs are recognized at fair value at the inception of an executed guarantee. The fair value of a GO constitutes a component of the valuation of a PC residual (where a recognized PC residual is effectively equivalent to the net fair value of the underlying GA and GO). Like the cash flows associated with recognized GAs, GO-related future cash flows associated with each referenced Loan Group are estimated using Monte

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Carlo simulation. The components of estimated future cash flows associated with GOs include: (a) estimates of expected future credit losses using statistically based models that evaluate a variety of factors (such as default experience and loss severity trends), as well as an estimated risk premium for the uncertainty in expected credit losses that would be required to be paid to a third party with a credit standing similar to Freddie Mac; (b) estimates of the costs to administer the collection and distribution of payments on the mortgage loans underlying a PC; and (c) expected net cash flows due to security program cycles. When deriving the present value of GO-related cash flows for each scenario for each Loan Group, Freddie Mac uses a convention that is similar to the methodology described above to discount GA-related future cash flows, except that a London Interbank Offered Rate (“LIBOR”) rate is generally used to discount such cash flows. Additionally, projected credit related costs that are factored into the GO-related cash flows are benchmarked periodically to the non-conforming loan securitization market.

Like recognized GAs, Freddie Mac recognized as GOs the average of the present value of the GO-related cash flows generated for each Loan Group for each of the scenarios.

#### *Recognized PC residuals*

PC residuals relate to certain PCs and Structured Securities held by Freddie Mac in its Retained portfolio and Cash and investments portfolio and represent the fair value of the future cash flows of guarantee contracts that specifically correspond to such PCs. By the end of 2004, the company had ceased certain PC market-making and support activities and the Cash and investments portfolio no longer held mortgage-related securities. Since the future cash flows associated with such guarantee contracts are represented by those that define a PC’s corresponding GA and GO, the fair value of a recognized PC residual is effectively equivalent to the fair value of a GA less that of a corresponding GO. Accordingly, the fair value of recognized PC residuals is determined in a manner that is reflective of the methodologies described above for recognized GAs and GOs.

#### *Recognized Credit Enhancements*

Many of the credit enhancements that Freddie Mac employs in connection with securitized mortgage loans are recognized at fair value at the inception of each contract. Future credit enhancement-related cash flows associated with each referenced Loan Group are estimated using a Monte Carlo simulation. More specifically, based upon the terms of a credit-enhancement contract, the portion of the total GO-related future cash flows estimated for each Loan Group that would be reimbursed to Freddie Mac by a third party (e.g., a mortgage insurer) are identified as the estimated future cash inflows due Freddie Mac on each of such contracts. These projected cash inflows are then discounted using a LIBOR rate.

Freddie Mac recognizes as an Other asset the average of the present value of the credit enhancement-related cash flows generated for each Loan Group for each of the scenarios related to pool insurance, recourse and indemnifications. The average of the present value of the credit enhancements-related cash flows generated for each Loan Group for each of the scenarios related to primary mortgage insurance is recognized at inception at fair value as a reduction of recognized GOs.

Credit enhancements that were recognized as Other assets had a carrying value of approximately \$232 million and \$200 million at December 31, 2004 and 2003, respectively.

#### *Other Retained Interests*

Other Retained Interests (as defined in footnote 3 to “Table 2.3 — Sensitivity Analysis”) are valued based upon observed market or matrix-based prices (for the latter, prices for comparable securities, as adjusted for product-specific attributes, are used as a basis to value such interests). Because these interests are not model-valued, the corresponding valuation assumptions are not provided in Table 2.2 below. Sensitivity analysis of these interests (as shown in “Table 2.3 — Sensitivity Analysis”) is estimated using a company model that is not the source of the actual valuation used to determine their carrying value.

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Table 2.2 summarizes the key assumptions Freddie Mac used in fair value measurements of recognized GAs, GOs and PC residuals.

**Table 2.2 — Key Assumptions Utilized in Fair Value Measurements<sup>(1)</sup>**

Assumptions	2004		2003		2002	
	GA, GO and PC residual		GA, GO and PC residual		GA, GO and PC residual	
	Range <sup>(6)</sup>	Mean <sup>(7)</sup>	Range <sup>(6)</sup>	Mean <sup>(7)</sup>	Range <sup>(6)</sup>	Mean <sup>(7)</sup>
Internal rates of return <sup>(2)</sup>						
GA	(1.4)% - 13.6%	6.7%	4.5% - 15.1%	9.4%	5.9% - 15.7%	9.4%
GO	1.3% - 9.4%	5.3%	1.9% - 9.5%	5.6%	3.8% - 8.2%	6.0%
PC residual	0.0% - 11.9%	6.1%	4.0% - 12.2%	7.6%	5.1% - 11.8%	7.4%
Prepayment rates <sup>(3)</sup>	6.8% - 58.6%	18.8%	7.5% - 62.9%	22.6%	8.8% - 54.6%	22.5%
Default rates <sup>(4)</sup>	0.1% - 8.5%	1.1%	0.1% - 8.5%	1.2%	0.1% - 8.1%	1.2%
Loss severity rates <sup>(5)</sup>	4.0% - 46.0%	23.9%	4.0% - 46.0%	24.6%	3.6% - 48.4%	22.9%

- (1) The assumptions included in this table relate to those used to measure the fair value of single-family GAs, GOs and PC residuals at the time of securitization and the subsequent fair value measurements, which occurred throughout each of the years presented. Additionally, the range of assumptions used to facilitate the valuation of recognized credit enhancements was consistent with those provided above for recognized GOs.
- (2) The internal rates of return (“IRR”) reported above represent a duration weighted average of the discount rates used to value recognized GAs and GOs. Such rates were derived by determining a single rate that equated (a) the simple average of future cash flows (for all 300 scenario paths described above) of the GA and GO for each Loan Group with that of (b) the calculated fair value of the GA and GO for each Loan Group. With respect to PC residuals, IRRs reported above represent the weighted average of the derived IRR values for corresponding GAs and GOs (where weightings are based upon the fair values of corresponding GAs and GOs). Negative IRRs can occur when sufficiently large negative option adjusted spreads are applied to LIBOR. When Freddie Mac calibrates its modeled discounted cash flows to the traded price of an interest-only security, a negative option-adjusted spread can result when the traded price exceeds the implied market value of the modeled discounted cash flows. A negative option-adjusted spread is necessary to calibrate the implied market value of the modeled discounted cash flows to the traded price.
- (3) Scenario average Prepayment rates are simulated on a monthly frequency, although rates reported above represent an unpaid principal balance weighted average of annualized values of such Prepayment rates.
- (4) Default rates are simulated on a monthly frequency, although Default rates reported above represent simple averages of cumulative default rates determined for each of the 300 scenarios for each Loan Group.
- (5) Loss severity rates reported above represent the ratio of (a) the simple average of cumulative credit losses generated for each scenario to (b) defaulted unpaid principal balance for each Loan Group.
- (6) The lowest value in each presented range represents the first percentile IRRs, prepayment rates, default rates and loss severity rates throughout 2004, 2003 and 2002. Likewise, the highest value in each range represents the 99th percentile IRRs, prepayment rates, default rates and loss severity rates throughout 2004, 2003 and 2002.
- (7) Reported values represent the weighted average value of all IRRs, prepayment rates, default rates and loss severity rates throughout the 2004, 2003 and 2002 periods.

Weighted average lives of GAs and PC residuals during 2004, 2003 and 2002 ranged between 1.2 – 8.7 years, 1.0 – 8.6 years and 1.5 – 7.8 years, respectively, while the average derived weighted average lives of GAs and PC residuals for the same periods were 5.2, 4.8 and 5.0 years, respectively. Such derived weighted average lives are reflective of prepayment speed assumptions cited in Table 2.2 above.

The sensitivity analysis in Table 2.3 below illustrates estimated changes in the fair value at December 31, 2004 of recognized GAs, PC residuals and other retained interests (which are further described below) based upon:

- 100 basis point and 200 basis point increases and decreases in discount rate assumptions;
- 10% and 20 increases and decreases in prepayment rate assumptions;
- 10% and 20% increases in default rate assumptions; and
- 10% and 20% increases in loss severity rate assumptions.

GOs are not included in the sensitivity analysis in Table 2.3 since such items are not subsequently measured on a fair value basis in the consolidated balance sheets.

**Table 2.3 — Sensitivity Analysis**

	At December 31, 2004		
	PC residual <sup>(1)</sup>	GA <sup>(2)</sup>	Other retained interests <sup>(3)</sup>
	(dollars in millions)		
Fair value .....	\$ 845	\$4,516	\$ 713 <sup>(4)</sup>
Weighted average IRR assumptions: .....	5.8%	6.1%	10.8%
Impact on fair value of 100 bps upward change .....	\$ (28)	\$ (161)	\$ (23)
Impact on fair value of 200 bps upward change .....	\$ (54)	\$ (312)	\$ (44)
Impact on fair value of 100 bps downward change .....	\$ 29	\$ 172	\$ 25
Impact on fair value of 200 bps downward change .....	\$ 59	\$ 348	\$ 52
Weighted average prepayment rate assumptions: .....	19.0%	19.5%	14.3%
Impact on fair value of 10% upward change .....	\$ (16)	\$ (207)	\$ (28)
Impact on fair value of 20% upward change .....	\$ (32)	\$ (393)	\$ (53)
Impact on fair value of 10% downward change .....	\$ 17	\$ 231	\$ 32
Impact on fair value of 20% downward change .....	\$ 36	\$ 490	\$ 68
Weighted average default rate assumptions: .....	1.0%	1.0%	N/A <sup>(5)</sup>
Impact on fair value of 10% upward change .....	\$ (65)	\$ (3)	N/A <sup>(5)</sup>
Impact on fair value of 20% upward change .....	\$ (130)	\$ (7)	N/A <sup>(5)</sup>
Weighted average loss severity rate assumptions: .....	24.0%	N/A <sup>(6)</sup>	N/A <sup>(5)</sup>
Impact on fair value of 10% upward change .....	\$ (86)	N/A <sup>(6)</sup>	N/A <sup>(5)</sup>
Impact on fair value of 20% upward change .....	\$ (174)	N/A <sup>(6)</sup>	N/A <sup>(5)</sup>

- (1) At December 31, 2004 and 2003, approximately \$107 million and \$47 million, respectively, of recognized PC residuals were classified as available-for-sale representing, as a function of the unpaid principal balances of related PCs or Structured Securities, approximately 17 percent of recognized PC residuals. Therefore, approximately 83 percent of the future changes in fair value of recognized PC residuals would be recognized in earnings, while the balance of such future changes in fair value would be reflected in AOCI, net of taxes.
- (2) At December 31, 2004, GAs totaled \$4,516 million on Freddie Mac's consolidated balance sheet and of that amount, approximately \$88 million (or approximately 2 percent), relates to PCs backed by multifamily mortgage loans. The sensitivity analysis presented in Table 2.3 relates solely to GAs associated with PCs backed by single-family mortgage loans.
- (3) Includes interest-only securities that were issued by Freddie Mac as part of a securitization transaction for which sale accounting treatment was applied, and Freddie Mac securities that were (a) purchased at a premium (to par) of 10 percent or greater and (b) associated with either a securitization or securitization transaction for which sale accounting treatment was applied. Also included are Freddie Mac securities held by the company for which securitized / securitized mortgage-related assets were (a) not of high credit quality and (b) associated with either a securitization or securitization transaction for which sale accounting treatment was applied.
- (4) Includes accrued interest.
- (5) Sensitivities of reported fair value to changes in default and loss severity rates associated with Other retained interests for which a recognized PC residual exists are captured in the corresponding column entitled PC residual. Otherwise, with respect to Other retained interests for which a PC residual was not recognized, such securities are valued for consolidated financial statement purposes at the observed market price for such securities, which reflect inherent credit protection provided by Freddie Mac. In this case, changes in the reported fair value of such securities would not be affected by variations in default and loss severity assumptions and, as a result, a corresponding sensitivity analysis was not prepared.
- (6) Severity of loss has no impact on the underlying cash flows of the guarantee asset or the resultant fair values.

The sensitivity analysis in the preceding table is hypothetical. Each of the calculated effects summarized above was determined by adjusting only one assumption at a time, as opposed to having determined a hypothetical effect on fair value based upon assumed, correlating changes in more than one assumption (where, in reality, a change in one assumption would generally result in changes to one or more of the other specified assumptions). Additionally, any corresponding hedge transactions executed by Freddie Mac were not considered in determining the hypothetical effects summarized above. Results provided above should not be extrapolated to either (a) other sensitivity analyses in which changes in other assumptions are made or (b) to other securities held by Freddie Mac.

*Periodic Cash Flows on Transfers of Securitized Interests and Corresponding Retained Interests*

Table 2.4 below summarizes:

- cash flows received by Freddie Mac in connection with transfers of PCs and Structured Securities to third parties that were accounted for as sales and where retained interests related to guarantee activities were initially recognized or resulted from a resecuritization transaction;
- contractual guarantee-related cash flows received by Freddie Mac in connection with recognized GAs (as further discussed below);
- contractual guarantee-related cash flows received by Freddie Mac in connection with recognized PC residuals (as further discussed below);
- receipts of payments of principal and interest on Other retained interests; and
- amounts paid by Freddie Mac to repurchase delinquent mortgage loans that back PCs and Structured Securities.

**Table 2.4 — Details of Cash Flows**

	Year Ended December 31,		
	2004	2003 <sup>(1)</sup>	2002
	(dollars in millions)		
Cash flows from:			
Transfers of Freddie Mac securities that were accounted for as sales	\$152,662	\$347,874	\$241,214
Cash flows received on retained interests:			
GAs <sup>(2)</sup> .....	1,086	891	771
PC residuals <sup>(2)</sup> .....	524	449	325
Other Retained Interests .....	491	810	654
Purchases of delinquent or foreclosed loans <sup>(3)(4)</sup> .....	(4,931)	(5,822)	(5,039)

- (1) Certain cash flow amounts previously reported for the year ended December 31, 2003 have been revised to reflect current year quantification methods.
- (2) Amounts specifically correspond to guarantee fee-related cash flows of recognized GAs and PC residuals, and do not reflect cash flows received in connection with certain credit enhancements whose fair value in 2002 was also reported as GAs or PC residuals or certain GO-related cash flows whose value was reported as a component of recognized PC residuals. Total cash flows received on recognized GAs during 2004, 2003 and 2002 were \$1,086 million, \$891 million and \$820 million, respectively. Total net cash flows received on recognized PC residuals during 2004, 2003 and 2002 were \$227 million, \$140 million and \$169 million, respectively. Total GA cash flows and total net cash flows received on PC residuals in 2004 are exclusive of proceeds received in connection with credit enhancements.
- (3) Represents delinquent mortgage loans purchased out of securitized pools that back issued PCs or Structured Securities.
- (4) Subsequent to the release of Freddie Mac's Information Statement dated September 24, 2004, the company revised the methodology for disclosing the Purchases of delinquent or foreclosed loans. The effect of this was a \$473 million decrease and an \$87 million decrease in the balances for the years ended December 31, 2003 and 2002, respectively.

**Attribution of GA- and PC Residual-Related Cash Flows**

As previously discussed, GAs and PC residuals are financial assets accounted for on a fair value basis. Similar to other financial assets, cash flows received in connection with GAs and PC residuals represent both a return *on* such assets (*i.e.*, imputed interest) as well as a return *of* such assets (*i.e.*, return of principal). Freddie Mac receives cash flows on these assets related to contractual guarantee fees. Additionally, Freddie Mac receives or pays other cash flows associated with PC residuals that relate to the PC guarantee contract, such as credit-related expenses and administrative expenses.

Rather than recording a portion of the cash flows associated with GAs and PC residuals as a reduction of their respective recorded amounts, similar to a return of principal, the related income and expense amounts are recorded directly on the consolidated statements of income based on the nature of such cash flows. For example, guarantee-related cash inflows are recorded as Management and guarantee income. As these cash flows are received, the remaining cash flows (and the related GA and PC residual fair values) decrease. These decreases related to the GA and PC residuals are reflected in the Gains (losses) on Guarantee asset for Participation Certificates, at fair value and Gains (losses) on investment activity, respectively.

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#### *Recognized GAs — Guarantee Fee-Related Cash Flows*

Freddie Mac recorded \$1,086 million, \$891 million and \$771 million of income associated with guarantee-related cash flows received during 2004, 2003 and 2002, respectively. These amounts were recorded as Management and guarantee income. Of such amounts, approximately \$257 million, \$244 million and \$242 million, respectively, related to imputed interest. The remaining portion related to return of principal, which totaled \$829 million, \$647 million and \$529 million for 2004, 2003 and 2002, respectively.

#### *Recognized GAs — All Cash Flows*

As noted above, Freddie Mac discontinued the inclusion of credit enhancements as a component of recognized GAs effective January 1, 2003. As a result, imputed interest amounts reported above for 2004 and 2003 do not consider cash flows received that relate to credit enhancements that were previously recorded as a component of recognized GAs. With respect to amounts reported in 2002, Freddie Mac recorded total income of \$820 million associated with recognized GAs. Approximately \$259 million of such amounts constitute imputed interest, while the remaining portion, which totaled \$561 million, related to return of principal for 2002.

#### *Recognized PC Residuals*

Freddie Mac recorded \$524 million, \$449 million and \$325 million of income associated with guarantee-related cash flows received in connection with the GA component of recognized PC residuals during 2004, 2003 and 2002, respectively. These amounts were recorded as interest income. Of these amounts, approximately \$117 million, \$109 million and \$96 million during 2004, 2003 and 2002, respectively, related to imputed interest. The remaining portion related to return of principal, which totaled \$407 million, \$340 million and \$229 million during 2004, 2003 and 2002, respectively.

Considering all cash flows related to recognized PC residuals (*i.e.*, related to both the GA and GO components of recognized PC residuals), the amount of imputed interest on PC residuals was approximately \$67 million, \$66 million and \$73 million during 2004, 2003 and 2002, respectively. Consistent with the description above, however, cash flows used to derive the imputed interest for 2004 and 2003 were exclusive of proceeds received in connection with credit enhancements.

### NOTE 3: VARIABLE INTEREST ENTITIES

The company is a party to numerous entities that are considered to be variable interest entities (“VIEs”) under FIN 46-R. These VIEs include low-income housing tax credit partnerships, West\*Mac, certain asset-backed investment trusts, certain Structured Securities transactions and a mortgage reinsurance company. In addition, Freddie Mac buys the highly-rated senior securities in certain mortgage securitization trusts that are VIEs. Highly-rated senior securities issued by these securitization trusts are not designed to absorb a significant portion of the variability created by the assets/collateral in the trusts. Freddie Mac’s investments in these securities do not represent a significant variable interest in the securitization trusts. Further, Freddie Mac invests in securitization entities that are qualifying special purpose entities (“QSPEs”) as described in SFAS 125/140. Interests in these QSPEs are exempt from FIN 46-R because of the company’s inability to unilaterally liquidate or change the QSPE. See “NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES” for further information regarding FIN 46-R.

#### **Low-Income Housing Tax Credit Partnerships**

Freddie Mac invests as a limited partner in low-income housing tax credit partnerships formed for the purpose of providing funding for affordable multifamily rental properties. These low-income housing tax credit partnerships invest directly in limited partnerships that develop or rehabilitate multifamily rental properties. Completed properties are rented to qualified low-income tenants, allowing the properties to be eligible for federal tax credits. A general partner operates the partnership, identifying investments and obtaining debt financing as needed to finance partnership activities. Although these partnerships generate operating losses, Freddie Mac realizes a return on its investment through reductions in income tax expense that result from tax credits and the deductibility of the operating losses. The partnership agreements are typically structured to meet a required 15-year period of occupancy by qualified low-income tenants. These investments were made between 1989 and 2004. At December 31, 2004, Freddie Mac did not guarantee any obligations of these partnerships and Freddie Mac’s exposure is limited to the amount of its investments.

#### **West\*Mac**

Freddie Mac is one of two general partners in West\*Mac, which was formed in 1986. The purpose of West\*Mac is to acquire, develop and manage certain real property located in McLean, Virginia. This real property is Freddie Mac’s corporate headquarters.

#### **Asset-Backed Investment Trusts**

Freddie Mac invests in a variety of non-mortgage-related, asset-backed investment trusts. These investments represent interests in trusts consisting of a pool of receivables or other financial assets, typically credit card receivables, auto loans or student loans. The trusts act as vehicles to allow originators to securitize assets. The originators of the financial assets or the underwriters of the deal create the trusts and typically own the residual interest in the trust assets.

Securities are structured from the underlying pool of assets to provide for varying degrees of risk. Primary risks include potential loss from the credit risk and interest rate risk of the underlying pool. Freddie Mac invests in these securities to manage its cash flows, create a diverse source of liquidity and achieve profitable investment returns. These investments were made between 2000 and 2004.

#### **Structured Securities — T-Series Transactions**

In T-Series transactions (or alternative collateral deals), a seller or sellers of mortgage loans transfers mortgage loans to a trust specifically for the purpose of issuing securities collateralized by the mortgage loans. These T-Series transactions issue various senior and subordinated interests. Freddie Mac guarantees and purchases certain of the senior interests. Simultaneous with this guarantee and purchase, Freddie Mac issues and guarantees Structured Securities. These Structured Securities represent an interest in the senior interests of the T-series transactions. The subordinated interests are generally either held by the seller or other party or sold in the capital markets.

*Freddie Mac*

## Mortgage Reinsurance Company

In May 1998, Freddie Mac transferred credit risk to a consolidated special purpose entity in a reinsurance transaction.

### Consolidated VIEs

As of December 31, 2004, the company had investments in five low-income housing tax credit partnerships, West\*Mac and the mortgage reinsurance company referred to above, of which Freddie Mac was the primary beneficiary. These are consolidated pursuant to the requirements of FIN 46-R. Prior to 2004, Freddie Mac consolidated these in accordance with other applicable requirements under GAAP. Table 3.1 represents the carrying amounts and classification of consolidated assets that are collateral for the consolidated VIEs.

**Table 3.1 — Assets of Consolidated VIEs**

<u>Consolidated Balance Sheets Line Item</u>	<u>December 31, 2004</u> <u>(dollars in millions)</u>
Cash and cash equivalents .....	\$ 51
Accounts and other receivables, net .....	170
Other assets .....	239
Total assets of consolidated VIEs .....	<u>\$460</u>

The investors in the obligations of consolidated VIEs have recourse only to the assets of those VIEs and do not have recourse to the company.

### VIEs Not Consolidated

As of December 31, 2004, the company had unconsolidated investments in 149 low-income housing tax credit partnerships in which Freddie Mac had a significant variable interest. The size of these partnerships at December 31, 2004, as measured in total assets, was \$7.5 billion. These partnerships are accounted for using the equity method, as described in “NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES.” As a limited partner, Freddie Mac’s maximum exposure to loss equals the book value of its equity investment. As of December 31, 2004, Freddie Mac’s maximum exposure to loss on unconsolidated low-income housing tax credit partnerships, in which Freddie Mac had a significant variable interest, was \$2.9 billion.

At December 31, 2004, the company had investments in three trusts related to non-mortgage-related, asset-backed securities in which Freddie Mac had a significant variable interest. These trusts had total assets of \$12.8 billion. At December 31, 2003, the company had investments in 15 trusts related to non-mortgage-related, asset-backed securities in which Freddie Mac had a significant variable interest. These trusts had total assets of \$7.9 billion. As an investor, Freddie Mac’s maximum exposure to loss consisted of the book value of its investment. As of December 31, 2004, Freddie Mac’s maximum exposure to loss on non-mortgage-related, asset-backed investment trusts in which Freddie Mac had a significant variable interest was approximately \$3.4 billion. As of December 31, 2003, Freddie Mac’s maximum exposure to loss on non-mortgage-related, asset-backed investment trusts in which Freddie Mac had a significant variable interest was approximately \$1.8 billion. These investments are typically senior interests rated A1 and P1 by Standard & Poor’s and Moody’s, respectively, which is the short-term equivalent to between A and AAA in typical long-term rating scales.

At both December 31, 2004 and 2003, the company had investments or guarantees related to two T-Series transactions in which Freddie Mac had a significant variable interest. Freddie Mac’s involvement in the T-Series transactions began in 1996 and 2002, respectively. The size of these transactions at December 31, 2004 and 2003, as measured in total assets, was \$170 million and \$367 million, respectively. As of December 31, 2004 and 2003, Freddie Mac’s maximum exposure to loss on T-Series transactions in which Freddie Mac had a significant variable interest was \$147 million and \$339 million, respectively, consisting of the book value of the company’s investments plus incremental guarantees of the senior interests that are held by third parties.

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#### NOTE 4: FINANCIAL GUARANTEES

Freddie Mac executes a variety of financial guarantees. Each of the principal types of such guarantees, including relevant qualitative and quantitative information associated with such items, is further discussed below.

