Offering Circular dated April 2, 2004

Freddie Mac

Debentures
Medium-Term Notes
Discount Notes

Offered Securities:	Debentures, Medium-Term Notes and Discount Notes.
Reference Securities[SM]:	We may designate some Securities as Reference Bills® securities (''Reference Bills''), which are regularly scheduled issues auctioned in large principal amounts.
Amount:	Unlimited.
Maturities:	One day or longer, but not more than one year in the case of Discount Notes.
Offering Terms:	We will offer the Securities primarily through dealers on the terms described in this Offering Circular and, for Debentures and Medium-Term Notes, related Pricing Supplements.
Priority:	The Securities will be unsecured general obligations or unsecured subordinated obligations of Freddie Mac.
Tax Status:	The Securities are not tax-exempt.
Form of Securities:	Book-entry (Federal Reserve Banks or Depository Trust Company).

You should consider carefully the risks involved in investing in the Securities because the Securities may not be suitable investments for you. You should purchase Securities only if you understand this Offering Circular, the related Pricing Supplement for the Debentures or Medium-Term Notes you are considering and the documents that we incorporate by reference in this Offering Circular. You should consider carefully the *Risk Factors* described beginning on page 8.

The Securities are obligations of Freddie Mac only. The Securities, including any interest or return of discount on the Securities, are not guaranteed by, and are not debts or obligations of, the United States or any agency or instrumentality of the United States other than Freddie Mac.

Because of applicable securities law exemptions, we have not registered the Securities with any federal or state securities commission. No securities commission has reviewed this Offering Circular.

The *Index of Terms* (Appendix A) shows where definitions of defined terms appear in this Offering Circular.

''Reference Securities[SM]'' is a service mark of Freddie Mac and ''Reference Bills®'' is a registered trademark of Freddie Mac.

The Securities generally will not have an established trading market when issued. Certain Dealers have advised Freddie Mac that they intend to use reasonable efforts to make a secondary market in the Securities that they offer. However, they are not obligated to do so. These Dealers could discontinue their secondary market activities at any time without notice. There is no assurance that a secondary market for any of the Securities will develop or, if such a market develops, that it will continue or will be liquid. Consequently, you may not be able to sell your Securities readily or at prices that will enable you to realize your anticipated yield.

If you intend to purchase Securities, you should rely only on the information in this Offering Circular and in any related Pricing Supplement for the Securities that you are considering, including the information in any documents that we incorporate by reference. We have not authorized anyone to provide you with different information. We are not offering the Securities in any jurisdiction that prohibits their offer. This Offering Circular, any related Pricing Supplement and any incorporated documents speak only as of their dates, regardless of the date you receive these documents or purchase Securities.

This Offering Circular replaces and supersedes our Offering Circular dated December 31, 2003 for issues of Debentures, Medium-Term Notes and Discount Notes priced on or after the date of this Offering Circular. This Offering Circular relates to our Debentures, Medium-Term Notes (including Estate Notes[SM] securities and FreddieNotes[SM] securities) and Discount Notes (including Reference Bills®) and not to any other securities of Freddie Mac, including €Reference Securities[SM] or other securities offered under the Freddie Mac Global Debt Facility.

''Estate Notes[SM],'' ''FreddieNotes[SM]'' and ''€Reference Securities[SM]'' are service marks of Freddie Mac and ''Reference Bills®'' is a registered trademark of Freddie Mac.

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*We use defined terms throughout this Offering Circular. Appendix A provides the page locations of the definitions of these terms.

SUMMARY

This Summary contains selected information about the Securities. It does not contain all of the information you should consider before purchasing the Securities. You should refer to the remainder of this Offering Circular and to any related Pricing Supplement for further information. If a Pricing Supplement contains different information from this Offering Circular, you should rely on the Pricing Supplement.

Issuer . . . . . Federal Home Loan Mortgage Corporation or ''Freddie Mac,'' a shareholder owned government-sponsored enterprise.

Securities Offered . . . . . Debentures, Medium-Term Notes and Discount Notes (the ''Securities'').

Legal Status . . . . . Unless otherwise specified in the applicable Pricing Supplement, the Securities will be unsecured general obligations having the same priority as all of our other unsecured and unsubordinated debt and ranking senior to any subordinated debt. If specified in the applicable Pricing Supplement, the Securities will be unsecured subordinated obligations with the terms, including but not limited to terms relating to payment priority or payment suspension, limitation or deferral (if any), set forth in the applicable Pricing Supplement (''Subordinated Securities''). The United States does not guarantee the Securities or any interest or return of discount on the Securities. The Securities are not debts or obligations of the United States or any agency or instrumentality of the United States other than Freddie Mac.

Pricing Supplement . . . . . We will offer Debentures and Medium-Term Notes by means of Pricing Supplements, which will describe the specific terms of the Securities (each, a ''Pricing Supplement''). If a Pricing Supplement contains different information from this Offering Circular, you should rely on the Pricing Supplement.

Debentures and Medium-Term Notes . . . . . A Debenture or Medium-Term Note will:

- pay principal in one or more of the following methods: (i) only at maturity, (ii) periodically until maturity or (iii) upon redemption or repayment before maturity;
- bear interest at a fixed or variable interest rate or bear no interest; and
- have a maturity of one day or more from its issue date.

Discount Notes . . . . . A Discount Note will:

- have a maturity of one year or less from its issue date;
- be sold at a discount to its stated principal amount;
- not bear interest; and
- be paid only at maturity.

Reference Securities . . . . . We will designate some Securities as Reference Securities, which are regularly scheduled issues auctioned in large principal amounts. For example, Reference Bills® are U.S. Dollar denominated Discount Notes.

Form of Securities . . . . . *Fed Book-Entry.* Most Securities will be issued, held and transferrable on the book-entry system of the Federal Reserve Banks (''Fed Book-Entry System''). Securities on the Fed Book-Entry System may be held of record only by entities eligible to maintain book-entry accounts with a Federal Reserve Bank (''Fed Participants'').

DTC Book-Entry. Certain Debentures and Medium-Term Notes will be represented by one or more certificates held by, or on behalf of, The Depository Trust Company or its successor (''Depository''). The Depository will maintain each such issue through its book-entry facilities (''DTC Book-Entry System'').

Other Trading Arrangements. If so specified in the related Pricing Supplement, Debentures and Medium-Term Notes may be made eligible for trading on the clearing systems operated by the Euroclear System and Clearstream Banking, société anonyme, through custody accounts maintained by them with certain Fed Participants.

Holders . . . . . The term ''Holders'' means:

- the Fed Participants appearing on the book-entry records of a Federal Reserve Bank as Holders, in the case of an issue of Securities on the Fed Book-Entry System; or
- the Depository or its nominee, in the case of an issue of Securities on the DTC Book-Entry System.

A Holder of a Security is not necessarily the beneficial owner of that Security. Beneficial owners ordinarily will hold Securities through one or more financial intermediaries, such as banks, brokerage firms and securities clearing organizations. A Holder that is not the beneficial owner of a Security, and each other financial intermediary in the chain between the Holder and the beneficial owner, will be responsible for establishing and maintaining accounts for their respective customers and for remitting payments to those accounts.

See ''Description of the Securities — Holders.''

Securities Agreements . . . . . We will issue Debentures and Medium-Term Notes under the Debenture and Medium-Term Note Agreement, dated the same date as this Offering Circular, among Freddie Mac and the Holders of Debentures and Medium-Term Notes (''Debenture and Medium-Term Note Agreement'').

We will issue Discount Notes under the Discount Note Agreement, dated the same date as this Offering Circular, among Freddie Mac and the Holders of Discount Notes (''Discount Note Agreement'').

Redemption and Repayment . . . . . We may have the option to redeem some Debentures or Medium-Term Notes, in whole or in part, before their Maturity Dates (including redemption by installment). Also, certain Holders of some Debentures or Medium-Term Notes may have the option to require repayment of their Securities, in whole or in part, before their Maturity Dates. The Pricing Supplement for an

issue of Debentures or Medium-Term Notes will say whether the Debentures or Medium-Term Notes are redeemable at our option or repayable at your option and will describe the redemption or repayment right.

Estate Notes[SM] and FreddieNotes[SM] ..... Medium-Term Notes that permit persons acting on behalf of deceased beneficial owners to require us to repay principal prior to their Maturity Date.

Payment Terms ..... The related Pricing Supplement will specify the payment terms of the Debentures and Medium-Term Notes.

Principal:

Fixed Principal Repayment Amount ..... Either (i) an amount equal to 100% of the principal amount of a Debenture or Medium-Term Note, payable on the applicable Maturity Date or date of redemption or repayment, or (ii) a specified amount above or below its principal amount, payable on that date.

Variable Principal Repayment Amount ..... A principal amount determined by reference to one or more indices, such as interest or exchange rate indices or other formulas, payable on the applicable Maturity Date or date of redemption or repayment of a Debenture or Medium-Term Note.

Amortizing Principal Repayment Amounts .... Amounts of periodic payments of principal made during the term of a Debenture or Medium-Term Note.

Interest:

Fixed Rate ..... Debentures or Medium-Term Notes that bear interest at a single fixed rate.

Variable Rate ..... Debentures or Medium-Term Notes that bear interest at a variable rate determined by reference to one or more specified indices.

Fixed/Variable Rate ..... Debentures or Medium-Term Notes that bear interest at a fixed rate during one or more periods and at a variable rate during other periods.

Step ..... Debentures or Medium-Term Notes that bear interest at different fixed rates during different periods.

Zero Coupon ..... Debentures or Medium-Term Notes that do not bear interest and are issued at a discount to their principal amount.

Tax Status ..... The Securities and income or return of discount derived from the Securities are generally subject to taxation by the United States and are generally not exempt from taxation. See ''Certain United States Federal Tax Consequences.''

Method of Payment ..... The Federal Reserve Banks will credit payments on Securities maintained on the Fed Book-Entry System on applicable payment dates to the accounts of Fed Participants. Each Holder, and each other financial intermediary in the chain to the benefi-

cial owner, will be responsible for remitting payments to their customers.

We will make payments on Securities maintained on the DTC Book-Entry System to the Depository in immediately available funds. The Depository will be responsible for crediting payments to the accounts of the appropriate Depository Participants in accordance with the Depository's normal procedures. Each Depository Participant, and each other financial intermediary in the chain to the beneficial owner, will be responsible for remitting payments to their customers.

Denominations . . . . . We will issue and maintain the Securities in minimum principal amounts and additional increments of $1,000, unless otherwise indicated in the related Pricing Supplement.

Method of Distribution . . . . . We generally will sell Debentures and Medium-Term Notes to one or more Dealers, acting as principals, that are named in the related Pricing Supplement. Alternatively, we may allow Dealers to solicit purchases of Debentures and Medium-Term Notes on an agency basis or we may sell Debentures and Medium-Term Notes directly to investors.

In general, we will sell Discount Notes through Dealers, acting as our agents.

AVAILABLE INFORMATION

We prepare an annual Information Statement that describes our business and operations and contains important financial and other information, including our consolidated financial statements (the ''Information Statement''). We also prepare quarterly and other periodic Information Statement Supplements that include unaudited consolidated financial data and other information concerning our business and operations (each, an ''Information Statement Supplement''). These documents are (or upon publication will be) incorporated by reference in this Offering Circular, which means that we are disclosing information to you by referring you to those documents. These documents are considered part of this Offering Circular. You should read this Offering Circular, and any applicable supplements or amendments, in conjunction with our most recent Information Statement and any subsequent Information Statement Supplements we incorporate by reference in this Offering Circular. As of the date of this Offering Circular, our current Information Statement (which is attached as Appendix B to this Offering Circular) is dated February 27, 2004 and contains our restated and revised financial statements for the years 2002, 2001 and 2000. The public release of our 2003 financial results has been delayed. Our objective is to release quarterly and full-year results for 2003 by June 30, 2004. However, there can be no assurance that we will meet this objective. You should rely only on the most current information provided or incorporated by reference in this Offering Circular and any applicable supplement or amendment.

You can obtain any of these documents and any other documents that we make available from:

Freddie Mac
Debt Securities Marketing Office
1551 Park Run Drive
McLean, Virginia U.S.A. 22102-3110
E-Mail: debt_securities@freddiemac.com
www.freddiemac.com*

You also can read the Information Statement and other information about Freddie Mac at the offices of the New York Stock Exchange.

* We are providing this Internet address solely for the information of prospective investors. We do not intend this Internet address to be an active link and are not using reference to this address to incorporate additional information into this Offering Circular or any Pricing Supplement.

FREDDIE MAC

Freddie Mac is one of the largest participants in the U.S. mortgage market. We are a shareholder-owned government-sponsored enterprise, or GSE, chartered by Congress on July 24, 1970 under the Federal Home Loan Mortgage Corporation Act, which we refer to in this Offering Circular as the ''Freddie Mac Act.'' 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; and
- to promote access to mortgage credit throughout the United States (including central cities, rural areas and underserved areas) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing.

We fulfill these statutory purposes primarily by purchasing residential mortgages and mortgage securities from mortgage lenders, other mortgage sellers and securities dealers. We finance our purchases with debt and equity securities and by guaranteeing the timely payment of principal and interest on mortgage securities.

RISK FACTORS

This section describes some of the general risks and considerations that you should examine before investing in the Securities. There may be other risks and considerations not discussed below or discussed in the applicable Pricing Supplement that you should consider. These risks and considerations may vary depending on your particular circumstances and on various economic and interest rate scenarios. Therefore, you should consult your own financial and legal advisors to determine the suitability for you of a particular issue of Securities.

The Securities May Not Be Suitable For You

The Securities are not suitable investments for all investors. Before investing in a particular issue of Securities, you should:

- possess, either alone or with an investment advisor, the expertise and analytical tools necessary to evaluate, in the context of your financial situation, the particular features of the Securities, the risks and benefits of investing in the Securities and the effect of the Securities on your overall investment portfolio;
- have sufficient financial resources and liquidity to bear the risks associated with the Securities;
- understand the information contained and incorporated in this Offering Circular and any related Pricing Supplement;
- understand the terms of the Securities; and
- understand any applicable legal investment restrictions.

Sophisticated institutional investors generally do not purchase complex securities as stand-alone investments. Rather, they invest in certain types of complex securities to reduce the risk of their overall portfolio or to enhance their yield by adding an appropriate level of risk to their overall portfolio. You should not purchase any Securities unless you understand and are able to bear the associated yield, market, liquidity and structure risks, including risks associated with any redemption provisions, periodic interest rate adjustments and exchange rates and controls. You should decide whether to invest in an issue of Securities based on your own financial needs and the anticipated

performance of the Securities under a variety of economic, interest rate and exchange rate scenarios.

Structured Securities May Be Complex and Involve Greater Risks

Historically, the majority of the Debentures and Medium-Term Notes we issue have been fixed rate debt obligations, including those that are redeemable at our option beginning on a specified date. Although these Securities present certain risks to investors, they do not present all of the risks associated with more complex Securities.

More complex Securities (such as Variable Rate, Variable Principal Repayment Amount and Amortizing Debentures and Medium-Term Notes) may involve greater risk. They may have principal or interest payments determined, either directly or inversely, by reference to one or more indices (including interest rate, exchange rate, currency, swap or equity indices or formulas). An investment in such Debentures or Medium-Term Notes entails risks not associated with an investment in a conventional fixed rate debt security. These risks include the possibility that:

- the applicable index or indices may change significantly;
- changes in the applicable index or indices may not correlate with changes in interest rates or currencies, generally, or with changes in other indices;
- changes in the applicable index or indices will be magnified or diminished if the Securities' principal or interest formula contains a leverage factor or a deleverage factor;
- the applicable index or indices may be subject to maximum (''Cap'') or minimum (''Floor'') interest rate or exchange rate limitations;
- the timing of changes in an applicable index or indices may affect your actual yield, even if the average level is consistent with your expectations (in general, the earlier the change in the applicable index or indices, the greater the effect on yield);
- two or more indices or formulas that you may expect to move in tandem or in some other relationship to each other may unexpectedly converge, diverge or otherwise not move as expected;
- currency devaluations may occur or monetary authorities may impose or modify currency exchange controls;
- the resulting interest rate may be less than the interest rate payable on a conventional fixed rate debt security we issued at the same time and, in some cases, may be as low as zero;
- you may receive repayments of principal at times other than you expect;
- you may lose all or a substantial portion of the principal of your Security (whether payable at maturity, upon redemption or otherwise); and
- the value of Securities with complex formulas or other terms may be volatile.

These risks may depend on a number of interrelated factors that we cannot control, including financial, economic, regulatory and political developments. In the past, certain interest rates, currencies, currency units, exchange rates, swap, equity and other indices have been highly volatile. Past fluctuations, moreover, do not necessarily indicate fluctuations that may occur in the future.

You should have knowledge of, and access to, appropriate analytical tools to evaluate quantitatively the effect of the particular features of the Securities you are considering purchasing and the resulting effects upon their yields and values.

Various Factors Could Adversely Affect the Trading Value and Yield of Your Securities

Secondary Markets and Market Values

The Securities generally will not have an established trading market when issued. Certain Dealers have advised us that they intend to use reasonable efforts to make a secondary market in the Securities that they offer, but, in general, they are not obligated to do so. These Dealers may discontinue any such secondary market making at any time without notice. Consequently:

- a secondary market for any of the Securities may not develop, particularly for those Securities that are especially sensitive to interest rate or market risks or that are structured to meet the investment requirements of limited categories of investors; or
- if a secondary market develops, it may not be liquid at all times.

As a result, you may not be able to sell your Securities readily or at prices comparable to similar instruments with a developed secondary market. If you are seeking to purchase or sell very small or very large amounts of Securities, you may not be able to do so at prices comparable to those available to other investors.

The market values of the Securities likely will fluctuate over time, perhaps significantly. These fluctuations could cause significant losses to your investment in Securities, especially if you dispose of your Securities prior to their maturity. The market prices of Securities issued at either a substantial discount (such as Zero Coupon Debentures) or a substantial premium (such as Securities that have significantly above-market interest rates) from their principal amount tend to fluctuate more in relation to general changes in interest rates than do the prices of Securities with comparable maturities that are not issued at such a discount or premium.