##### **Principal and Interest Guarantees of PCs and Structured Securities**

As is further discussed in “NOTE 2: TRANSFERS OF SECURITIZED INTERESTS IN MORTGAGE-RELATED ASSETS,” Freddie Mac issues two types of mortgage-related securities: PCs and Structured Securities. PCs represent undivided interests in pools of mortgage loans that are secured by either single-family or multifamily mortgage loans. Similarly, Structured Securities represent undivided interests in PCs or other mortgage-related securities that are issued by either Ginnie Mae or non-agency issuers. Freddie Mac guarantees the payment of principal and interest on all issued PCs and Structured Securities. Freddie Mac’s guarantees related to Structured Securities include its guarantees on PCs or any non-Freddie Mac mortgage-related securities that underlie these Structured Securities.

Depending upon the manner by which Freddie Mac transferred PCs or Structured Securities to third parties in 2004 and 2003, all such transfers, which totaled \$365,108 million and \$713,787 million, respectively, were accounted for pursuant to the requirements of FIN 45 and SFAS 125/140. Upon completion of the transfer of PCs or Structured Securities to third parties, Freddie Mac recognizes the fair value of its obligation to make guarantee payments. The methods by which Freddie Mac accounts for its guarantees of PCs and Structured Securities are further discussed in “NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES.”

The maximum potential amount of future principal payments Freddie Mac could be required to make in connection with the unpaid principal balance of all PCs and Structured Securities held by third parties totaled \$852 billion and \$752 billion at December 31, 2004 and 2003, respectively. Included in these amounts are \$5.4 billion and \$5.0 billion at December 31, 2004 and 2003, respectively, that pertain to guarantees related to multifamily housing revenue bonds that come in three principal forms. First, Freddie Mac provides a guarantee of the payment of principal and interest on tax-exempt multifamily housing revenue bonds that support pass-through certificates issued by third parties. These housing revenue bonds are collateralized by mortgage loans on low- and moderate-income multifamily housing projects. Second, Freddie Mac issues pass-through certificates which are backed by tax-exempt multifamily housing revenue bonds and related taxable bonds and/or loans. Freddie Mac guarantees all scheduled principal on the bonds or loans, and guarantees interest on the certificates. And third, Freddie Mac guarantees the payment of principal and interest related to low- and moderate-income multifamily mortgage loans that are originated and held by state and municipal agencies to support tax-exempt multifamily housing revenue bonds. Additionally, Freddie Mac provided credit guarantees of \$1.8 billion and \$2.3 billion at December 31, 2004 and 2003, respectively, of single-family mortgage loans held by third parties.

As part of these guarantee arrangements, Freddie Mac also provides a commitment to advance funds, commonly referred to as “liquidity guarantees,” totaling \$5.0 billion and \$4.5 billion, at December 31, 2004 and 2003, respectively, to enable the repurchase by others of tendered tax-exempt pass-through certificates and housing revenue bonds that are unable to be remarketed. Any repurchased securities would be pledged to Freddie Mac as collateral for such funding until such time as the securities could be remarketed. There have been no payments made to date by Freddie Mac under this type of loan commitment.

Generally, the contractual terms of Freddie Mac’s guarantees on PCs and Structured Securities are 15 to 30 years. However, the actual term of each guarantee may be significantly less than the contractual terms due to the prepayment characteristics of the mortgage-related assets that back PCs and Structured Securities. Maximum potential interest payments Freddie Mac could be required to make associated with these guarantees are not expected to significantly exceed 120 days of interest at the certificate rate, given that Freddie Mac generally begins a process to purchase the defaulted mortgages when they have been delinquent for 120 consecutive days.

In connection with PCs or Structured Securities backed by single-family mortgage loans, Freddie Mac had maximum coverage totaling \$27.2 billion and \$27.1 billion in primary mortgage insurance at

*Freddie Mac*

December 31, 2004 and 2003, respectively, \$3.5 billion and \$4.1 billion in pool insurance and other credit enhancements at December 31, 2004 and 2003, respectively, and \$4.1 billion and \$4.6 billion in recourse to lenders at December 31, 2004 and 2003, respectively. In addition, \$2.6 billion and \$4.1 billion of outstanding Structured Securities relate to Ginnie Mae Certificates, which are backed by the full faith and credit of the U.S. government, at December 31, 2004 and 2003, respectively. With respect to PCs and Structured Securities backed by multifamily mortgage loans, Freddie Mac had maximum combined credit enhancements totaling \$9.1 billion and \$9.5 billion at December 31, 2004 and 2003, respectively.

At December 31, 2004, Freddie Mac had a recognized Guarantee obligation for Participation Certificates on the consolidated balance sheets of \$4.1 billion, which included \$1.3 billion of Deferred Guarantee Income. At December 31, 2003, the Guarantee obligation for Participation Certificates totaled \$2.9 billion, which included \$0.8 billion of Deferred Guarantee Income. In addition, the company had a Reserve for Guarantee Losses on Participation Certificates that totaled \$150 million and \$125 million at December 31, 2004 and 2003, respectively, for incurred credit losses that were recognized in conjunction with PCs and Structured Securities held by third parties.

### **Guarantees of Stated Final Maturity of Issued Structured Securities**

Freddie Mac commonly issues Structured Securities with stated final maturities that are shorter than the stated maturity of the underlying mortgage loans. If the assets that back such Structured Securities have not fully matured as of the stated final maturity date of such securities, either Freddie Mac will sponsor an auction of the underlying assets or a third party who holds a par-based call option on such underlying assets will exercise its option to purchase such underlying assets (an option which, if exercised, would provide cash flows that Freddie Mac would pass through to investors in such Structured Securities). If an auction occurs, Freddie Mac would pass through proceeds received to investors of such Structured Securities. To the extent, however, that auction proceeds are insufficient to cover unpaid principal amounts due to investors in such Structured Securities, Freddie Mac is obligated to fund such principal. With respect to such guarantees of stated final maturity, Freddie Mac effectively writes a cash-settled put option to investors in such Structured Securities. Such guarantees are accounted for as derivative instruments pursuant to the requirements of SFAS 133.

As of December 31, 2004 and 2003, the maximum potential amount of payments Freddie Mac could be required to make under such guarantees was \$9.2 billion and \$8.4 billion, respectively, which represents the outstanding unpaid principal balance of the underlying mortgage loans. At both December 31, 2004 and 2003, the total fair value of recognized liabilities concerning such guarantees was \$1.0 million. The longest remaining contractual maturity of any outstanding written put option was 15 years and 16 years at December 31, 2004 and 2003, respectively; however, the actual terms may be significantly less than the contractual terms as the amortizing notional balance is linked to prepayable mortgage loans.

### **Indemnifications**

In connection with various business transactions, Freddie Mac provides indemnification to counterparties for breaches of standard representations and warranties in contracts entered into in the normal course of business. It is difficult to estimate Freddie Mac's maximum exposure under these indemnification agreements since in many cases there are no stated or notional amounts included in the indemnification clauses. However, the contingencies triggering the obligation to indemnify have not occurred. Freddie Mac's assessment is that the risk would be remote. Such representations and warranties pertain to hold harmless clauses, adverse changes in tax laws and potential claims from third parties related to items such as actual or alleged infringement of intellectual property. At December 31, 2004 and 2003, there were 14 and 13 identified transactions, respectively, that contain intellectual property related indemnifications, as defined by FASB Staff Position No. 45-1, "Accounting for Intellectual Property Infringement Indemnifications under FASB Interpretation No. 45." Freddie Mac had not recorded any liabilities related to these indemnifications in its consolidated balance sheets as of December 31, 2004 and 2003 because it was not probable that the company would be required to make payments under these contractual agreements on those dates.

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### *Other Guarantees*

Freddie Mac has guaranteed the performance of interest-rate swap contracts in two circumstances. First, as part of a securitization transaction, Freddie Mac transferred certain swaps and related assets to a third party. Freddie Mac guaranteed that interest income generated from the assets would be sufficient to cover the required payments under the interest-rate swap contracts. In the other circumstance, Freddie Mac guaranteed that a customer would perform under an interest-rate swap contract linked to the customer's variable rate mortgage. The maximum remaining terms of any of these guarantees at December 31, 2004 and 2003 was 29 years and 27 years, respectively; however, the actual terms may be significantly less than the contractual terms as the amortizing notional balance of the swaps is linked to prepayable mortgage loans. The maximum potential amount of future payments under the guarantees was \$50 million and \$136 million at December 31, 2004 and 2003, respectively. The company has not established a liability on its consolidated balance sheets at December 31, 2004 and 2003 because it was not probable that it would be required to make payments under these contractual arrangements on those dates.

Freddie Mac provides guarantees to reimburse servicers for premiums paid to acquire servicing in situations where Freddie Mac requires the original seller to repurchase the loan and the original seller is unable to perform under a separate agreement to reimburse the servicer for those servicing premiums. Freddie Mac's servicing related premium guarantees are payable according to a vesting schedule for up to five years from the date of purchase of servicing rights. Freddie Mac's servicing-related premium guarantees issued in 2003 and 2004 extend through 2008 and 2009, respectively. The maximum potential amount of future payments under the guarantees was \$113 million and \$151 million at December 31, 2004 and 2003, respectively. The company has not established a liability on its consolidated balance sheets at December 31, 2004 and 2003 because it was not probable that it would be required to make payments under these contractual arrangements on those dates.

**NOTE 5: RETAINED PORTFOLIO AND CASH AND INVESTMENTS PORTFOLIO**

Table 5.1 summarizes amortized cost, estimated fair values and corresponding gross unrealized gains and gross unrealized losses by major security type for available-for-sale mortgage-related securities held in the Retained portfolio and available-for-sale non-mortgage-related securities held in the Cash and investments portfolio at December 31, 2004 and 2003, respectively.

**Table 5.1 — Available-For-Sale Securities**

	December 31, 2004			Fair Value
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	
	(dollars in millions)			
<b>Retained portfolio</b>				
<b>Mortgage-related securities issued by:</b>				
Freddie Mac .....	\$348,034	\$5,506	\$(1,438)	\$352,102
Fannie Mae .....	58,922	950	(353)	59,519
Ginnie Mae .....	1,677	86	(1)	1,762
Other .....	166,738	1,700	(380)	168,058
Obligations of states and political subdivisions .....	8,751	301	(32)	9,020
Total mortgage-related securities .....	<u>584,122</u>	<u>8,543</u>	<u>(2,204)</u>	<u>590,461</u>
<b>Cash and investments portfolio</b>				
<b>Non-mortgage-related securities:</b>				
Asset-backed securities .....	21,668	120	(55)	21,733
Obligations of states and political subdivisions .....	8,098	—	(1)	8,097
Total non-mortgage-related securities .....	<u>29,766</u>	<u>120</u>	<u>(56)</u>	<u>29,830</u>
<b>Total available-for-sale securities .....</b>	<b><u>\$613,888</u></b>	<b><u>\$8,663</u></b>	<b><u>\$(2,260)</u></b>	<b><u>\$620,291</u></b>
	December 31, 2003			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(dollars in millions)			
<b>Retained portfolio</b>				
<b>Mortgage-related securities issued by:</b>				
Freddie Mac .....	\$378,956	\$ 7,010	\$(1,540)	\$384,426
Fannie Mae .....	75,705	1,524	(385)	76,844
Ginnie Mae .....	2,785	134	(1)	2,918
Other .....	107,522	2,152	(265)	109,409
Obligations of states and political subdivisions .....	7,449	306	(26)	7,729
Total mortgage-related securities .....	<u>572,417</u>	<u>11,126</u>	<u>(2,217)</u>	<u>581,326</u>
<b>Cash and investments portfolio</b>				
<b>Non-mortgage-related securities:</b>				
Asset-backed securities .....	16,209	394	(7)	16,596
Corporate debt securities .....	4,698	230	(4)	4,924
Obligations of states and political subdivisions .....	9,494	—	—	9,494
Commercial paper .....	150	—	—	150
Preferred stock .....	64	—	—	64
Total non-mortgage-related securities .....	<u>30,615</u>	<u>624</u>	<u>(11)</u>	<u>31,228</u>
<b>Total available-for-sale securities .....</b>	<b><u>\$603,032</u></b>	<b><u>\$11,750</u></b>	<b><u>\$(2,228)</u></b>	<b><u>\$612,554</u></b>

In 2004, 2003 and 2002, Freddie Mac received proceeds of \$85,583 million, \$142,167 million and \$172,964 million, respectively, from the sale of securities from its available-for-sale portfolio. The proceeds received resulted in gross realized gains of \$800 million and gross realized losses of \$203 million in 2004, gross realized gains of \$1,903 million and gross realized losses of \$1,077 million in 2003 and gross realized gains of \$1,575 million and gross realized losses of \$257 million in 2002.

Management has determined that the \$2,260 million of gross unrealized losses on the company's available-for-sale mortgage-related and non-mortgage-related securities at December 31, 2004 are not other

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than temporary in nature. Management conducts periodic reviews to identify and evaluate investments that have indications of impairment. Impairment losses related to investments are recognized in earnings if fair value is less than amortized cost and the decline is considered other than temporary. See “NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES” for additional information about the company’s impairment accounting policies.

Table 5.2 below shows the fair value of available-for-sale securities in a gross unrealized loss position at December 31, 2004 and how long they have been in that position.

**Table 5.2 — Available-For-Sale Securities in a Gross Unrealized Loss Position at December 31, 2004**

	Less than 12 months		12 months or Greater		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
(dollars in millions)						
<b>Retained portfolio</b>						
<b>Mortgage-related securities issued by:</b>						
Freddie Mac	\$103,976	\$ (713)	\$34,161	\$ (725)	\$138,137	\$(1,438)
Fannie Mae	20,727	(134)	9,913	(219)	30,640	(353)
Ginnie Mae	77	—	52	(1)	129	(1)
Other	55,398	(268)	4,323	(112)	59,721	(380)
Obligations of states and political subdivisions	1,025	(17)	591	(15)	1,616	(32)
Total mortgage related-securities	<u>181,203</u>	<u>(1,132)</u>	<u>49,040</u>	<u>(1,072)</u>	<u>230,243</u>	<u>(2,204)</u>
<b>Cash and investments portfolio</b>						
<b>Non-mortgage related securities:</b>						
Asset-backed securities	9,242	(51)	205	(4)	9,447	(55)
Obligations of states and political subdivisions	582	(1)	7	—	589	(1)
Total non-mortgage related securities	<u>9,824</u>	<u>(52)</u>	<u>212</u>	<u>(4)</u>	<u>10,036</u>	<u>(56)</u>
<b>Total</b>	<u>\$191,027</u>	<u>\$(1,184)</u>	<u>\$49,252</u>	<u>\$(1,076)</u>	<u>\$240,279</u>	<u>\$(2,260)</u>

At December 31, 2004, gross unrealized losses on available-for-sale securities were \$2,260 million, or approximately one percent of the fair value of such securities in an unrealized loss position, as noted in Table 5.1 and Table 5.2. The gross unrealized losses relate to approximately 54 thousand individual lots representing approximately 10 thousand separate securities. Freddie Mac routinely purchases multiple lots of individual securities at different times and at different costs. The company determines gross unrealized gains and gross unrealized losses by specifically identifying investment positions at the lot level; therefore, Freddie Mac often holds several lots of one security including both unrealized gain and unrealized loss positions, depending upon the amortized cost of the specific lot.

The following is a summary of management’s analysis of why available-for-sale securities in an unrealized loss position are not considered other than temporarily impaired:

- **Freddie Mac securities.** The unrealized losses on Freddie Mac securities are primarily a result of movements in interest rates. The extent and duration of the decline in fair value relative to the amortized cost have not met the company’s criteria that are used to indicate other-than-temporary impairment as described in “NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES.” The company reviews the estimated credit exposure of the mortgages underlying these securities. As a result of this review, management has determined that these securities are not other than temporarily impaired. See “NOTE 2: TRANSFERS OF SECURITIZED INTERESTS IN MORTGAGE-RELATED ASSETS” for further information on Freddie Mac’s estimates of credit exposure and credit support.
- **Fannie Mae securities and Obligations of states and political subdivisions.** The unrealized losses on Fannie Mae securities and Obligations of states and political subdivisions are primarily a result of movements in interest rates. The extent and duration of the decline in fair value relative to the amortized cost have not met the company’s criteria that are used to indicate other-than-temporary impairment and no other facts or circumstances existed to suggest that the decline was other than temporary. The issuer guarantees related to these securities have led management to conclude that any credit risk is minimal.

*Freddie Mac*

- **Other securities in the Retained portfolio and Asset-backed securities.** The unrealized losses on mortgage-related securities included in Other and Asset-backed securities are principally a result of movements in interest rates. The extent and duration of the decline in fair value relative to the amortized cost have not met the company's criteria that are used to indicate other-than-temporary impairment. These securities are all investment grade (*i.e.*, rated BBB- or better on a Standard & Poor's ("S&P") equivalent scale).

Table 5.3 summarizes the estimated fair values by major security type for trading securities at December 31, 2004 and 2003, respectively.

**Table 5.3 — Trading Securities**

	December 31,	
	2004	2003
	Fair Value	Fair Value
	(dollars in millions)	
<b>Retained portfolio</b>		
<b>Mortgage-related securities issued by:</b>		
Freddie Mac .....	\$11,398	\$17,590
Fannie Mae .....	385	586
Ginnie Mae .....	59	24
Total .....	<u>11,842</u>	<u>18,200</u>
<b>Cash and investments portfolio</b>		
<b>Mortgage-related securities issued by:</b>		
Freddie Mac .....	—	17,266
Fannie Mae .....	—	15,052
Ginnie Mae .....	—	490
Other .....	—	9
Total .....	<u>—</u>	<u>32,817</u>
<b>Non-mortgage-related securities:</b>		
Asset-backed securities .....	—	52
Debt securities issued by the U.S. Treasury and other U.S. government corporations and agencies .....	—	479
Commercial paper .....	—	341
Corporate debt securities .....	—	437
Debt securities issued by foreign governments .....	—	5
Total .....	<u>—</u>	<u>1,314</u>
<b>Total trading securities</b> .....	<u>\$11,842</u>	<u>\$52,331</u>

In the fourth quarter of 2004, as part of an effort to realign the company's business around its mission and core business, Freddie Mac decided to cease its PC market making and support activities accomplished through the company's Securities Sales & Trading Group business unit and its external Money Manager program. In connection with ceasing these activities, the trading securities held in the Cash and investments portfolio were disposed of by the end of 2004. During the periods these trading assets were held, they were reported at fair value with the changes in fair value included in Gains (losses) on investment activity. Interest income on these trading assets was included in Net interest income. The Net proceeds from purchases and sales of trading securities reported in the company's consolidated statement of cash flows for 2004 of approximately \$39.0 billion was primarily driven by the disposition of securities classified as trading from the Cash and investments portfolio. In connection with ceasing these activities, Freddie Mac incurred approximately \$18 million of employee severance and related costs and approximately \$5 million of other expenses during the fourth quarter of 2004.

In addition, Freddie Mac's investments in mortgage-related securities held by its Securities Sales & Trading Group business unit were generally hedged by entering into forward sales of mortgage-related securities. When determining the fair value of these positions, the held investment was valued at the current market, or spot, price, while the forward sale commitment was valued at the discounted sales, or forward, price. The spot-forward difference between the trading security and the forward sale commitment resulted in a loss in Gains (losses) on investment activities that was offset by Net interest income on the held position. This spot-forward difference was \$976 million, \$981 million and \$938 million in 2004, 2003, and 2002, respectively.

*Freddie Mac*

The portion of Gains (losses) on investment activity that relates to trading securities held in the trading portfolio at December 31, 2004, 2003 and 2002 is \$(240) million, \$(402) million and \$1,293 million, respectively.

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

At December 31, 2004, Freddie Mac held available-for-sale and trading securities with a fair value of \$59,904 million guaranteed by Fannie Mae that represented 191% of Total stockholders' equity. No other individual issuer at the individual trust level exceeded 10 percent of Total stockholders' equity at December 31, 2004.

Table 5.4 summarizes, by major security type, the remaining contractual maturities and weighted average yield of available-for-sale mortgage-related and non-mortgage-related securities at December 31, 2004.

**Table 5.4 — Maturities and Weighted Average Yield of Available-For-Sale Securities**

<u>December 31, 2004</u>	<u>Amortized Cost</u>	<u>Fair Value</u>	<u>Weighted Average Yield<sup>(1)</sup></u>
	(dollars in millions)		
<b>Retained portfolio</b>			
<b>Total mortgage-related securities<sup>(2)</sup></b>			
Due 1 year or less . . . . .	\$ 81	\$ 81	3.22%
Due after 1 through 5 years . . . . .	5,187	5,380	5.31
Due after 5 through 10 years . . . . .	18,362	19,042	5.66
Due after 10 years . . . . .	<u>560,492</u>	<u>565,958</u>	4.54
Total . . . . .	<u>584,122</u>	<u>590,461</u>	4.58
<b>Cash and investments portfolio</b>			
<b>Non-mortgage-related securities</b>			
Asset-backed securities <sup>(2)</sup>			
Due 1 year or less . . . . .	46	47	2.68
Due after 1 through 5 years . . . . .	14,115	14,166	3.27
Due after 5 through 10 years . . . . .	6,679	6,692	2.76
Due after 10 years . . . . .	<u>828</u>	<u>828</u>	2.48
Total . . . . .	<u>21,668</u>	<u>21,733</u>	3.08
Obligations of states and political subdivisions			
Due 1 year or less . . . . .	1,103	1,102	1.81
Due after 1 through 5 years . . . . .	36	36	1.95
Due after 5 through 10 years . . . . .	72	72	1.94
Due after 10 years . . . . .	<u>6,887</u>	<u>6,887</u>	2.04
Total . . . . .	<u>8,098</u>	<u>8,097</u>	2.01
<b>Total non-mortgage-related securities</b>			
Due 1 year or less . . . . .	1,149	1,149	1.84
Due after 1 through 5 years . . . . .	14,151	14,202	3.27
Due after 5 through 10 years . . . . .	6,751	6,764	2.75
Due after 10 years . . . . .	<u>7,715</u>	<u>7,715</u>	2.09
Total . . . . .	<u>29,766</u>	<u>29,830</u>	2.79
<b>Total available-for-sale securities</b>			
Due 1 year or less . . . . .	1,230	1,230	1.94
Due after 1 through 5 years . . . . .	19,338	19,582	3.82
Due after 5 through 10 years . . . . .	25,113	25,806	4.87
Due after 10 years . . . . .	<u>568,207</u>	<u>573,673</u>	4.50
Total . . . . .	<u>\$613,888</u>	<u>\$620,291</u>	4.49%

(1) The weighted average yield is calculated based on a yield for each individual security held at the balance sheet date. The numerator for the individual security yield consists of the sum of (a) the year-end interest coupon rate multiplied by the year-end unpaid principal balance and (b) the annualized amortization income or expense calculated for December 2004 (excluding any adjustments recorded for changes in the effective rate). The denominator for the individual security yield consists of the year-end amortized cost of the security excluding effects of other-than-temporary impairments.

(2) Information provided for mortgage-related securities and asset-backed securities is based on contractual maturities, which may not represent their expected lives. Obligations underlying these securities may be prepaid at any time without penalty.

Table 5.5 presents the changes in AOCI, net of taxes, related to available-for-sale securities. The Net unrealized holding (losses) gains, net of tax (benefit) expense line represents the net fair value adjustments recorded on available-for-sale securities throughout the year after the effects of the company's statutory tax rate of 35 percent. The Net reclassification adjustment for realized (gains) losses included in net income, net of tax (expense) represents the amount of those fair value adjustments, after the effects of the company's statutory tax rate of 35 percent, that have been recognized in earnings due to a sale of an available-for-sale security or the recognition of an impairment loss. See "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES" for further information regarding the component of AOCI related to available-for-sale securities.

**Table 5.5 — AOCI, Net of Taxes, Related to Available-For-Sale Securities**

	<u>Year Ended December 31,</u>		
	<u>2004</u>	<u>2003</u>	<u>2002</u>
	(dollars in millions)		
Beginning balance .....	\$ 6,349	\$12,217	\$ 4,200
Net unrealized holding (losses) gains, net of tax (benefit) expense of \$(920), \$(3,107) and \$4,583, respectively .....	(1,709)	(5,770)	8,512
Net reclassification adjustment for realized (gains) losses included in net income, net of tax (expense) of \$(162), \$(53) and \$(267), respectively <sup>(1)</sup> .....	<u>(301)</u>	<u>(98)</u>	<u>(495)</u>
Ending balance .....	<u>\$ 4,339</u>	<u>\$ 6,349</u>	<u>\$12,217</u>

(1) Includes impairment losses on available-for-sale securities, where the decline in fair value is considered to be other than temporary, of \$72 million, \$438 million and \$422 million, net of tax for the years ended December 31, 2004, 2003 and 2002, respectively.