A number of factors may affect any secondary market for, and the market value of, an issue of Securities, including:

- the creditworthiness of Freddie Mac;
- the value, complexity and volatility of any applicable index or indices;
- the method of calculating the principal or any interest payments on the Securities;
- the time remaining to the maturity of the Securities;
- any redemption or repayment features of the Securities;
- the outstanding amount of the Securities;
- the amount of other securities linked to any applicable index or indices;
- the amount of Securities being sold in any secondary market from time to time;
- the subordinated status or other terms of any Subordinated Securities;
- any legal restrictions or tax treatment that limits demand for the Securities;
- the availability of comparable securities, including comparable U.S. Treasury securities;
- fluctuations in the ''spread'' of the Securities to comparable U.S. Treasury securities; and
- the level, direction and volatility of market interest rates generally.

You should not purchase any Securities unless you understand and can bear the risks that you may not be able to resell them easily, that their value will fluctuate over time and that these fluctuations may be significant and cause losses to you. Illiquidity may have a severely adverse

effect on the market values of the Securities. These risks of limited liquidity and price volatility are greatest for Securities that are:

- especially sensitive to interest rate, currency or market risks;
- designed for specific investment objectives or strategies;
- structured to meet the investment requirements of limited categories of investors; or
- not held until maturity.

Subordinated Securities

If specified in the applicable Pricing Supplement, the indebtedness represented by Subordinated Securities and the payment of principal of and interest on Subordinated Securities may be subordinated to prior payment in full of all of our ''Senior Obligations'' which are due and payable. Therefore, we will not be permitted to make any payments of principal of or interest on the Subordinated Securities (including redeeming any redeemable Subordinated Securities) while we are in default on any of our Senior Obligations. In the event of a liquidation or dissolution of Freddie Mac, our assets would not be available to pay obligations under the Subordinated Securities until our Senior Obligations have been paid in full. Such Senior Obligations will be identified by category in the applicable Pricing Supplement.

In addition, there may be other terms applicable to specific offerings of Subordinated Securities that would defer, limit or suspend our obligation to make any payment of principal of or interest on these Subordinated Securities under certain specified conditions. Moreover, Events of Default that apply to Senior Obligations may not necessarily be Events of Default for Subordinated Securities. As a result, the Holders of Subordinated Securities may not have the same acceleration rights as Holders of other Securities. See ''The Agreements — Events of Default'' and '' — Rights Upon Event of Default — Debentures and Medium-Term Notes.'' The terms and conditions of any issue of Subordinated Securities will be described in the applicable Pricing Supplement.

Redeemable Debentures and Medium-Term Notes

We will have the option to redeem certain Debentures and Medium-Term Notes after a specified date if we so provide in the related Pricing Supplement. The redemption price typically is 100% of the principal amount plus accrued interest, in the case of Debentures and Medium-Term Notes which bear interest, and the accreted value to the redemption date, in the case of Zero Coupon Debentures and Medium-Term Notes. These optional redemption provisions are likely to restrict the market values that the Securities would otherwise have. For example, the market price of such Securities generally will not rise substantially above their redemption price during (and possibly before) any period when we may redeem the Securities because of the increased likelihood of redemption. If we redeem a portion of an issue of Securities, the market for the Securities left outstanding may become less liquid.

In general, we are most likely to redeem such Debentures and Medium-Term Notes when prevailing interest rates and our borrowing costs are relatively low and least likely to redeem them when prevailing interest rates and our borrowing costs are relatively high. Our decision to redeem or not to redeem an issue of Debentures or Medium-Term Notes may also be affected by any related hedge or derivative position that we hold. If we redeem Debentures or Medium-Term Notes when prevailing interest rates are relatively low, you may not be able to reinvest the redemption proceeds in comparable securities with similar yields.

Some Debentures and Medium-Term Notes may be redeemable at a variable amount determined by reference to one or more interest rate, exchange rate or other indices. The redemption proceeds of such Securities will vary depending on the level of the applicable index, and you may receive less than 100% of your original principal amount upon redemption.

Fixed Rate Debentures and Medium Term Notes

Fixed Rate Debentures and Medium-Term Notes, if held to maturity, will provide return of their principal and the certainty of interest payments at a fixed rate. However, the market values of these Securities are likely to fluctuate with changes in prevailing interest rates.

The market values of fixed rate Securities generally will rise in a falling interest rate environment and will fall in a rising interest rate environment. This fluctuation creates risk of loss of investment capital if you dispose of these Securities prior to maturity. This effect on market values is generally greater for Securities having relatively long remaining terms to maturity than for Securities having relatively short remaining terms to maturity. For example, this effect on market values is generally greater for Debentures and Medium-Term Notes than for Discount Notes because of the generally short terms to maturity of Discount Notes.

Zero Coupon Debentures and Medium-Term Notes

An investment in Zero Coupon Debentures and Medium-Term Notes presents certain risks that are different from an investment in fixed-rate Securities that pay interest periodically. If you hold the Zero Coupon Debentures and Medium-Term Notes to maturity, they will provide return of your principal, including return of the discount, but their market value is likely to fluctuate substantially with changes in prevailing interest rates. The market values of Zero Coupon Debentures and Medium-Term Notes generally will fall in a rising interest rate environment, creating a risk of loss of your investment capital if your circumstances do not permit you to hold the Zero Coupon Debentures and Medium-Term Notes to maturity. The market values of Zero Coupon Debentures and Medium-Term Notes generally will rise in a falling interest rate environment. The possibility of substantial price volatility, combined with the fact that payments on Zero Coupon Debentures and Medium-Term Notes will be made only at maturity, also could affect the secondary market for, and the liquidity of, Zero Coupon Debentures and Medium-Term Notes. Zero Coupon Debentures and Medium-Term Notes that are redeemable involve certain additional risks. See ''Risk Factors — Various Factors Could Adversely Affect the Trading Value and Yield of Your Securities — Redeemable Debentures and Medium-Term Notes.''

The market values of Zero Coupon Debentures and Medium-Term Notes and other Securities issued at substantial discounts tend to fluctuate more in relation to general changes in interest rates than do prices for conventional interest-bearing securities. Generally, the longer their remaining term, the greater the price volatility as compared to conventional interest-bearing securities with comparable maturities.

Step Debentures and Medium-Term Notes

Step Debentures and Medium-Term Notes provide for one or more prescribed increases (or decreases) in their interest rates on specified dates. However, we may have the option to redeem Step Debentures and Medium-Term Notes before, at the beginning of or during one or more step periods. Therefore, you should consider the likelihood that we will redeem Step Debentures and Medium-Term Notes if their subsequent interest rates exceed the interest rates then available to us for comparable borrowings.

Although the interest rate on a Step Debenture or Medium-Term Note may increase on specified dates, the increased interest rate may be below the interest rate that you would receive on newly issued but otherwise comparable instruments with the same remaining term to maturity.

Variable Rate Debentures and Medium-Term Notes

If the interest rate on a Variable Rate Debenture or Medium-Term Note bears a direct relationship to a specified index or indices, lower than anticipated levels of such index or indices could result in actual yields that are lower than anticipated. Conversely, if the interest rate on a Variable Rate Debenture or Medium-Term Note bears an inverse relationship to a specified index or

indices, higher than anticipated levels of such index or indices could result in actual yields that are lower than anticipated.

Inverse Variable Rate Securities have an interest rate equal to a fixed rate minus a rate based upon an applicable index. The market values of inverse Variable Rate Securities typically are more volatile than market values of our conventional Variable Rate Securities based on the same applicable index (and with otherwise comparable terms). Inverse Variable Rate Securities are more volatile because an increase in the applicable index not only decreases the interest rate of the inverse Variable Rate Security, but also often reflects an increase in prevailing interest rates, which further adversely affects the market value of these Securities.

The indices applicable to Variable Rate Debentures and Medium-Term Notes are not likely to remain constant at any level. The timing of a change in the level of an applicable index may affect the actual yield you receive, even if the average level is consistent with your expectation. In general, the earlier a change in the level of an applicable index, the greater the effect on the yield you receive, especially for Debentures and Medium-Term Notes that provide for repayment of principal at one or more times prior to maturity. As a result, the effect on the yield you receive of an index level that is lower (or higher) than the anticipated level during earlier periods is not likely to be offset by a later equivalent increase (or reduction). Moreover, changes in the index applicable to a particular Variable Rate Debenture or Medium-Term Note may not correlate with changes in interest rates generally or with changes in other indices. Your yield could be adversely affected if changes in the index applicable to your Variable Rate Debenture or Medium-Term Note do not reflect changes in interest rates generally.

The interest rate formula for a Variable Rate Debenture or Medium-Term Note may include a multiplier that is applied to an index in determining the applicable interest rate. In general, a multiplier of greater than one will cause changes in the interest rate of the Debentures or Medium-Term Notes to be more pronounced than changes in the value of the applicable index, while a multiplier of less than one will have the opposite effect. Variable Rate Debentures or Medium-Term Notes with multipliers of greater than one are ''leveraged,'' and those with multipliers of less than one are ''deleveraged.''

In general, the volatility associated with the level of an applicable index is higher for leveraged Debentures or Medium-Term Notes and lower for deleveraged Debentures or Medium-Term Notes. For example, the interest rate of a leveraged Variable Rate Debenture or Medium-Term Note bearing an inverse relationship to a specified index generally will decline sharply as the value of the applicable index increases. By contrast, the interest rate of a deleveraged Variable Rate Debenture or Medium-Term Note bearing an inverse relationship to a specified index generally will decline more slowly as the value of the applicable index increases.

Investors in Variable Rate Debentures or Medium-Term Notes should also consider the effects on their interest rates and yields of any applicable Caps or Floors and of any delays in periodic interest rate adjustments. Some Variable Rate Debentures and Medium-Term Notes may provide for no interest to accrue during periods when the applicable index is outside a specified range. The market values of Variable Rate Debentures and Medium-Term Notes with Caps or Floors or with such a range feature generally are more volatile than those of Variable Rate Debentures and Medium-Term Notes linked to the same applicable index without Caps or Floors or a range feature, especially when the applicable index approaches or passes the Cap or Floor or the endpoint of the applicable range.

Fixed/Variable Rate Securities

Some Fixed/Variable Rate Securities may bear interest at a rate that we may elect to convert from a fixed rate to a variable rate, or from a variable rate to a fixed rate. Our ability to convert the interest rate will affect the secondary market and the market value of the Securities since we may be expected to convert the rate when it is likely to produce a lower overall cost of borrowing. If we convert from a fixed rate to a variable rate, the ''spread'' above or below the applicable index may

be less favorable than the prevailing spreads on our conventional Variable Rate Securities tied to the same index. In addition, the new variable rate at any time may be lower than the rates on our other Variable Rate Securities. If we convert from a variable rate to a fixed rate, the fixed rate may be lower than then prevailing rates on our other Fixed Rate Securities.

Debentures and Medium-Term Notes with Variable or Amortizing Principal Repayment Amounts

Debentures and Medium-Term Notes with Variable or Amortizing Principal Repayment Amounts provide for payments of principal or their redemption price to be determined based on one or more indices. Before purchasing such a Debenture or Medium-Term Note you should understand the indices used in calculating payments. Such indices may fluctuate independently of other indices. Fluctuations in such indices may cause you to receive principal at a different time or in a lesser amount than you anticipate.

Securities Eligible for Stripping

Some issues of Fixed Rate Securities and Step Securities will be eligible to be separated (''stripped'') into Interest Components and Principal Components. The related Pricing Supplement will indicate which issues of Securities are eligible to be stripped. The secondary market, if any, for the Interest Components and Principal Components of stripped Securities may be more limited and have less liquidity than the secondary market for Securities of the same issue that have not been stripped. The liquidity of an issue of Securities also may be reduced if a significant portion of the Securities are stripped. See ''Description of the Securities — Debentures and Medium-Term Notes — Stripped Debentures and Medium-Term Notes'' for more information on stripping.

Exchange Rate Risks and Exchange Controls May Affect the Timing or Amount of Interest and Principal Paid on Your Securities

The amount of principal or interest to be paid on Debentures and Medium-Term Notes may be determined by reference to one or more currencies or currency units (including exchange rates and swap indices between currencies or currency units). Government and monetary authorities have imposed, and may impose in the future, exchange controls that could adversely affect an applicable exchange rate. As a result, you may receive less interest or principal than expected, or no interest or principal at all.

Principal and interest on most Debentures and Medium-Term Notes will be payable in U.S. dollars. This presents risks relating to currency conversions if you conduct business in another currency. These include the risk that exchange rates may significantly change (including changes due to devaluation of the U.S. dollar or revaluation of your currency) and the risk that government or monetary authorities may impose or modify exchange controls. Any appreciation in the value of your currency relative to the U.S. dollar would decrease the currency-equivalent yield and value of your Debenture or Medium-Term Note.

Legal Investment Considerations May Restrict Certain Investors

You should consult your own legal advisors in determining whether the Securities are legal investments for you and whether you can pledge the Securities as collateral for various types of borrowings. In addition, if you are a financial institution, you should consult your legal advisors or regulators to determine how to treat Securities under any applicable risk-based capital or similar rules.

Certain legal investment laws and regulations or regulatory authorities may restrict an institution's investment in certain types of Securities or in Securities generally. An institution under the jurisdiction of regulatory agencies should review any applicable regulations, policy statements and guidelines before purchasing or pledging Securities.

Credit Ratings May Not Reflect All Risks

Rating agencies may assign credit ratings to the Securities. Any credit ratings assigned to the Securities may not reflect the potential impact of all risks related to structure, yield, market, liquidity and other factors affecting their value. A credit rating is not a recommendation to buy, sell or hold the Securities and may be revised or withdrawn by the rating agency.

DESCRIPTION OF THE SECURITIES

General

The Securities will be issued pursuant to:

- Section 306(a) of the Freddie Mac Act;
- in the case of Debentures and Medium-Term Notes, the Debenture and Medium-Term Note Agreement and the related Pricing Supplement; and
- in the case of Discount Notes, the Discount Note Agreement.

Copies of the Debenture and Medium-Term Note Agreement and the Discount Note Agreement (''Agreements'') and any applicable Pricing Supplement are available as described under ''Available Information'' above. By receiving and accepting a Security, or an interest in a Security, you agree to be bound by the terms and conditions of the applicable Agreement, as supplemented or amended from time to time. See ''The Agreements — Binding Effect of the Agreements.''

The Securities are obligations of Freddie Mac only. The Securities, including any interest or return of discount on the Securities, are not guaranteed by and are not debts or obligations of the United States or any agency or instrumentality of the United States other than Freddie Mac.

Debentures and Medium-Term Notes

Status of the Securities

The Debentures and Medium-Term Notes will be unsecured general obligations of Freddie Mac or, if specified in the applicable Pricing Supplement, unsecured subordinated obligations of Freddie Mac. See ''Description of the Securities — Debentures and Medium-Term Notes — Subordinated Securities.'' The Debenture and Medium-Term Note Agreement does not limit other indebtedness that we may incur and does not contain any financial or similar restrictions on us or any restrictions on our ability to secure our indebtedness. We may issue an unlimited amount of Debentures and Medium-Term Notes under the Debenture and Medium-Term Note Agreement.

We may designate some Debentures and Medium-Term Notes as ''Reference Securities^{SM},'' which are regularly scheduled issues auctioned in large principal amounts.

Maturity, Redemption and Optional Repayment

Each Debenture and Medium-Term Note will mature on a date (the ''Maturity Date'') one day or longer from its issue date, unless redeemed earlier at our option or repaid at your option, as specified in the applicable Pricing Supplement. The Pricing Supplement will specify whether an issue of Debentures or Medium-Term Notes may be redeemable at our option or repayable at your option, in whole or in part, prior to its Maturity Date. An issue of Debentures or Medium-Term Notes may be redeemable or repayable:

- in whole or from time to time in part as applicable;
- on one or more specified dates;
- at any time on or after a specified date; or
- during one or more specified periods of time.

The principal amount payable on the Maturity Date or upon redemption or repayment of a Debenture or Medium-Term Note will be determined as described in the related Pricing Supplement and may be either:

- a fixed amount (the ''Fixed Principal Repayment Amount'') equal to 100% of the principal amount (*i.e.*, par), or a specified amount above or below that principal amount; or
- an amount (the ''Variable Principal Repayment Amount'') determined by reference to one or more interest rate or exchange rate indices or otherwise.

In addition, we may issue ''Amortizing Debentures or Medium-Term Notes'' on which we make periodic payments of principal during their terms as described in the related Pricing Supplement. Amortizing Debentures or Medium-Term Notes may bear interest at fixed or variable rates.

Unless a different notice period is specified in the Pricing Supplement, we will give you notice of optional redemption from 5 Business Days to 60 calendar days before the redemption date in the manner described under ''The Agreements — Notice.'' Notice provisions relating to Holders' exercise of any option to require repayment will be provided in the related Pricing Supplement.

In the case of a partial redemption of an issue of Debentures or Medium-Term Notes, we will redeem a pro rata portion of each outstanding Debenture or Medium-Term Note of the affected issue.

Estate Notes^{SM} and FreddieNotes^{SM} are types of repayable Medium-Term Notes. They are repayable at the option of a representative of a deceased beneficial owner subject to limits on both the amount of repayments on Estate Notes^{SM} and FreddieNotes^{SM} owned by one person or estate and the aggregate amount of repayments on an Estate Notes^{SM} or FreddieNotes^{SM} issue.

Interest Payments

The Securities may bear interest at one or more fixed rates or variable rates or may not bear interest. The applicable Pricing Supplement will specify how frequently interest, if any, is payable on an issue of Debentures or Medium-Term Notes. Interest on Debentures and Medium-Term Notes will be payable in arrears on each date specified in the Pricing Supplement (each, an ''Interest Payment Date''). Zero Coupon Debentures and Medium-Term Notes will not bear interest.