## Collateral Pledged

Freddie Mac enters into several types of secured financing transactions, including interest-rate swap, repurchase and resale agreements. See “NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES” for more information regarding secured financing transactions.

Freddie Mac’s counterparties are required to pledge collateral for reverse repurchase transactions and most interest-rate swap agreements after giving consideration to collateral posting thresholds, which are generally related to a counterparty’s credit rating. Even though it is Freddie Mac’s practice not to repledge assets held as collateral, based on master agreements, a portion of the collateral can be repledged. At December 31, 2004 and 2003, the fair value amount of collateral held by Freddie Mac under secured lending transactions and interest-rate swap agreements that was available for repledging was approximately \$3 million and \$8,200 million, respectively. This decrease was primarily a result of the company ceasing operations of its PC market-making and support activities accomplished through its Securities Sales & Trading Group business unit and external Money Manager program during the fourth quarter of 2004.

Freddie Mac is also required to pledge collateral for margin requirements with some custodians in connection with secured financing and daily trade activities. Based on agreements between Freddie Mac and the custodians, as illustrated in Table 5.6, some collateral may be permitted by contract to be repledged by the custodian. Freddie Mac has parenthetically disclosed on the consolidated balance sheets the fair value of assets pledged as collateral with the right to repledge. Table 5.6 summarizes all assets pledged as collateral by the company including assets that the secured party can repledge and those that cannot be repledged.

**Table 5.6 — Collateral Pledged**

	December 31,	
	2004	2003
	(dollars in millions)	
<b>Assets pledged with ability for secured party to repledge (parenthetically disclosed on the consolidated balance sheets)</b>		
Available for sale .....	\$ 194	\$282
Trading .....	—	61
Subtotal .....	194	343
<b>Assets pledged without ability for secured party to repledge</b>		
Available for sale .....	221	558
Trading .....	—	28
Subtotal .....	221	586
Total assets pledged .....	<u>\$ 415</u>	<u>\$929</u>

## Cash and Cash Equivalents

Table 5.7 summarizes the components of Cash and cash equivalents for the years ended December 31, 2004 and 2003, respectively.

**Table 5.7 — Cash and Cash Equivalents**

	December 31,	
	2004	2003
	(dollars in millions)	
Interest-bearing <sup>(1)</sup> .....	\$35,199	\$23,100
Non-interest-bearing .....	54	42
Total .....	<u>\$35,253</u>	<u>\$23,142</u>

(1) Includes collateral that Freddie Mac holds when its exposure to its derivative counterparties exceeds mutually agreed upon limits. Interest earned on the collateral is paid to the counterparties at the contractual rate, while Freddie Mac retains any interest earned above the contractual rate.

## NOTE 6: LOAN LOSS RESERVES

Freddie Mac maintains separate loan loss reserves for mortgage loans in the Retained portfolio that it classifies as held-for-investment and for credit-related losses associated with certain mortgage loans that underlie PCs held by third parties.

Table 6.1 summarizes loan loss reserve activity during 2004, 2003 and 2002.

**Table 6.1 — Detail of Loan Loss Reserves Balance**

	December 31,								
	2004			2003			2002		
	Reserves related to:			Reserves related to:			Reserves related to:		
	Retained Mortgages	PCs Outstanding	Total Loan Loss Reserves	Retained Mortgages	PCs Outstanding	Total Loan Loss Reserves	Retained Mortgages	PCs Outstanding	Total Loan Loss Reserves
	(dollars in millions)								
Beginning balance	\$ 174	\$125	\$ 299	\$ 177	\$ 88	\$ 265	\$ 103	\$121	\$ 224
Provision (benefit) for credit losses <sup>(1)</sup>	111	32	143	76	(81)	(5)	146	(24)	122
Charge-offs <sup>(2)</sup>	(300)	—	(300)	(224)	—	(224)	(171)	—	(171)
Recoveries <sup>(1)(2)</sup>	160	—	160	145	—	145	99	—	99
Adjustment for change in accounting <sup>(3)</sup>	—	—	—	—	110	110	—	—	—
Transfers-out during the period <sup>(4)</sup>	—	(20)	(20)	—	(11)	(11)	—	(9)	(9)
Other transfers, net, during the period <sup>(5)</sup>	(31)	13	(18)	—	19	19	—	—	—
Ending balance	<u>\$ 114</u>	<u>\$150</u>	<u>\$ 264</u>	<u>\$ 174</u>	<u>\$125</u>	<u>\$ 299</u>	<u>\$ 177</u>	<u>\$ 88</u>	<u>\$ 265</u>

- (1) Freddie Mac reclassified certain income for the full years ended December 31, 2003 and 2002 from REO operations income (expense) to Provision (benefit) for credit losses to conform with the 2004 presentation. In addition, it reclassified certain expenses related to uncollectible interest on PCs held by third parties from Management and guarantee income to Provision (benefit) for credit losses to conform with the 2004 presentation. This resulted in a \$15 million decrease and a \$6 million decrease in Provision (benefit) for credit losses during 2003 and 2002, respectively. As a result of these reclassifications, it increased recoveries by \$26 million and \$15 million for the full years ended December 31, 2003 and 2002, respectively.
- (2) It is Freddie Mac's practice to purchase mortgage loans from the pools that underlie PCs principally at the point the mortgage loan is identified as being 120 days past due. Upon repurchase, that portion of amounts classified in Reserve for guarantee losses on Participation Certificates that relates to a purchased loan is reclassified to Reserve for losses on mortgage loans held-for-investment, since all credit losses related to off-balance sheet PCs are preceded by the purchase of a delinquent mortgage loan from the PC pool, all charge-offs or recoveries are presented in the Retained Mortgages columns above.
- (3) On January 1, 2003, \$110 million of recognized guarantee obligations that was attributable to estimated incurred losses on outstanding PCs or Structured Securities was reclassified to Reserve for guarantee losses on Participation Certificates.
- (4) Represents the reclassification of the reserve amount attributable to uncollectible interest on outstanding PCs and Structured Securities which is included as an offset to the related receivable balance within Accounts and other receivables, net on the consolidated balance sheets.
- (5) Represents the reclassification of the portions of guarantee obligations recognized upon the sale of PCs or Structured Securities that corresponds to incurred credit losses reclassified to Reserve for guarantee losses on Participation Certificates upon initial recognition of a guarantee obligation. In addition, the 2004 amount includes a reduction of loan loss reserves of \$31 million related to prior period adjustments for which the related income was recorded in Other income.

### Impaired Loans

Total loan loss reserves, as presented in "Table 6.1 — Detail of Loan Loss Reserves Balance," consists of a specific valuation allowance related to impaired loans, which are presented in Table 6.2, and an additional reserve for other probable incurred losses which equaled \$261 million, \$289 million and \$240 million at December 31, 2004, 2003 and 2002, respectively. The company's recorded investment in impaired loans and the related valuation allowance are summarized in Table 6.2.

**Table 6.2 — Impaired Loans<sup>(1)</sup>**

	December 31,								
	2004			2003			2002		
	Recorded Investment <sup>(2)</sup>	Specific Reserve	Net Investment	Recorded Investment <sup>(2)</sup>	Specific Reserve	Net Investment	Recorded Investment <sup>(2)</sup>	Specific Reserve	Net Investment
	(dollars in millions)								
Impaired loans having:									
Related-valuation allowance .....	\$ 46	\$(3)	\$ 43	\$ 60	\$(10)	\$ 50	\$ 169	\$(25)	\$ 144
No related-valuation allowance <sup>(3)</sup> .....	2,261	—	2,261	2,309	—	2,309	2,077	—	2,077
Total .....	<u>\$2,307</u>	<u>\$(3)</u>	<u>\$2,304</u>	<u>\$2,369</u>	<u>\$(10)</u>	<u>\$2,359</u>	<u>\$2,246</u>	<u>\$(25)</u>	<u>\$2,221</u>

(1) Single-family impaired loans include performing and non-performing TDRs. Multifamily impaired loans are defined as performing and non-performing TDR loans, loans 60 days or more delinquent except for certain credit enhanced loans and certain mortgage loans with real estate collateral values less than the outstanding unpaid principal balances. For more details on multifamily impaired loans, see “NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES.”

(2) Recorded Investment includes the unpaid principal balance of mortgage loans plus other amortized basis adjustments, which are modifications to their carrying value.

(3) Impaired loans with no related valuation allowance primarily represent performing single-family TDR loans.

For the years ended December 31, 2004, 2003 and 2002, the average recorded investment in impaired loans was \$2,310 million, \$2,330 million and \$2,029 million, respectively.

Interest income on multifamily impaired loans is recognized on an accrual basis for loans performing under the original or restructured terms and on a cash basis for non-performing loans, which collectively totaled approximately \$13 million, \$16 million and \$22 million for the years ended December 31, 2004, 2003 and 2002, respectively. For single-family performing and non-performing loans, Freddie Mac recognizes interest income on an accrual basis and establishes reserves for estimated accrued, but uncollectible, interest for these loans as of the consolidated balance sheet dates. Gross interest income on impaired single-family loans totaled \$157 million, \$160 million and \$129 million for the years ended December 31, 2004, 2003 and 2002, respectively.

### Delinquency Rates

Table 6.3 summarizes the delinquency rates for Freddie Mac’s Total mortgage portfolio, excluding non-Freddie Mac mortgage-related securities and that portion of Structured Securities that is backed by Ginnie Mae Certificates at December 31, 2004, 2003 and 2002.

**Table 6.3 — Delinquency Performance<sup>(1)</sup>**

	December 31,		
	2004	2003	2002
Delinquencies, end of period			
Single-family: <sup>(2)</sup>			
Credit-enhanced portfolio <sup>(3)</sup> .....	2.75%	2.96%	2.07%
Non-credit-enhanced portfolio .....	0.24%	0.27%	0.28%
Total portfolio .....	0.73%	0.86%	0.77%
Multifamily <sup>(4)</sup> .....	0.06%	0.05%	0.13%

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

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

(3) Includes alternative collateral deals.

(4) Based on net carrying value of mortgages 60 days or more delinquent or in foreclosure.

## NOTE 7: REAL ESTATE OWNED

Table 7.1 provides a summary of Freddie Mac's REO activity.

Freddie Mac obtains REO properties when it is the highest bidder at foreclosure sales of properties that collateralize non-performing single-family and multifamily mortgage loans owned by the company. Upon acquiring single-family properties, Freddie Mac establishes a marketing plan to sell the property as soon as practicable by either listing it with a sales broker or by other means, such as arranging a real estate auction. Upon acquiring multifamily properties, Freddie Mac may operate them with third-party property-management firms for a period to stabilize value and then sell the properties through commercial real estate brokers. For each of the three years ended December 31, 2004, the weighted average holding period for single-family disposed REO properties was less than one year and the weighted average holding period for multifamily disposed REO properties was about two years.

**Table 7.1 — Real Estate Owned**

	REO, Gross	Valuation Allowance	REO, Net
(dollars in millions)			
Balance, December 31, 2001 .....	\$ 505	\$ (58)	\$ 447
Additions .....	1,197	(70)	1,127
Dispositions and write-downs .....	<u>(1,032)</u>	<u>52</u>	<u>(980)</u>
Balance, December 31, 2002 .....	670	(76)	594
Additions .....	1,663	(93)	1,570
Dispositions and write-downs .....	<u>(1,422)</u>	<u>53</u>	<u>(1,369)</u>
Balance, December 31, 2003 .....	911	(116)	795
Additions .....	1,641	(95)	1,546
Dispositions and write-downs .....	<u>(1,685)</u>	<u>85</u>	<u>(1,600)</u>
Balance, December 31, 2004 .....	<u>\$ 867</u>	<u>\$ (126)</u>	<u>\$ 741</u>

Freddie Mac recognized losses of \$67 million, \$50 million, and \$5 million on REO dispositions for the years ended December 31, 2004, 2003 and 2002, respectively, which are included in REO operations income (expense). Valuation allowance includes impairment write-downs on fair value of assets and selling expenses related to REO property holdings. This allowance is shown as part of REO operations income (expense) on the consolidated statements of income. Freddie Mac reclassified certain components of REO operations income (expense) for the years ended December 31, 2003 and 2002 to (Provision) benefit for credit losses to conform with the 2004 presentation.

## NOTE 8: DEBT SECURITIES AND SUBORDINATED BORROWINGS

Debt securities are classified as either Due within one year or Due after one year based on their remaining contractual maturity. Table 8.1 summarizes the balances and effective interest rates at December 31, 2004 and 2003 for debt securities, as well as subordinated borrowings.

**Table 8.1 — Total Debt Securities, Net**

	December 31,			
	2004		2003	
	Balance, Net <sup>(1)</sup>	Effective Rate <sup>(2)</sup>	Balance, Net <sup>(1)</sup>	Effective Rate <sup>(2)</sup>
	(dollars in millions)			
Senior debt, due within one year:				
Short-term debt securities <sup>(3)</sup> .....	\$196,639	2.05%	\$212,035	1.11%
Current portion of long-term debt .....	<u>85,664</u>	3.33	<u>83,227</u>	3.61
Senior debt, due within one year .....	282,303	2.44	295,262	1.81
Senior debt, due after one year .....	443,772	4.36	438,738	4.34
Subordinated debt, due after one year .....	<u>5,622</u>	6.15	<u>5,613</u>	6.15
Senior and subordinated debt, due after one year .....	<u>449,394</u>	4.38	<u>444,351</u>	4.36
Total debt securities, net .....	<u>\$731,697</u>		<u>\$739,613</u>	

(1) Includes unamortized discounts and premiums. Current portion of long-term debt, and Senior and subordinated debt, due after one year, also include foreign-currency-related and hedging-related basis adjustments.

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

(3) Effective rate previously reported for December 31, 2003 has been revised.

Freddie Mac finances the purchase of mortgage loans and mortgage-related securities primarily through the issuance of Senior debt and Subordinated debt.

### Senior Debt, Due Within One Year

As indicated in Table 8.2, a majority of Senior debt, due within one year (excluding current portion of long-term debt) consisted of discount notes, paying only principal at maturity. Discount notes and medium-term notes are unsecured general obligations. Certain medium-term notes that have original maturities of one year or less are classified as Short-term debt securities. Securities sold under agreements to repurchase are effectively collateralized borrowing transactions where Freddie Mac sells securities with an agreement to repurchase such securities. These agreements require the underlying securities to be delivered to the dealers who arranged the transactions. Federal funds purchased are unsecuritized borrowings from commercial banks that are members of the Federal Reserve System.

Table 8.2 provides additional information related to Freddie Mac's debt securities due within one year.

**Table 8.2 — Senior Debt, Due Within One Year**

	2004				
	At December 31,		Average Outstanding During the Year		Maximum Balance, Net Outstanding at Any Month End
	Balance, Net	Weighted Average Effective Rate <sup>(1)</sup>	Balance, Net <sup>(2)</sup>	Weighted Average Effective Rate <sup>(3)</sup>	
	(dollars in millions)				
Discount notes . . . . .	\$180,198	2.04%	\$184,834	1.40%	\$212,715
Medium-term notes . . . . .	162	2.51	4,289	1.31	5,320
Securities sold under agreements to repurchase and Federal funds purchased	—	—	801	1.37	3,046
Swap collateral obligations . . . . .	<u>16,279</u>	2.24	13,549	1.36	16,279
Short-term debt securities . . . . .	196,639				
Current portion of long-term debt . . . . .	<u>85,664</u>				
Senior debt, due within one year . . . . .	<u><u>\$282,303</u></u>				
	2003				
	At December 31,		Average Outstanding During the Year		Maximum Balance, Net Outstanding at Any Month End
	Balance, Net	Weighted Average Effective Rate <sup>(1)</sup>	Balance, Net <sup>(2)</sup>	Weighted Average Effective Rate <sup>(3)</sup>	
	(dollars in millions)				
Discount notes <sup>(4)</sup> . . . . .	\$188,309	1.12%	\$207,374	1.21%	\$264,370
Medium-term notes . . . . .	5,300	1.18	1,243	1.32	5,300
Securities sold under agreements to repurchase and Federal funds purchased <sup>(5)</sup> . . . . .	1,611	0.96	2,283	0.94	8,296
Swap collateral obligations <sup>(6)</sup> . . . . .	16,082	1.02	11,694	1.13	16,082
Securities sold, not yet purchased . . . . .	<u>733</u>				
Short-term debt securities . . . . .	212,035				
Current portion of long-term debt . . . . .	<u>83,227</u>				
Senior debt, due within one year . . . . .	<u><u>\$295,262</u></u>				

- (1) Represents the weighted average effective rate at the end of the period, which includes the amortization of discounts or premiums and issuance costs, but excludes the amortization of foreign-currency-related and hedging-related basis adjustments.
- (2) Includes unamortized discounts or premiums and issuance costs. Issuance costs are reported in the Other assets caption on the consolidated balance sheets.
- (3) Represents the approximate weighted average effective rate during the period, which includes the amortization of discounts or premiums and issuance costs, but excludes the amortization of foreign-currency-related and hedging-related basis adjustments.
- (4) Maximum Balance, Net Outstanding at Any Month End for 2003 has been revised to conform with the 2004 presentation.
- (5) Balance, Net and Weighted Average Effective Rate for Average Outstanding During the Year for 2003 have been revised for Securities sold under agreements to repurchase and Federal funds purchased to conform with the 2004 presentation.
- (6) Weighted Average Effective Rate at December 31, 2003 has been revised to conform with the 2004 presentation.

## Senior and Subordinated Debt, Due After One Year

Table 8.3 summarizes Freddie Mac's Senior and Subordinated debt, due after one year at December 31, 2004 and 2003.

**Table 8.3 — Senior and Subordinated Debt, Due After One Year**

	Contractual Maturity <sup>(1)</sup>	December 31,			
		2004		2003	
		Balance Outstanding <sup>(2)</sup>	Interest Rates	Balance Outstanding <sup>(2)</sup>	Interest Rates
(dollars in millions)					
Senior debt, due after one year <sup>(3)</sup> :					
Fixed-rate:					
Medium-term notes — Callable <sup>(4)</sup>	2006 - 2029	\$180,957	1.63% - 8.05%	\$159,939	1.30% - 9.00%
Medium-term notes — Non-callable	2006 - 2028	8,587	1.00% - 7.69%	6,460	1.00% - 8.12%
U.S. dollar-denominated Reference Notes® securities	2006 - 2032	167,622	1.88% - 7.00%	181,901	1.50% - 7.00%
€Reference Notes® securities	2006 - 2014	28,967	3.50% - 5.75%	24,954	3.50% - 5.75%
Other <sup>(5)</sup>	N/A	—	N/A	6	12.10% - 12.90%
Floating-rate:					
Medium-term notes — Callable <sup>(6)</sup>	2006 - 2030	33,041	Various	28,412	Various
Medium-term notes — Non-callable <sup>(5)(7)</sup>	2007 - 2026	1,207	Various	16,440	Various
Zero-coupon <sup>(8)</sup> :					
Medium-term notes — Callable	2014 - 2034	7,078	0%	6,608	0%
Medium-term notes — Non-callable	2006 - 2034	1,968	0%	1,723	0%
Foreign-currency-related and hedging-related basis adjustments		14,345		12,295	
Total senior debt, due after one year		443,772		438,738	
Subordinated debt, due after one year:					
Fixed-rate <sup>(9)</sup>	2011 - 2016	5,547	5.25% - 8.25%	5,545	5.25% - 8.25%
Zero-coupon <sup>(8)</sup>	2019	75	0%	68	0%
Total subordinated debt, due after one year		5,622		5,613	
Total senior and subordinated debt, due after one year		<u>\$449,394</u>		<u>\$444,351</u>	

(1) Represents contractual maturities at December 31, 2004.

(2) Represents unpaid principal balance of long-term debt securities and subordinated borrowings, net of associated discounts or premiums.

(3) For debt denominated in a currency other than the U.S. dollar, the outstanding balance is based on the exchange rate at the date of the debt issuance. Subsequent changes in exchange rates are reflected in Foreign-currency-related and hedging-related basis adjustments.

(4) Includes callable Estate Notes<sup>SM</sup> and Freddie Notes<sup>SM</sup> of \$11,850 million and \$11,041 million at December 31, 2004 and 2003, respectively. These debt instruments represent medium-term notes that permit persons acting on behalf of deceased beneficial owners to require Freddie Mac to repay principal prior to their contractual maturity date.

(5) Amounts for 2003 have been revised to conform with the 2004 presentation.

(6) Includes callable Estate Notes<sup>SM</sup> and Freddie Notes<sup>SM</sup> of \$6,142 million and \$4,132 million at December 31, 2004 and 2003, respectively. See related footnote (4) above concerning the nature of these debt instruments.

(7) Includes medium-term notes of \$800 million and \$700 million at December 31, 2004 and 2003, respectively, which are repayable in whole or in part at the option of the beneficial owner, acting through the holder, on or after November 22, 2002 and prior to November 20, 2007 at 100% of the principal amount plus accrued interest.

(8) Balance outstanding is net of associated discounts of \$32,649 million and \$37,870 million as of December 31, 2004 and 2003, respectively.

(9) Includes callable subordinated debt of \$3,491 million and \$3,490 million at December 31, 2004 and 2003, respectively.

A portion of Freddie Mac's long-term debt is callable. Callable debt gives Freddie Mac the option to redeem the debt security on one or more specified call dates or at any time on or after a specified call date. Table 8.4 summarizes the maturities, balances and effective interest rates at December 31, 2004 for callable debt (including current portion of callable debt and callable debt due after one year) by estimated call period.

**Table 8.4 — Callable Debt, Due After One Year (including current portion of callable debt)**

<u>Estimated Call Period</u>	<u>Contractual Maturity</u>	<u>Balance Outstanding<sup>(1)</sup></u>	<u>Effective Rate<sup>(2)</sup></u>
		(dollars in millions)	
2005 .....	2005 - 2022	\$ 20,255	2.84%
2006 .....	2006 - 2021	39,316	2.63
2007 .....	2007 - 2019	37,425	3.15
2008 .....	2008 - 2019	23,953	3.46
2009 .....	2009 - 2019	26,798	4.03
Thereafter .....	2010 - 2034	91,512	5.09
Total .....		<u>\$239,259</u>	3.91%

- (1) Represents unpaid principal balance of callable long-term debt securities and subordinated borrowings. However, callable zero-coupon debt is reflected on a net basis (*i.e.*, net of associated discounts of \$28,825 million) and its estimated call period is based on contractual maturity.
- (2) Represents the weighted-average effective rate at the end of the period, which includes the amortization of discounts or premiums and issuance costs but excludes the amortization of foreign-currency-related and hedging-related basis adjustments.

Table 8.5 summarizes the contractual maturities of long-term debt securities (including current portion of long-term debt) and subordinated borrowings outstanding at December 31, 2004, assuming callable debt is paid at contractual maturity.

**Table 8.5 — Senior and Subordinated Debt, Due After One Year (including current portion of long-term debt)**

<u>Annual Maturities</u>	<u>Contractual Maturity<sup>(1)(2)</sup></u>
	(dollars in millions)
2005 .....	\$ 83,625
2006 .....	83,447
2007 .....	64,838
2008 .....	46,092
2009 .....	55,574
Thereafter .....	<u>218,131</u>
Total <sup>(1)</sup> .....	551,707
Net premiums, discounts, and foreign-currency-related and hedging-related basis adjustments <sup>(2)</sup> .....	<u>(16,649)</u>
Senior and subordinated debt, due after one year, including current portion of long-term debt .....	<u>\$535,058</u>

- (1) Represents unpaid principal balance of long-term debt securities and subordinated borrowings.
- (2) For debt denominated in a currency other than the U.S. dollar, the outstanding balance is based on the exchange rate at the date of the debt issuance. Subsequent changes in exchange rates are reflected in Net premiums, discounts, and foreign-currency-related and hedging-related basis adjustments.

Freddie Mac records gains and losses on debt repurchases that are accounted for as extinguishments of debt based on the difference between the principal amount of the debt securities repurchased (adjusted for deferred premiums, discounts, and hedging gains and losses) and current market prices, and the write-off of related deferred debt issuance costs. Freddie Mac incurred pre-tax losses of \$327 million, \$1,775 million and \$674 million on the repurchase of approximately \$14.5 billion, \$27.3 billion and \$20.3 billion in principal amount of debt outstanding in 2004, 2003 and 2002, respectively.



## NOTE 9: STOCKHOLDERS' EQUITY

### Preferred Stock

During 2004 and 2003, Freddie Mac completed no preferred stock offerings (see “Table 9.1 — Preferred Stock” for more information). All 17 classes of preferred stock outstanding at December 31, 2004 have a par value of \$1 per share. The company has the option to redeem these shares, on specified dates, at their redemption price plus dividends accrued through the redemption date. In addition, all 17 classes of preferred stock are perpetual and non-cumulative, and carry no significant voting rights or rights to purchase additional Freddie Mac stock or securities. Costs incurred in connection with the issuance of preferred stock are charged to Additional paid-in capital.