Each issue of interest-bearing Debentures or Medium-Term Notes will bear interest (i) from and including the immediately preceding Interest Payment Date or, if no interest has been paid or made available for payment on the issue of Securities, from and including the date on which we issue the Securities (''Issue Date'') or any other date specified in the Pricing Supplement (ii) to but excluding the next succeeding Interest Payment Date or the applicable Principal Payment Date (each such period is an ''Interest Payment Period''). The Maturity Date or, if applicable, the earlier date of redemption or repayment is the ''Principal Payment Date'' for the principal of Debentures or Medium-Term Notes redeemable or repayable on that date. No interest will accrue on the principal of any Debenture or Medium-Term Note on or after the Principal Payment Date.

Interest on Debentures and Medium-Term Notes accrues on the then outstanding principal amount. Interest payments will be rounded to the nearest cent (with one-half cent being rounded upwards).

The terms of our Subordinated Securities may require the deferral of interest payments under certain circumstances. See ''Risk Factors — Various Factors Could Adversely Affect the Trading Value and Yield of Your Securities — Subordinated Securities.''

If any jurisdiction imposes any withholding or other tax, we will not pay additional interest or other amounts, or redeem the Debentures or Medium-Term Notes prior to maturity, as a result.

Fixed Rate Debentures and Medium-Term Notes

The Pricing Supplement will specify the single fixed interest rate per annum on a Fixed Rate Debenture or Medium-Term Note. Unless we otherwise specify in the Pricing Supplement, we compute interest on a Fixed Rate Debenture or Medium-Term Note on the basis of a 360-day year of twelve 30-day months.

Step Debentures and Medium-Term Notes

Each Step Debenture or Medium-Term Note will bear interest from its Issue Date to a specified date at an initial fixed interest rate and then at one or more different fixed interest rates. A Step Debenture or Medium-Term Note can have one or more step periods. Step Debentures and Medium-Term Notes may contain provisions giving us the option to redeem them before, at the beginning of or during one or more step periods. The Pricing Supplement will specify the fixed interest rate payable for each step period from issuance to maturity. Unless we otherwise specify in the Pricing Supplement, we compute interest on a Step Debenture or Medium-Term Note on the basis of a 360-day year of twelve 30-day months.

Zero Coupon Debentures and Medium-Term Notes

Zero Coupon Debentures and Medium-Term Notes will not bear interest and will be issued at a price that is less than the principal amount payable on the Maturity Date. Some Zero Coupon Debentures and Medium-Term Notes may be redeemable. If an issue is subject to redemption, the Pricing Supplement will show, in percentage terms, the amount of principal that will be paid upon redemption for each potential redemption date.

Variable Rate Debentures and Medium-Term Notes

Variable Rate Debentures and Medium-Term Notes will bear interest at a variable rate, determined on the basis of either a direct or an inverse relationship to one or more specified indices. Variable Rate Debentures and Medium-Term Notes also may bear interest in any other manner described in the applicable Pricing Supplement.

The interest rate formula for a Variable Rate Debenture or Medium-Term Note may contain a Spread or Multiplier. A ''Spread'' means a constant or variable number to be added to or subtracted from the relevant index or formula. A ''Multiplier'' means a constant or variable number (which may be greater or less than one) to be multiplied by the relevant index or formula.

Variable Rate Debentures and Medium-Term Notes also may have Caps and Floors. In addition, some Variable Rate Debentures and Medium-Term Notes may provide for no interest to accrue during periods when the applicable index is outside a specified range.

We will specify in the applicable Pricing Supplement the accrual method (*i.e.*, the day count convention) for calculating interest or any other relevant accrual factor on the related Variable Rate Debentures or Medium-Term Notes. The accrual method may incorporate one or more of the following defined terms:

- ''Actual/360'' means that interest will be calculated on the basis of the actual number of days elapsed in a year of 360 days.
- ''Actual/365 (fixed)'' means that interest will be calculated on the basis of the actual number of days elapsed in a year of 365 days, regardless of whether payment occurs during a calendar leap year.
- ''Actual/Actual'' means that interest will be calculated on the basis of (i) the actual number of days elapsed in the Interest Payment Period divided by 365, or (ii) if any portion of the Interest Payment Period falls in a leap year, (A) the actual number of days in that portion divided by 366 plus (B) the actual number of days in the remaining portion divided by 365.

We will also specify in the Pricing Supplement (i) how frequently the rate of interest will reset and (ii) the dates on which a new rate of interest becomes effective (each, a ''Reset Date'').

If the interest rate will reset within an Interest Payment Period, then:

- the interest rate in effect on the sixth Business Day preceding an Interest Payment Date will be the interest rate for the remainder of that Interest Payment Period; and
- the first day of each Interest Payment Period also will be a Reset Date.

Variable Rate Debentures or Medium-Term Notes may bear interest prior to the initial Reset Date at an initial interest rate specified in the related Pricing Supplement. If so, then the first day of the initial Interest Payment Period will not be a Reset Date.

Each period beginning on the applicable Reset Date and ending on the calendar day preceding the next Reset Date is an ''Interest Reset Period.'' The rate of interest applicable to each Interest Reset Period will be determined as described below under ''LIBOR,'' ''Prime Rate'' and ''Treasury Rate.''

If the rate of interest will reset within an Interest Payment Period, we will calculate accrued interest by multiplying the principal amount of the Variable Rate Debenture or Medium-Term Note by an accrued interest factor. Unless we otherwise specify in the applicable Pricing Supplement, we will calculate this accrued interest factor by adding the interest factor for each Interest Reset Period in such Interest Payment Period and rounding the sum to nine decimal places. The interest factor for each such Interest Reset Period will be computed by (i) multiplying the number of days in the Interest Reset Period by the interest rate (expressed as a decimal) applicable to such Interest Reset Period and (ii) dividing the product by the number of days in the year referred to in the accrual method specified in the applicable Pricing Supplement.

If the source of an index changes in format, but the Calculation Agent determines that the index source continues to disclose the information necessary to determine the related interest rate substantially as required, the Calculation Agent will amend the procedure for obtaining information from that source to reflect the changed format.

The Calculation Agent's determination of an index value or interest rate will be final and binding on all parties, absent manifest error. The ''Calculation Agent'' will be Freddie Mac unless we specify otherwise in the applicable Pricing Supplement. See ''Description of the Securities — Corrections'' below.

Information concerning the current interest rate on an issue of Variable Rate Debentures or Medium-Term Notes will be available from us by contacting our Debt Securities Marketing Office as shown under ''Available Information'' and, if we are not the Calculation Agent, from the Calculation Agent.

Indices

The Pricing Supplement will specify the applicable interest rate index for an issue of Variable Rate Debentures or Medium-Term Notes. The provisions set forth below under the heading of the specific interest rate index will apply to the related Variable Rate Debentures or Medium-Term Notes.

LIBOR

''LIBOR'' means the daily average of the London interbank offered rates for Deposits in the Index Currency having the Index Maturity, as determined by the Calculation Agent. If we specify LIBOR as the interest rate for Variable Rate Debentures or Medium-Term Notes, LIBOR for any Reset Date will be determined as follows (in the following order of priority):

(1) LIBOR will be the rate that is displayed, at 11:00 a.m. (London time) on the LIBOR Determination Date, on the Designated Telerate Page for Deposits in the Index Currency having the Index Maturity;

(2) if that rate is not displayed, LIBOR will be the rate that is displayed, at 11:00 a.m. (London Time) on the LIBOR Determination Date, on the Designated Reuters Page for Deposits in the Index Currency having the Index Maturity;

(3) if that rate is not displayed, the Calculation Agent will request the principal London offices of four leading banks in the London interbank market selected by the Calculation Agent (after consultation with Freddie Mac, if Freddie Mac is not then acting as Calculation Agent) to provide such banks' offered quotations to prime banks in the London interbank market for Deposits in the Index Currency having the Index Maturity at 11:00 a.m. (London time) on the LIBOR Determination Date and in a Representative Amount. If at least two quotations are provided, LIBOR will be the arithmetic mean (if necessary rounded upwards) of such quotations;

(4) if fewer than two such quotations are provided, the Calculation Agent will request four major banks in the Principal Financial Center selected by the Calculation Agent (after consultation with Freddie Mac, if Freddie Mac is not then acting as Calculation Agent) to provide such banks' offered quotations to leading European banks for a loan in the Index Currency for a period of time corresponding to the Index Maturity, starting on the Reset Date, at approximately 11:00 a.m. in the Principal Financial Center on the LIBOR Determination Date and in a Representative Amount. If at least two quotations are provided, LIBOR will be the arithmetic mean (if necessary rounded upwards) of such quotations; and

(5) if fewer than two quotations are provided, LIBOR will be LIBOR as determined for the immediately preceding Reset Date or, in the case of the first Reset Date, will be the rate for Deposits in the Index Currency having the Index Maturity at 11:00 a.m. (London time) on the most recent London Banking Day preceding the LIBOR Determination Date for which the rate was displayed on either the Designated Telerate Page or the Designated Reuters Page for deposits starting on the second London Banking Day following such date (and if such rate appears on both such screens on that London Banking Day, using the Designated Telerate Page).

The following definitions apply to the preceding description of LIBOR:

- ''Deposits'' means deposits commencing on the applicable Reset Date.
- ''Designated Reuters Page'' means the display on the Reuters Page ISDA (or any successor page) of interbank rates from London for Deposits in the Index Currency.
- ''Designated Telerate Page'' means the display of rates on the Moneyline Telerate Capital Markets Report Page 3750 (or any successor page) for Deposits in the Index Currency.
- ''Index Currency'' means the currency or currency unit specified in the related Pricing Supplement with respect to which LIBOR will be calculated for a Variable Rate Debenture or Medium-Term Note. If no such currency or currency unit is specified in the related Pricing Supplement, the Index Currency will be U.S. dollars.
- ''Index Maturity'' means the period with respect to which LIBOR will be calculated that is specified in the related Pricing Supplement.
- ''LIBOR Determination Date'' means the second London Banking Day preceding the applicable Reset Date unless the Index Currency is British pounds sterling, in which case it means the applicable Reset Date.
- ''London Banking Day'' means any day on which commercial banks are open for business (including dealings in foreign exchange and deposits in the Index Currency) in London.
- ''Principal Financial Center'' means (i) with respect to U.S. dollars, British pounds sterling, the euro, Japanese yen and Swiss francs, the City of New York, London,

Brussels, Tokyo and Zurich, respectively, or (ii) with respect to any other Index Currency, the city specified in the related Pricing Supplement.

- ''Representative Amount'' means a principal amount of not less than U.S. $1,000,000 (or, if the Index Currency is other than U.S. dollars, a principal amount not less than the equivalent in the Index Currency) that, in the Calculation Agent's sole judgment, is representative for a single transaction in the relevant market at the relevant time.

Prime Rate

The ''Prime Rate'' means, with respect to any Reset Date (in the following order of priority):

(1) the arithmetic mean, determined by the Calculation Agent, of the rates (after eliminating certain rates, as described below in this clause (1)) that appear, at 11:00 a.m. on the Prime Rate Determination Date, on Reuters USPRIME1 Page as the U.S. dollar prime rate or base lending rate of each bank appearing on that page, *provided that* at least 3 rates appear. In determining the arithmetic mean:

- if 20 or more rates appear, the highest 5 rates (or in the event of equality, 5 of the highest) and the lowest 5 rates (or in the event of equality, 5 of the lowest) will be eliminated,
- if fewer than 20 but 10 or more rates appear, the highest 2 rates (or in the event of equality, 2 of the highest) and the lowest 2 rates (or in the event of equality, 2 of the lowest) will be eliminated, or
- if fewer than 10 but 5 or more rates appear, the highest rate (or in the event of equality, 1 of the highest) and the lowest rate (or in the event of equality, 1 of the lowest) will be eliminated;

(2) if fewer than 3 rates so appear, then the Prime Rate will be the arithmetic mean, determined by the Calculation Agent, of the rates (after eliminating certain rates, as described below in this clause(2)) that appear, at 11:00 a.m. on the Prime Rate Determination Date, on Telerate Page 38 as the U.S. dollar prime rate or base lending rate of each bank appearing on that page, *provided that* at least 3 rates appear. In determining the arithmetic mean:

- if 20 or more rates appear, the highest 5 rates (or in the event of equality, 5 of the highest) and the lowest 5 rates (or in the event of equality, 5 of the lowest) will be eliminated,
- if fewer than 20 but 10 or more rates appear, the highest 2 rates (or in the event of equality, 2 of the highest) and the lowest 2 rates (or in the event of equality, 2 of the lowest) will be eliminated, or
- if fewer than 10 but 5 or more rates appear, the highest rate (or in the event of equality, 1 of the highest) and the lowest rate (or in the event of equality, 1 of the lowest) will be eliminated;

(3) if fewer than 3 rates so appear, then the Calculation Agent will request 5 major banks in the City of New York selected by the Calculation Agent (after consultation with Freddie Mac, if Freddie Mac is not then acting as Calculation Agent) to provide a quotation of such banks' U.S. dollar prime rates or base lending rates on the basis of the actual number of days in the year divided by 360 as of the close of business on the Prime Rate Determination Date. If at least 3 quotations are provided, then the Prime Rate will be the arithmetic mean, determined by the Calculation Agent, of the quotations obtained (and, if 5 quotations are provided, eliminating the highest quotation (or in the event of equality, 1 of the highest) and the lowest quotation (or in the event of equality, 1 of the lowest));

(4) if fewer than 3 quotations are so provided, the Calculation Agent will request 5 banks or trust companies organized and doing business under the laws of the United States or any

state, each having total equity capital of at least U.S. $500,000,000 and being subject to supervision or examination by federal or state authority, selected by the Calculation Agent (after consultation with Freddie Mac, if Freddie Mac is not then acting as Calculation Agent), to provide a quotation of such banks' or trust companies' U.S. dollar prime rates or base lending rates on the basis of the actual number of days in the year divided by 360 as of the close of business on the Prime Rate Determination Date. In making such selection of 5 banks or trust companies, the Calculation Agent will include each bank, if any, that provided a quotation as requested in clause (3) above and exclude each bank that failed to provide a quotation as requested in clause (3). If at least 3 quotations are provided, then the Prime Rate will be the arithmetic mean, determined by the Calculation Agent, of the quotations obtained; and

(5) if fewer than 3 quotations are so provided, then the Prime Rate will be the Prime Rate determined for the immediately preceding Reset Date. If the applicable Reset Date is the first Reset Date, then the Prime Rate will be the rate calculated pursuant to clause (1) or (2) for the most recent New York Banking Day preceding the Reset Date for which at least 3 rates appeared at 11:00 a.m. on either Reuters USPRIME1 Page or Telerate Page 38 (and, if rates appear on both screens on such New York Banking Day, using Reuters USPRIME1 Page).

The following definitions apply to the preceding description of Prime Rate:

- ''New York Banking Day'' means any day other than (a) a Saturday, (b) a Sunday, (c) a day on which banking institutions in the City of New York are required or permitted by law or executive order to close or (d) a day on which the Federal Reserve Bank of New York is closed.
- ''Prime Rate Determination Date'' means the New York Banking Day preceding the applicable Reset Date.
- ''Reuters USPRIME1 Page'' means the display designated as page ''USPRIME1'' (or any successor page) on Reuters.
- ''Telerate Page 38'' means the display designated as ''Page 38'' (or any successor page) provided by Moneyline Telerate Capital Markets.

Treasury Rate

The ''Treasury Rate'' means, with respect to any Reset Date (in the following order of priority):

(1) the auction average rate for direct obligations of the United States (''Treasury Bills'') having the Index Maturity obtained from the most recent auction of Treasury Bills prior to the Reset Date (''Reference Treasury Bill Auction'') as announced by the United States Department of the Treasury (''Treasury Department'') in the form of a press release under the heading ''Investment Rate'' by 3:00 p.m. on such Reset Date;

(2) if such rate is not so announced, then the Treasury Rate will be the auction average rate for Treasury Bills having the Index Maturity obtained from the Reference Treasury Bill Auction as otherwise announced by the Treasury Department by 3:00 p.m. on the Reset Date as determined by the Calculation Agent;

(3) if such rate is not so announced, the Calculation Agent will request 5 leading primary United States government securities dealers in the City of New York selected by the Calculation Agent (after consultation with Freddie Mac, if Freddie Mac is not then acting as Calculation Agent) to provide a quotation of such dealers' secondary market bid yields, as of 3:00 p.m. on such Reset Date, for Treasury Bills with a remaining maturity closest to the Index Maturity (or, in the event that the remaining maturities are equally close, the longer remaining maturity). If at least 3 quotations are provided, then the Treasury Rate will be the arithmetic mean, determined by the Calculation Agent, of the quotations obtained; and

(4) if fewer than 3 quotations are so provided, the Treasury Rate will be the Treasury Rate for the immediately preceding Reset Date. If the applicable Reset Date is the first Reset Date,

the Treasury Rate will be the auction average rate for Treasury Bills having the Index Maturity from the most recent auction of Treasury Bills prior to the Reset Date for which such rate was announced by the Treasury Department in the form of a press release under the heading ''Investment Rate.''

The auction average rate for Treasury Bills and the secondary market bid yield for Treasury Bills will be obtained expressed as a bond equivalent yield on the basis of a year of 365 or 366 days, as applicable (or, if not so expressed, will be converted by the Calculation Agent to such a bond equivalent yield).

Fixed/Variable Rate Debentures and Medium-Term Notes

Fixed/Variable Rate Debentures and Medium-Term Notes will bear interest at a fixed rate for one or more periods and at a variable rate for one or more other periods. Fixed/Variable Rate Debentures and Medium-Term Notes also may bear interest at a rate that we may elect to convert from a fixed rate to a variable rate or from a variable rate to a fixed rate, as further described in the applicable Pricing Supplement. See ''Description of the Securities — Debentures and Medium-Term Notes — Fixed Rate Debentures and Medium-Term Notes'' as to fixed rates and ''Description of the Securities — Debentures and Medium-Term Notes — Variable Rate Debentures and Medium-Term Notes'' as to variable rates.