Table 9.1 provides a summary of Freddie Mac’s preferred stock outstanding at December 31, 2004.

**Table 9.1 — Preferred Stock**

	Issue Date	Shares Authorized	Shares Outstanding	Total Par Value	Redemption Price per Share	Total Outstanding Balance <sup>(1)</sup>	Redeemable <sup>(2)</sup> On or After	NYSE Symbol <sup>(3)</sup>
(shares and dollars in millions, except redemption price per share)								
1996 Variable-rate <sup>(4)</sup> . . .	April 26, 1996	5.00	5.00	\$ 5.00	\$50.00	\$ 250	June 30, 2001	FRE.prB
6.14% . . . . .	June 3, 1997	12.00	12.00	12.00	50.00	600	June 30, 2002	FRE.prD
5.81% . . . . .	October 27, 1997	3.00	3.00	3.00	50.00	150	October 27, 1998	(5)
5% . . . . .	March 23, 1998	8.00	8.00	8.00	50.00	400	March 31, 2003	FRE.prF
1998 Variable-rate <sup>(6)</sup> . . .	September 23 and 29, 1998	4.40	4.40	4.40	50.00	220	September 30, 2003	FRE.prG
5.1% . . . . .	September 23, 1998	8.00	8.00	8.00	50.00	400	September 30, 2003	FRE.prH
5.3% . . . . .	October 28, 1998	4.00	4.00	4.00	50.00	200	October 30, 2000	(5)
5.1% . . . . .	March 19, 1999	3.00	3.00	3.00	50.00	150	March 31, 2004	(5)
5.79% . . . . .	July 21, 1999	5.00	5.00	5.00	50.00	250	June 30, 2009	FRE.prK
1999 Variable-rate <sup>(7)</sup> . . .	November 5, 1999	5.75	5.75	5.75	50.00	287	December 31, 2004	FRE.prL
2001 Variable-rate <sup>(8)</sup> . . .	January 26, 2001	6.50	6.50	6.50	50.00	325	March 31, 2003	FRE.prM
2001 Variable-rate <sup>(9)</sup> . . .	March 23, 2001	4.60	4.60	4.60	50.00	230	March 31, 2003	FRE.prN
5.81% . . . . .	March 23, 2001	3.45	3.45	3.45	50.00	173	March 31, 2011	FRE.prO
6% . . . . .	May 30, 2001	3.45	3.45	3.45	50.00	173	June 30, 2006	FRE.prP
2001 Variable-rate <sup>(10)</sup> . . .	May 30, 2001	4.02	4.02	4.02	50.00	201	June 30, 2003	FRE.prQ
5.7% . . . . .	October 30, 2001	6.00	6.00	6.00	50.00	300	December 31, 2006	FRE.prR
5.81% . . . . .	January 29, 2002	6.00	6.00	6.00	50.00	300	March 31, 2007	(5)
Total . . . . .		<u>92.17</u>	<u>92.17</u>	<u>\$92.17</u>		<u>\$4,609</u>		

- (1) Amounts stated at redemption value.
- (2) As long as the capital monitoring framework established by the Office of Federal Housing Enterprise Oversight (“OFHEO”) in January 2004 remains in effect, any preferred stock redemption will require prior approval by OFHEO. See “NOTE 10: REGULATORY CAPITAL” for more information.
- (3) Preferred Stock is listed on the New York Stock Exchange (“NYSE”), unless otherwise noted.
- (4) The dividend rate resets quarterly and is equal to the sum of the three-month LIBOR plus one percent divided by 1.377, and is capped at 9.00 percent.
- (5) Not listed on any exchange.
- (6) The dividend rate resets quarterly and is equal to the sum of the three-month LIBOR rate plus one percent divided by 1.377, and is capped at 7.50 percent.
- (7) Initial dividend rate is 5.97 percent per annum through December 31, 2004. Dividend rate resets on January 1, 2005 and on January 1 every five years thereafter based on a five-year constant maturity Treasury (“CMT”) rate which is capped at 11.00 percent. Optional redemption on December 31, 2004 and on December 31 every five years thereafter.
- (8) Dividend rate resets on April 1 every two years after April 1, 2003 based on the two-year CMT rate plus 0.10 percent and is capped at 11.00 percent. Optional redemption on March 31, 2003 and on March 31 every two years thereafter.
- (9) Dividend rate resets on April 1 every year based on the 12-month LIBOR rate minus 0.20 percent and is capped at 11.00 percent. Optional redemption on March 31, 2003 and on March 31 every year thereafter.
- (10) Dividend rate resets on July 1 every two years after July 1, 2003 based on the two-year CMT rate plus 0.20 percent and is capped at 11.00 percent. Optional redemption on June 30, 2003 and on June 30 every two years thereafter.

### Common Stock Repurchase Program

In September 1997, Freddie Mac’s Board of Directors authorized the company to repurchase up to five percent, or approximately 34 million shares, of its common stock outstanding as of September 5, 1997. Under this authorization, Freddie Mac repurchased no outstanding shares in 2004 and 2003 and 9.1 million outstanding shares in 2002. At December 31, 2004, approximately 13 million common shares remained available for repurchase under this authorization. Common stock repurchases are considered (assuming current financial reporting) when Freddie Mac is adequately capitalized and other more attractive investment opportunities are not available. Under OFHEO’s January 29, 2004 framework for monitoring Freddie Mac’s capital, Freddie Mac is currently required to obtain prior written approval from the Director of OFHEO before engaging in certain capital transactions, including the repurchase of any shares of common stock. See “NOTE 10: REGULATORY CAPITAL” for more information.

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## NOTE 10: REGULATORY CAPITAL

The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (“GSE Act”) established risk-based, minimum and critical capital standards for Freddie Mac and Fannie Mae.

The risk-based capital standard determines the amount of capital that Freddie Mac must hold to absorb projected losses resulting from future adverse interest-rate and credit-risk conditions specified by the GSE Act, plus 30 percent mandated by the GSE Act to cover management and operations risk. The risk-based capital standard is based on stress test results calculated under two interest-rate scenarios prescribed by the GSE Act, one in which 10-year Treasury yields rise by as much as 75 percent (up-rate scenario) and one in which they fall by as much as 50 percent (down-rate scenario). The credit component of the stress tests simulates the performance of Freddie Mac’s mortgage portfolio based on loss rates for the Benchmark Region. The criteria for the Benchmark Region are set forth by the GSE Act and are intended to capture the region that experienced the highest historical rates of default and severity of mortgage losses for two consecutive origination years. The risk-based capital requirement is the amount of Total capital needed to absorb the stress test losses in the most adverse scenario, plus 30 percent of that amount to cover management and operations risk. Total capital includes Core capital and general reserves for mortgage and foreclosure losses and any other amounts available to absorb losses that OFHEO includes by regulation. Core capital consists of the par value of outstanding common stock (common stock issued less common stock held in treasury), the par value of outstanding perpetual noncumulative preferred stock, additional paid-in capital and retained earnings, as determined in accordance with GAAP.

The minimum capital standard requires Freddie Mac to hold an amount of Core capital that is generally the sum of 2.50 percent of aggregate on-balance sheet assets, as determined in accordance with GAAP, and approximately 0.45 percent of outstanding mortgage-related securities guaranteed by Freddie Mac and other aggregate off-balance sheet obligations. As discussed below, in 2004 OFHEO implemented a framework for monitoring Freddie Mac’s capital adequacy, which includes a targeted capital surplus of 30 percent of its minimum capital requirement.

The critical capital standard requires Freddie Mac to hold an amount of Core capital that is generally the sum of 1.25 percent of aggregate on-balance sheet assets, as determined in accordance with GAAP, and approximately 0.25 percent of outstanding mortgage-related securities guaranteed by Freddie Mac and other aggregate off-balance sheet obligations.

OFHEO is required to classify Freddie Mac’s capital adequacy not less than quarterly.

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.” Under OFHEO regulations, the company will be deemed “significantly undercapitalized” if it fails to meet the minimum capital requirement but exceeds the critical capital requirement. If Freddie Mac fails to meet the critical capital standard, Freddie Mac must be classified as “critically undercapitalized.” OFHEO retains discretion to reduce Freddie Mac’s capital classification by one level if OFHEO determines that Freddie Mac is engaging in conduct not approved by OFHEO that could result in a rapid depletion of Core capital or that the value of property subject to mortgage loans held or secured by Freddie Mac has decreased significantly.

OFHEO has never classified Freddie Mac as other than “adequately capitalized,” the highest possible classification. When Freddie Mac is classified as adequately capitalized, the company can generally pay a dividend on its common or preferred stock without prior OFHEO approval so long as the payment would not decrease Total capital to an amount less than its risk-based capital requirement and would not decrease the company’s Core capital to an amount less than the minimum capital requirement.

If Freddie Mac were classified as undercapitalized, the company would be prohibited from making a capital distribution (which includes common and preferred dividend payments, common stock repurchases and preferred stock redemptions) that would decrease its Core capital to an amount less than the minimum capital requirement. Freddie Mac also would be required to submit a capital restoration plan for OFHEO approval, which could adversely affect its ability to make capital distributions.

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If Freddie Mac were classified as significantly undercapitalized, the company would be able to make a capital distribution only if OFHEO determined that the distribution satisfied certain statutory standards. Under these circumstances, Freddie Mac would be prohibited from making any capital distribution that would decrease its Core capital to less than the critical capital level, and OFHEO also could take action to limit Freddie Mac's growth, require it to acquire new capital or restrict it from activities that create excessive risk. Freddie Mac also would be required to submit a capital restoration plan for OFHEO approval, which could adversely affect its ability to make capital distributions.

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.

Factors that may adversely affect the adequacy of Freddie Mac's regulatory capital include declines in GAAP income, increases in the company's risk profile, and changes in the economic environment, such as large interest-rate or implied volatility moves or house price declines. In particular, interest-rate levels or implied volatility can affect the amount of Freddie Mac's Core capital, even if Freddie Mac is economically well hedged against interest-rate changes, because certain gains or losses are recognized through GAAP earnings while other offsetting gains or losses may not be.

Table 10.1 summarizes the company's regulatory capital requirements and surpluses at December 31, 2004 and 2003. Amounts for 2004 are as currently reported to OFHEO.

**Table 10.1 — Regulatory Capital Requirements**

	December 31,	
	2004	2003
	(dollars in millions)	
<i>Minimum capital requirement</i> <sup>(1)</sup> .....	\$24,131	\$23,774
Core capital <sup>(1)(2)</sup> .....	35,009	32,985
Minimum capital surplus <sup>(1)</sup> .....	10,878	9,211
 <i>Critical capital requirement</i> <sup>(1)</sup> .....	 12,308	 12,097
Core capital <sup>(1)(2)</sup> .....	35,009	32,985
Critical capital surplus <sup>(1)</sup> .....	22,701	20,888
 <i>Risk-based capital requirement</i> <sup>(3)</sup> .....	 11,108	 5,426
Total capital <sup>(3)(4)</sup> .....	34,691	33,436
Risk-based capital surplus <sup>(3)</sup> .....	23,583	28,010

(1) OFHEO is the authoritative source of the capital calculations that underlie the company's capital classifications. For 2004, Freddie Mac amended the minimum and critical capital requirements, core capital and surplus amounts previously reported to OFHEO to incorporate adjustments reflected in Freddie Mac's consolidated financial statements. The 2004 minimum and critical capital requirements, core capital and surplus amounts are estimates and have been revised to reflect changes related to a closing agreement entered into with the Internal Revenue Service ("IRS") concerning the company's REIT subsidiaries. See "NOTE 14: INCOME TAXES" for further information.

(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 noncumulative 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 issuance of Freddie Mac's 2004 and 2003 financial results. 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.

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

On January 29, 2004, OFHEO announced the creation of a framework for monitoring Freddie Mac's capital due to the temporarily higher operational risk arising from the company's current inability to produce timely financial statements in accordance with GAAP. The framework includes a target capital surplus of 30 percent of Freddie Mac's minimum capital requirement, subject to certain conditions and variations; weekly monitoring; and prior approval of certain capital transactions, to verify that appropriate levels of capital are maintained. At December 31, 2004, Freddie Mac's estimated surplus in excess of the target surplus was approximately \$3.6 billion. Had the target capital surplus been in effect at December 31, 2003, Freddie Mac's estimated surplus in excess of the target surplus would have been approximately \$2.1 billion.

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A failure by Freddie Mac to meet the target capital surplus would result in discussions between Freddie Mac and OFHEO concerning the reason for such failure. If OFHEO were to determine, based on these discussions and weekly monitoring, that Freddie Mac had unreasonably deviated from the framework established by OFHEO, the company would be required to submit a remedial plan or take other remedial steps.

In addition, Freddie Mac is required to obtain prior written approval from the Director of OFHEO before engaging in certain capital transactions, including the repurchase of any shares of common stock, redemption of any preferred stock or payment of preferred stock dividends above stated contractual rates. Freddie Mac also must submit a written report to the Director of OFHEO after the declaration, but before the payment, of any dividend on its common stock. The report must contain certain information on the amount of the dividend, the rationale for the payment and the impact on Freddie Mac's capital surplus.

OFHEO indicated that this framework is temporary and will be lifted when the Director of OFHEO determines that it should expire, based on Freddie Mac's reduction of operational risks, resumption of timely regulatory reporting that complies with GAAP and certain other factors.

Management believes that this monitoring framework will provide OFHEO with a mechanism to ensure that the company manages its business with continued prudence and appropriate levels of capital, taking into account that the company is not currently able to produce timely financial statements.

## NOTE 11: STOCK-BASED COMPENSATION

Freddie Mac has three stock-based compensation plans under which grants are currently being made: the ESPP, as amended and restated in 2004, the 2004 Stock Compensation Plan (the “2004 Employee Plan”) and the 1995 Directors’ Stock Compensation Plan, as amended and restated in 1998 (“Directors’ Plan”). Prior to the stockholder approval of the 2004 Employee Plan on November 4, 2004, employee stock-based compensation was awarded in accordance with the terms of the stockholder-approved 1995 Stock Compensation Plan (the “1995 Employee Plan”). Freddie Mac collectively refers to the 2004 Employee Plan and 1995 Employee Plan as the “Employee Plans.”

Common stock delivered under these plans may be shares currently held by Freddie Mac as treasury stock, shares purchased by Freddie Mac in the open market or authorized but previously unissued shares.

**ESPP:** Freddie Mac has established a stockholder-approved ESPP that is qualified under Internal Revenue Code (“IRC”) Section 423. Under the ESPP, substantially all full-time and part-time employees may purchase shares of common stock at a discount. During 2004, 2003 and 2002, the annual maximum market value of stock available for purchase was \$20,000 per employee as determined on the subscription (grant) date. For grants made through 2004, the purchase price was equal to 85 percent of the average price of the stock on the subscription (grant) date or the average price of the stock on the purchase (exercise) date, whichever was lower.

The maximum number of shares of common stock authorized to be granted to employees under the ESPP prior to the effective date of the 2004 amendment and restatement was 12 million shares. At December 31, 2004, approximately 8.8 million shares had been issued under the ESPP and approximately 3.2 million shares remained available for grant. Grants under the ESPP in effect prior to its amendment and restatement ceased pursuant to its terms on December 31, 2004. On November 4, 2004, stockholders approved the amendment and restatement of the ESPP effective as of January 1, 2005. The restated ESPP authorizes granting 3.6 million shares in addition to the remaining 3.2 million shares discussed above. The amended and restated ESPP changes the expiration date to January 1, 2015.

Table 11.1 provides a summary of activity related to the ESPP.

**Table 11.1 — Summary of ESPP Activity**

	Year Ended December 31,		
	2004	2003	2002
Shares pledged <sup>(1)</sup> .....	250,899	145,866	1,000,370
Fair value on grant date <sup>(2)</sup> .....	\$ 11.23	\$ 10.72	\$ 13.53
Shares purchased <sup>(1)</sup> .....	244,625	355,485	351,629
Purchase price <sup>(3)</sup> .....	\$ 50.53	\$ 41.76	\$ 51.74

- (1) Beginning in August 2003, employees pledged to purchase shares every three months with the purchase occurring three months later. Prior to August 2003, employees pledged to purchase shares on August 1 with purchase occurring on July 31 of the following year. As such, a portion of the shares purchased in a given year may relate to shares pledged in the previous year.
- (2) Represents the fair value of ESPP options granted to employees. The 2004 fair value is the weighted average of the fair values on four separate grant dates. The 2003 fair value is the weighted average of the fair values on two separate grant dates and the 2002 fair value is the fair value on a single grant date.
- (3) The 2004 purchase price is the weighted average of the purchase prices on four separate purchase dates. The 2003 purchase price is the weighted average of the purchase prices on two separate purchase dates and the 2002 purchase price is the purchase price on a single purchase date.

**Employee Plans:** Under the 2004 Employee Plan, Freddie Mac is permitted to grant to employees stock-based awards, including stock options with dividend equivalent rights, Restricted Stock Units (“RSUs”) with dividend equivalent rights, restricted stock and Stock Appreciation Rights (“SARs”). Such awards are generally forfeitable for at least one year after the date of grant, with vesting provisions contingent upon service requirements. In addition, Freddie Mac has the right to impose performance conditions with respect to any awards under the 2004 Employee Plan. As of December 31, 2004, no SARs had been granted under the Employee Plans.

- Stock options granted under the Employee Plans allow for the purchase of Freddie Mac’s common stock at an exercise price equal to the fair value of the common stock on the grant date. Options generally may be exercised for a period of 10 years from the grant date, subject to a vesting schedule

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commencing on the grant date. Dividend equivalent rights provide participants with the right to receive, at the time stock options are exercised or upon expiration, an amount equal to the accumulated dividends declared on the stock from the date the options were granted.

- Each RSU entitles the participant to receive one share of common stock at a specified future date. RSUs do not have voting rights, but do have dividend equivalent rights, which are paid to the RSU holder as and when dividends on common stock are declared.
- Restricted stock entitles participants to all the rights of a stockholder, including dividends, except that the shares awarded are subject to a risk of forfeiture and may not be disposed of by the participant until the end of the restriction period established by Freddie Mac at the grant of the restricted stock.

The maximum number of shares of common stock authorized to be granted to employees under the 2004 Employee Plan is 12.9 million shares, which includes approximately 2.8 million remaining shares plus any future forfeited, cancelled or surrendered shares from the 1995 Employee Plan. At December 31, 2004, fewer than 0.1 million shares had been issued and approximately 12.9 million shares remained available for grant. Grants under the 2004 Employee Plan will cease upon the earlier of the exhausting of the authorized share pool or November 4, 2014.

**Directors' Plan:** Under the stockholder-approved Directors' Plan, Freddie Mac is permitted to grant stock options with dividend equivalent rights, restricted stock and RSUs with dividend equivalent rights to non-employee members of the Board of Directors ("Directors").

Under the Directors' Plan, on the date of the annual meeting, each reelected or reappointed Director is granted an option to purchase shares of Freddie Mac's common stock with a market value of approximately \$150,000 on the date of the grant. Each such Director also receives restricted stock units relating to common stock with a market value of approximately \$65,000 on the date of the award. The number of restricted stock units and shares subject to a stock option are calculated by dividing the dollar amount of the award by the market value of Freddie Mac's common stock on the date of grant. Through 2004, vesting with respect to both stock options and restricted stock units occurred in even increments over five terms on the Board, with 20 percent vesting at the end of every term of office, unless vesting was accelerated under certain circumstances including death, disability or retirement from the Board. A term is defined as the period between annual stockholders' meetings. Effective January 1, 2005 and thereafter, vesting occurs in even increments over four terms.

Through 2004, on the date of the annual meeting (or for new Directors elected by the Board or appointed by the President between annual meetings, the first meeting attended after their election or appointment), newly elected and newly appointed Directors received an option to purchase shares with a market value of approximately \$300,000 and restricted stock units relating to common stock with a market value on the date of grant of approximately \$130,000. During their second term of service, those Directors were not eligible to receive any additional grants. Beginning in 2005, newly elected or appointed Directors will receive the same grants as other Directors and they will be eligible to receive similar grants in their second term.

For Directors, stock options and restricted stock units have dividend equivalent rights that entitle the grantee to dividend equivalents on each share subject to the grant in the amount of dividends per share payable on Freddie Mac's outstanding shares of common stock. Dividend equivalents on stock options are accrued and are payable in cash upon exercise or expiration of the option. Dividend equivalents on restricted stock units are accrued as additional restricted stock units to be settled at the same time as the underlying restricted stock units.

The maximum number of shares of common stock authorized for grant to Directors under the Directors' Plan is 2.4 million shares. At December 31, 2004, a total of approximately 0.8 million shares had been issued and approximately 1.6 million shares remained available for grant. Grants under the Directors' Plan will cease upon the earlier of exhaustion of the authorized share pool or Freddie Mac's Annual Meeting of Stockholders in 2008.

See "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES," for a description of the accounting treatment for employee stock-based compensation, including grants under the ESPP and

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Employee Plans. The accounting for stock options with dividend equivalent rights, restricted stock and RSUs granted under the Directors' Plan is identical to that of the Employee Plans.

Table 11.2 provides a summary of activity related to stock options under the Employee Plans and the Directors' Plan.

**Table 11.2 — Employee Plans and Directors' Plan Stock Options Activity**

	Year Ended December 31,					
	2004		2003		2002	
	Stock Options	Weighted Average Exercise Price	Stock Options	Weighted Average Exercise Price	Stock Options	Weighted Average Exercise Price
Outstanding, beginning of year . . . . .	8,656,340	\$46.89	9,231,105	\$44.21	8,721,962	\$37.56
Granted . . . . .	1,343,554	61.09	1,216,442	53.28	1,686,285	64.12
Exercised . . . . .	(1,861,617)	29.06	(1,052,156)	23.12	(997,127)	18.44
Forfeited or expired . . . .	(510,336)	58.84	(739,051)	57.18	(180,015)	51.52
Outstanding, end of year	<u>7,627,941</u>	<u>\$52.94</u>	<u>8,656,340</u>	<u>\$46.89</u>	<u>9,231,105</u>	<u>\$44.21</u>
Options exercisable at year-end . . . . .	4,018,666	\$47.46	4,755,640	\$38.23	4,508,095	\$29.60
Weighted-average fair value of options granted during year . . .	\$ 25.04		\$ 21.84		\$ 28.13	

Table 11.3 provides a summary of activity related to restricted stock and RSUs under the Employee Plans and the Directors' Plan.

**Table 11.3 — Employee Plans and Directors' Plan Restricted Stock and RSU Activity**

	Year Ended December 31,					
	2004		2003		2002	
	Restricted Stock	Restricted Stock Units	Restricted Stock	Restricted Stock Units	Restricted Stock	Restricted Stock Units
Outstanding, beginning of year . . . . .	566,635	1,295,722	1,089,327	359,227	1,478,779	51,632
Granted <sup>(1)</sup> . . . . .	—	698,587	—	1,146,164	—	325,902
Lapse of restrictions . . . . .	(240,514)	(145,340)	(381,103)	(114,240)	(383,199)	(10,457)
Forfeited . . . . .	(161,340)	(224,341)	(141,589)	(95,429)	(6,253)	(7,850)
Outstanding, end of year . . . . .	<u>164,781</u>	<u>1,624,628</u>	<u>566,635</u>	<u>1,295,722</u>	<u>1,089,327</u>	<u>359,227</u>
Weighted-average fair value of awards granted during year . . . . .		\$ 62.97		\$ 55.01		\$ 64.22

(1) RSUs granted under the Employee Plans were 673,720, 1,143,810 and 313,740 in 2004, 2003 and 2002, respectively. RSUs granted under the Directors' Plan were 24,867, 2,354 and 12,162 in 2004, 2003 and 2002, respectively.

Table 11.4 provides additional information for stock options outstanding under the Employee Plans and the Directors' Plan at December 31, 2004 by range of exercise prices.

**Table 11.4 — Employee Plans and Directors' Plan Stock Options Outstanding**

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Outstanding at December 31, 2004	Weighted Average Remaining Contract Life in Years	Weighted Average Exercise Price	Exercisable at December 31, 2004	Weighted Average Exercise Price
\$9.00 to 14.99 .....	7,960	0.2	\$14.67	7,960	\$14.67
15.00 to 24.99 .....	648,812	1.1	19.81	648,812	19.81
25.00 to 34.99 .....	369,271	2.4	34.22	369,271	34.22
35.00 to 44.99 .....	919,490	5.0	41.56	695,809	41.60
45.00 to 54.99 .....	1,610,027	6.0	50.69	679,337	47.54
55.00 to 64.99 .....	3,102,483	7.1	62.13	1,057,661	62.38
65.00 to 68.99 .....	969,898	5.3	67.66	559,816	67.70
	<u>7,627,941</u>	5.6	\$52.94	<u>4,018,666</u>	\$47.46

**Compensation Expense:** Compensation expense related to stock-based compensation plans charged to Salaries and employee benefits was \$59 million, \$65 million and \$66 million for the years ended December 31, 2004, 2003 and 2002, respectively. The recognition of compensation expense affects Additional paid-in capital and, for awards that are probable of cash settlement, Other liabilities.

Table 11.5 summarizes the weighted-average assumptions used in determining the fair value of options granted under Freddie Mac's stock-based compensation plans using a Black-Scholes option pricing model.

**Table 11.5 — Assumptions Used to Determine the Fair Value of Options**

	Employee Stock Purchase Plan			Employee and Directors' Stock Compensation Plans		
	2004	2003	2002	2004	2003	2002
Dividend yield <sup>(1)</sup> .....	1.85%	2.01%	1.56%	—	—	—
Expected life .....	3 months	3 months	1 year	7 years	7 years	7 years
Expected volatility .....	17.8%	35.0%	21.0%	31.5%	32.0%	32.0%
Risk-free interest rate .....	1.33%	0.95%	1.75%	3.55%	3.40%	4.75%

(1) The dividend yield assumption is zero percent for the Employee Plans and Directors' Plan since options granted under these plans include dividend equivalent rights; thus, the fair value of these options would not be reduced for foregone dividends.



## NOTE 12: DERIVATIVES

Freddie Mac principally uses the following types of derivatives:

- **LIBOR-Based Interest-Rate Swaps:** Interest-rate swaps are contractual agreements between two parties for the exchange of periodic payments based on a pre-determined amount (“notional”) and agreed-upon fixed and floating interest rates.
- **LIBOR- and Treasury-Based, Exchange-Traded Futures Contracts:** Futures contracts are exchange-traded agreements that obligate one party to sell and another party to purchase a specified amount of a designated financial instrument at a specified price and date.
- **LIBOR- and Treasury-Based Options and Swaptions:** Options are exchange-traded or over-the-counter (“OTC”) agreements in which the holder pays a one-time up-front premium to another party in exchange for the right, but not the obligation, to buy or sell a specified asset or enter into a contract at a specified price during a specified period of time. Option holders will generally exercise their options only if there is an economic advantage in doing so. Swaptions are OTC options to execute an interest-rate swap at a specific date and specific rates.
- **LIBOR- and Treasury-Based Interest-Rate Caps and Floors:** Interest-rate caps and floors are OTC agreements in which the holder pays a one-time up-front premium to another party in exchange for the right to receive interest payments based on a particular notional amount and the amount, if any, by which the agreed-upon index rate exceeds a specified maximum (“cap”) or by which the agreed-upon index is below a specified minimum (“floor”) rate.
- **Foreign-Currency Swaps:** Currency swaps are contractual agreements between two parties for the exchange of a specified amount of a designated foreign currency for a specified amount of U.S. dollars at the inception and termination of the contract. Each party will also make periodic interest payments on the currency it receives in the swap at agreed-upon fixed or floating interest rates.
- **Forward Purchase and Sale Commitments:** Forward purchase and sale commitments are OTC agreements that obligate one party to purchase (sell) and another party to sell (purchase) a specified amount of a designated financial instrument at a specified price and date.
- **Other:** Certain other agreements entered into are accounted for as derivatives in accordance with SFAS 133 or SFAS 149. These include (a) a prepayment management agreement in which Freddie Mac is partially compensated for the adverse impacts caused by disproportionately higher mortgage prepayments on certain mortgage pools; (b) credit risk-sharing agreements where Freddie Mac remits or receives payments based upon the default performance of certain mortgage loans; and (c) swap guarantee derivatives where Freddie Mac guarantees the sponsor’s or the borrower’s performance as a counterparty on certain interest-rate swaps.

### Hedging Activity

Derivative instruments are reported at their fair value as either Derivative assets, at fair value, or Derivative liabilities, at fair value, on the consolidated balance sheets.

#### *No hedge designation*

At December 31, 2004, most of the company’s derivatives portfolio, except for a portion of interest-rate swaps, foreign-currency swaps and forward purchase and sale commitments, was not designated in hedge accounting relationships. Freddie Mac reports changes in the fair value of these derivatives as Derivative gains (losses) on the consolidated statements of income. For interest-rate swaps that are not designated in hedge accounting relationships, the associated interest received or paid is recognized on an accrual basis and recorded in Derivative gains (losses) on the consolidated statements of income.

Effective as of the beginning of the second quarter of 2004, Freddie Mac determined that substantially all pay-fixed interest-rate swaps and other derivatives that previously had been in cash flow hedge accounting relationships no longer met the hedged item shared risk exposure requirement and hedge effectiveness

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assessment as required by SFAS 133. Consequently, Freddie Mac discontinued hedge accounting treatment for these relationships for financial reporting purposes effective as of the beginning of the second quarter of 2004, resulting in pay-fixed swaps with a notional balance of approximately \$108 billion being moved from the cash flow hedge designation to no hedge designation.

Freddie Mac voluntarily discontinued hedge accounting treatment for a significant amount of its receive-fixed interest-rate swaps effective November 1, 2004, resulting in receive-fixed interest-rate swaps with a notional balance of approximately \$50 billion being moved from a fair value hedge designation to no hedge designation.

#### *Fair value hedges*

Fair value hedges represent hedges of exposure to foreign currency fluctuations and changes in the fair value of a recognized liability. Freddie Mac uses interest-rate swaps, futures and foreign-currency swaps to hedge against the changes in fair value of fixed rate debt due to changes in benchmark interest rates, either the rate on U.S. Treasury obligations or LIBOR, or foreign currency fluctuations, or a combination of both. These derivatives may be executed to manage interest-rate risk at an aggregate portfolio level or at an individual debt instrument level. For accounting purposes, Freddie Mac ultimately links these derivatives to specific debt positions. Where derivatives were executed to manage interest-rate risk at an aggregate portfolio level, Freddie Mac frequently reset the amount of fixed-rate debt being hedged in order to maintain highly effective accounting hedges in this strategy. To accomplish this, the accounting hedges were typically terminated at the time of reset and the derivatives were contemporaneously redesignated in new hedge accounting relationships of fixed-rate debt. These derivatives were moved to no hedge designation effective November 1, 2004 as part of the voluntary discontinuance of hedge accounting treatment, as discussed above. Alternatively, when derivatives are executed for specific debt instruments, redesignation is typically not necessary to maintain highly effective accounting hedges. For 2004 and 2003, no amounts have been excluded from the assessment of effectiveness for derivatives designated as fair value hedges. For 2002, pre-tax losses of \$103 million were excluded from the assessment of effectiveness for derivatives designated as fair value hedges. The excluded component represents the change in fair value related to the difference between the spot price and the forward price on certain sale commitments used as hedges of existing mortgage-related securities.

For a derivative qualifying as a fair value hedge, Freddie Mac reports changes in the fair value of the derivative as Hedge accounting gains (losses) on the consolidated statements of income along with the changes in the fair value of the hedged item attributable to the risk being hedged. Hedge ineffectiveness arises when the fair value change of a derivative is not equal to the fair value change of the hedged item. For 2004, 2003 and 2002, hedge ineffectiveness related to fair value hedges was a net \$742 million gain, \$697 million gain and \$241 million gain, respectively, on a pre-tax basis, and was reported in Hedge accounting gains (losses). Hedge accounting gains (losses) will vary from period to period based on the notional amount of derivatives accounted for in hedge accounting relationships and the extent to which differences in the characteristics or terms of the derivative and the hedged item result in fair value changes that are not exactly offset. For example, a portion of derivatives in Freddie Mac's fair value hedges are forward starting and valued using forward rates while the hedged debt is valued using spot rates. Therefore, the difference between the spot rate and the forward rate generally produces ineffectiveness in these fair value hedges.

#### *Cash flow hedges*

Cash flow hedges represent hedges of exposure to the variability in the cash flows of a forecasted transaction. Freddie Mac uses interest-rate swaps, futures, foreign-currency swaps and forward purchase and sale commitments to hedge the changes in cash flows associated with the forecasted issuances of debt, forecasted purchase or sale of mortgage-related assets, and foreign currency fluctuations.

For a derivative qualifying as a cash flow hedge, changes in fair value are generally reported in AOCI, net of taxes, on the consolidated balance sheets to the extent the hedge is effective. The remaining ineffective portion is reported as Hedge accounting gains (losses) on the consolidated statements of income. For 2004, 2003 and 2002, hedge ineffectiveness related to cash flow hedges was a net \$1 million gain, \$53 million loss

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and \$54 million loss, respectively. No amounts have been excluded from the assessment of effectiveness for derivatives designated as cash flow hedges for 2004, 2003 and 2002.

At December 31, 2004, the maximum remaining length of time over which Freddie Mac has hedged the exposure related to the variability in future cash flows on forecasted transactions is 29 years. However, over 90 percent of the AOCI, net of taxes, balance at December 31, 2004 relating to cash flow hedges is attributable to cash flow hedges of the exposure related to the variability in future cash flows on forecasted transactions occurring in the next 10 years. The occurrence of forecasted transactions may be satisfied by either periodic issuances of short-term debt over the required time period or longer term debt, such as Reference Notes® securities, with maturities covering all or part of the remaining hedge time period.

AOCI amounts are reclassified to earnings as the associated hedged forecasted issuance of debt and forecasted mortgage purchase transaction affects earnings. During 2004, 2003 and 2002, pre-tax amounts reclassified into earnings also include net gains of \$2 million, \$29 million and \$116 million, respectively, resulting from the determination that it was probable that forecasted transactions related to certain mortgage purchases and sales would not occur. At December 31, 2004, the total AOCI, net of taxes, related to cash-flow hedge relationships was a loss of \$7.9 billion. The \$7.9 billion in hedging losses related to cash-flow hedges was composed of less than \$0.1 billion in net unrealized losses on open cash flow hedges and approximately \$7.9 billion in deferred net losses on closed cash flow hedges. The unrealized fair value losses on open cash flow hedges can change substantially due to future changes in interest rates. Closed cash flow hedges involve derivatives that have been terminated or are no longer designated as cash flow hedges. Fluctuations in prevailing market interest rates have no impact on the deferred portion of AOCI relating to losses on closed cash flow hedges. The company estimates that approximately \$1.6 billion, net of taxes, of the \$7.9 billion of hedging losses in AOCI, net of taxes, at December 31, 2004 will be reclassified into earnings during 2005.

Table 12.1 presents the changes in AOCI, net of taxes, related to derivatives designated as cash flow hedges. The Net change in fair value related to cash flow hedging activities, net of tax benefit line represents the net changes in the fair value of the derivatives that were designated as cash-flow hedges throughout the year, after the effects of Freddie Mac's statutory tax rate of 35 percent, to the extent the hedges were effective. The Net reclassifications of losses to earnings, net of tax benefit line represents the AOCI amount, after the effects of Freddie Mac's statutory tax rate of 35 percent, that was recognized in earnings as the originally hedged forecasted transactions affected earnings unless it was deemed probable that the forecasted transaction would not occur. If it is probable that the forecasted transaction will not occur, then the entire deferred gain or loss associated with the hedge related to the forecasted transaction is reclassified into earnings immediately.

**Table 12.1 — AOCI, net of taxes, Related to Cash Flow Hedge Relationships**

	Year Ended December 31,		
	2004	2003	2002
	(dollars in millions)		
Beginning Balance <sup>(1)</sup> .....	\$(7,837)	\$(9,877)	\$(4,757)
Net change in fair value related to cash flow hedging activities, net of tax benefit of \$(1,089), \$(352) and \$(4,516), respectively <sup>(2)</sup> .....	(2,021)	(653)	(8,388)
Net reclassifications of losses to earnings, net of tax benefit of \$1,042, \$1,450 and \$1,760, respectively <sup>(2)</sup> .....	1,934	2,693	3,268
Ending Balance <sup>(1)</sup> .....	<u>\$(7,924)</u>	<u>\$(7,837)</u>	<u>\$(9,877)</u>

(1) Represents the effective portion of the fair value of open derivative contracts (*i.e.*, net unrealized gains and losses) and net deferred gains and losses on closed (*i.e.*, terminated or redesignated) cash flow hedges.

(2) Net reclassifications to earnings, net of tax expense includes the accrual of periodic cash settlements in accordance with the contractual terms of the derivatives designated in cash flow hedge relationships for all periods presented above.

### NOTE 13: LEGAL CONTINGENCIES

Freddie Mac is involved as a party to a variety of legal proceedings arising from time to time in the ordinary course of business including, among other things, contractual disputes, personal injury claims, employment-related litigation and other legal proceedings incidental to the company's business. Freddie Mac is frequently involved, directly or indirectly, in litigation involving mortgage foreclosures. Freddie Mac is also involved in proceedings arising from its termination of a seller/servicer's eligibility to sell mortgages to, and service mortgages for, the company. In these cases, the former seller/servicer sometimes seeks damages against Freddie Mac for wrongful termination under a variety of legal theories. In addition, Freddie Mac is sometimes sued in connection with the origination or servicing of mortgages. These suits generally involve claims alleging wrongful actions of seller/servicers. Freddie Mac's contracts with its seller/servicers generally provide for them to indemnify the company against liability arising from their wrongful actions.

Freddie Mac is now subject to various legal proceedings, including regulatory investigations and administrative and civil litigation, arising from the restatement of its previously issued consolidated financial statements for the years 2000 and 2001 and the first three quarters of 2002 and the revision of fourth quarter and full-year consolidated financial statements for 2002 (collectively referred to as the "restatement"). Freddie Mac believes that a loss in connection with the proceedings arising from the restatement is probable and currently estimates the range of minimum loss to be from \$75 million to \$100 million. Freddie Mac has established a reserve of \$75 million for this loss contingency in the second quarter of 2003, the period in which many of the legal proceedings were initiated. The ultimate resolution of these proceedings could result in losses lower than or in excess of the estimated range of minimum loss. Litigation and claims resolution are subject to many uncertainties and are not susceptible to accurate prediction. It is not possible for the company to reasonably estimate the upper end of the range of any additional losses that might result from the adverse resolution of any of these legal proceedings, or their potential effect on the company's financial condition or results of operations.

**Securities Class Action Lawsuits.** In June 2003, and thereafter, securities class action lawsuits were brought in three separate federal district courts against Freddie Mac and certain former executive officers in connection with the restatement. While most of the cases were voluntarily dismissed by the plaintiffs, the two remaining ones were consolidated and are now pending in the U.S. District Court for the Southern District of New York.

In essence, the plaintiffs in the consolidated action, claim that the defendants improperly managed earnings to create a misleading impression of steady earnings by Freddie Mac. Plaintiffs further allege that defendants engaged in a number of improper transactions that violated GAAP and that they made false and misleading statements regarding Freddie Mac's financial status. The complaint, which covers the period from June 15, 1999 through June 6, 2003, seeks unspecified compensatory damages, costs and expenses.

In March 2004, the plaintiffs in one of the cases, the Ohio Public Employees Retirement System and the State Teachers Retirement System, were appointed lead plaintiffs for the consolidated action. Freddie Mac filed a motion to dismiss the action in April, which was denied by the court on July 19, 2004. The case is now in the discovery phase.

**Shareholder Derivative Lawsuits.** Two shareholder derivative lawsuits were filed during 2003 against Freddie Mac and certain former and current executives and, in one of the suits, members of Freddie Mac's Board of Directors alleging breach of fiduciary duty and seeking indemnification in connection with the restatement. Both cases were ultimately assigned to the same judge in New York who is handling the securities class action lawsuits described above. In July 2003, all of the then current Board members were dismissed from the lawsuits in which they were named with the consent of the plaintiff. On January 16, 2004, Freddie Mac moved to dismiss one of the lawsuits brought by the Ester Sadowsky Testamentary Trust because of the plaintiff's failure to make a pre-suit demand. The court dismissed the case without prejudice on July 19, 2004. The other lawsuit is still pending, awaiting a response to the plaintiff's pre-suit demand notice by a Special Litigation Committee of Freddie Mac's Board of Directors. Subsequently, the Sadowsky plaintiff sent a demand notice to Freddie Mac and on March 4, 2005, filed a new complaint in an action in the same court.

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The complaint was purportedly brought on Freddie Mac's behalf (as a nominal defendant) as a derivative action by a purported shareholder to recover damages Freddie Mac allegedly suffered in connection with certain events underlying the restatement of its financial statements. The defendants in the action include former officers, the current Board of Directors, ten former Directors, and five counterparties to transactions Freddie Mac executed. The plaintiff subsequently has amended its complaint by, among other actions, dropping Messrs. Syron and McQuade from the list of defendants. The plaintiff alleges claims for breach of fiduciary duties, indemnification, waste of corporate assets, unjust enrichment, and aiding and abetting breach of fiduciary duties. The Special Litigation Committee of Freddie Mac's Board of Directors is considering the allegations raised by this complaint.

Freddie Mac was also served on February 11, 2005, with an amended derivative complaint filed by shareholder E.L. Greenfield against the lead engagement partner of Arthur Andersen, Freddie Mac's former outside auditor, alleging breach of contract for failing to properly conduct audits of the company's financial statements. No ruling is sought against Freddie Mac, which is named as a nominal party to that suit.

**ERISA Lawsuits.** Two class action lawsuits were filed in 2003 in the U.S. District Court for the Southern District of Ohio against Freddie Mac, certain individuals, and the company's Retirement Committee alleging violations of the Employee Retirement Income Security Act ("ERISA"). Both actions were consolidated and transferred to the same judge in New York who is handling the securities and derivative lawsuits described above. In July 2004, Freddie Mac and the other defendants filed a motion to dismiss the consolidated ERISA lawsuit. That motion was denied on February 7, 2005, and the company along with the individual defendants have filed a motion for interlocutory appeal which is pending.

**OFHEO Proceedings.** In June 2003, OFHEO commenced a special investigation of the company in connection with the restatement. As part of this investigation, OFHEO took the testimony of certain Freddie Mac employees and directors, external third parties and former employees. OFHEO also requested and received documents from the company.

On December 9, 2003, Freddie Mac and OFHEO entered into a consent order and settlement which concluded OFHEO's investigation of the company. Under the terms of the consent order, Freddie Mac agreed to pay a civil money penalty of \$125 million, which was recorded in the second quarter of 2003 (the period in which OFHEO commenced its special investigation), as well as to undertake certain remedial actions relating to governance, corporate culture, internal controls, accounting practices, disclosure and oversight. In agreeing to the consent order, Freddie Mac made no admission regarding any wrongdoing or any asserted or implied findings.

In December 2003, OFHEO filed administrative notices of charges against Freddie Mac and Messrs. Brendsel and Clarke, two former executive officers of Freddie Mac. In its charge against Freddie Mac, OFHEO seeks to have Freddie Mac take certain actions in connection with these individuals' salaries and compensation as well as their termination status with the company. Freddie Mac and Messrs. Brendsel and Clarke moved, among other things, to dismiss the OFHEO administrative charges. These motions are pending. On February 18, 2005, OFHEO filed an amended notice of charges against Messrs. Brendsel and Clarke, who opposed the amended notice on several grounds. On April 26, 2005, the Administrative Law Judge presiding over the OFHEO administrative proceeding ruled that the amended notice of charges against Messrs. Brendsel and Clarke did not clearly identify the factual and legal issues, and consequently ordered OFHEO to file a second amended notice of charges that must clearly set forth the factual and legal bases for the charges and satisfy several other requirements identified by the judge. The parties are also engaged in the discovery phase of the case.

In a separate action, the U.S. District Court for the District of Columbia issued orders finding that OFHEO lacked the authority to freeze the compensation and benefits provided under Mr. Brendsel's and Mr. Clarke's employment agreements. Freddie Mac was not a party to these actions. OFHEO has appealed these orders. Freddie Mac has paid Messrs. Brendsel and Clarke the compensation and benefits that were due them in accordance with the U.S. District Court's orders.

**SEC Investigation.** In June 2003, the SEC initiated a formal investigation of Freddie Mac in connection with the restatement. As part of the investigation, the SEC subpoenaed company documents and took the sworn testimony of various present and former Freddie Mac employees and directors, as well as third parties.

On August 18, 2004, Freddie Mac announced that it had received a “Wells Notice” from the staff of the SEC. The Wells Notice advised the company that the SEC staff is considering recommending that the SEC initiate a civil injunctive action against the company for possible violations of federal securities laws, including Section 10(b) of the Securities Exchange Act of 1934 and the SEC’s Rule 10b-5, as well as Sections 17(a)(1), (2) and (3) of the Securities Act of 1933. The Wells Notice also indicated that the SEC staff may seek a permanent injunction and a civil money penalty in connection with the contemplated action. Freddie Mac continues to cooperate fully with the SEC’s investigation as the company evaluates its response to the Wells Notice.

**U.S. Attorney’s Investigation.** In June 2003, the U.S. Attorney’s Office in Alexandria, Virginia commenced an investigation of Freddie Mac surrounding the restatement. As part of its investigation, the U.S. Attorney’s Office requested and received documents and information from Freddie Mac, interviewed certain Freddie Mac employees and possibly other parties and took testimony before the grand jury. The investigation is still pending and Freddie Mac will continue to cooperate with the U.S. Attorney’s Office.

**Department of Labor Investigation.** In July 2003, the Department of Labor (“DOL”) began an investigation of Freddie Mac’s Thrift/401(k) Savings Plan in relation to the restatement. In connection with the investigation, the DOL sought and received documents from the company as well as interviewed certain individuals who served as members of Freddie Mac’s Retirement Committee. The investigation is still pending and Freddie Mac continues to cooperate fully with the DOL.

**FEC Investigation.** In March 2004, Freddie Mac provided certain information to the Federal Election Commission (the “FEC”) concerning compliance with federal election laws. The FEC has been conducting an investigation into this matter and, in November 2004, subpoenaed documents and responses to interrogatories from Freddie Mac, which Freddie Mac subsequently provided. The FEC has also interviewed certain present and former Freddie Mac employees. The investigation is still pending and Freddie Mac will continue to cooperate with the FEC.

**Antitrust Lawsuits.** Since January 18, 2005, Freddie Mac and Fannie Mae have been named in multiple lawsuits alleging violations of federal and state antitrust laws and state consumer protection laws. All of the suits essentially allege that the defendants conspired to establish and maintain artificially high guarantee fees. One suit contains additional allegations of price fixing in connection with other mortgage fees, as well as a claim of illegally maintaining a monopoly in the market for conforming mortgages and the market for securitization of conforming mortgages. At present, it is not possible for Freddie Mac to predict the probable outcome of these lawsuits or any potential impact on Freddie Mac’s business, financial condition or results of operations.

**Other Inquiries.** Freddie Mac receives inquiries from the IRS in connection with its regular audits of Freddie Mac’s tax returns for prior years, some of which relate to matters connected with the restatement. Freddie Mac continues to respond to these inquiries. See “NOTE 14: INCOME TAXES” for more information. The Committee on Energy and Commerce of the House of Representatives also sent Freddie Mac an inquiry relating to the restatement. Freddie Mac has responded to the Committee’s inquiry.

## NOTE 14: INCOME TAXES

Freddie Mac is exempt from state and local income taxes. Table 14.1 presents the components of the company's provision for income taxes.

**Table 14.1 — Provision for Income Taxes**

	Year Ended December 31,		
	2004	2003	2002
	(dollars in millions)		
Current tax provision .....	\$1,136	\$1,465	\$2,023
Deferred tax provision (benefit) .....	(346)	737	2,690
Total provision for income taxes .....	<u>\$ 790</u>	<u>\$2,202</u>	<u>\$4,713</u>

Table 14.2 summarizes Freddie Mac's deferred tax assets and liabilities.

**Table 14.2 — Deferred Tax Assets/(Liabilities)**

	December 31,	
	2004	2003
	(dollars in millions)	
Deferred tax assets:		
Deferred fees related to securitizations .....	\$ 1,612	\$ 1,550
Basis differences related to assets held-for-investment .....	—	195
Credit related items and reserve for loan losses .....	5	—
Employee compensation and benefit plans .....	166	141
Cash flow hedge deferrals and unrealized (gains) losses related to available-for-sale securities .....	1,930	801
Total deferred tax assets .....	<u>3,713</u>	<u>2,687</u>
Deferred tax liabilities:		
Premium and discount amortization .....	(1,961)	(1,958)
Basis differences related to assets held-for-investment .....	(502)	—
Basis differences related to derivative instruments .....	(2,478)	(3,468)
Credit related items and reserve for loan losses .....	—	(2)
Other items, net .....	(43)	(5)
Total deferred tax liabilities .....	<u>(4,984)</u>	<u>(5,433)</u>
Net deferred tax liabilities .....	<u>\$(1,271)</u>	<u>\$(2,746)</u>

Included in deferred taxes is the tax effect on the (a) net unrealized (gain) loss on available-for-sale securities and (b) net (gain) loss related to derivatives designated in cash flow hedge relationships, which are both reported in AOCI, net of taxes.