If we can convert the interest rate on a Fixed/Variable Rate Debenture or Medium-Term Note from a fixed rate to a variable rate, or from a variable rate to a fixed rate, accrued interest for each Interest Payment Period generally will be calculated using an accrued interest factor in the manner described under ''Description of the Securities — Variable Rate Debentures and Medium-Term Notes.''

Amortizing Debentures and Medium-Term Notes

Amortizing Debentures and Medium-Term Notes are those on which we make periodic payments of principal during their terms as described in the related Pricing Supplement. Amortizing Debentures and Medium-Term Notes may bear interest at fixed or variable rates.

Debentures and Medium-Term Notes with Variable Principal Repayment Amounts

Variable Principal Repayment Amount, or ''Indexed,'' Debentures and Medium-Term Notes are those on which the amount of principal payable is determined with reference to an index specified in the related Pricing Supplement.

Subordinated Securities

If specified in the applicable Pricing Supplement, the indebtedness represented by Subordinated Securities and the payment of principal of and interest on Subordinated Securities will be subordinated to prior payment in full of all Senior Obligations of Freddie Mac which are due and payable. Such Senior Obligations will be identified by category in the applicable Pricing Supplement. In addition, there may be other terms applicable to specific offerings of Subordinated Securities that would defer, limit or suspend our obligation to make any payment of principal of or interest on these Subordinated Securities under certain specified conditions. Any such terms and conditions will be specified in the applicable Pricing Supplement.

Stripped Debentures and Medium-Term Notes

We may designate certain issues of Debentures and Medium-Term Notes (the ''Eligible Securities'') as eligible to be stripped into their separate Interest Components and Principal

Components (each, a ''Component'') on the book-entry records of the Federal Reserve Bank of New York (the ''FRBNY''). The Components of an Eligible Security are:

(i) each future interest payment or portion of an interest payment (each, an ''Interest Component'') due on or prior to the Maturity Date or, if the Eligible Security is subject to redemption or repayment prior to the Maturity Date, the first date on which the Eligible Security is subject to redemption or repayment (in either case, the ''Cut-off Date''); and

(ii) the principal payment plus any interest payments that either are due after the Cut-off Date or are specified as ineligible for stripping in the applicable Pricing Supplement (the ''Principal Component'').

The initial or final interest payment on an issue of Eligible Securities will not be an Interest Component if the applicable Interest Payment Period is shorter or longer than other Interest Payment Periods, based on a 360-day year consisting of twelve 30-day months. In such case, the initial or final interest payment will remain with the Principal Component. Each Component of an issue of Eligible Securities will receive a different CUSIP Number.

We may designate an issue of Debentures or Medium-Term Notes as Eligible Securities either at the time of original issuance or at any later time prior to the Cut-off Date. We are under no obligation, however, to designate any issue of Debentures or Medium-Term Notes as Eligible Securities.

For an Eligible Security to be stripped into Components, its principal amount must produce an interest payment of $1,000 or a multiple of $1,000 on each Interest Payment Date, based on the stated interest rate of the Eligible Security. The minimum principal amount required to strip an Eligible Security at its original issuance will be specified in the related Pricing Supplement.

You may request that an Eligible Security be stripped into its Components at any time beginning on the date it becomes eligible for stripping until the Cut-off Date. You must make your request to the FRBNY and comply with any requirements and procedures, including payment of any fees, of the FRBNY.

If any modification, amendment or supplement of the terms of an issue of Eligible Securities requires the consent of Holders, only the Holders of Principal Components will be entitled to give or withhold that consent. Holders of Interest Components will have no right to give or withhold such consent. See ''The Agreements — Amendment.''

Currently, the FRBNY will restore (''reconstitute'') the Principal Components and unmatured Interest Components of a stripped Eligible Security at the request of a Holder holding a Principal Component and all applicable unmatured Interest Components. The Holder must pay a reconstitution fee (currently the FRBNY's fee applicable to on-line book-entry securities transfers). Generally, the Principal Component of an issue of Eligible Securities may be combined with either Interest Components of the same issue or Interest Components from other issues of Eligible Securities that have the same CUSIP Number. (Interest Components of two or more issues due on the same date sometimes have the same CUSIP Number). Holders wishing to reconstitute Components into an Eligible Security must also comply with all applicable FRBNY requirements and procedures relating to the stripping and reconstitution of securities.

The preceding discussion is based on our understanding of the way the FRBNY currently strips and reconstitutes securities on the Fed Book-Entry System. The FRBNY may cease stripping or reconstituting Eligible Securities or may change the way this is done or the applicable requirements, procedures or charges at any time without notice.

Reopened Issues

In our discretion and at any time, we may ''reopen'' an issue by offering additional Debentures or Medium-Term Notes with terms identical (other than issue date, interest commencement date and issue price) to those of existing Debentures or Medium-Term Notes for which settlement has

previously occurred or been scheduled. The additional and existing Debentures or Medium-Term Notes will be consolidated and will form a single series of Securities as specified in the applicable Pricing Supplement.

Discount Notes

Discount Notes will:

- be unsecured general obligations of Freddie Mac;
- be offered on a continuous basis;
- have maturities of one year or less from their issue date;
- not bear interest;
- be paid only on their Maturity Dates at their principal amounts; and
- be issued, maintained and transferred in minimum principal amounts and additional increments of $1,000 (in each case expressed in terms of the principal amount payable on the Maturity Date).

We will offer each Discount Note at a fixed price representing a discount from the principal amount payable at maturity. The initial offering price of a Discount Note will be the difference between the face amount of the Discount Note and the amount derived from the following formula:

$$\text{Face Amount} \times \frac{\text{Applicable Discount Expressed as a Decimal} \times \text{Number of Days From Issue Date to Maturity Date}}{360 \text{ days}}$$

We generally will not offer a Discount Note having a Maturity Date that is not a Business Day. If the Maturity Date of a Discount Note should fall on a day that is not a Business Day, its Maturity Date will become the first Business Day following such day. We will pay interest for the days from the original Maturity Date to (but excluding) the revised Maturity Date based on the percentage of discount at which this Discount Note was issued.

We may designate some Discount Notes as Reference Bills, which are regularly scheduled issues auctioned in large principal amounts.

Corrections

If a principal or interest payment error occurs, we may correct it by adjusting payments to be made on later Interest Payment Dates or Principal Payment Dates (as appropriate) or in any other manner we consider appropriate.

All index values used to determine principal or interest payments are subject to correction within 30 days from the applicable payment. The source of a corrected value must be the same source from which the original value was obtained. A correction might result in an adjustment on a later date to the amount paid to you or a subsequent investor.

For example, if the index value initially used for determining the rate of interest on an issue of Securities is superseded by a corrected value from the original source, the Calculation Agent will use that corrected value to determine the rate of interest payable on such Securities on the applicable Interest Payment Date. To illustrate, assume that LIBOR is the applicable interest rate index for determining the rate of interest payable on a Security. If the Calculation Agent obtains LIBOR for a Reset Date from a Designated Telerate Page, only a corrected rate for that Reset Date obtained from the same Designated Telerate Page may supersede the initial rate. The Calculation Agent will use the corrected rate to determine the rate of interest payable on the Security as of the applicable Interest Payment Date.

We will notify any exchange on which Securities are listed if the Calculation Agent corrects an applicable rate for such Securities.

Business Day Convention

Unless otherwise specified in the applicable Pricing Supplement, if the specified date for a payment is not a Business Day, we will pay the interest or principal of the Security on the next Business Day with the same force and effect as if such payment was made on the applicable Interest Payment Date or Principal Payment Date. Except in the case of Discount Notes, and unless otherwise specified in the applicable Pricing Supplement for an issue of Debentures or Medium-Term Notes, no interest on such payment will accrue for the period from such specified date to the actual date of the payment.

''Business Day'' means a day other than (1) a Saturday, (2) a Sunday, (3) as to any Securities on the Fed Book-Entry System, a day on which the FRBNY is closed, (4) as to any Holder of a Security on the Fed Book-Entry System, a day on which the Federal Reserve Bank that maintains the Holder's account is closed, (5) as to any Securities on the DTC Book-Entry System, a day on which the Depository is closed, or (6) a day on which our offices are closed.

Form and Denominations

Only Fed Participants may be Holders of Securities held on the Fed Book-Entry System. The Federal Reserve Banks will be our fiscal agents for Securities held on the Fed Book-Entry System. There is a Fiscal Agency Agreement between us and the FRBNY, acting on behalf of the Federal Reserve Banks (''Fiscal Agency Agreement''), which makes generally applicable to the Securities:

- The Department of Housing and Urban Development regulations (24 C.F.R. Part 81, Subpart H) applicable to Freddie Mac's book-entry securities (''Book-Entry Rules''); and
- Any procedures to which we and the FRBNY may agree.

These regulations and procedures relate to the issuance and recordation of, and transfers of interests (including security interests) in, all of our book-entry securities held on the Fed Book-Entry System, regardless of when such securities were issued. Fed Participants' individual accounts are governed by operating circulars and letters of the Federal Reserve Banks.

The Depository is a limited purpose trust company organized under the laws of the State of New York that provides book-entry holding and settlement services for its participants (''Depository Participants''), mostly brokerage firms and other financial institutions. Securities held on the DTC Book-Entry System will be represented by certificates registered in the name of the Depository or its nominee.

The Fed Book-Entry System and the DTC Book-Entry System use a unique nine-character designation, known as a ''CUSIP Number,'' to identify each issue of Securities and, for Eligible Securities, the Components of an issue. Each issue of Discount Notes having the same Maturity Date will have the same CUSIP Number.

The Fed Book-Entry System or the DTC Book-Entry System will hold and transfer Securities in minimum original principal amounts of $1,000 and additional increments of $1,000. You may not transfer a Security if, as a result of the transfer, you would have remaining in your account Securities of any issue having a principal amount less than the applicable minimum. Transfers of Securities on the Fed Book-Entry System will also have to comply with any Federal Reserve Bank minimum wire transfer requirements.

The laws of some jurisdictions require that certain purchasers of securities take physical delivery of such securities in certificated form. Such laws may impair the ability to transfer beneficial interests in Securities held on the Fed Book-Entry System or the DTC Book-Entry System.

Holders

A Holder is not necessarily the beneficial owner of a Security. Beneficial owners ordinarily hold Securities through one or more financial intermediaries, such as banks, brokerage firms and securities clearing organizations. For example, an investor may hold a Security through a brokerage firm which, in turn, holds the Security through a Fed Participant. In that case, you would be the beneficial owner and the Fed Participant appearing as the holder on the records of a Federal Reserve Bank would be the Holder.

In the case of a Security maintained on the DTC Book-Entry System, your beneficial ownership will be recorded on the records of the brokerage firm, bank, thrift institution or other financial intermediary where you maintain an account for that purpose. In turn, the financial intermediary's interest in the Security will be recorded on the records of the Depository (or of a Depository Participant that acts as agent for the financial intermediary, if the intermediary is not itself a Depository Participant).

A Holder that is not also the beneficial owner of a Security, and each other financial intermediary in the chain between the Holder and the beneficial owner, will be responsible for establishing and maintaining accounts for their customers. Beneficial owners of a Security may exercise their rights against Freddie Mac, the Federal Reserve Banks and the Depository only through the Holder of the Security. Freddie Mac, the Federal Reserve Banks and the Depository will not have a direct obligation to a beneficial owner of a Security (unless the beneficial owner is also the Holder). A Federal Reserve Bank or the Depository will act only upon the instructions of the Fed Participant or Depository Participant, as applicable, in recording transfers of a Security. Freddie Mac, the Federal Reserve Banks and the Depository may treat the Holder as the absolute owner of a Security for the purpose of making payments and for all other purposes, regardless of any notice to the contrary.

Payment Procedures

A Federal Reserve Bank will credit payments to Holders on the Fed Book-Entry System. Holders of a Security on the records of a Federal Reserve Bank will be entitled to any payments on the Security made on the related Payment Date.

We will make payments on Securities held on the DTC Book-Entry System to the Depository in immediately available funds. The Depository will be responsible for crediting the payment to the accounts of the appropriate Depository Participants in accordance with its normal procedures. Each Depository Participant and each other financial intermediary in the chain to the beneficial owner of a Security will be responsible for remitting payments to the beneficial owner.

THE AGREEMENTS

The following summary describes certain provisions of the Agreements not otherwise described in this Offering Circular.

Binding Effect of the Agreements

You and any financial intermediary or the Holder acting on your behalf agree that the receipt and acceptance of a Security indicates acceptance of the terms and conditions of the applicable Agreement, as that Agreement may be supplemented or amended by its terms.

The Agreements will be binding upon and inure to the benefit of any successor to Freddie Mac.

Various Matters Regarding Freddie Mac

The Agreements provide that Freddie Mac and its directors, officers, employees or agents will not be liable to the Holders for any action taken or omitted in good faith under the Agreements or for errors in judgment. However, they will not be protected against any liability imposed by reason of

willful misfeasance, bad faith or gross negligence or by reason of reckless disregard of their obligations and duties.

We may employ agents or independent contractors to perform our responsibilities under the Agreements.

Except upon an Event of Default (as defined below), we will not be subject to the control of the Holders in any manner in the discharge of our responsibilities under the Agreements. Except with regard to our payment obligations, we will have no liability to you other than for any direct damage resulting from our failure to exercise that degree of ordinary care which we exercise in the conduct and management of our own affairs. We will have no liability of any nature for consequential damages.

In addition, the Agreements provide that we need not appear in any legal action that is not incidental to our responsibilities under the Agreements and that we believe may result in any expense or liability. However, we may undertake any legal action that we believe is necessary or desirable in the interests of the Holders in our discretion. We will bear the legal costs of any such action.

Events of Default

An ''Event of Default'' under the Debenture and Medium-Term Note Agreement (other than for Subordinated Securities) will consist of:

- any failure by us to pay principal or interest that continues unremedied for 30 days;
- any failure by us to perform in any material way any other obligation under the Debenture and Medium-Term Note Agreement if the failure continues unremedied for 60 days after we receive notification by the Holders of at least 25% of the outstanding balance of an issue of Debentures or Medium-Term Notes; or
- specified events of bankruptcy, insolvency or similar proceedings involving us.

The appointment of a conservator (or other similar official) by a regulator having jurisdiction over us, whether or not we consent to such appointment, will not constitute an Event of Default.

The applicable Pricing Supplement for any issue of Subordinated Securities will specify Events of Default that will apply to any such Subordinated Securities.

The Discount Note Agreement does not define events of default or specify the remedies available to you in the event of our default.

Rights Upon Event of Default—Debentures and Medium-Term Notes

If an Event of Default under the Debenture and Medium-Term Note Agreement continues unremedied, Holders of at least 50% of the outstanding principal amount or notional principal amount of an issue of Debentures or Medium-Term Notes to which such Event of Default relates may, by written notice to us, declare such Debentures or Medium-Term Notes due and payable.

No Holder has the right under the Debenture and Medium-Term Note Agreement to institute any action or proceeding at law or in equity or in bankruptcy or otherwise, or for the appointment of a receiver or trustee, or for any other remedy, unless:

- the Holder previously has given us written notice of an Event of Default;
- the Holders of not less than 50% of the outstanding principal amount or notional principal amount of the same issue of Debentures or Medium-Term Notes have given us written notice of the Event of Default; and
- the Event of Default continues uncured for 60 days following such notice.

You do not have any right under the Debenture and Medium-Term Note Agreement to disturb or prejudice the rights of any other investor, to obtain or seek to obtain preference or priority over any other investor or to enforce any right under the Debenture and Medium-Term Note Agreement, except as provided in the Debenture and Medium-Term Note Agreement and for the ratable and common benefit of all such Holders and except for the priority rights of Holders of Senior Obligations over the rights of Holders of Subordinated Securities.

Events of Default that apply to an issue of Senior Obligations may not necessarily be Events of Default for an issue of Subordinated Securities. As a result, the Holders of an issue of Subordinated Securities may not have the same acceleration rights as Holders of other Securities.

The Holders of not less than 50% of the outstanding principal amount or notional principal amount of an issue of Debentures or Medium-Term Notes may waive, rescind or annul an Event of Default at any time.

Amendment

We may amend either Agreement without your consent:

- to cure any ambiguity or to correct any provision in the Agreement if the amendment does not materially and adversely affect any Holder;
- to add to our covenants for your benefit or surrender any right or power conferred upon us;
- to evidence the succession of another entity to us and its assumption of our covenants;
- to conform the terms of an issue of Securities to, or cure any ambiguity or discrepancy resulting from any changes in, the Book-Entry Rules;
- to increase the amount of an issue of Securities; or
- in any other manner we may determine that will not adversely affect your interests in any material way.

With the consent of the Holders of at least 50% of the outstanding balance of an issue of Securities, we may from time to time and at any time amend the terms of such Securities, but no such amendment may, without the written consent or affirmative vote of each affected Holder of a Security,

- change the Maturity Date or Interest Payment Date of such Security;
- materially modify the redemption or repayment provisions, if any, relating to the redemption or repayment price of, or any redemption or repayment date or period for, such Security;
- reduce the principal amount of, delay the principal payment of, or materially modify the rate of interest or the calculation of the rate of interest on, such Security; or
- reduce the percentage of Holders whose consent or affirmative vote is necessary to amend the terms of the relevant issue of Securities.

Any instrument given by a Holder on your behalf relating to a consent will be irrevocable once given and will be conclusive and binding on all subsequent Holders of that Security or any substitute or replacement Security. Any amendment of an Agreement or of the terms of Securities will be conclusive and binding on all Holders of those Securities, whether or not they have given such consent or were present at any meeting.

Securities Owned by Freddie Mac

We may, from time to time, repurchase or otherwise acquire (either for cash or in exchange for newly-issued Securities) some or all of any issue of Securities at any price or prices, in the open

market or otherwise. We may hold, sell or cancel any Securities that we repurchase. Any Securities we own will have an equal and proportionate benefit under the provisions of the applicable Agreement, without preference, priority or distinction as among those Securities. However, in determining whether the required percentage of Holders of an issue of Securities have given any required demand, authorization, notice, consent or waiver, Securities we own, directly or indirectly, will be deemed not to be outstanding.

Notice

Any notice, demand or other communication which is required or permitted to be given to a Holder may be given in writing by mail addressed to the Holder or, in the case of a Holder of a Security maintained on the Fed Book-Entry System, by transmission through the communication system linking the Federal Reserve Banks. The communication will be deemed to have been sufficiently given or made upon mailing or transmission.

Any notice, demand or other communication which is required or permitted to be delivered to us must be given in writing addressed as follows: Freddie Mac, 8200 Jones Branch Drive, McLean, Virginia 22102, Attention: Executive Vice President—General Counsel and Secretary. The communication will be deemed to have been sufficiently given or made only upon actual receipt of the writing by us.

Governing Law

The Agreements and the rights and obligations of the Holders and Freddie Mac with respect to the Securities each are to be interpreted in accordance with U.S. federal law. If there is no applicable U.S. federal law precedent, and if the application of New York law would not frustrate the purposes of the Freddie Mac Act or any provision of the applicable Agreement or the transactions governed by the Agreements, then the laws of the State of New York will be deemed to reflect U.S. federal law.

CERTAIN UNITED STATES FEDERAL TAX CONSEQUENCES

The Securities and payments on the Securities generally are not exempt from taxation by the United States or other U.S. or non-U.S. taxing jurisdictions.

The following summary addresses certain U.S. tax consequences of an investment in those Securities (referred to as ''Debt Obligations'' in this section) that do not have a Variable Principal Repayment Amount. This summary is based upon U.S. laws, regulations and decisions now in effect, all of which are subject to change, potentially with retroactive effect, or to differing interpretations.

This summary discusses only Debt Obligations held by investors as capital assets within the meaning of Section 1221 of the Internal Revenue Code of 1986, as amended to the date of this Offering Circular (the ''Code''). It does not discuss all of the tax consequences that may be relevant to an investor in light of its particular circumstances or to investors subject to special rules, such as certain financial institutions, insurance companies, dealers or investors holding Debt Obligations as part of a hedging transaction, straddle or synthetic security transaction. Moreover, this summary does not address Debt Obligations held by a foreign partnership or other foreign flow-through entities. Further, the tax consequences arising from the ownership of any Debt Obligations with special characteristics (*e.g.*, subordinated Debt Obligations providing for deferral of, limitation on or suspension of payments of principal or interest in some circumstances) may be set forth in the related Pricing Supplement. In all cases, you are advised to consult your own tax advisor regarding the U.S. tax consequences to you of purchasing, owning and disposing of Debt Obligations (or of stripped payment rights derived from such Debt Obligations), including the advisability of making any of the elections described below, as well as any tax consequences arising under the laws of any state or other taxing jurisdiction.

For purposes of this summary, ''U.S. Person'' means:

- an individual who, for U.S. income tax purposes, is a citizen or resident of the United States;
- a corporation, partnership or other entity created or organized in or under the laws of the United States, any state thereof, or the District of Columbia, other than a partnership that is not treated as a U.S. Person under any applicable U.S. Treasury regulations (''Regulations'');
- an estate the income of which is subject to U.S. income taxation regardless of its source; or
- a trust if a court within the United States is able to exercise primary supervision over the administration of the trust and one or more U.S. persons have the authority to control all substantial decisions of the trust. Certain trusts in existence on or before August 20, 1996, that were treated as U.S. persons under the law in effect on such date but fail to qualify as U.S. persons under current law, may elect to continue to be treated as U.S. persons to the extent prescribed in the Regulations.

''U.S. Owner'' means a U.S. Person that beneficially owns a Debt Obligation. ''Non-U.S. Owner'' means a beneficial owner of a Debt Obligation other than a U.S. Person. ''Owner'' means either a U.S. Owner or a Non-U.S. Owner.

If we issue Debentures or Medium-Term Notes having a Variable Principal Repayment Amount, the U.S. federal tax treatment of investors in such Debentures or Medium-Term Notes will be described in the related Pricing Supplement.

As a condition to our payment on a Security or to the transfer or exchange of such Security, we may require a Holder to present a certificate in a prescribed form to enable us to determine our duties and liabilities with respect to any taxes or other charges required to be deducted or withheld under United States law or any reporting or other requirements.

U.S. Owners

In General

Income derived from a Debt Obligation by a U.S. Owner is subject to U.S. income taxation. In addition, a Debt Obligation owned by an individual who, at the time of death, is a U.S. citizen or domiciliary is subject to U.S. federal estate tax.

The U.S. Internal Revenue Service (''IRS'') has ruled that Freddie Mac is an instrumentality of the United States for purposes of Section 7701(a)(19) of the Code; therefore, domestic building and loan associations and savings banks are permitted to invest in Debt Obligations to meet the percentage of total assets required to be invested in, among other things, stock or obligations of a corporation which is an instrumentality of the United States. Further, Debt Obligations held by a real estate investment trust will constitute ''Government securities'' within the meaning of Section 856(c)(4)(A) of the Code, and Debt Obligations held by a regulated investment company will constitute ''Government securities'' within the meaning of Section 851(b)(3) of the Code.

The Freddie Mac Act does not contain any specific exemption from any taxes on the principal of or interest on obligations issued by Freddie Mac imposed by any state or possession of the United States or by any local taxing authority. Purchasers residing in states of the United States that impose intangible property or income taxes should consult their own tax advisors as to the status of the Debt Obligations and interest paid on them under applicable tax laws.

Payments of Interest

Interest paid on a Debt Obligation generally will be taxable to a U.S. Owner as ordinary interest income at the time it accrues or is received in accordance with the U.S. Owner's method of accounting for U.S. federal income tax purposes.

Debt Obligations with Original Issue Discount

Debt Obligations that are Zero Coupon Debentures will, and other Debt Obligations may, be issued with original issue discount. The Code and Regulations concerning the tax treatment of debt instruments issued with original issue discount (''OID Regulations'') provide that the excess of the ''stated redemption price at maturity'' of a Debt Obligation over its ''issue price'' will be original issue discount unless such excess is *de minimis* (defined below). The ''stated redemption price at maturity'' of a Debt Obligation is equal to the sum of all payments on the Debt Obligation other than interest based on a fixed rate (or a variable rate, unless a related Pricing Supplement provides otherwise) and payable unconditionally at least annually. The ''issue price'' of a Debt Obligation is the first price at which a substantial amount of the issue of which the Debt Obligation is a part is sold to persons other than those acting as placement agents, underwriters, brokers or wholesalers. The issue price of a Debt Obligation generally includes any pre-issuance accrued interest unless a U.S. Owner excludes such amount from the issue price and treats a portion of the stated interest payable on the first interest payment date as a return of that accrued interest rather than as an amount payable under the Debt Obligation. Original issue discount is considered to be *de minimis* if it is less than one-quarter of one percent of a Debt Obligation's stated redemption price at maturity multiplied by the number of complete years to its maturity (weighted average maturity if principal is payable in installments). A Debt Obligation having original issue discount is referred to as an ''OID Debt Obligation.'' A U.S. Owner of a Debt Obligation with *de minimis* original issue discount will include any *de minimis* original issue discount in income, as capital gain, on a pro rata basis as principal payments are made on the Debt Obligation.

Special rules apply to Debt Obligations that are callable by us, including Debt Obligations that are Step Debentures and Medium-Term Notes that have an initial fixed interest rate that will change to a different fixed rate on the first day on which such Debt Obligations may be redeemed (''Step Debt Obligations''). See ''Certain United States Federal Tax Consequences — U.S. Owners — Callable Debt Obligations.'' Other special rules may apply to Debt Obligations that are Variable Rate Notes, Debt Obligations that provide for a fixed rate and a variable rate in different periods, Debt Obligations with a zero or reduced interest rate for certain periods, and certain other situations.

Subject to certain special rules for Debt Obligations having a maturity of one year or less (discussed below), U.S. Owners are required to include original issue discount on OID Debt Obligations in income as it accrues, which may be before the receipt of the cash attributable to such income, based on a compounding of interest at a constant rate (using the yield to maturity of the Debt Obligation when originally issued). Under these rules, the portion of the original issue discount includible in income is lowest in the first accrual period and increases in each successive accrual period. The OID Regulations permit U.S. Owners to use accrual periods of any length up to one year to compute accruals of original issue discount, provided each scheduled payment of principal or interest occurs either on the first or the last day of an accrual period.

Callable Debt Obligations

The OID Regulations provide special rules for determining the yield and maturity of debt instruments that are unconditionally callable prior to their final maturity date. Under these rules, we will be presumed to exercise a call right if such exercise would minimize the yield to maturity of the Debt Obligation. If a call right with respect to an OID Debt Obligation is presumed to be exercised but we do not in fact exercise the call right, the Debt Obligation will be treated as reissued at the ''adjusted issue price'' on the call date solely for purposes of determining future accruals of interest and original issue discount. The adjusted issue price is defined as the sum of the issue price of the

Debt Obligation and the aggregate amount of previously accrued original issue discount (determined without regard to the acquisition premium rules), less any prior payments of amounts included in its stated redemption price at maturity.

For example, a fixed rate Debt Obligation that is issued at a discount and is callable at par will not be deemed to be called because exercise of the call right will not minimize the yield of such Debt Obligation. A Step Debt Obligation that is issued at par and is callable at par on the dates specified for increases in interest rates will be deemed to be called on the first step date because the yield to maturity on the Debt Obligation will be lower than if the interest rate were stepped up. If the Step Debt Obligation is not called on that date, or is called only in part, the Step Debt Obligation (to the extent of its remaining outstanding principal amount) will be deemed to be called and reissued at par. As a result of these special rules, a Step Debt Obligation issued at par will not have any original issue discount and stated interest will be taken into account by a U.S. Owner under its regular method of accounting.

If a principal purpose in structuring a debt instrument is to achieve a result that is unreasonable in light of the purposes of the statutes relating to original issue discount, then the OID Regulations provide that the IRS can apply or depart from the OID Regulations, including the rules relating to the exercise of call rights described above, as necessary or appropriate to achieve a reasonable result. We intend to report income on any Step Debt Obligations with the features described above assuming this anti-abuse rule does not apply.

Debt Obligations with a Term of One Year or Less

A Debt Obligation that matures one year or less from the date of its issuance is referred to as a ''Short-Term Debt Obligation.'' For purposes of determining whether a Debt Obligation is a Short-Term Debt Obligation, the maturity date of the Debt Obligation is the last possible date it could be outstanding under its terms. For example, a Step Debt Obligation that has a maturity of more than one year but, under the rules described in the previous section, is presumed to be called on a date that is one year or less from the issue date, will not constitute a Short-Term Debt Obligation.

Accrual method U.S. Owners and certain other U.S. Owners described in Section 1281(b) of the Code, regardless of their method of accounting, are required to include original issue discount and stated interest (if any) with respect to a Short-Term Debt Obligation in income as it accrues. Original issue discount and stated interest must be accrued on a straight-line basis unless the U.S. Owner makes an irrevocable election to accrue such amounts on the basis of the Short-Term Debt Obligation's yield to maturity and daily compounding. U.S. Owners described in this paragraph may irrevocably elect to accrue ''acquisition discount'' (*i.e.*, the excess of the stated redemption price at maturity over the U.S. Owner's basis in the Short-Term Debt Obligation) rather than original issue discount. Such U.S. Owners should consult their tax advisors before making this election.

Cash method U.S. Owners of a Short-Term Debt Obligation generally include original issue discount and stated interest (if any) in income as payments are received. A cash method U.S. Owner of a Short-Term Debt Obligation described in Section 1281(b) of the Code, however, is subject to the rules described in the preceding paragraph. In addition, a cash method U.S. Owner of a Short-Term Debt Obligation (that is not otherwise required to account for interest or original issue discount on such Short-Term Debt Obligation as it accrues) may nevertheless elect to include in income interest and original issue discount as they accrue (under the rules discussed above) on all obligations having a maturity of one year or less held by the U.S. Owner in the taxable year of the election and in all subsequent years. This election is irrevocable without the consent of the IRS. In the case of a U.S. Owner that is not required and that does not elect to include original issue discount in income currently, (i) any gain realized upon the sale, exchange or retirement of a Short-Term Debt Obligation will be ordinary income to the extent of accrued original issue discount and (ii) such U.S. Owner will be required to defer deductions for interest expense on any indebtedness incurred or continued to purchase or carry the Short-Term Debt Obligation, in an amount not exceeding the deferred interest income, until the deferred interest income is recognized.

Acquisition Premium and Market Discount

In the event that a U.S. Owner purchases an OID Debt Obligation at an ''acquisition premium'' (*i.e.*, at a price in excess of its adjusted issue price but less than its remaining stated redemption price at maturity), an adjustment must be made to the amount includible in income in each taxable year as original issue discount. Unless a U.S. Owner makes the accrual method election described below, the original issue discount includible for any taxable year is reduced by the product of the amount of original issue discount otherwise accruing during that taxable year under the rules described above and a constant fraction, the numerator of which is the excess of the purchase price of the Debt Obligation over the adjusted issue price of the Debt Obligation as of the acquisition date, and the denominator of which is the remaining original issue discount on the Debt Obligation as of the acquisition date.

A U.S. Owner that purchases a Debt Obligation (other than a Short-Term Debt Obligation) at a ''market discount'' (*i.e.*, at a price less than its stated redemption price at maturity or, in the case of an OID Debt Obligation, its adjusted issue price) will be required (unless such difference is a *de minimis* amount) to treat any principal payments on, or any gain realized in a taxable disposition or retirement of, such Debt Obligation as ordinary income to the extent of the market discount that accrued while such U.S. Owner held such Debt Obligation, unless the U.S. Owner elects to include such market discount in income on a current basis. Market discount is considered to be *de minimis* if it is less than one-quarter of one percent of the Debt Obligation's stated redemption price at maturity multiplied by the number of complete years to maturity (weighted average maturity if principal is payable in installments) after the U.S. Owner acquired such Debt Obligation. If a Debt Obligation with more than a *de minimis* amount of market discount is disposed of in a transaction that is nontaxable in whole or in part (other than certain transactions described in Section 1276(d) of the Code), accrued market discount will be includible as ordinary income to the U.S. Owner as if such U.S. Owner had sold the Debt Obligation at its then fair market value. Generally, market discount accrues ratably over the number of days from the date of acquisition to the date of maturity. A U.S. Owner may, however, irrevocably elect with respect to any Debt Obligation to use a constant interest method. A U.S. Owner of a Debt Obligation that acquired it at a market discount and that does not elect under Section 1278(b) of the Code to include market discount in income on a current basis also may be required to defer the deduction for a portion of the interest expense on any indebtedness incurred or continued to purchase or carry the Debt Obligation until the deferred income is realized.

Debt Obligations Purchased at a Premium

Except as noted below, a U.S. Owner that purchases a Debt Obligation for an amount in excess of its remaining stated redemption price at maturity will be treated as having premium with respect to such Debt Obligation in the amount of such excess. A U.S. Owner that purchases an OID Debt Obligation at a premium is not required to include in income any original issue discount with respect to such Debt Obligation. If such a U.S. Owner makes an election under Section 171(c)(2) of the Code to treat such premium as ''amortizable bond premium,'' the amount of interest on a Debt Obligation that must be included in such U.S. Owner's income for each accrual period (where such Debt Obligation is not optionally redeemable prior to its maturity date) will be reduced (but not below zero) by the portion of the premium allocable to such period based on the Debt Obligation's yield to maturity. If such Debt Obligation may be called prior to maturity after the U.S. Owner has acquired it, the U.S. Owner generally may not assume that the call will be exercised and must amortize premium to the maturity date. If the Debt Obligation is in fact called, any unamortized premium may be deducted in the year of the call. If a U.S. Owner makes the election under Section 171(c)(2) of the Code, the election also shall apply to all bonds the interest on which is not excludable from gross income (''Fully Taxable Bonds'') held by the U.S. Owner at the beginning of, or acquired during, the first taxable year to which the election applies and to all Fully Taxable Bonds acquired by it in subsequent years. This election is irrevocable without the consent of the IRS. If such an election is not made, such a U.S. Owner must include the full amount of each interest

payment in income in accordance with its regular method of accounting and will take the premium into account in computing its gain or loss upon the sale or other disposition or retirement of the Debt Obligation. Thus, the premium may reduce capital gain or increase capital loss realized on the disposition or retirement. See ''Certain United States Federal Tax Consequences — U.S. Owners — Disposition or Retirement of Debt Obligations.''

Accrual Method Election

Under the OID Regulations, a U.S. Owner of a Debt Obligation is permitted to elect to include in gross income its entire return on a Debt Obligation (*i.e.*, the excess of all remaining payments to be received on the Debt Obligation over the amount paid for the Debt Obligation by such U.S. Owner) based on the compounding of interest at a constant rate. If the U.S. Owner has not made an election under Section 171(c)(2) of the Code to amortize bond premium, an accrual method election for a Debt Obligation with amortizable bond premium will result in a deemed election under Section 171(c)(2) of the Code for all of the U.S. Owner's debt instruments with amortizable bond premium acquired during the current year and all subsequent years. Similarly, an accrual method election for a Debt Obligation with market discount by a U.S. Owner that has not made an election under Section 1278(b) of the Code to include market discount in income on a current basis will result in a deemed election under Section 1278(b) of the Code. Such a deemed election will apply to all debt instruments with market discount acquired by the U.S. Owner during the current year and all subsequent years. Neither the bond premium election under Section 171(c)(2) of the Code nor the market discount election under Section 1278(b) of the Code may be revoked without the permission of the IRS.