A valuation allowance has not been established against Freddie Mac's deferred tax assets at December 31, 2004 or 2003, as Freddie Mac has determined that it is more likely than not that all such tax assets will be realized in the future.

Table 14.3 reconciles the statutory federal tax rate to the effective tax rate.

**Table 14.3 — Reconciliation of Statutory to Effective Tax Rate**

	<u>Year Ended December 31,</u>		
	<u>2004</u>	<u>2003</u>	<u>2002</u>
Statutory corporate rate .....	35.0%	35.0%	35.0%
Tax-exempt interest .....	(4.7)	(2.1)	(1.2)
Tax credits .....	(7.3)	(3.0)	(1.1)
Provision (benefit) related to tax contingencies .....	(2.0)	0.4	(1.0)
OFHEO civil money penalty and loss contingency accrual .....	—	1.0	—
Other .....	<u>0.2</u>	<u>0.1</u>	<u>0.1</u>
Effective rate .....	<u>21.2%</u>	<u>31.4%</u>	<u>31.8%</u>

**Impact of tax issues.** The IRS has a policy to examine the income tax returns of large corporate taxpayers, including Freddie Mac, generally every year. Management believes that an adequate provision in accordance with SFAS 5 has been made for contingencies related to all income taxes and related interest. However, the ultimate outcome of these tax contingencies could result in a tax benefit or tax provision that could be material to Freddie Mac’s quarterly or annual results of operations. Based on current knowledge and after consultation with outside counsel, management does not believe that liabilities arising from these matters, if any, will have a material adverse effect on Freddie Mac’s consolidated financial condition.

**Tax Years 1985 through 1990.** In 1998, the IRS issued Freddie Mac a Statutory Notice which asserts income tax deficiencies for the company’s first two tax years, 1985 and 1986. In the first quarter of 1999, Freddie Mac filed a petition in the United States Tax Court (the “Court”) to contest the deficiencies. In the third quarter of 1999, the IRS issued a Statutory Notice for Freddie Mac’s tax years 1987 through 1990, and Freddie Mac filed a petition in the Court. Subsequently, the Court combined the 1985 through 1990 tax years into one case. The principal matters in controversy in the case involve questions of tax law as applied to Freddie Mac’s transition from non-taxable to taxable status in 1985 and primarily involve the amortization of certain intangible assets, the two most significant of which are:

- *Favorable Financing.* A number of financing arrangements where the contract rates of interest were less than the market rates of interest as of January 1, 1985 due to an increase in interest rates since the date on which Freddie Mac had entered into the respective arrangements; and
- *Customer Relationships.* Freddie Mac’s business relationships with a substantial number of mortgage originating institutions that sold mortgages to Freddie Mac on a regular basis.

**Tax Court Rulings.** On September 4, 2003 and September 29, 2003, the Court decided favorably for Freddie Mac on two preliminary motions involving questions of law in the case. On September 4, the Court ruled favorably for Freddie Mac on the question whether Freddie Mac’s intangibles are amortizable using, as the adjusted basis, the higher of (a) the regular adjusted cost basis or (b) the fair market value on January 1, 1985. On September 29, the Court ruled favorably for Freddie Mac on the question whether, as a matter of law, “favorable financing” (as defined above) was amortizable for tax purposes. As part of this case, Freddie Mac claimed, and the court agreed, that the economic benefit of this below-market financing as of January 1, 1985 is an intangible asset subject to amortization. In October 2003, the Court ruled unfavorably on two other less significant issues in the case.

While significant, the Court’s rulings do not dispose of all of the matters in controversy in the case, which, upon final resolution by the Court of all such matters, are subject to appeal by the parties. In addition, Freddie Mac still must demonstrate that the intangible assets in question have an ascertainable value and have a limited useful life, the duration of which can be ascertained with reasonable accuracy. A trial on the value and useful life of Favorable Financing began in early June 2005.

In view of the favorable rulings described above and in accordance with GAAP, Freddie Mac recorded in the fourth quarter of 2002 a reduction in its tax reserves in the amount of \$155 million. If the IRS were to

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appeal the Court decisions and an adverse ruling resulted, Freddie Mac may reconsider its reserves related to this matter.

If Freddie Mac's tax position on the customer relationship amortization issue described above is upheld through the administrative and legal process, Freddie Mac will be able to recognize additional tax benefits that could be material in the quarter during which they are recognized. However, Freddie Mac is unable to provide assurances that any such tax benefits will be realized.

**Tax Years 1991 through 1993.** The IRS examination of Freddie Mac's federal income tax returns for the years 1991 through 1993 has been completed. In December 2001, the IRS issued a Statutory Notice for these years. In the first quarter of 2002, Freddie Mac filed a petition in the Court to contest the deficiencies. The principal matters in controversy in this case are the same questions at issue in the 1985 through 1990 case as applied to years 1991 to 1993, plus an additional question of tax law regarding the timing of taxation of Freddie Mac's management and guarantee fee income.

**Tax Years 1994 through 1997.** In the second quarter of 2002, the IRS completed its examination of Freddie Mac's federal income tax returns for the years 1994 through 1997. Freddie Mac is involved in discussions with the IRS Appeals Division regarding the company's disagreement with certain aspects of the examination report. The principal matter in controversy, other than the same questions at issue in the 1985 through 1993 cases, involve the character of losses on dispositions of mortgage-related securities.

*Tax Treatment of REITs.* In February 1997, Freddie Mac formed two REIT subsidiaries that issued a total of \$4.0 billion in step-down preferred stock to investors. Under the IRS regulations in effect when the REITs were formed, the company believed that the dividend payments by the REITs to holders of the REITs' step-down preferred stock were fully tax deductible. In 1997, subsequent to the formation of Freddie Mac's REIT subsidiaries, the Department of the Treasury announced its intention to propose regulations that would retroactively limit the tax benefits attributable to the REITs, preferred stock and effectively eliminate the potential tax advantages of REITs that issued step-down preferred stock. On January 7, 2000, the Treasury issued final regulations that retroactively deny certain tax benefits attributable to Freddie Mac's REIT preferred stock for tax years ending on or after February 27, 1997. Based upon this guidance, the IRS challenged Freddie Mac's position that the REIT dividends were fully deductible. The company has since changed its position that the REIT dividends are fully deductible. Freddie Mac announced on May 12, 2005 that it entered into a closing agreement with the IRS that resolves issues related to the tax treatment of dividends paid on the step-down preferred stock. Freddie Mac and the IRS have agreed that Freddie Mac will only be entitled to deductions attributable to the step-down preferred stock transactions as if it had borrowed directly from the REITs' preferred shareholders. As a result of this closing agreement, Freddie Mac recorded a reduction in tax reserves of \$94 million. See "NOTE 18: MINORITY INTERESTS" for more information concerning the REITs.

**Tax Years 1998 through 2002.** The IRS is currently examining Freddie Mac's tax returns for the years 1998 through 2002. This examination includes the years for which Freddie Mac has restated its financial reporting.

*Tax Treatment of Linked Swaps.* In August and September of 2001, Freddie Mac entered into a series of nine sets of paired swap transactions. Freddie Mac has reported and paid tax treating each pair of those swap transactions as a single integrated transaction for federal income tax purposes. In addition, two additional swaps were executed in November 2001. Although the facts and circumstances surrounding these swaps were different from the earlier swaps, Freddie Mac also reported and paid tax treating these swaps as a single integrated transaction for federal income tax purposes. There is a risk that the IRS could challenge Freddie Mac's tax treatment of all of these transactions ("the Linked Swaps") and make an adverse determination relating to this tax treatment. If this should occur, the potential aggregate additional tax liability could be as much as approximately \$750 million plus interest.

Freddie Mac has not provided reserves for any tax issues related to these transactions because management has determined that the potential for loss does not meet the criteria for recognition under SFAS 5. The IRS is currently examining Freddie Mac's 2001 and 2002 tax returns, including the Linked Swaps transactions. The company does not know whether the IRS will assert a tax deficiency related to these

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transactions as part of the current examination and if so, what the final resolution of those issues will be. If the IRS were to propose the maximum potential aggregate assessment and that additional tax liability was upheld through the administrative and legal process, the recognition of such additional liability could have a material adverse impact on Freddie Mac's results of operations in the quarter in which it was recognized. Based on current knowledge and after consultation with counsel, management does not currently believe that the final resolution of any issues that may arise from the Linked Swaps transactions will result in IRS adjustments that would have a material adverse impact on Freddie Mac's consolidated financial condition.

## NOTE 15: EMPLOYEE BENEFITS

### Defined Benefit Plans

Freddie Mac maintains a tax-qualified defined benefit pension plan (“Pension Plan”) covering substantially all of its employees. Pension Plan benefits are based on years of service and the employee’s highest average compensation (up to legal plan limits) over any consecutive 36 months of employment. Freddie Mac’s general practice is to contribute to the Pension Plan an amount equal to at least the minimum required contribution, if any, but no more than the maximum amount deductible for federal income tax purposes each year. Based on a preliminary analysis, Freddie Mac currently believes that under applicable law no minimum contribution will be required and no tax-deductible contribution will be permitted for 2005. Therefore, Freddie Mac does not currently expect to contribute to its Pension Plan in 2005. Pension Plan assets are held in trust and investments consist primarily of listed stocks and corporate bonds. In addition to the Pension Plan, Freddie Mac maintains nonqualified, unfunded defined benefit pension plans for officers and certain other employees of the company (the “non-qualified pension plans”). The related retirement benefits for the nonqualified pension plans are paid from Freddie Mac’s general assets. These nonqualified and qualified defined benefit pension plans are collectively referred to in this NOTE 15 as “defined benefit pension plans.”

Freddie Mac maintains a defined benefit post-retirement health care plan (“Retiree Health Plan”) that generally provides post-retirement health care benefits on a contributory basis to retired employees age 55 or older who rendered at least ten years of service (five years of service if retiree is eligible to retire prior to March 1, 2007) and who, upon separation or termination, immediately elected to commence benefits under the Pension Plan in the form of an annuity. The company’s Retiree Health Plan is currently unfunded and the benefits are paid from Freddie Mac’s general assets. This plan, along with the defined benefit pension plans, are collectively referred to in this NOTE 15 as “defined benefit plans.”

The Medicare Prescription Drug, Improvement and Modernization Act of 2003 (“Medicare Part D”) was signed into law on December 8, 2003. Medicare Part D authorizes a federal subsidy for sponsors of retiree health care plans with prescription drug benefits that are at least actuarially equivalent to the prescription drug benefits available under Medicare Part D. In May 2004, the FASB issued FASB Staff Position (“FSP”) 106-2, “Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003,” which supersedes FSP 106-1 of the same title. FSP 106-2 clarified the accounting for benefits provided by the new government subsidies. Freddie Mac, in consultation with its actuaries, has determined that the prescription drug benefits provided to participants by the Retiree Health Plan are at least actuarially equivalent to those available under Medicare Part D. Therefore, in accordance with the FSP 106-2 transition provisions, the effects of the future Medicare Part D subsidies are reflected as an actuarial gain, included in Net actuarial loss (gain) in Table 15.1, that reduces the year-end accumulated post-retirement benefit obligation for 2004 by \$12 million. No determination has yet been made with respect to actuarially equivalent benefits provided to participants’ spouses and dependents. The ongoing effect of the subsidy under Medicare Part D is to reduce the current service cost.

For financial reporting purposes, Freddie Mac uses a September 30 valuation measurement date for all of its defined benefit plans. The company is required to accrue the estimated cost of retiree benefits as employees render the services necessary to earn their pension and post-retirement health benefits. Freddie Mac’s pension and post-retirement health care costs related to these defined benefit plans for 2004, 2003 and 2002 presented in the following tables were calculated using assumptions as of September 30, 2003, 2002 and 2001, respectively. The funded status of Freddie Mac’s pension and post-retirement health care defined benefit plans for 2004, 2003 and 2002 presented in the following tables was calculated using assumptions as of September 30, 2004, 2003 and 2002, respectively.

Table 15.1 sets forth the changes in the benefit obligations and plan assets for the twelve months ended September 30, 2004 and 2003, the funded status at September 30, 2004 and 2003 and the amounts recognized in the consolidated balance sheets for the defined benefit plans at December 31, 2004 and 2003.

**Table 15.1 — Defined Benefit Plan Obligations and Funded Status**

	Pension Benefits <sup>(1)</sup>		Post-Retirement Health Benefits	
	2004	2003	2004	2003
	(dollars in millions)			
<b>Change in Benefit Obligation:</b>				
Benefit obligation at beginning of period	\$339	\$230	\$102	\$ 54
Service cost	24	16	10	6
Interest cost	20	16	6	3
Net actuarial loss (gain)	6	80	(15)	39
Benefits paid	(4)	(3)	(1)	—
Benefit obligation at end of period	<u>\$385</u>	<u>\$339</u>	<u>\$102</u>	<u>\$102</u>
<b>Change in Plan Assets:</b>				
Fair value of plan assets at beginning of period	229	160		
Actual return on plan assets	22	26		
Employer contributions	13	46		
Benefits paid	(4)	(3)		
Fair value of plan assets at end of period	<u>\$260</u>	<u>\$229</u>		
<b>Funded Status:</b>				
Funded status at end of period	(125)	(110)	(102)	(102)
Unrecognized net actuarial loss	112	120	40	60
Unrecognized prior service cost	1	2	(6)	(6)
Initial unrecognized net transition asset	1	1	—	—
Net amount recognized	<u>\$(11)</u>	<u>\$ 13</u>	<u>\$(68)</u>	<u>\$(48)</u>
<b>Amounts Recognized in the Consolidated Balance Sheets:</b>				
Other assets:				
Prepaid benefit cost	\$ —	\$ 29	\$ —	\$ —
Intangible and other assets	6	1	—	—
Other liabilities:				
Accrued benefit liability	(25)	(27)	(68)	(48)
AOCI:				
Minimum pension liability	8	10	—	—
Net amount recognized	<u>\$(11)</u>	<u>\$ 13</u>	<u>\$(68)</u>	<u>\$(48)</u>

(1) The benefit obligations refer to projected benefit obligations (“PBO”). The measurement of the PBO includes assumptions about the rate of future compensation increases.

The accumulated benefit obligation (“ABO”) for all defined benefit pension plans was \$282 million and \$248 million at September 30, 2004 and 2003, respectively. The ABO represents the actuarial present value of future expected benefits, assuming current salary levels remain in effect.

The change in the minimum pension liability recognized in AOCI, net of taxes, was a \$2 million decrease for the year ended December 31, 2004 and a \$10 million increase for year ended December 31, 2003.

Table 15.2 provides additional information for defined benefit pension plans.

**Table 15.2 — Additional Information for Defined Benefit Pension Plans**

	2004		2003	
	Pension Plan	Non-qualified Pension Plans	Pension Plan	Non-qualified Pension Plans
	(dollars in millions)			
PBO .....	\$356	\$29	\$301	\$38
ABO .....	\$262	\$20	\$221	\$27
Fair value of plan assets .....	<u>260</u>	<u>—</u>	<u>229</u>	<u>—</u>
ABO over (under) fair value of plan assets ....	<u>\$ 2</u>	<u>\$20</u>	<u>\$ (8)</u>	<u>\$27</u>

Table 15.3 presents the components of the net periodic benefit costs with respect to pensions and post-retirement health benefits for the years ended December 31, 2004, 2003 and 2002. Net periodic benefit costs are included in the line Salaries and employee benefits on the company's consolidated statements of income.

**Table 15.3 — Net Periodic Benefit Cost Detail**

	Pension Benefits			Post-Retirement Health Benefits		
	Year Ended December 31,			Year Ended December 31,		
	2004	2003	2002	2004	2003	2002
	(dollars in millions)					
Service cost of current period .....	\$ 24	\$ 16	\$ 12	\$10	\$ 6	\$ 4
Interest cost on benefit obligation .....	20	16	14	6	3	3
Expected return on plan assets .....	(16)	(12)	(13)	—	—	—
Recognized net actuarial loss .....	7	3	—	5	2	1
Recognized prior service cost .....	<u>—</u>	<u>—</u>	<u>—</u>	<u>(1)</u>	<u>(1)</u>	<u>(1)</u>
Net periodic benefit costs .....	<u>\$ 35</u>	<u>\$ 23</u>	<u>\$ 13</u>	<u>\$20</u>	<u>\$10</u>	<u>\$ 7</u>

Tables 15.4 and 15.5 summarize the weighted average assumptions used to determine the benefit obligations at September 30, 2004 and 2003 and net periodic benefit costs recognized for the years ended December 31, 2004, 2003 and 2002, respectively.

**Table 15.4 — Weighted Average Assumptions Used to Determine Projected and Accumulated Benefit Obligations**

	Pension Benefits		Post-Retirement Health Benefits	
	September 30,		September 30,	
	2004	2003	2004	2003
<b>Major Assumptions:</b>				
Discount rate .....	5.75%	6.00%	5.75%	6.00%
Rate of future compensation increase .....	4.50%	4.50%	—	—

**Table 15.5 — Weighted Average Assumptions Used to Determine Net Periodic Benefit Cost**

	Pension Benefits			Post-Retirement Health Benefits		
	Year Ended December 31,			Year Ended December 31,		
	2004	2003	2002	2004	2003	2002
<b>Major Assumptions:</b>						
Discount rate .....	6.00%	7.00%	7.50%	6.00%	7.00%	7.50%
Rate of future compensation increase .....	4.50%	4.50%	4.50%	—	—	—
Expected long-term rate of return on plan assets .....	7.00%	7.25%	9.00%	—	—	—

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For the 2004 and 2003 benefit obligations, Freddie Mac used the Moody's Aa Corporate Bond Rate Index as a basis for selecting the discount rate shown in Table 15.4. The expected long-term rate of return on plan assets for 2004 and 2003 is estimated using a portfolio return calculator model. The model considers the historical returns and the future expectations for returns for each asset class in the company's defined benefit plans in conjunction with Freddie Mac's target investment allocation to arrive at the expected rate of return.

The assumed health care cost trend rates used in measuring the accumulated post-retirement benefit obligation as of September 30, 2004 are 13 percent in 2005, gradually declining to an ultimate rate of five percent in 2011 and remaining at that level thereafter.

Table 15.6 sets forth the effect on the accumulated post-retirement health benefit obligation as of September 30, 2004, and the sum of the service-cost and interest-cost components of the net periodic post-retirement health benefit costs that would result from a one percent increase or decrease in the assumed health care cost trend rate.

**Table 15.6 — Selected Data Regarding the Retiree Health Plan**

	<u>One Percent Increase</u>	<u>One Percent Decrease</u>
	(dollars in millions)	
Effect on the accumulated post-retirement benefit obligation for health care benefits . . . . .	\$24	\$(19)
Effect on the net periodic post-retirement health benefit cost components	4	(3)

**Plan Assets**

Table 15.7 sets forth Freddie Mac's Pension Plan weighted average asset allocations, based on fair value, at September 30, 2004 and 2003, and target allocation by asset category.

**Table 15.7 — Pension Plan Assets by Category**

<u>Asset Category</u>	<u>Target Allocation 2003 - 2004</u>	<u>Plan Assets at September 30,</u>	
		<u>2004</u>	<u>2003</u>
Equity securities . . . . .	65.0%	61.2%	51.7%
Debt securities . . . . .	35.0%	34.0%	28.0%
Other <sup>(1)</sup> . . . . .	—	4.8%	20.3%
Total . . . . .	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>

(1) Consists of cash contributions made in the third quarter of 2004 and 2003 that were not fully invested by September 30th of that year.

Freddie Mac's Retirement Committee has fiduciary responsibility for establishing and overseeing the Pension Plan's investment policies and objectives. The Retirement Committee reviews the appropriateness of the Pension Plan's investment strategy on an ongoing basis. Freddie Mac's Pension Plan employs a total return investment approach whereby a diversified blend of equities and fixed income investments are used to maximize the long-term return of plan assets for a prudent level of risk. Risk tolerance is established through careful consideration of plan liabilities, plan funded status, and corporate financial condition. Furthermore, equity investments are diversified across U.S. and non-U.S. listed companies with small and large capitalizations. Derivatives may be used to gain market exposure in an efficient and timely manner; however, derivatives may not be used to leverage the portfolio beyond the market value of the underlying investments. Investment risk is measured and monitored on an ongoing basis through quarterly investment portfolio reviews, annual liability measurements and periodic asset/liability studies.

The Pension Plan assets did not include any direct ownership of Freddie Mac securities at September 30, 2004 and 2003.

**Contributions**

As discussed above, Freddie Mac does not currently expect to contribute to its Pension Plan in 2005. Any contributions to the company's Retiree Health Plan will be in the form of benefit payments since it is an unfunded plan.

### Estimated Future Benefit Payments

Table 15.8 sets forth estimated future benefit payments expected to be paid for the defined benefit plans. The expected benefits are based on the same assumptions used to measure Freddie Mac's benefit obligation at September 30, 2004.

**Table 15.8 — Estimated Future Benefit Payments**

	<u>Pension Benefits</u>	<u>Post-Retirement Health Benefits</u>
	<u>(dollars in millions)</u>	
2005 .....	\$3.7	\$0.9
2006 .....	4.3	1.2
2007 .....	5.2	1.6
2008 .....	6.1	1.9
2009 .....	7.5	2.4
Years 2010-2014 .....	70.9	20.4

### Defined Contribution Plans

Freddie Mac's Thrift/401(k) Savings Plan, a tax-qualified defined contribution pension plan (the "Savings Plan"), is offered to all eligible employees. Employees were permitted to contribute from 1 percent to 15 percent of their annual salaries to the Savings Plan, subject to limits set by the IRC. The company also maintains a non-qualified defined contribution plan for officers of the company designed to make up for benefits lost due to limitations on eligible compensation imposed by the IRC. Freddie Mac matches employees' contributions up to 6 percent of their salaries per pay period; the percentage matched depends upon the length of service. Employee contributions and Freddie Mac's matching contributions are immediately vested. In addition, Freddie Mac has discretionary authority to make additional contributions to the Savings Plan that are allocated uniformly on behalf of each eligible employee, based on salary level. Employees become vested in Freddie Mac's discretionary contributions after 5 years. Freddie Mac incurred costs of \$29 million, \$28 million and \$22 million for the years ended December 31, 2004, 2003 and 2002, respectively, related to these plans. These expenses were included in Salaries and employee benefits on the consolidated statements of income.

See "NOTE 13: LEGAL CONTINGENCIES" for more information regarding civil litigation and a DOL investigation of Freddie Mac's Thrift/401(k) Savings Plan in relation to the restatement.

### Executive Deferred Compensation Plan

The Executive Deferred Compensation Plan is an unfunded, non-qualified plan that allows certain key employees to elect to defer a portion of their annual salary and cash bonus, and certain key management employees to defer the settlement of restricted stock units received from Freddie Mac, as well as a portion of their annual salary and cash bonus, for any number of years specified by the employee, but under no circumstances may the period elected exceed his or her life expectancy. Deferred salary, cash bonus and stock units are credited to an employee's account as of the date such amounts or units would have otherwise been paid or settled by delivery of shares to the employee. Subject to provisions for hardship withdrawals and certain terminations of employment, deferred distributions are payable at the end of the deferral period in lump sums or installments over five, ten or fifteen years. Distributions are paid from Freddie Mac's general assets. Freddie Mac records a liability equal to the accumulated deferred salary, cash bonus and accrued interest as set forth in the plan, net of any related distributions made to plan participants. Freddie Mac recognizes expense equal to the interest accrued on deferred salary and bonus throughout the year. Expense associated with unvested deferred restricted stock units is recognized as part of stock-based compensation.

## NOTE 16: FAIR VALUE DISCLOSURES

The consolidated fair value balance sheets in Table 16.1 present Freddie Mac's estimates of the fair value of the company's recorded assets and liabilities and off-balance sheet financial instruments as of December 31, 2004 and 2003. The fair value information on the consolidated fair value balance sheets includes the fair values of all items recorded in the consolidated balance sheets prepared in accordance with GAAP, as well as all off-balance sheet financial instruments that represent assets or liabilities of Freddie Mac that are not recorded in the GAAP consolidated balance sheets. These off-balance sheet items predominantly consist of the unrecognized guarantee assets and obligations associated with a portion of Freddie Mac PCs issued through the 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. The valuations of financial instruments on the consolidated fair value balance sheets are in accordance with GAAP fair value guidelines prescribed by SFAS No. 107, "Disclosures about Fair Value of Financial Instruments" ("SFAS 107") and other relevant pronouncements.