Disposition or Retirement of Debt Obligations

Upon the sale, exchange or other disposition of a Debt Obligation, or upon the retirement of a Debt Obligation (including by redemption), a U.S. Owner will recognize gain or loss equal to the difference, if any, between the amount realized upon the disposition or retirement (not including any amount attributable to accrued but unpaid interest) and the U.S. Owner's tax basis in the Debt Obligation. A U.S. Owner's tax basis for determining gain or loss on the disposition or retirement of a Debt Obligation is the cost of such Debt Obligation to such U.S. Owner, increased by the amount of original issue discount and any market discount includible in such U.S. Owner's gross income with respect to such Debt Obligation, and decreased by (i) the amount of any payments under the Debt Obligation that are part of its stated redemption price at maturity and (ii) the portion of any premium applied to reduce interest payments as described above.

Gain or loss upon the disposition or retirement of a Debt Obligation will be capital gain or loss, except to the extent the gain represents accrued original issue discount or market discount on the Debt Obligation not previously included in gross income, to which extent such gain or loss would be treated as ordinary income. Any capital gain or loss will be long-term capital gain or loss if at the time of disposition or retirement the Debt Obligation has been held for more than one year. With respect to Step Debt Obligations described above, if a call that is presumed exercised is not in fact exercised, the deemed reissuance of the Debt Obligations for purposes of computing subsequent accruals of interest and original issue discount will not result in a deemed disposition or retirement of the Step Debt Obligations.

Stripped Debt Obligations

Tax Treatment of Purchasers of Principal or Interest Components. Pursuant to Section 1286 of the Code, the separation of ownership of the right to receive some or all of the interest payments on a debt obligation from ownership of the right to receive some or all of the principal payments results in the creation of ''stripped bonds'' with respect to principal payments and ''stripped coupons'' with respect to interest payments. Consequently, a purchaser of a Principal Component or an Interest Component will be considered to own stripped bonds or stripped coupons, respectively.

Section 1286 of the Code treats a stripped bond or a stripped coupon, for purposes of applying the original issue discount rules, as a debt instrument issued with original issue discount on the date that such stripped bond or stripped coupon is purchased. Accordingly, the tax consequences to a purchaser of a Component are determined as if the Component were an OID Debt Obligation issued on the date of purchase or, in the case of a Component maturing one year or less from the date of purchase, a Short-Term Debt Obligation issued on that date. See ''Certain United States Federal Tax Consequences — U.S. Owners — Debt Obligations with Original Issue Discount'' and '' — Debt Obligations with a Term of One Year or Less'' and ''Certain United States Federal Tax Consequences — Non-U.S. Owners — Interest.'' The amount of original issue discount is equal to the excess (if any) of the Component's stated redemption price at maturity (in the case of an Interest Component, the amount payable on the due date of such Component), over the purchase price.

If a U.S. Owner purchases in one transaction a pro rata share of the Principal Component and applicable unmatured Interest Components relating to the same Debt Obligation, while the matter is not free from doubt, such U.S. Owner should be treated as purchasing an undivided interest in the Debt Obligation rather than the separate Components. If such Components are purchased in separate transactions, then the U.S. Owner likely should be treated as purchasing the separate Components for U.S. federal income tax purposes. Such a U.S. Owner must account for taxable income with respect to such Components as described in the preceding paragraph.

Tax Treatment of Person That Strips the Debt Obligation and Disposes of Some of the Components. A U.S. Owner of a Debt Obligation that strips the Debt Obligation into its related Components and disposes of some of such Components will also be subject to the rules of Section 1286 of the Code. On the date of disposition, the U.S. Owner must (i) include in income all interest and market discount accrued on the Debt Obligation and not previously included in income, (ii) increase its basis in the Debt Obligation by the same amount, (iii) allocate its basis in the Debt Obligation among the Principal Component and Interest Components retained and disposed of according to their respective fair market values, and (iv) recognize gain or loss with respect to the Principal Component and Interest Components disposed of. Such U.S. Owner will be treated as having purchased the retained Components for an amount equal to the basis allocable to such Components.

Tax Treatment of Stripping and Reconstitution Transactions. An exchange by a U.S. Owner of a Debt Obligation for the related Components will not constitute a taxable exchange to the U.S. Owner. Similarly, a reconstitution of Components into a single instrument will not constitute a taxable exchange. In either case, the U.S. Owner will be treated as continuing to own for Federal income tax purposes the property that it owned prior to the exchange.

Non-U.S. Owners

Interest

Interest (including original issue discount) on a Debt Obligation held by a Non-U.S. Owner will be subject to a 30-percent U.S. federal income and withholding tax, unless an exemption applies. An exemption generally exists in the following circumstances:

Exemption for Certain Short-Term Obligations. Interest on a Debt Obligation held by a Non-U.S. Owner that is not effectively connected with a trade or business of the Non-U.S. Owner within the United States will be exempt from U.S. federal income and withholding taxes if the Debt Obligation is payable in full within 183 days after the date of original issue.

Exemption for Portfolio Interest. Interest on a Debt Obligation held by a Non-U.S. Owner that is not effectively connected with a trade or business of the Non-U.S. Owner within the United States generally will be exempt from U.S. federal income and withholding taxes if the person otherwise required to withhold receives, in the manner provided by U.S. tax authorities, a certification that the Non-U.S. Owner is not a U.S. Person. A Non-U.S. Owner may provide this certification by providing a properly completed Form W-8BEN or other documentation prescribed by U.S. tax authorities. The

appropriate documentation must be effective as to the interest and be provided prior to the payment of such interest. If a change in circumstances makes any information on such documentation incorrect, then the Non-U.S. Owner must report the change within 30 days and provide new documentation.

The portfolio interest exemption will not apply if: (i) the interest is determined by reference to any receipts, sales or other cash flow of Freddie Mac or a related person, the income or profits of Freddie Mac or a related person, a change in value of any property of Freddie Mac or a related person, or any other item specified in Section 871(h)(4)(A) of the Code, (ii) the Non-U.S. Owner is a bank that receives payments on the Debt Obligations that are described in Section 881(c)(3)(A) of the Code, (iii) the Non-U.S. Owner is a 10-percent shareholder of Freddie Mac within the meaning of Section 871(h)(3)(B) of the Code or (iv) the Non-U.S. Owner is a ''controlled foreign corporation'' related to Freddie Mac within the meaning of Section 881(c)(3)(C) of the Code.

Exemption or Reduced Rate for Non-U.S. Owners Entitled to the Benefits of a Treaty. Interest on a Debt Obligation held by a Non-U.S. Owner may be exempt from U.S. federal income and withholding taxes (or subject to such tax at a reduced rate) under an income tax treaty between the United States and a foreign jurisdiction. In general, the exemption (or reduced rate) applies only if the Non-U.S. Owner provides a properly completed Form W-8BEN or other documentation prescribed by U.S. tax authorities. The appropriate documentation must be effective as to the interest and be provided prior to the payment of such interest. If a change in circumstances makes any information on such documentation incorrect, then the Non-U.S. Owner must report the change, generally within 30 days, and provide new documentation.

A treaty exemption (or reduced rate of tax) generally will not apply if the Non-U.S. Owner holds the Debt Obligation through an entity that is ''fiscally transparent'' for U.S. federal income tax purposes but not fiscally transparent under the laws of the Non-U.S. Owner's jurisdiction of residence. An entity is considered fiscally transparent if its interest holders currently take into account their respective shares of the entity's income and determine the character of such income as if they realized it directly.

Exemption for Non-U.S. Owners with Effectively Connected Income. Interest on a Debt Obligation held by a Non-U.S. Owner will be exempt from the 30-percent U.S. federal withholding tax if it is effectively connected with the conduct of a trade or business within the United States and the Non-U.S. Owner establishes this exemption by providing a properly completed Form W-8ECI or other documentation prescribed by U.S. tax authorities. The appropriate documentation must be effective as to the interest and be provided prior to the payment of such interest. If a change in circumstances makes any information on such documentation incorrect, then the Non-U.S. Owner must report the change, generally within 30 days, and provide new documentation. Interest on a Debt Obligation that is, or is deemed to be, effectively connected with the conduct of a trade or business in the United States by a Non-U.S. Owner, although exempt from the withholding tax, generally will be subject to U.S. federal income tax at graduated rates and, in the case of a foreign corporation, U.S. federal branch profits tax.

Disposition or Retirement of Debt Obligations

Except as provided in the discussion of backup withholding below, a Non-U.S. Owner of a Debt Obligation will not be subject to U.S. federal income and withholding taxes on any gain realized on the sale, exchange, retirement or other disposition of a Debt Obligation unless (i) such gain is, or is deemed to be, effectively connected with a trade or business in the United States of the Non-U.S. Owner or (ii) such Non-U.S. Owner is an individual who is present in the United States for 183 days or more in the taxable year of sale, exchange, retirement or other disposition and certain conditions are met.

U.S. Federal Estate and Gift Tax

Debt Obligations owned by an individual who is not a citizen or domiciliary of the United States will not be subject to U.S. federal estate tax if interest paid on the Debt Obligations to such individual at the time of his or her death would have been exempt from U.S. federal income and withholding tax as described above under either ''Certain United States Federal Tax Consequences — Non-U.S. Owners — Interest —Exemption for Portfolio Interest'' (without regard to the requirement that a non-U.S. beneficial ownership statement be received) or ''Certain United States Federal Tax Consequences — Non-U.S. Owners — Interest — Exemption for Certain Short-Term Obligations.'' A Non-U.S. Owner of a Debt Obligation will not be subject to U.S. gift tax on a transfer of the Debt Obligation, unless the Non-U.S. Owner is an expatriate subject to Section 2501(a)(3) of the Code.

Information Reporting and Backup Withholding

Payments of interest on a Debt Obligation to a U.S. Owner (other than a corporation or other exempt recipient) are required to be reported to the IRS and the U.S. Owner. Payments of interest on a Debt Obligation to a Non-U.S. Owner (other than interest described above under ''Certain United States Federal Tax Consequences — Non-U.S. Owners — Interest — Exemption for Certain Short-Term Obligations'') generally will be reported to U.S. tax authorities and the Non-U.S. Owner. Form W-8BEN, Form W-8ECI or other documentation or information about the Non-U.S. Owner may be provided to U.S. tax authorities.

Backup withholding of U.S. federal income tax at a rate of 28% may apply to a payment made in respect of a Debt Obligation, as well as a payment of proceeds from the sale of a Debt Obligation, to an Owner (other than a corporation or other exempt recipient), unless the Owner provides certain information.

If an Owner (other than a corporation or other exempt person) sells a Debt Obligation before the stated maturity to (or through) certain brokers, the broker must report the sale to the IRS and the Owner unless, in the case of a Non-U.S. Owner, the Non-U.S. Owner certifies that it is not a U.S. Person (and certain other conditions are met). The broker may be required to withhold U.S. federal income tax at a rate of 28% on the entire sale price unless such Owner provides certain information and, in the case of a Non-U.S. Owner, the Non-U.S. Owner certifies that it is not a U.S. Person (and certain other conditions are met).

THE U.S. FEDERAL TAX DISCUSSION SET FORTH ABOVE IS INCLUDED FOR GENERAL INFORMATION ONLY AND MAY NOT BE APPLICABLE DEPENDING UPON AN OWNER'S PARTICULAR SITUATION. OWNERS SHOULD CONSULT THEIR OWN TAX ADVISORS WITH RESPECT TO THE TAX CONSEQUENCES TO THEM OF THE OWNERSHIP AND DISPOSITION OF THE DEBT OBLIGATIONS, INCLUDING THE TAX CONSEQUENCES UNDER THE TAX LAWS OF THE UNITED STATES, STATES, LOCALITIES, COUNTRIES OTHER THAN THE UNITED STATES AND ANY OTHER TAXING JURISDICTIONS AND THE POSSIBLE EFFECTS OF CHANGES IN SUCH TAX LAWS.

EUROPEAN UNION DIRECTIVE ON TAXATION OF SAVINGS INCOME

The European Union has adopted a Directive regarding the taxation of savings income (the ''EU Tax Directive''). Subject to a number of important conditions being met, it is proposed that countries that are member states of the European Union (''Member States'') will be required from a date not earlier than January 1, 2005 to provide to the tax authorities of other Member States details of payments of interest and other similar income paid by a person to an individual in another Member State, except that Austria, Belgium and Luxembourg will instead impose a withholding system for a transitional period unless during such period they elect otherwise.

The withholding tax provisions of the EU Tax Directive could apply to payments on Debt Securities made through any Luxembourg paying agent. It is expected that holders will be able to take steps to keep payments from being subject to such withholding tax, for example, by using a

procedure (or procedures) to be made available pursuant to the EU Tax Directive (namely, releasing the paying agent of its professional secrecy duty to the extent permitted by law or by producing an appropriate tax certificate), or by receiving payments from a paying agent within the European Union but outside Luxembourg, Belgium and Austria, although we cannot preclude the possibility that withholding tax will eventually be levied in some situations. In any event, details of payments made on Debt Securities from a Member State will likely have to be reported to the tax or other relevant authorities under the EU Tax Directive or local law, including, for example, to Member States in cases where recipients are located in the jurisdiction where payments are actually made.

APPLICATION OF PROCEEDS

The net proceeds we receive from sales of the Securities will provide funds for general corporate purposes, including the purchase and financing of mortgages.

LEGAL INVESTMENT CONSIDERATIONS

You should consult your own legal advisors to determine whether the Securities constitute legal investments for you and whether the Securities can be used as collateral for borrowings. In addition, financial institutions should consult their legal advisors or regulators to determine the appropriate treatment of the Securities under risk-based capital and similar rules.

If you are subject to legal investment laws and regulations or to review by regulatory authorities, you may be subject to restrictions on investing in certain types of Securities generally. Institutions regulated by the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, the National Credit Union Administration, the Treasury Department or any other federal or state agency with similar authority should review applicable regulations, policy statements and guidelines before purchasing or pledging Securities.

DISTRIBUTION ARRANGEMENTS

Debentures and Medium Term-Notes

We will offer the Debentures and Medium-Term Notes to or through Dealers under the terms and conditions set forth in a Master Dealer Agreement, dated as of January 31, 2001 and as further amended, supplemented or modified or replaced from time to time (the ''Dealer Agreement''), between us and certain Dealers. Dealers are firms that engage in the business of dealing or trading in Securities as agents, brokers or principals. Under the terms of the Dealer Agreement, we may add other securities dealers or banks in connection with the distribution of the Securities or any particular issue of Securities. These securities dealers or banks, together with the initial Dealers with whom Freddie Mac executed the Dealer Agreement, are referred to in this Offering Circular collectively as the ''Dealers.'' The Dealer Agreement also provides that we may remove Dealers from time to time.

We will sell Debentures and Medium-Term Notes to Dealers as principals, either individually or as part of a syndicate. These sales may be by auction or other methods. Dealers will resell the Securities to investors at a fixed offering price or at varying offering prices related to market prices prevailing at the time of resale as determined by such Dealers. Offering prices may be established through negotiations with dealers, auctions (which may include standard auctions, Dutch auctions or other formats) or otherwise. The Dealer Agreement entitles the Dealers or us to terminate such sale in certain circumstances before payment for the Securities is made to us. Except under certain circumstances, any such Dealer may sell the Debentures or Medium-Term Notes it has purchased as principal to other dealers at a concession, in the form of a discount that other dealers may receive. The applicable Dealers will advise us whether an offering is on a fixed price or variable price basis and of any concessions or reallowances that will be provided to other dealers in connection

with such offering. We will include this information that the Dealers provide in the applicable Pricing Supplement. After the initial offering of any issue of Debentures or Medium-Term Notes, the offering price (in the case of a fixed price offering), the concession and the reallowance may be changed. There will be no underwriting compensation where such sales are by auction.

Debentures and Medium-Term Notes also may be offered through certain Dealers as our agents. We will have the sole right to accept offers to purchase such Securities and may reject any proposed purchase of such Securities. Each Dealer will have the right, in its reasonable discretion, without notice to us, to reject any proposed purchase of the Securities through it as agent. Each Dealer is acting solely as our agent in soliciting offers to purchase Securities as agent, and not as principal, and does not assume any obligation towards or relationship of agency or trust with any purchaser of Securities.

We also may sell Debentures and Medium-Term Notes directly to investors on our own behalf. We will not pay a commission to any Dealer on these direct sales. These sales may be by auction or other method.

A Dealer acting as a principal for a fixed price offering may engage in certain transactions that stabilize, maintain or otherwise affect the market price, or that support the market price at a higher level than that which might otherwise prevail, in connection with any offering of Debentures or Medium-Term Notes. Those transactions may include stabilizing bids or purchases for the purpose of pegging, fixing or maintaining the market price of the Debentures or Medium-Term Notes and the purchase of Debentures or Medium-Term Notes to cover syndicate short positions created in connection with an offering of Debentures or Medium-Term Notes. Any such transactions will be conducted in compliance with all applicable laws, regulations and rules.

A Dealer may create a short position in the Debentures or Medium-Term Notes in connection with the offering by selling Debentures or Medium-Term Notes with a principal amount greater than that set forth on the cover of the applicable Pricing Supplement, and may reduce that short position by purchasing Debentures or Medium-Term Notes in the open market.

In general, purchases of a security for the purpose of stabilization or to reduce a short position could cause the price of the security to be higher than it might be in the absence of such purchases. We and the Dealers make no representation or prediction as to the direction or magnitude of any effect that the transactions described above may have on the price of the Debentures or Medium-Term Notes. In addition, we and the Dealers make no representation that the Dealers will engage in such transactions or that such transactions, once commenced, will be continued. A Dealer that engages in such transactions does so on its own behalf and not as our agent.

We and the Dealers have agreed to indemnify each other against and contribute toward certain liabilities.

Discount Notes

We offer Discount Notes for sale through one or a combination of methods, including auction, allocation to selected Dealers for reoffering or placement with investors, and direct placement with Dealers or investors.

Discount Notes generally are offered on a continuous basis for sale to Dealers. The sales may be held on a daily basis and there may be more than one sale on a given day. Current quotations for Discount Notes of varying maturities can be obtained by contacting any Dealer for Discount Notes.

Freddie Mac may compensate Dealers in connection with sales of Discount Notes by allowing a concession to the Dealers. Part of any concession allowed by Freddie Mac may be in the form of a commission payable by Freddie Mac to Dealers that place customer bids during an auction that are subsequently awarded to the Dealer's customer.

General

The Dealers and certain affiliates of the Dealers engage in transactions with and perform services for us in the ordinary course of business. We may enter into hedging transactions in connection with any particular issue of Securities, including forwards, futures, options, interest rate or exchange rate swaps and repurchase or reverse repurchase transactions with, or arranged by, the applicable Dealer, an affiliate of the Dealer or an unrelated entity. We, the Dealers or other parties may receive compensation, trading gain or other benefits in connection with these transactions. We are not required to engage in any of these transactions. If we commence these transactions, we may discontinue them at any time. Counterparties to these hedging activities also may engage in market transactions involving Securities.

Payment of the purchase price of Securities to us must be made in immediately available funds and will be effective only upon our receipt of such funds.

You can obtain lists of Dealers for the Securities by contacting our Investor Relations Department.

We may request the Dealers to provide us with information relating to the Securities that they sell, including the identities of investors that have made purchases of Securities.

Selling Restrictions

The Securities may be offered and sold only where it is legal to make such offers and sales.

LEGAL MATTERS

The legality of Securities that are offered in underwritten transactions will be passed upon for us by our General Counsel (or one of our Deputy General Counsels).

SELECTED FINANCIAL INFORMATION

The financial statements and other financial information in our Information Statement dated February 27, 2004 (which is attached as Appendix B to this Offering Circular) fairly present in all material respects the financial position of Freddie Mac as of December 31, 2002 and significant subsequent events that occurred from December 31, 2002 through February 27, 2004. You should review our Information Statement dated February 27, 2004 for important information about our restated and revised financial statements for 2002, 2001 and 2000 and the status of the public release of our 2003 financial results. You should review ''SUBSEQUENT EVENTS'' in the Information Statement for a discussion of significant events occurring after December 31, 2002 and through February 27, 2004, as noted above. From December 31, 2002 through December 31, 2003 (the latest date for which OFHEO has classified Freddie Mac for capital purposes), Freddie Mac continues to be classified by OFHEO as ''adequately capitalized,'' the highest rating category.

Appendix A

Index of Terms

The following is a list of defined terms used in this Offering Circular and the pages where their definitions appear.

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INFORMATION STATEMENT
AND
ANNUAL REPORT TO SHAREHOLDERS
For the fiscal year ended December 31, 2002

Freddie Mac is a shareholder-owned government-sponsored enterprise, or GSE, established by Congress to provide a continuous flow of funds for residential mortgages. We perform this function 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 Act, or under the Securities Exchange Act of 1934, or the Exchange Act, and we are not currently required to file periodic reports with the Securities and Exchange Commission, or SEC, 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 once we return to timely financial reporting. We alone are responsible for making payments on our securities. Neither the United States nor any agency or instrumentality of the United States is obligated to fund our mortgage purchase or financing activities or to guarantee our securities or other obligations.

On November 21, 2003, Freddie Mac announced the results of our restatement of previously issued financial statements for the years 2000 and 2001 and the first three quarters of 2002 and the revision of fourth quarter and full-year consolidated financial statements for 2002 (collectively referred to as the "restatement"). We are in the process of preparing our quarterly and annual financial statements for the year 2003. For more details, *see* "EXPLANATORY NOTE."

This Information Statement and Annual Report, or the Information Statement, contains important financial and other information about Freddie Mac. The 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 web site (www.freddiemac.com) or by writing or calling us at:

Freddie Mac
Investor Relations Department
1551 Park Run Drive
McLean, Virginia 22102-3110
Telephone: 1-800-FREDDIE (800-373-3343)

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

THIS INFORMATION STATEMENT IS DATED FEBRUARY 27, 2004

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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 future business plans, results of operations and financial condition. Forward-looking statements are typically accompanied by, and identified with, terms such as "anticipates," "believes," "expects," "intends," "objectives," "will," "may" and similar phrases. This Information Statement includes forward-looking statements. These statements are based on current plans, estimates and projections, and you should not rely on them. Forward-looking statements involve known and unknown risks, uncertainties and other factors, some of which are beyond Freddie Mac's control. 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 the level and volatility of interest rates, house prices, employment rates and the general economy;
- Changes in our strategies for and results of credit loss mitigation, interest-rate and other market risk management activities and investment activities;
- The availability of debt funding 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 standards;
- The availability from acceptable counterparties of options, interest-rate and currency swaps, and other derivative financial instruments, or derivatives, 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;
- The size of the residential mortgage market;
- Borrower preferences for fixed-rate mortgages or adjustable-rate mortgages, which we refer to as ARMs;
- Preferences of originators to sell mortgages into the secondary market;
- Changes in investor preferences for mortgage loans and mortgage-related and debt securities versus other investments;
- Competition in the mortgage market and in the market for mortgage-related and debt securities;
- Our ability to effectively manage operational risk;
- Our ability to implement solutions to business processing systems issues;
- Our ability to effectively and timely implement the remediation plan undertaken as a result of the restatement of our financial statements and the consent order entered into with our safety and soundness regulator, the Office of Federal Housing Enterprise Oversight, or OFHEO, including in particular initiatives relating to technical infrastructure and controls;
- Significant business disruptions resulting from acts of war or terrorism;
- The occurrence of a major natural or other disaster in a geographic area in which our total mortgage portfolio is heavily concentrated;
- The degree to which our business and financial forecasting methods accurately predict actual results;
- The impact of new accounting standards, including the timely development of supporting systems; and
- Changes in the legislative or regulatory environment, affordable housing goals, regulatory capital requirements or our Congressional charter.

Freddie Mac

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

EXPLANATORY NOTE

The publication of this Information Statement for the year 2002 has been delayed significantly as a result of our restatement. The need for our restatement was announced in January 2003, when we, with the concurrence of our independent auditors, PricewaterhouseCoopers LLP, or PwC, concluded that in some instances our application of certain accounting policies was not consistent with generally accepted accounting principles in the United States, or GAAP.

A number of significant events affecting the company occurred during the course of the restatement effort. These included:

- Major changes in the senior management of the company (commencing in June 2003 with the departures of the former Chairman and Chief Executive Officer, President and Chief Operating Officer and Chief Financial Officer and culminating in the December 2003 announcement of the election of Richard F. Syron as Chairman and Chief Executive Officer);
- The commencement of various investigations relating to Freddie Mac (including by OFHEO, the SEC and the U.S. Attorney's Office for the Eastern District of Virginia);
- The publication of the results of the investigation by Baker Botts L.L.P., or Baker Botts, independent outside counsel to the Board of Directors; and
- The initiation of numerous private lawsuits.

During this period, we also began a comprehensive remediation program, under the oversight of our Board of Directors, to address each of the principal factors that contributed to the need for the restatement. This program includes initiatives relating to corporate culture, governance, accounting staffing and expertise, accounting policies, processes and controls as well as financial reporting and disclosure, and is discussed in more detail in "MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS, or MD&A, — RESTATEMENT RESULTS — Restatement Background and Remediation Program" and "MD&A — RISK MANAGEMENT — Operational Risk — Internal Control Weaknesses." Freddie Mac has generally resolved certain matters relating to OFHEO's investigation pursuant to the consent order entered into on December 9, 2003, under which we paid a civil money penalty of $125 million and are undertaking additional remedial actions relating to many of the same areas as our remediation program. We continue to cooperate fully with all pending investigations by governmental authorities. The Director of OFHEO, or the Director, has indicated his intent to adopt additional regulations affecting the activities of Freddie Mac and the Federal National Mortgage Association, or Fannie Mae, based on the recommendations of the OFHEO staff report released in connection with the investigation. *See* "SUBSEQUENT EVENTS — Legal Proceedings — OFHEO Investigation" and "SUBSEQUENT EVENTS — Regulatory Developments — OFHEO" for further information.

Our restatement effort was completed and announced on November 21, 2003. Our restated and revised financial statements, referred to as the restated financial statements, are contained in this Information Statement. Unless otherwise indicated, all financial information in this Information Statement is derived from the restated consolidated financial statements. As discussed in "MD&A— RESTATEMENT RESULTS," our restated net income reflects significantly greater volatility than results reported before the restatement, in large part due to the impact on earnings of changes in the fair values of a significantly higher proportion of our derivative portfolio, mortgage-related securities, guarantee assets and guarantee obligations. A detailed discussion of the accounting errors that were corrected and other accounting changes that were made in conjunction with the restatement is provided in "FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA — NOTE 1: RESTATEMENT."

We intend to return to timely financial reporting as soon as possible. However, we currently are not able to predict when we will do so. Significant revisions to our accounting systems are necessary to implement the revised accounting policies adopted in connection with the restatement, as well as new accounting guidance

applicable for 2003, so that those accounting systems can fully support the preparation of consolidated financial statements in accordance with GAAP. As a result, the public release of our 2003 financial results also has been delayed. While this Information Statement focuses on a presentation and analysis of our financial results for the years 2002, 2001 and 2000, it also includes selected information about certain topics pertaining to the year 2003 that are not affected by the restatement or our current inability to produce timely financial statements. Our objective is to release combined quarterly and full-year results for 2003 by June 30, 2004 and to provide our 2003 annual report and hold our related annual stockholders' meeting as soon as practicable thereafter. However, there can be no assurance that we will meet this objective. Although we have put plans in place 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 of these activities remains. *See* "MD&A — RISK MANAGEMENT — Operational Risk — *Internal Control Weaknesses*" for more information.

While we are not yet subject to the SEC's disclosure requirements with respect to this Information Statement, we have attempted to comply with them to the extent possible. However, in some instances we have departed from specific SEC data requirements, principally in cases where we have provided data for fewer years than would be required if we were an SEC registrant. The omission of data for these years primarily arises because we have not restated our consolidated financial statements for periods prior to 2000. We do not believe the omissions are material to an understanding of our results as restated for the periods presented. We will be subject to all applicable SEC requirements when we complete the voluntary registration of our common stock with the SEC.

In addition, 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 disclosure controls or procedures or internal controls over financial reporting as of the end of the period covered by this Information Statement. This is because the required evaluation and assessment of the effectiveness of these controls and procedures were not adequately performed as of December 31, 2002. *See* "MD&A — RISK MANAGEMENT — Operational Risk — Internal Control Weaknesses" for additional information regarding our internal control weaknesses and remediation effort.

BUSINESS

General Development of Business

Freddie Mac is one of the largest participants in the U.S. mortgage market. We are a shareholder-owned GSE 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.

Our statutory purposes are:

- To provide stability in the secondary market for residential mortgages;
- To respond appropriately to the private capital markets;
- 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 finance; 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.

We fulfill these statutory purposes primarily by purchasing residential mortgage loans and mortgage-related securities from mortgage lenders and securities dealers, financing these purchases with debt, equity and mortgage-related securities, and guaranteeing the timely payment of principal and interest on these mortgage-related securities. For purposes of this discussion, and as further described in "— Business Review" below, the

terms "purchase" and "mortgage purchase" encompass both the purchase of mortgages financed with debt and equity securities and the issuance of guaranteed securities representing undivided interests in mortgage loans and mortgage-related securities.

We purchase mortgages that finance homes in every geographic segment of the U.S. In this way, we reduce the cost of homeownership and rental housing and improve the quality of life by making the American dream of decent, accessible housing a reality. For more than three decades, we have been a successful competitor in a large and consistently growing market.

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. As of January 15, 2004, we had 4,275 full-time and 139 part-time employees.

We do not currently file periodic reports with the SEC, although we will begin to do so upon completion of the voluntary registration of our common stock under the Exchange Act. We make our financial disclosure documents available free of charge on our web site. Our Internet address is www.freddiemac.com. (We are providing this Internet address solely for the information of prospective investors. We do not intend this Internet address to be an active link, and are not using references to this address here or elsewhere in this Information Statement to incorporate additional information into this Information Statement.)

Financial Information about Segments

During the periods covered by the restatement, we did not meet the criteria for reporting business segments that are prescribed in Statement of Financial Accounting Standards, or SFAS, "Disclosures About Segments of an Enterprise and Related Information, or SFAS 131." For example, we did not maintain, as required by SFAS 131, discretely available and reliable financial information that we used to allocate internal resources and to evaluate the performance of internal business units. As a result, we have determined that we have only one business segment for financial reporting purposes, rather than two as previously reported prior to the restatement.

Business Review

Freddie Mac plays a fundamental role in the American housing finance system, linking the domestic mortgage market and the global capital markets. In this role, we focus on the following business strategies:

- Maintaining the lowest possible cost of financing for our mortgage investments by creating broader and more liquid markets for our mortgage-related and debt securities;
- Delivering these low-cost funds to a broad spectrum of America's homeowners by bringing innovation and efficiency to the mortgage market; and
- Managing the operational risk, interest-rate risk, credit risk and other business and market risks that arise from these business activities.

Our participation in the secondary mortgage market includes providing our credit guarantee for residential mortgages originated by mortgage lenders and investing in mortgages and mortgage-related securities held in our retained portfolio. These activities are summarized below:

- *Credit Guarantee.* In our credit guarantee activities, we securitize mortgages by issuing Mortgage Participation Certificates, or PCs, to third party investors. We also resecuritize mortgage-related securities that are issued by the Government National Mortgage Association, or Ginnie Mae, as well as non-agency entities. Securities issued through our resecuritization activities are one type of Structured Securities, a term defined and further discussed under "Resecuritization" below. In each case, securitized mortgage-related assets that back PCs and Structured Securities that are held by third parties are not reflected as assets of Freddie Mac under GAAP. However, we do retain an obligation to provide the payment of principal and interest on issued PCs and Structured Securities, which may result in the recognition of an asset and obligation on our consolidated balance sheets. For further details, *see* "FINANCIAL STATEMENTS AND

SUPPLEMENTARY DATA — NOTE 2: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES."

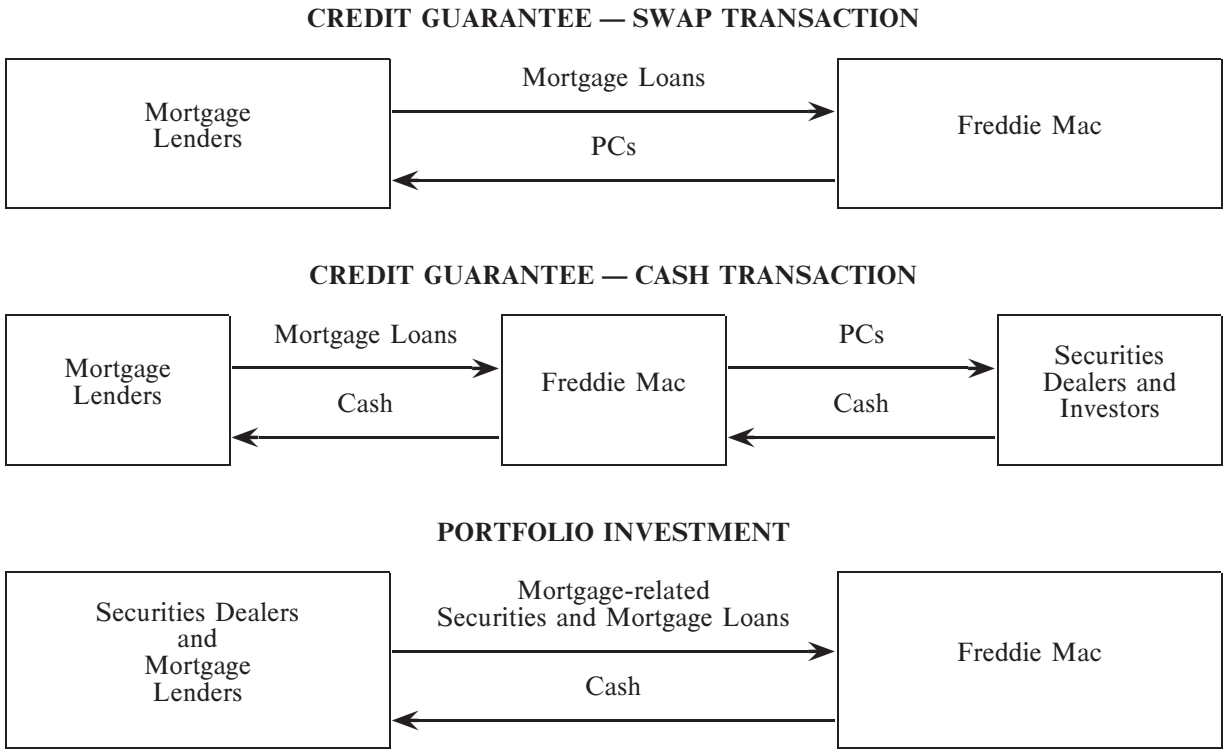
- *Portfolio Investment.* In our retained portfolio investment activities, we purchase mortgage loans and mortgage-related securities (including PCs and Structured Securities previously issued by us) and hold such securities for investment purposes in our retained portfolio. We finance these purchases by issuing debt and equity securities. Portfolio investments (including PCs in our retained portfolio) are recorded on our consolidated balance sheets as assets within our retained portfolio.

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 or other seller delivers mortgages to us in exchange for our PCs, which represent undivided interests in those same mortgages for which we guarantee the payment of principal and interest.

Mortgage lenders and other originators also sell mortgages to us for cash. In these cash transactions, we decide whether to hold the mortgage loans in our retained portfolio and finance them with debt and equity securities (portfolio investment), or sell them in the secondary market in the form of PCs that carry our guarantee of timely payment of principal and interest (credit guarantee).

Figure 1 illustrates our basic credit guarantee and portfolio investment activities:

Figure 1



Our retained portfolio consists of our investments in mortgage loans and mortgage-related securities, including previously issued PCs and Structured Securities that we have acquired.

Our total mortgage portfolio consists of:

- PCs and Structured Securities held by us in our retained portfolio;
- Non-Freddie Mac mortgage-related securities held by us in our retained portfolio;
- Mortgage loans held by us in our retained portfolio;
- PCs and Structured Securities held for our PC market-making and support activities; and
- PCs and Structured Securities backed by non-Freddie Mac mortgage-related securities that are held by third parties.