**Table 16.1 — Consolidated Fair Value Balance Sheets<sup>(1)</sup>**

	December 31,			
	2004		2003	
	Carrying Amount <sup>(2)</sup>	Fair Value <sup>(3)</sup>	Carrying Amount <sup>(2)</sup>	Fair Value
(dollars in billions)				
<b>Assets</b>				
Mortgage loans	\$ 61.3	\$ 63.3	\$ 60.2	\$ 62.5
Mortgage-related securities <sup>(4)</sup>	603.2	603.4	600.2	600.4
Retained portfolio	664.5	666.7	660.4	662.9
Cash and cash equivalents	35.3	35.3	23.1	23.1
Investments	29.8	29.8	65.4	65.4
Securities purchased under agreements to resell and Federal funds sold	32.2	32.2	20.6	20.6
Derivative assets	15.3	15.3	16.2	16.2
Guarantee asset for Participation Certificates	4.5	5.0	3.7	4.5
Other assets	13.7	13.3	14.0	13.2
Total assets	<u>\$795.3</u>	<u>\$797.6</u>	<u>\$803.4</u>	<u>\$805.9</u>
<b>Liabilities and minority interest</b>				
Total debt securities, net	\$731.7	\$737.0	\$739.6	\$749.8
Guarantee obligation for Participation Certificates	4.1	2.1	2.9	2.4
Derivative liabilities	0.2	0.2	0.4	0.4
Reserve for guarantee losses on Participation Certificates	0.2	—	0.1	—
Other liabilities <sup>(5)</sup>	26.2	25.7	27.0	23.9
Minority interests in consolidated subsidiaries	1.5	1.7	1.9	2.1
Total liabilities and minority interest	<u>763.9</u>	<u>766.7</u>	<u>771.9</u>	<u>778.6</u>
<b>Net assets attributable to stockholders</b>				
Preferred stockholders	4.6	4.1	4.6	4.4
Common stockholders	26.8	26.8	26.9	22.9
Total net assets	<u>31.4</u>	<u>30.9</u>	<u>31.5</u>	<u>27.3</u>
Total liabilities and net assets	<u>\$795.3</u>	<u>\$797.6</u>	<u>\$803.4</u>	<u>\$805.9</u>

(1) The consolidated fair value balance sheets do not purport to present the net realizable, liquidation or market value of Freddie Mac as a whole. Furthermore, amounts Freddie Mac ultimately realizes from the disposition of the assets or settlement of liabilities may vary significantly from the fair values presented.

(2) Carrying amounts equal the amounts reported on Freddie Mac's GAAP consolidated balance sheets.

(3) Methodologies employed to calculate fair values are periodically changed on a prospective basis to reflect improvements in the underlying estimation processes. The estimated impact of these improvements resulted in net after-tax changes to Total net assets of approximately \$0.6 billion at December 31, 2004. The most significant of these changes occurred in the fourth quarter when Freddie Mac began using newly available market prices received from broker/dealers and reliable third-party pricing providers for the valuation of a greater portion of its debt instruments.

(4) The fair value of Mortgage-related securities reported in this table exceeds the carrying value because the fair value includes PC residuals related to Participation Certificates held in the Retained portfolio that are not recognized under GAAP because such PCs were issued prior to the implementation of FIN 45 in 2003.

(5) Fair values include estimated income taxes on the difference between the consolidated fair value balance sheets pre-tax net assets and the consolidated GAAP balance sheets pre-tax net assets.

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## Limitations

The consolidated fair value balance sheets do not capture all elements of value that are implicit in Freddie Mac's operations as a going concern since the consolidated fair value balance sheets only capture the values of the current investment and securitization portfolios. For example, the consolidated fair value balance sheets do not capture the value of new investment and securitization business that would likely replace prepayments as they occur. In addition, the consolidated fair value balance sheets do not capture the value associated with future growth opportunities in Freddie Mac's investment and securitization portfolios. Thus, the fair value of net assets attributable to stockholders presented in the consolidated fair value balance sheets does not represent an estimate of the net realizable, liquidation or market value of Freddie Mac as a whole.

Freddie Mac reports assets and liabilities that are not financial instruments (such as property, plant and equipment and deferred taxes), as well as certain financial instruments that are not covered by the SFAS 107 disclosure requirements (such as pension liabilities) at their GAAP carrying amounts in the consolidated fair value balance sheets. Management believes these items do not have a significant impact on Freddie Mac's overall financial condition or fair value results.

## Valuation Methods and Assumptions

Fair value is generally based on independent price quotations obtained from third-party pricing services, dealer marks or direct market observations, where available. However, certain financial instruments are less actively traded and, therefore, are not always able to be valued based on prices obtained from third parties. If quoted prices or market data are not available, fair value is based on internal valuation models using market data inputs or internally developed assumptions, where appropriate.

The following methods and assumptions were used to estimate the fair value of assets and liabilities at December 31, 2004 and 2003.

### *Mortgage loans*

Mortgage loans represent single-family and multifamily whole loans held in Freddie Mac's Retained portfolio. For GAAP purposes, management must determine the fair value of these mortgage loans to calculate lower-of-cost-or-market value adjustments for mortgages classified as held-for-sale. Management uses this same approach when determining the fair value of all whole loans, including those held for investment, for fair value balance sheet purposes.

Freddie Mac determines the fair value of mortgage loans based on comparisons to actively traded mortgage-related securities with similar characteristics, with adjustments for yield, credit and liquidity differences. Specifically, Freddie Mac aggregates mortgage loans into pools by product type, coupon and maturity and then converts the pools into notional mortgage-related securities based on their specific characteristics. Freddie Mac then calculates fair values for these notional mortgage-related securities using the process that is described in the "Mortgage-related securities" section, below.

As described above, the fair value of these mortgage loans also includes adjustments for yield, credit and liquidity differences. To accomplish this, the fair value of the single-family whole loans includes an adjustment representing the estimated present value of the additional cash flows on the mortgage coupon of the whole loan in excess of the coupon expected on the notional mortgage-related securities. For multifamily whole loans, the fair value adjustment is estimated by calculating the net present value of guarantee fees expected to be retained by Freddie Mac. This retained guarantee fee is estimated by subtracting the expected cost of funding and securitizing a multifamily whole loan of a comparable maturity and credit rating from the coupon on the whole loan at the time of purchase.

The implied guarantee fee is also net of the related credit and other components inherent in the company's guarantee obligation. For single-family whole loans, the process for estimating the related credit and other guarantee obligation components is described in the "Guarantee obligation for Participation Certificates" section. For multifamily whole loans, the process for estimating the related credit and other guarantee obligation components employs a market-based approach to estimate the potential credit obligation. This obligation is estimated by extracting the credit risk premium that multifamily whole loan investors require from market prices on similar securities. This credit risk premium is net of expected funding, liquidity and other risk premiums that are embedded in the market price of the reference securities.

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### *Mortgage-related securities*

Mortgage-related securities represent passthroughs and other mortgage-related securities classified as available-for-sale and trading, which are already reflected at fair value on the GAAP consolidated balance sheets. Mortgage-related securities consist of securities issued by Freddie Mac, Fannie Mae and Ginnie Mae as well as non-agency mortgage-related securities.

The fair value of securities with readily available third-party market prices is generally based on market prices obtained from broker/dealers or reliable third-party pricing service providers. Fair value may be estimated by using third-party quotes for similar instruments, adjusted for differences in contractual terms. For other securities, a market option-adjusted spread approach based on observable market parameters is used to estimate fair value. Option-adjusted spreads for certain securities are estimated by deriving the option-adjusted spread for the most closely comparable security with an available market price, using proprietary interest-rate and prepayment models. If necessary, management judgment is applied to estimate the impact of differences in prepayment uncertainty or other unique cash flow characteristics related to that particular security. Fair values for these securities are then estimated by using the estimated option-adjusted spread as an input to the interest-rate and prepayment models, and estimating the net present value of the projected cash flows. The remaining instruments are priced using other modeling techniques or by using other securities as proxies.

Mortgage-related securities also include PC residuals related to PCs held by Freddie Mac and reported in the mortgage-related securities line item. PC residuals are reported at fair value on Freddie Mac's consolidated balance sheets. Fair value for PC residuals is estimated in the same manner as described for guarantee assets and guarantee obligations for PCs below.

### *Cash and cash equivalents*

Cash and cash equivalents largely consist of highly liquid investment securities with an original maturity of three months or less used for cash management purposes, as well as cash collateral posted by Freddie Mac's derivative counterparties. Given that these assets are short-term in nature with limited market value volatility, the carrying amount on the GAAP consolidated balance sheets is presumed to be a reasonable approximation of fair value.

### *Investments*

At December 31, 2004, Investments consists solely of non-mortgage-related securities, which are reported at fair value on Freddie Mac's consolidated balance sheets. At December 31, 2003, Investments included non-mortgage-related securities and mortgage-related securities held in connection with PC market making and support activities, which were reported at fair value on Freddie Mac's consolidated balance sheets. Freddie Mac ceased its PC market making and support activities accomplished through the Securities Sales & Trading Group business unit and the external Money Manager program during the fourth quarter of 2004. The fair values of Investments are estimated using the methods described above in "Mortgage-related securities."

### *Securities purchased under agreements to resell and Federal funds sold*

Securities purchased under agreements to resell and Federal funds sold principally consists of short-term contractual agreements such as reverse repurchase agreements involving Treasury and agency securities, Federal funds sold and Eurodollar time deposits. Given that these assets are short-term in nature, the carrying amount on the GAAP consolidated balance sheets is presumed to be a reasonable approximation of fair value.

### *Guarantee assets for Participation Certificates*

At December 31, 2004 and 2003, Freddie Mac established guarantee assets for approximately 87 percent and 81 percent, respectively, of PCs and Structured Securities held by third parties. For more information regarding the accounting for guarantee assets related to PCs and Structured Securities, see "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES."

For fair value balance sheet purposes, guarantee assets are reflected for all PCs and Structured Securities held by third parties and are valued using the same method as used for GAAP fair value purposes. For a description of how Freddie Mac determines the fair value of its guarantee assets, see "NOTE 2: TRANSFERS OF SECURITIZED INTERESTS IN MORTGAGE-RELATED ASSETS."

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### *Derivative assets*

Derivative assets, at fair value largely consists of interest-rate swaps, option-based derivatives, futures, and forward purchase and sale commitments that Freddie Mac accounts for as derivatives, which are reflected at fair value on the GAAP consolidated balance sheets. The fair values of interest-rate swaps are determined by using the appropriate yield curves to calculate and discount the expected cash flows for both the fixed-rate and floating-rate components of the swap contracts. Option-based derivatives, which principally include call and put swaptions, are valued using an option-pricing model. This model uses market interest rates and market-implied option volatilities, where available, to calculate the option's fair value. Market-implied option volatilities are based on information obtained from broker/dealers. The fair value of exchange-traded futures is based on end-of-day closing prices obtained from third-party pricing services. Derivative forward purchase and sale commitments are valued using the methods described for mortgage-related securities valuation, above.

The fair value of derivative assets considers the impact of institutional credit risk in the event that the counterparty does not honor its payment obligation. Freddie Mac's fair value of derivatives is not adjusted for expected credit losses because management obtains collateral from most counterparties typically within one to three business days of the daily market value calculation and substantially all of Freddie Mac's credit risk arises from counterparties with investment-grade credit ratings of A- or above.

### *Other assets*

Other assets consists of accrued interest and other receivables, investments in qualified LIHTC limited partnerships that are eligible for federal tax credits, financial guarantee contracts for additional credit protection on certain manufactured housing asset-backed securities, real estate owned, property, plant and equipment, and other miscellaneous assets.

The receivables are financial instruments and are required to be measured at fair value for disclosure purposes pursuant to SFAS 107. Because these receivables are short-term in nature, management believes the carrying amount on the GAAP consolidated balance sheets is a reasonable approximation of their fair values. For the LIHTC partnerships, the fair value of expected tax benefits is estimated using expected cash flows discounted at a market-based yield. For the credit enhancements on manufactured housing asset-backed securities, the fair value is based on the difference between the market price of non-credit impaired manufactured housing securities and credit-impaired manufactured housing securities that are likely to produce future credit losses, as adjusted for management's estimate of a risk premium attributable to the financial guarantee contracts. The value of the contracts, over time, will be determined by the actual credit-related losses incurred and, therefore, may have a value that is higher or lower than management's market-based estimate.

The other categories of assets that comprise Other assets are not financial instruments required to be valued at fair value under SFAS 107, such as REO properties. The fair market value of REO properties is calculated using a model-based approach, incorporating market sales data, that estimates a discount to full fair market value for a comparable property that has not been subject to foreclosure proceedings. This adjustment is intended to capture the sale price discount generally evidenced in the market for properties that have been subject to a foreclosure sale.

Other non-financial assets included in Other assets represent an insignificant portion of the GAAP consolidated balance sheets. Because any change in their fair value would not be a meaningful part of Freddie Mac's fair value of net assets business results, Freddie Mac has not adjusted the carrying amount on the GAAP consolidated balance sheets for estimates of the fair value of these non-financial assets.

### *Total debt securities, net*

Total debt securities, net represents short-term and long-term debt used to finance Freddie Mac's assets and, for GAAP presentation, is net of deferred items, including premiums, discounts and hedging-related basis adjustments. It includes both non-callable and callable debt as well as short-term zero coupon discount notes. The fair value of the short-term zero coupon discount notes is based on a discounted cash flow model with market inputs. The valuation of other debt securities is generally based on market prices obtained from broker/dealers, reliable third-party pricing service providers, or direct market observations. In the fourth quarter of 2004, Freddie Mac began using newly available market prices received from broker/dealers and

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reliable third-party pricing services for the valuation of a greater portion of its debt instruments. Previously the calculation of the fair value of these instruments was based primarily on an internal model using available market inputs.

#### *Guarantee obligation for Participation Certificates*

Freddie Mac does not establish guarantee obligations for all PCs and Structured Securities held by third parties for GAAP purposes. In addition, guarantee obligations are not carried at fair value for GAAP purposes. For fair value balance sheet purposes, guarantee obligations reflect the fair value of Freddie Mac's guarantee obligation on all PCs held by third parties. Additionally, for fair value balance sheet purposes, guarantee obligations are valued using the same method as used for GAAP to determine the guarantee obligation's initial fair value. For information concerning the company's valuation methodologies and accounting policies related to guarantee-related credit losses, see "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES," and "NOTE 2: TRANSFERS OF SECURITIZED INTERESTS IN MORTGAGE-RELATED ASSETS."

#### *Reserve for guarantee losses on Participation Certificates*

The carrying amount of the Reserve for guarantee losses on Participation Certificates on the GAAP consolidated balance sheets represents GAAP loan loss reserves for off-balance sheet PCs that are not already accounted for under SFAS 125/140. This line item has no basis in the consolidated fair value balance sheets, because the estimated fair value of all expected default losses is included in the guarantee obligation reported on the consolidated fair value balance sheets, as discussed above.

#### *Derivative liabilities*

See discussion under "Derivative assets" above.

#### *Other liabilities*

Other liabilities principally consists of amounts due to PC investors (*i.e.*, principal and interest), funding liabilities associated with investments in LIHTC partnerships, accrued interest payable on debt securities and other miscellaneous obligations of less than one year. Management believes the carrying amount of these liabilities is a reasonable approximation of their fair value, except for funding liabilities associated with investments in LIHTC partnerships, for which fair value is estimated using expected cash flows discounted at a market-based yield. Also, management adjusts the GAAP-basis deferred taxes for consolidated fair value balance sheets purposes. Fair values include estimated income taxes on the difference between the consolidated fair value balance sheets pre-tax net assets and the consolidated GAAP balance sheets pre-tax net assets.

#### *Minority interests in consolidated subsidiaries*

Minority interests in consolidated subsidiaries primarily represent preferred stock interests that third parties hold in Freddie Mac's two majority-owned REIT subsidiaries. In accordance with GAAP, Freddie Mac consolidated the REITs. The fair value of the third-party minority interests in these REITs was based on the estimated value of the underlying REIT preferred stock determined by management based on a valuation model adjusted to consider the impact of embedded call options, using market-based information to the extent available.

#### *Net assets attributable to preferred stockholders*

To determine the preferred stock fair value, Freddie Mac uses a market-based approach incorporating quoted dealer prices.

#### *Net assets attributable to common stockholders*

Net assets attributable to common stockholders is equal to the fair value of net assets (the difference between the fair value of Freddie Mac's assets and the fair value of liabilities and minority interest), less the fair value of net assets attributable to preferred stockholders.

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## NOTE 17: CONCENTRATION OF CREDIT AND OTHER RISKS

### Mortgages and Mortgage-Related Securities

Table 17.1 summarizes the geographical concentration of mortgages and mortgage-related securities that are held by Freddie Mac or that are collateral for PCs and Structured Securities excluding:

- \$3,015 million and \$4,729 million of mortgage-related securities issued by Ginnie Mae that back Structured Securities at December 31, 2004 and 2003, respectively, because these securities do not expose Freddie Mac to meaningful amounts of credit risk;
- \$59,715 million and \$77,289 million of agency mortgage-related securities at December 31, 2004 and 2003, respectively, because these securities do not expose Freddie Mac to meaningful amounts of credit risk;
- \$175,163 million and \$114,772 million of non-agency mortgage-related securities held in the Retained portfolio at December 31, 2004 and 2003, respectively, because geographic information regarding these securities is not available. With respect to these securities, Freddie Mac looks to third party credit enhancements (*e.g.*, bond insurance) or other credit enhancements resulting from the securitization structure (*e.g.*, subordination levels) supporting such securities as a primary means of managing credit risk; and
- \$29,830 million and \$48,585 million of non-Freddie Mac mortgage-related securities and mortgage-related securities held in its Cash and investments portfolio that are important to Freddie Mac's financial management and the company's ability to provide liquidity and stability to the mortgage market at December 31, 2004 and 2003, respectively. These securities are excluded because Freddie Mac tends to hold them for a short time period and the geographic information regarding these securities is not available. In fourth quarter 2004, Freddie Mac ceased its PC market-making and support activities accomplished through its Securities Sales & Trading Group business unit and its external Money Manager program, which was a component of the \$48,585 million balance at December 31, 2003.

See "NOTE 5: RETAINED PORTFOLIO AND CASH AND INVESTMENTS PORTFOLIO" for more information about the securities Freddie Mac holds.

**Table 17.1 — Concentration of Credit Risk**

	December 31,			
	2004		2003	
	Amount <sup>(1)</sup>	Percentage	Amount <sup>(1)</sup>	Percentage
	(dollars in millions)			
<b>By Region<sup>(2)</sup></b>				
Northeast . . . . .	\$ 309,344	24%	\$ 288,865	24%
West . . . . .	296,390	23	295,349	24
North central . . . . .	280,618	22	271,339	22
Southeast . . . . .	220,858	18	210,570	17
Southwest . . . . .	160,249	13	151,486	13
	<u>\$1,267,459</u>	<u>100%</u>	<u>\$1,217,609</u>	<u>100%</u>
<b>By State</b>				
California . . . . .	\$ 171,209	14%	\$ 175,030	14%
Florida . . . . .	75,879	6	70,970	6
Illinois . . . . .	65,750	5	63,497	5
New York . . . . .	65,344	5	56,013	5
All Others . . . . .	889,277	70	852,099	70
	<u>\$1,267,459</u>	<u>100%</u>	<u>\$1,217,609</u>	<u>100%</u>

(1) Calculated as Total mortgage portfolio less mortgage-related securities issued by Ginnie Mae that back PCs and Structured Securities as well as agency and non-agency mortgage-related securities held in the Retained portfolio.

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

**Mortgage Lenders**

A significant portion of Freddie Mac’s single-family mortgage purchase volume is generated from several key mortgage lenders that have entered into special business arrangements with Freddie Mac. These individually negotiated arrangements characteristically involve a lender’s commitment to sell a high proportion of its conforming mortgage origination volume to Freddie Mac. During 2004, the four most significant of these arrangements together accounted for almost 63 percent of Freddie Mac’s volume. Wells Fargo Home Mortgage, Inc. was the largest source and accounted for approximately 33 percent of the company’s mortgage purchase volume in 2004 while Chase Home Finance LLC, the second largest source, accounted for approximately 14 percent of the company’s mortgage purchase volume. Freddie Mac is exposed to the risk that it could lose purchase volume to the extent these agreements are terminated or modified without replacement from other lenders.

**Derivative Portfolio**

On an ongoing basis, Freddie Mac reviews the credit fundamentals of all of its derivative counterparties to confirm that they continue to meet internal standards. Internal ratings, credit, capital and trading limits are assigned to each counterparty based on quantitative and qualitative analysis, and are updated and monitored on a regular basis. Additional reviews are completed when market conditions or events affecting an individual counterparty occur.

*Derivative Counterparties.* Freddie Mac’s use of derivatives exposes the company to counterparty credit risk. Exchange-traded derivatives, such as futures contracts, do not measurably increase the company’s counterparty credit risk because changes in the value of open exchange-traded contracts are settled daily through a financial clearinghouse established by each exchange. OTC derivatives, however, expose the company to counterparty credit risk because transactions are executed and settled between Freddie Mac and the counterparty. Freddie Mac’s standards for entering into OTC derivative agreements for interest-rate swaps, option-based derivatives and foreign-currency swaps include rigorous internal credit and legal reviews. Freddie Mac’s derivative counterparties carry external credit ratings among the highest available from major rating agencies. All of these counterparties are major financial institutions and are experienced participants in the OTC derivatives market.

*Master Netting and Collateral Agreements.* Freddie Mac uses master netting and collateral agreements to reduce its credit risk exposure to its active OTC derivative counterparties for interest-rate swaps, option-based derivatives and foreign-currency swaps. Master netting agreements provide for the netting of amounts receivable and payable from an individual counterparty, which reduces Freddie Mac's exposure to a single counterparty in the event of default. For example, if Freddie Mac has a gain position on one derivative and a loss position on another derivative with the same counterparty, then the gain can be netted with the loss to determine the amount of the company's net exposure to the counterparty. On a daily basis, the market value of each counterparty's derivatives outstanding is calculated to determine the amount of the company's net credit exposure, which is equal to derivatives in a net gain position by counterparty after giving consideration to collateral posted. Freddie Mac's collateral agreements require most counterparties to post collateral for the amount of the company's net exposure to them above the applicable threshold. Collateral posting thresholds are generally tied to a counterparty's credit rating. Derivative exposures and collateral amounts are monitored on a daily basis using both internal pricing models and dealer price quotes. Freddie Mac's derivative counterparties typically transfer collateral within one to three business days based on the values of the related derivatives. This time lag in posting collateral can affect Freddie Mac's net uncollateralized exposure to derivative counterparties.

The collateral posted by counterparties serves to protect Freddie Mac against the risk of counterparty credit losses. Collateral posted by a derivative counterparty is typically in the form of cash, U.S. Treasury securities, agency securities or other mortgage-related securities. In the event a counterparty defaults on its obligations under the derivatives agreement and the default is not remedied in the manner prescribed in the agreement, Freddie Mac has the right under the agreement to direct the custodian bank to transfer the collateral to the company or, in the case of non-cash collateral, to sell the collateral and transfer the proceeds to the company.

Freddie Mac's uncollateralized exposure to counterparties for OTC interest-rate swaps, option-based derivatives and foreign-currency swaps, after applying netting agreements and collateral, was \$601 million and \$796 million at December 31, 2004 and 2003, respectively. In the extremely unlikely event that all of Freddie Mac's counterparties for these derivatives were to have defaulted simultaneously on December 31, 2004, the maximum loss to Freddie Mac for accounting purposes would have been approximately \$601 million.

Freddie Mac's exposure to counterparties for OTC forward purchase and sale commitments treated as derivatives was \$40 million and \$101 million as of December 31, 2004 and 2003, respectively. Since the typical maturity for OTC commitments is less than one year, Freddie Mac does not require master netting and collateral agreements for the counterparties of these commitments. Therefore, Freddie Mac's exposure to its OTC commitments counterparties is uncollateralized. Similar to counterparties for its OTC interest-rate swaps, option-based derivatives and foreign-currency swaps, Freddie Mac monitors the credit fundamentals of its OTC commitments counterparties on an ongoing basis to ensure that they continue to meet internal risk-management standards.

#### NOTE 18: MINORITY INTERESTS

The equity and net earnings attributable to the minority stockholder interests in consolidated subsidiaries are reported in the consolidated balance sheets as Minority interests in consolidated subsidiaries and in the consolidated statements of income as Minority interests in earnings of consolidated subsidiaries, respectively. The majority of the balances in these accounts relate to the company's two majority-owned REITs.

In February 1997, Freddie Mac formed two majority-owned REIT subsidiaries funded through the issuance of common stock (99.9 percent of which is held by Freddie Mac) and a total of \$4.0 billion of perpetual, step-down preferred stock issued to outside investors. The dividend rate on the step-down preferred stock is 13.3 percent from initial issuance through 2006 (the "initial term"). Beginning in 2007, the dividend rate will step-down to 1.0 percent. Dividends on this preferred stock accrue in arrears. The balance of the two step-down preferred stock issuances as recorded within Minority interests in consolidated subsidiaries on the consolidated balance sheets totaled \$1.5 billion and \$1.9 billion at December 31, 2004 and 2003, respectively. The preferred stock is redeemable by the REITs under certain circumstances described in the preferred stock offering documents as a "tax event redemption." Additionally, after an initial period ending December 31, 2006, the REITs may be able to retire the preferred stock under favorable financing terms in accordance with the terms of the preferred stock. The REITs may decide to redeem the preferred stock in the future depending on market conditions and other factors. See "NOTE 14: INCOME TAXES" for more information concerning the REITs.



## NOTE 19: EARNINGS PER COMMON SHARE

Basic earnings per common share are computed as Net income available to common stockholders divided by the weighted average common shares outstanding (Weighted average common shares outstanding-basic) for the period. Diluted earnings per common share are computed as Net income available to common stockholders divided by the weighted average common shares outstanding considering the effect of dilutive common equivalent shares outstanding (Weighted average common shares outstanding-diluted) for the period. Dilutive common equivalent shares reflect the assumed issuance of additional common shares pursuant to certain of the company's stock-based compensation plans (see "NOTE 11: STOCK-BASED COMPENSATION") that could potentially reduce or "dilute" earnings per share, based on the treasury stock method.

Table 19.1 provides computations of Freddie Mac's basic and diluted earnings per common share.

**Table 19.1 — Earnings Per Common Share — Basic and Diluted**

	Year Ended December 31,		
	2004	2003	2002
	(dollars in millions and shares in thousands)		
Net income . . . . .	\$ 2,937	\$ 4,816	\$ 10,090
Preferred stock dividends and issuance costs on redeemed preferred stock (including \$0, \$0 and \$5 of issuance costs on redeemed preferred stock) . . . . .	(210)	(216)	(239)
Net income available to common stockholders <sup>(1)</sup> . . . . .	<u>\$ 2,727</u>	<u>\$ 4,600</u>	<u>\$ 9,851</u>
Weighted average common shares outstanding — basic . . . . .	689,282	687,094	692,727
Dilutive potential common shares <sup>(2)</sup> . . . . .	<u>2,239</u>	<u>1,581</u>	<u>2,389</u>
Weighted average common shares outstanding — diluted . . . . .	<u>691,521</u>	<u>688,675</u>	<u>695,116</u>
Basic earnings per common share . . . . .	\$ 3.96	\$ 6.69	\$ 14.22
Diluted earnings per common share . . . . .	\$ 3.94	\$ 6.68	\$ 14.17

- (1) Net income available to common stockholders is not affected by dilutive potential common shares for the years ended December 31, 2004, 2003 and 2002.
- (2) The effect of dilutive common equivalent shares outstanding includes: (a) the weighted average shares related to stock options (including the ESPP) that have an exercise price lower than the average market price during the period; (b) the weighted average of non-vested restricted shares; and (c) all restricted stock units. Such items are excluded from weighted average common shares outstanding — basic.

Options to purchase 2.4 million, 3.4 million and 2.5 million shares of common stock were excluded from the computation of Diluted earnings per common share at December 31, 2004, 2003 and 2002, respectively, because the options' exercise price exceeded the average market price of the common stock for the years ended December 31, 2004, 2003 and 2002, respectively.

## DIRECTORS AND EXECUTIVE OFFICERS

### Directors

Information on our Directors is set forth under “Proposal 1: Election of Directors — Nominees for Election” of our Proxy Statement for our annual meeting to be held on July 15, 2005, and is incorporated herein by reference.

### Executive Officers

As of June 1, 2005, our executive officers are as follows:

<u>Name</u>	<u>Age</u>	<u>Year of Affiliation</u>	<u>Position</u>
Richard F. Syron . . . . .	61	2003	Chairman and Chief Executive Officer
Eugene M. McQuade . . . . .	56	2004	President and Chief Operating Officer
Martin F. Baumann . . . . .	57	2003	Executive Vice President, Finance and Chief Financial Officer
Ralph F. Boyd, Jr. . . . .	48	2004	Executive Vice President, Community Relations
Patricia L. Cook . . . . .	52	2004	Executive Vice President, Investments
Joseph A. Smialowski . . . . .	56	2004	Executive Vice President, Operations and Technology
David A. Andrukonis . . . . .	47	1980	Senior Vice President and Chief Enterprise Risk Officer*
Margaret A. Colon . . . . .	47	1983	Senior Vice President and Chief Administrative Officer
Adrian B. Corbiere . . . . .	60	1999	Senior Vice President, Multifamily Sourcing
Joan E. Donoghue . . . . .	48	2001	Senior Vice President, General Counsel and Corporate Secretary
Stanley J.D. Martin . . . . .	58	2004	Senior Vice President and General Auditor
Timothy J. McBride . . . . .	46	2005	Senior Vice President, Government and Industry Relations
Hollis S. McLoughlin . . . . .	54	2004	Senior Vice President and Chief of Staff
Robert Y. Tsien . . . . .	52	2000	Senior Vice President, Mission Oversight and Development
Jerry Weiss . . . . .	47	2003	Senior Vice President and Chief Compliance Officer
John F. Woods . . . . .	40	2002	Senior Vice President, Corporate Controller and Principal Accounting Officer

\* Mr. Andrukonis announced his intention to leave Freddie Mac effective at the end of June 2005.

The following is a brief biographical description of each of our executive officers.

Richard F. Syron was appointed Chairman and Chief Executive Officer in December 2003. Prior to joining us, Mr. Syron was Executive Chairman of Thermo Electron Corporation, a position he assumed in November 2002. He joined Thermo Electron in June 1999 as its Chief Executive Officer and became its Chairman of the Board in January 2000. Prior to that, he was Chairman and Chief Executive Officer of the American Stock Exchange for five years, President of the Federal Reserve Bank of Boston for five years and President of the Federal Home Loan Bank of Boston for three years.

Eugene M. McQuade was appointed President and Chief Operating Officer effective September 1, 2004. Before joining us, Mr. McQuade was President of Bank of America Corporation. He also served as President and Chief Operating Officer of FleetBoston Financial Corp., which merged with Bank of America on April 1, 2004. Mr. McQuade joined Fleet in 1992 and became Chief Financial Officer in 1993, Vice Chairman in 1997, and President and Chief Operating Officer in 2002. Prior to joining Fleet, Mr. McQuade was Executive Vice President and Controller of Manufacturers Hanover Corp.

Martin F. Baumann was appointed Executive Vice President, Finance in April 2003 and Chief Financial Officer in June 2003. Prior to joining us, Mr. Baumann worked at PricewaterhouseCoopers since 1969, where he was a partner from 1980. At PricewaterhouseCoopers, he performed a variety of functions, including serving as the Deputy Chairman — World Financial Services Practice and as the Global Banking Leader. He also served on PricewaterhouseCoopers U.S. and World Financial Services Executive Committees.

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Ralph F. Boyd, Jr. was appointed Executive Vice President, Community Relations in February 2005. Prior to holding his current position, he served as our Executive Vice President, General Counsel and Corporate Secretary. Prior to joining us, Mr. Boyd was a senior partner with the law firm Alston & Bird LLP since August 2003 and was U.S. assistant attorney general and head of the Justice Department's Civil Rights Division from July 2001 through July 2003. From 1997 to 2001, Mr. Boyd was a trial partner with Goodwin Procter LLP, and before that, he served for six years as an Assistant U.S. Attorney in Boston. He also was an associate at the law firm of Ropes & Gray in Boston from 1987 to 1991.

Patricia L. Cook was appointed Executive Vice President, Investments, effective August 2, 2004. Prior to joining us, Ms. Cook was Managing Director and Chief Investment Officer, Global Fixed Income at JPMorgan Fleming Asset Management ("JP Morgan Fleming") since May 2003. Prior to joining JP Morgan Fleming, she was Managing Director and Chief Investment Officer, Fixed Income at Prudential Investment Management. From June 1991 to July 2001, Ms. Cook was Managing Director at Fisher Francis Trees and Watts. Prior to that, she worked in various management positions at Salomon Brothers, Inc. from January 1979 to June 1991.

Joseph A. Smialowski was named Freddie Mac's Executive Vice President of Operations and Technology in December 2004. Before joining Freddie Mac, Mr. Smialowski was Executive Vice President at Fleet Boston Financial from December 1998. Prior to that, he was Chief Information Officer at Sears, Roebuck and Co. from September 1993. Early in his career, Mr. Smialowski held increasingly responsible management, technology and operations positions at Dennison Manufacturing, Xerox and The Hartford.

David A. Andrukonis was appointed Senior Vice President and Chief Enterprise Risk Officer in October 2003. Prior to that he served as Senior Vice President of Single-Family Capital Deployment from September 2001 through October 2003. He also served as Senior Vice President and Chief Credit Officer from August 1998 through September 2001. Prior to that, he held various positions at our company since joining us in 1980, including Senior Vice President and General Manager of the Seller Division, Vice President of Mortgage Finance, Manager of Product Development and Pricing and Senior Economist.

Margaret A. Colon was named Senior Vice President and Chief Administrative Officer in October 2003. Prior to that, Ms. Colon served as Senior Vice President of Infrastructure Initiatives Program Management from July 2002 to October 2003 and as Senior Vice President and Single-Family Chief Operating Officer from June 2000 through June 2002. Prior to June 2000, she also has served in various other positions at our company, including Senior Vice President — Servicer, Vice President of Corporate Finance Operations, Vice President and Assistant to the President, Vice President and Multifamily Controller. Prior to joining us in 1983, Ms. Colon was a senior auditor with Deloitte Haskins and Sells.

Adrian B. Corbiere was named Senior Vice President, Multifamily Sourcing in August 1999. Before joining Freddie Mac, Mr. Corbiere was a managing director at Allstate Insurance Corp., responsible for all real estate, mortgage and CMBS investments. Prior to his position at Allstate, he was Senior Vice President of fixed-income investments, including mortgages and private placement bonds, at New England Mutual Life Insurance Company and held various real estate finance positions at both Cigna and Phoenix Mutual Insurance Companies.

Joan E. Donoghue was named Freddie Mac's Senior Vice President, General Counsel and Corporate Secretary in February 2005. Ms. Donoghue had previously served as Senior Vice President and Principal Deputy General Counsel since April 2004. She joined Freddie Mac in 2001 as Associate General Counsel and later served as Vice President and Acting General Counsel. Prior to joining Freddie Mac, Ms. Donoghue held positions of increasing importance with the U.S. Department of State including Deputy Legal Adviser. She also served as deputy general counsel at the U.S. Department of the Treasury. She also served as visiting professor at Boalt Hall School of Law, University of California at Berkeley, where she was a Council on Foreign Relations International Affairs Fellow. She began her legal career as an associate attorney with Covington and Burling.

Stanley J.D. Martin was appointed Senior Vice President and General Auditor in June 2004. Immediately prior to his appointment, Mr. Martin had served as interim General Auditor since February 2004. Before that, Mr. Martin served as Executive Vice President and then as a consultant to HSBC Bank USA from 2000

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to April 2003. From 1998 to 2000, he was Chief Financial Officer and Executive Vice President of Republic New York Corporation. Prior to that, Mr. Martin was a Partner at KPMG LLP from 1982 to 1998.

Timothy J. McBride was appointed Freddie Mac's Senior Vice President, Government and Industry Relations in January 2005. Prior to Freddie Mac, Mr. McBride served as Vice President, External Affairs/Public Policy for Daimler Chrysler Corporation, where he was responsible for directing Chrysler's federal lobbying and formulating public policy on a variety of issues. Before that, he worked at Sun Company, Incorporated as director of communications. Mr. McBride also held key positions with the Administration of former president George H.W. Bush where he served as Assistant to the President and Director of White House Management and Administration. During his tenure, he also held the positions of Assistant Secretary of Commerce for Trade Development and Special Assistant to the President. He also worked for a number of years in the Office of the Vice President of the United States for George H. W. Bush.

Hollis S. McLoughlin was named Senior Vice President and Chief of Staff in April 2004. Since 1998, Mr. McLoughlin has been Chief Operating Officer of two private equity-backed operating companies. Before that, he was one of the founding partners of Darby Overseas, a private equity partner based in Washington, D.C. He has also been a senior executive at Purolator Courier, the overnight delivery company and a privately held transportation company. From 1989 through 1992, Mr. McLoughlin served as Assistant Secretary of the Treasury under former president George H. W. Bush. He served as Chief of Staff to Sen. Nicholas Brady, R-N.J., in 1982 and to Rep. Millicent Fenwick, R-N.J., from 1975 to 1979.

Robert Y. Tsien was appointed Senior Vice President, Mission Oversight and Development in April 2004. Prior to that, he served as Senior Vice President, Production in the Multifamily Division from October 2003, and as our Chief Credit Officer from September 2001 to October 2003. Mr. Tsien joined us as Vice President of Multifamily Risk Management in April 2000. Prior to joining us, Mr. Tsien was director of risk management and securitization pricing at Titanium Investment Company.

Jerry Weiss was appointed Senior Vice President and Chief Compliance Officer in October 2003. Prior to joining us, Mr. Weiss worked from 1990 at Merrill Lynch Investment Managers, most recently as First Vice President and Global Head of Compliance. From 1982 to 1990, Mr. Weiss was with a national law practice in Washington, D.C., where he specialized in securities regulation and corporate finance matters.

John F. Woods was named Senior Vice President and Principal Accounting Officer in October 2003 and Corporate Controller in February 2005. Prior to that, Mr. Woods served as Senior Vice President, Control and Accounting in Funding and Investments from April 2002 to October 2003. Prior to joining us, Mr. Woods was a consulting partner at Arthur Andersen.

## **EXECUTIVE COMPENSATION**

Information regarding executive compensation is set forth under the section titled “Executive Compensation” of our Proxy Statement for our annual meeting of stockholders to be held on July 15, 2005 and is incorporated by reference into this Information Statement.

## **SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS**

### **Security Ownership of Management**

Information regarding the beneficial ownership of our common stock by each of our directors, certain executive officers and by all directors and executive officers as a group is set forth under the section titled “Corporate Governance — Stock Ownership by Directors and Officers” of our Proxy Statement for our annual meeting of stockholders to be held on July 15, 2005 and is incorporated by reference into this Information Statement.

### **Security Ownership of Certain Beneficial Owners**

Information regarding the beneficial ownership of our common stock by each director nominee and certain beneficial owners is set forth under the section titled “Corporate Governance — Stock Ownership by Directors and Officers” of our Proxy Statement for our annual meeting of stockholders to be held on July 15, 2005 and is incorporated by reference into this Information Statement.

## **CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS**

Information regarding certain relationships and related transactions is set forth under the section titled “Proposal 1: Election of Directors — Transactions with Institutions Related to Directors” of our Proxy Statement for our annual meeting of stockholders to be held on July 15, 2005 and is incorporated by reference into this Information Statement.

## **INDEMNIFICATION AND OTHER REIMBURSEMENTS OF DIRECTORS, OFFICERS AND EMPLOYEES**

Information concerning indemnification and reimbursement arrangements is set forth under the section titled “Proposal 1: Election of Directors — Indemnification and Other Reimbursements of Directors, Officers and Employees” of our Proxy Statement for our annual meeting of stockholders to be held on July 15, 2005 and is incorporated by reference into this Information Statement.

## **PRINCIPAL ACCOUNTANT FEES AND SERVICES**

Information regarding principal accountant fees and services is set forth under the section titled “Proposal 2: Ratification of Appointment of Independent Auditors” of our Proxy Statement for our annual meeting of stockholders to be held on July 15, 2005 and is incorporated by reference into this Information Statement.

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## RATIO OF EARNINGS TO FIXED CHARGES

	Year Ended December 31,				
	2004	2003	2002	2001	2000
	(dollars in millions)				
Income before cumulative effect of change in accounting principles, net of taxes	\$ 2,937	\$ 4,816	\$10,090	\$ 3,115	\$ 3,666
Add:					
Income tax expense	790	2,202	4,713	1,339	1,504
Minority interests in earnings of consolidated subsidiaries	129	157	184	208	231
Total interest expense	26,566	26,509	26,876	27,577	25,483
Interest factor in rental expenses	6	5	5	5	5
Capitalized interest <sup>(1)</sup>	1	—	1	1	1
Earnings, as adjusted	<u>\$30,429</u>	<u>\$33,689</u>	<u>\$41,869</u>	<u>\$32,245</u>	<u>\$30,890</u>
Fixed charges:					
Total interest expense	\$26,566	\$26,509	\$26,876	\$27,577	\$25,483
Interest factor in rental expenses	6	5	5	5	5
Capitalized interest <sup>(1)</sup>	1	—	1	1	1
Total fixed charges	<u>\$26,573</u>	<u>\$26,514</u>	<u>\$26,882</u>	<u>\$27,583</u>	<u>\$25,489</u>
Ratio of earnings to fixed charges <sup>(2)</sup>	<u>1.15</u>	<u>1.27</u>	<u>1.56</u>	<u>1.17</u>	<u>1.21</u>

(1) Subsequent to the issuance of our Information Statement dated September 24, 2004, we revised the capitalized interest to conform to 2004 presentation for 2003, 2002, 2001 and 2000. This resulted in a \$2 million, \$2 million and \$1 million decrease in capitalized interest for 2003, 2002 and 2001, respectively.

(2) Ratio of earnings to fixed charges is computed by dividing Earnings, as adjusted by Total fixed charges.

## RATIO OF EARNINGS TO COMBINED FIXED CHARGES AND PREFERRED STOCK DIVIDENDS

	Year Ended December 31,				
	2004	2003	2002	2001	2000
	(dollars in millions)				
Income before cumulative effect of change in accounting principles, net of taxes	\$ 2,937	\$ 4,816	\$10,090	\$ 3,115	\$ 3,666
Add:					
Income tax expense	790	2,202	4,713	1,339	1,504
Minority interests in earnings of consolidated subsidiaries	129	157	184	208	231
Total interest expense	26,566	26,509	26,876	27,577	25,483
Interest factor in rental expenses	6	5	5	5	5
Capitalized interest <sup>(1)</sup>	1	—	1	1	1
Earnings, as adjusted	<u>\$30,429</u>	<u>\$33,689</u>	<u>\$41,869</u>	<u>\$32,245</u>	<u>\$30,890</u>
Fixed charges:					
Total interest expense	\$26,566	\$26,509	\$26,876	\$27,577	\$25,483
Interest factor in rental expenses	6	5	5	5	5
Capitalized interest <sup>(1)</sup>	1	—	1	1	1
Preferred stock dividends <sup>(2)</sup>	266	315	351	310	252
Total fixed charges including preferred stock dividends	<u>\$26,839</u>	<u>\$26,829</u>	<u>\$27,233</u>	<u>\$27,893</u>	<u>\$25,741</u>
Ratio of earnings to combined fixed charges and preferred stock dividends <sup>(3)</sup>	<u>1.13</u>	<u>1.26</u>	<u>1.54</u>	<u>1.16</u>	<u>1.20</u>

(1) Subsequent to the issuance of our Information Statement dated September 24, 2004, we revised the capitalized interest to conform to 2004 presentation for 2003, 2002, 2001 and 2000. This resulted in a \$2 million, \$2 million and \$1 million decrease in capitalized interest for 2003, 2002 and 2001, respectively.

(2) Preferred stock dividends represent pre-tax earnings required to cover any preferred stock dividend requirements using our effective tax rate for the relevant periods.

(3) Ratio of earnings to combined fixed charges and preferred stock dividends is computed by dividing Earnings, as adjusted by Total fixed charges including preferred stock dividends.

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#### ADDITIONAL FINANCIAL INFORMATION

For more information about Freddie Mac stock contact:

Freddie Mac  
Mailstop D40  
1551 Park Run Drive  
McLean, Virginia 22102-3110  
Investor Relations: (571) 382-4732  
Toll Free: (800) FREDDIE  
On the Internet: <http://www.FreddieMac.com/investors>

#### ANNUAL MEETING

The annual meeting of Freddie Mac's stockholders will be held:

July 15, 2005  
9:00 a.m. eastern time  
8000 Jones Branch Drive  
McLean, Virginia 22102

Proxy material will be mailed to stockholders of record by the company's transfer agent in accordance with Freddie Mac's bylaws and New York Stock Exchange requirements.

#### DIVIDEND PAYMENT

Approved by Freddie Mac's Board of Directors, dividends on the company's common stock and non-cumulative preferred stock in 2004 and the first five months of 2005 were paid on:

March 31, 2004  
June 30, 2004  
September 30, 2004  
December 31, 2004  
March 31, 2005

Subject to approval by Freddie Mac's Board of Directors, dividends on the company's common stock and non-cumulative preferred stock in the last seven months of 2005 are expected to be paid on:

June 30, 2005  
September 30, 2005  
December 31, 2005

#### CORPORATE HEADQUARTERS

8200 Jones Branch Drive  
McLean, Virginia 22102-3110  
(703) 903-2000

#### NEW YORK CITY OFFICE

575 Lexington Avenue, Suite 1800  
New York, New York 10022-6102  
(212) 418-8900

#### NORTH CENTRAL REGION

333 West Wacker Drive, Suite 2500  
Chicago, Illinois 60606-1287  
(312) 407-7400

#### NORTHEAST REGION

1410 Spring Hill Road, Suite 600  
Post Office Box 50122  
McLean, Virginia 22102-8922  
(703) 902-7700

#### SOUTHEAST REGION

North Tower, Suite 200  
2300 Windy Ridge Parkway SE  
Atlanta, Georgia 30339-5665  
(770) 857-8800

#### SOUTHWEST REGION

5000 Plano Parkway  
Carrollton, Texas 75010-4902  
(972) 395-4000

#### WESTERN REGION

21700 Oxnard Street, Suite 1900  
Woodland Hills, California 91367-3642  
(818) 710-3000

*Freddie Mac*



## INDEX OF ACRONYMS

We are providing this index of acronyms used in this Information Statement for the convenience of the reader. All of the acronyms listed below are defined at their first use in this document.

ABO	Accumulated benefit obligation
AICPA	American Institute of Certified Public Accountants
AOCI	Accumulated other comprehensive income (loss), net of taxes
APB	Accounting Principles Board
ARM	Adjustable-Rate Mortgage
CMT	Constant Maturity Treasury
CON	Statements of Financial Accounting Concepts
DOL	Department of Labor
EITF	Emerging Issues Task Force
ERISA	Employee Retirement Income Security Act
ESPP	Employee Stock Purchase Plan
Fannie Mae	Federal National Mortgage Association
FASB	Financial Accounting Standards Board
FHA	Federal Housing Administration
FICO	Credit scores initially developed by Fair, Issac and Co., Inc.
FIN	Financial Accounting Standards Board Interpretation
Freddie SUBS	Subordinated debt securities issued by Freddie Mac
FSP	Financial Accounting Standards Board Staff Position
GA	Guarantee Asset
GAAP	Generally Accepted Accounting Principles
Ginnie Mae	Government National Mortgage Association
GO	Guarantee Obligation
GSE	Government-Sponsored Enterprise
GSE ACT	The Federal Housing Enterprises Financial Safety and Soundness Act of 1992
HUD	Department of Housing and Urban Development
IRC	Internal Revenue Code
IRR	Internal Rates of Return
IRS	Internal Revenue Service
LIBOR	London Interbank Offered Rate
LIHTC	Low-Income Housing Tax Credit
LTV	Loan-to-Value
MD&A	Management's Discussion and Analysis of Financial Condition and Results of Operations
NPV	Net Present Value
NYSE	New York Stock Exchange
OFHEO	Office of Federal Housing Enterprise Oversight
OTC	Over-the-Counter
PBO	Projected benefit obligation
PC	Mortgage Participation Certificate
PMI	Primary Mortgage Insurance
PMVS	Portfolio Market Value Sensitivity
PMVS-L	Portfolio Market Value Sensitivity Level
PMVS-YC	Portfolio Market Value Sensitivity Yield Curve
PwC	PricewaterhouseCoopers LLP
REIT	Real Estate Investment Trust
REMIC	Real Estate Mortgage Investment Conduit
REO	Real Estate Owned
RHS	Rural Housing Service
RSU	Restricted Stock Units
QFA	Quarterly Funding Announcement

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QSPE	Qualifying Special Purpose Entities
S&P	Standard & Poor's
SAR	Stock Appreciation Rights
SEC	Securities and Exchange Commission
SFAS	Statement of Financial Accounting Standards
SOP	The AICPA's Statement of Position
TBA	To Be Announced
TDR	Troubled Debt Restructuring
U.S.	United States
VA	Department of Veterans Affairs
VIE	Variable Interest Entity