Table 1 — Freddie Mac's Total Mortgage Portfolio[1][2]

	December 31,	
	2002	2001
	(dollars in millions)	
Outstanding PCs and Structured Securities[3][4][5]	$ 729,225	$ 631,150
Retained portfolio:		
PCs and Structured Securities[4][5]	341,287	308,427
Non-Freddie Mac mortgage-related securities	162,099	126,420
Mortgage loans	63,886	62,792
Total retained portfolio[6]	567,272	497,639
Other PCs and Structured Securities held by Freddie Mac[7]	20,112	21,934
Total mortgage portfolio	$1,316,609	$1,150,723
Total PCs issued and Structured Securities backed by non-Freddie Mac mortgage-related securities[4][5][8]	$1,090,624	$ 961,511

(1) Excludes mortgage loans and mortgage-related securities traded, but not yet settled.
(2) Based on unpaid principal balances, or UPB.
(3) Represents PCs and Structured Securities backed by non-Freddie Mac mortgage-related securities that are held by third parties.
(4) Reported UPB of Structured Securities relates only to that portion of issued Structured Securities that is backed by non-Freddie Mac mortgage-related securities.
(5) Historically, these balances included PCs as well as Structured Securities backed by non-agency mortgage-related securities (*i.e.*, excluding Ginnie Mae Certificates). These balances now include all Structured Securities backed by all non-Freddie Mac securities (including Ginnie Mae Certificates). All Structured Securities which are backed by Freddie Mac mortgage-related securities continue to be excluded.
(6) The retained portfolio presented in this table differs from the "Retained portfolio, net of reserve" presented in our consolidated balance sheets because the consolidated balance sheet 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).
(7) 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.
(8) Includes $8.6 billion and $13.1 billion of Structured Securities backed by Ginnie Mae Certificates at December 31, 2002 and 2001, respectively. Also includes approximately $5 billion and $3 billion at December 31, 2002 and 2001, respectively, of housing authority bonds that were issued by third parties to fund the origination of multifamily mortgage loans and for which Freddie Mac provided a credit guarantee.

Table 2 — Reconciliation of Retained Portfolio Unpaid Principal Balance to the Consolidated Balance Sheets

	December 31,	
	2002	2001
	(dollars in millions)	
Mortgage loans in the retained portfolio:		
Unpaid principal balances	$ 63,886	$ 62,792
Premiums, discounts, deferred fees and other basis adjustments[1]	232	(70)
Less: Reserve for losses on mortgage loans held for investment	(177)	(103)
Mortgage loans, net of reserve per consolidated balance sheets	63,941	62,619
Mortgage-related securities in the retained portfolio:[2]		
Unpaid principal balances[3]	503,386	434,847
Premiums, discounts, deferred fees and other basis adjustments[4]	3,463	(918)
Unrealized gains on mortgage-related securities	18,520	6,392
Participation Certificate residuals, or PCRs, at fair value	412	726
Mortgage-related securities per consolidated balance sheets	525,781	441,047
Total retained portfolio per consolidated balance sheets	$589,722	$503,666

(1) Other basis adjustments include valuation adjustments to record lower of cost or market value, or LOCOM, as well as basis adjustments related to 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 impairments of manufactured housing securities. Impairments to UPB are recorded in certain circumstances when the fair value declines below the amortized cost basis of a security.
(4) Other basis adjustments are related to hedging activities. Basis adjustments are modifications to the carrying value of these securities.

Our cash and investments portfolio, which primarily consists of non-mortgage-related securities, is excluded from our retained portfolio. Our cash and investments portfolio includes investments we acquire to manage recurring cash flows, provide a source of liquidity, temporarily deploy capital until the capital can be redeployed into retained portfolio investments and manage interest-rate risk exposure. The cash and investments portfolio also includes certain mortgage-related securities that are not included in the retained portfolio since they are acquired in conjunction with our PC market-making and support activities.

We generate two primary sources of revenue: 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 on PCs and Structured Securities for which we 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, including expenses related to the timing difference between the receipt of principal and interest payments from seller/servicers and the remittance of those payments to security holders. (*See* "Due to Participation Certificate Investors" in "FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA — NOTE 2: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES" for further information regarding the timing difference related to the PC remittance cycle).

Our credit guarantee activities significantly impact the volatility of reported earnings through the initial recognition of guarantee assets and obligations in connection with sales of PCs and Structured Securities, and subsequent unrealized gains or losses from the change in fair value of credit guarantee assets and obligations generated from such sales.

Net interest income is the difference between interest income earned on investments held by us and interest expense incurred on the debt funding those investments. To manage the interest-rate and other market risks associated with these investments and to reduce financing costs, we enter into interest-rate swaps, options and other derivatives. Although we execute derivative transactions to manage interest-rate risk, they may significantly impact, and increase the volatility of, our reported earnings, particularly when they are not accounted for in hedge relationships.

In addition to management and guarantee income and net interest income, Freddie Mac generates revenue from fee-based activities. For instance, we earn resecuritization fees in connection with the creation of Structured Securities, primarily Real Estate Mortgage Investment Conduits, or REMICs. We also earn fees associated with servicing and technology-related programs, including Loan Prospector® (our automated underwriting system).

For information regarding the components of net interest income, management and guarantee income and other sources of income, including derivative and investment gains (losses), as well as expenses related to net income, *see* "MD&A — CONSOLIDATED RESULTS OF OPERATIONS."

Market Overview

We conduct business in the U.S. residential mortgage market and the global securities market. Our participation in these markets links America's homebuyers with the world's capital markets.

In general terms, the U.S. residential mortgage market consists of a primary mortgage market that links homebuyers and lenders and a secondary mortgage market that links lenders and investors. In the primary market, residential mortgage lenders such as mortgage banking companies, commercial banks, savings institutions, credit unions and other financial institutions originate or provide mortgages to borrowers. They obtain the funds they lend to mortgage borrowers in a variety of ways, including by selling mortgages into the secondary market. Our charter does not permit us to originate loans in the primary mortgage market.

The secondary market consists of institutions engaged in buying and selling mortgages in the form of whole loans (*i.e.,* mortgages that have not been securitized) and mortgage-related securities. The magnitude of investment and trading activity in the secondary mortgage market supports a continuous flow of funds to the primary market. This stable flow of funds helps moderate cyclical swings in the housing market and helps ensure that mortgage funds are available at all times.

Various other participants also play significant roles in the residential mortgage market. Mortgage brokers advise prospective borrowers about mortgage products and lending rates, and they connect borrowers with lenders. Mortgage servicers administer mortgage loans by collecting payments of principal and interest from borrowers as well as amounts related to property taxes and insurance. They remit the principal and interest payments to us, less a servicing fee, and we pass these payments through to mortgage investors, less a fee we charge to guarantee the timely payment of principal and interest. The servicing fee charged by mortgage servicers varies by mortgage product. As of December 31, 2002, the required minimum percentage fee typically retained by our servicers was 0.25 percent of the UPB of the mortgage loans. Mortgage servicers also help us manage our loss mitigation and foreclosure process for mortgages that we own or guarantee. In addition, private mortgage insurance companies and other financial institutions sometimes provide third-party insurance for mortgage loans or pools of loans. Our charter requires third-party insurance or other credit protections on some loans that we purchase.

Freddie Mac and Fannie Mae are the largest participants in the U.S. secondary mortgage market. Freddie Mac and Fannie Mae are both GSEs with the public purpose of increasing the supply and availability of home mortgage financing. As discussed below, our statutory mission requires us to participate in the conforming mortgage market at all times. By contrast, non-GSE market participants are free to enter and exit the mortgage market as part of business strategies that allow them to pursue multiple lines of business in a variety of economic conditions.

Freddie Mac and Fannie Mae have charters that prohibit them from originating mortgage loans and limit them to purchasing mortgages with original principal balances at or below prescribed dollar limits. These limits are referred to as conforming loan limits and are subject to annual adjustment based on an index of national average house prices. The conforming loan limit for a first-lien conventional single-family mortgage in 2002 was $300,700 for a one-family dwelling, $384,900 for a two-family dwelling, $465,200 for a three-family dwelling and $578,150 for a four-family dwelling. For 2003, the conforming loan limit was $322,700 for a one-family dwelling, $413,100 for a two-family dwelling, $499,300 for a three-family dwelling and $620,500 for a four-family dwelling. The conforming loan limit for second-lien mortgages on one-family dwellings is 50 percent of the limit for first-lien mortgages on such dwellings. When we purchase both the first-lien and

second-lien mortgage on the same property, the total amount that we may purchase may not exceed the applicable conforming first-lien loan limit. The applicable conforming loan limits are 50 percent higher for mortgages secured by properties in Alaska, Guam, Hawaii or the U.S. Virgin Islands. No comparable limits apply to multifamily mortgage purchases.

With the exceptions noted below, the Freddie Mac Act also prohibits us from purchasing first-lien conventional (not guaranteed or insured by any agency or instrumentality of the U.S. government) single-family mortgages if the outstanding 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; a seller's agreement to repurchase or replace (for periods and under conditions as we may determine) any mortgage that has defaulted; or retention by the seller of at least a 10 percent participation interest in the mortgages. This requirement does not apply to multifamily mortgages or to mortgages insured by the Federal Housing Administration, or FHA, or partially guaranteed by the Department of Veterans Affairs, or VA.

Under the Freddie Mac Act, so far as practicable, we may only purchase mortgages that are of a quality, type and class that generally meet the purchase standards of private institutional mortgage investors. This means the mortgages we purchase must be readily marketable to institutional mortgage investors.

The U.S. residential mortgage debt outstanding exceeded $6.9 trillion and $6.1 trillion at December 31, 2002 and 2001, respectively. Mortgage debt outstanding has grown every year since World War II and grew at a 12 percent rate in 2002 and 10 percent rate in 2001, even while the economy slowed during these same periods.

During 2002, we estimate that approximately $2.6 trillion of conventional, conforming single-family mortgages were originated in the U.S. and that Freddie Mac and Fannie Mae purchased 21 percent and 26 percent of that amount, respectively. During 2001, we estimate that approximately $1.9 trillion of conventional, conforming single-family mortgages were originated in the U.S. and that Freddie Mac and Fannie Mae purchased 19 percent and 23 percent of that amount, respectively. Freddie Mac's and Fannie Mae's relatively high market share resulted from the high level of refinance activity in 2002 and 2001 as a consequence of declining interest rates and a strong demand for fixed-rate mortgage products, which loan originators tend to deliver to Freddie Mac and Fannie Mae.

We compete in the secondary mortgage market primarily with Fannie Mae. We also compete with other financial institutions that retain or securitize mortgages, such as banks and thrift institutions, and with the Federal Home Loan Banks. Competition from these entities can vary with economic, financial market and regulatory environments. Among other things, these factors may affect the degree to which depository and other institutions sell mortgages in the secondary market rather than retain them in their own portfolios.

We also compete in the global securities market as an issuer of mortgage-related and debt securities. Our securities have a number of attributes that help us operate efficiently and on a large scale in both our mortgage securitization and debt financing activities. These attributes include the high credit quality and liquidity of our securities. They also include legal attributes under our charter and other federal laws and regulations. These legal attributes, which facilitate our development and maintenance of the liquid markets that are essential to fulfilling our Congressional mandate, include the following:

- Exemption from securities registration under the Securities Act and the Exchange Act. We are, however, fully subject to the antifraud provisions of the federal securities laws. In addition, we are committed to the voluntary registration of our common stock under the Exchange Act;
- Access to the book-entry system operated by the Federal Reserve Banks that provides book-entry issuance, transfer, payment and settlement for U.S. dollar-denominated securities issued by the U.S. government, some government agencies, and other institutions such as Freddie Mac and Fannie Mae. This system enables participants to hold and transfer securities and funds through the Federal Reserve Banks' Fedwire System; and
- The ability of many financial and other institutions to invest in our mortgage-related and debt securities free of legal limits that would otherwise apply. The Secondary Mortgage Market

Enhancement Act of 1984 and other federal laws and regulations allow these investors to buy and hold securities issued or guaranteed by Freddie Mac or Fannie Mae to the same extent they can invest in obligations issued or guaranteed by the United States or its agencies, subject to limited exceptions.

Mortgage Purchase and Guarantee Activity

We purchase single-family mortgages mainly from mortgage bankers and federally insured financial institutions. We purchase multifamily mortgages from mortgage lenders, including federally insured financial institutions, mortgage bankers, investment bankers and insurance companies.

Our single-family mortgage products, services and initiatives are designed to provide a steady source of low-cost mortgage funding to America's homebuyers. Our multifamily mortgage products, services and initiatives are designed primarily to finance rental housing affordable to low- and moderate-income families.

A significant portion of our single-family mortgage purchase volume is generated from several large mortgage lenders. During 2002 and 2001, Wells Fargo Home Mortgage, Inc., or Wells Fargo, ABN Amro Mortgage Group, Inc., or ABN Amro, Bank of America N.A. and Principal Residential Mortgage Inc. together accounted for approximately 61 percent and 55 percent, respectively, of our mortgage volume. In 2002, Wells Fargo accounted for approximately 32 percent of our mortgage volume while ABN Amro accounted for approximately 16 percent of our mortgage volume. We have contracts with some of these lenders that include a commitment by the lender to sell us a minimum share or dollar amount of its conventional conforming mortgage origination volume. Because the typical length of these contracts is one year, some of the contracts may expire in close proximity to each other at any given time. We actively monitor these lenders' share volume and if a mortgage lender fails to meet its contractual commitment, we have a variety of contractual protections, including the assessment of financial penalties.

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 these key lenders chooses to significantly reduce the volume of mortgages it delivers to us. The loss of any one of these 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. *See* "SUBSEQUENT EVENTS — Mortgage Security Performance" for more information. 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. This anticipated recovery, however, might not occur quickly or at all.

Single-Family Mortgages

Single-family mortgages are mortgages secured by one- to four-family properties. We purchase single-family mortgages of various types, including 30-year, 20-year and 15-year fixed-rate mortgages, ARMs and balloon/reset mortgages. The substantial majority of the mortgages we purchase are conventional mortgages. However, we purchase some mortgages that are fully insured by the FHA, and some mortgages that are partially guaranteed by the VA.

Single-family mortgages generally are subject to our internal credit policies and the credit, appraisal, underwriting and other purchase policies and guidelines incorporated into Loan Prospector and set forth in our *Single-Family Seller/Servicer Guide*. However, we may modify or grant waivers to these policies and guidelines.

Multifamily Mortgages

We purchase multifamily mortgages, which are secured by structures with 5 or more units designed principally for residential use, with terms generally ranging from 5 to 30 years from approved lenders. 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 when compensating factors (such as higher debt coverage ratios or credit enhancements) are present.

Credit Guarantee

We typically assume the mortgage credit risk on the mortgages underlying PCs by guaranteeing the timely payment of principal and interest to PC holders. We manage this risk carefully, sharing the risk in some cases with third parties through the use of primary loan-level mortgage insurance, insurance on pools of loans (known as "pool insurance") and other credit enhancements. *See* "MD&A — RISK MANAGEMENT — Credit Risk" for more information.

We form PCs under our Mortgage Participation Certificates Agreement, which we refer to as the PC Agreement, among Freddie Mac and the holders of our PCs. The PC Agreement describes the manner in which mortgages are transferred to a pool and, upon sale of a PC, a proportional undivided interest in the mortgages in the pool is conveyed to the holder of the PC. The PC Agreement also describes our obligations as guarantor of principal and interest on the PCs, and the manner in which those payments are passed through to the PC holders. In addition, the PC Agreement describes the rights of the PC holders in the event of our default. Once mortgages are placed in a pool, the mortgages cannot be removed from the pool except in limited circumstances specified in the PC Agreement. We generally begin a process to repurchase defaulted mortgages when they have been identified as being delinquent for 120 consecutive days. We then hold these repurchased mortgages in our retained portfolio. In order to manage and resolve troubled assets and lower credit losses, we utilize a number of loss mitigation strategies, which emphasize early intervention in delinquent mortgages and alternatives to foreclosure. *See* "MD&A — RISK MANAGEMENT — Credit Risk — *Mortgage Credit Risk* — Mortgage Credit Risk Management Strategies — *Loss Mitigation Activities*" for more information.

OFHEO is our safety and soundness regulator. If we were to experience significant financial difficulties and the Director were to appoint a conservator, we believe, based on an opinion of counsel analyzing various provisions in the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, or the GSE Act, and other relevant law, that the conservator would determine that the mortgages underlying the PCs held by investors would be beyond the reach of the conservator or any other entity appointed to operate Freddie Mac. This means that the proportional undivided interests of the PC holders would be preserved and borrowers' payments and other recoveries on the mortgage loans would continue to be passed through to the PC holders. Payments due to PC holders pursuant to our guarantees could be made only from our general funds to the extent and so long as they were available. *See* "— Regulation and Governmental Relationships" for more information about OFHEO. If we were unable to meet our guarantee obligations, the primary sources of funds available to investors would be payments by mortgage borrowers and recoveries on mortgage loans. In that case, payments to the PC holders could be adversely affected by loan delinquencies and defaults.

The profitability of our credit guarantee activities and our ability to compete for mortgage purchases and guarantee business tend to be affected, and may be affected significantly, by the price difference, or spread, between PCs and competing securities, primarily those issued by Fannie Mae. *See* "— PC Market-Making and Support Activities." Other key factors affecting the profitability of credit guarantee activities include the assumption of mortgage credit risk, the costs incurred to administer PC pools and net interest income or expense from security program cycles.

The To Be Announced, or TBA, Market

Most of the PCs we issue represent pools of mortgages that have similar characteristics – such as PCs comprising 30-year fully amortizing fixed-rate mortgages with mortgage coupons within a specified range. Because these PCs are homogeneous and are issued in high volume, they are highly liquid and trade on a "generic" basis, also referred to as trading in the TBA market. A TBA trade represents a contract for the purchase or sale of PCs to be delivered at a future agreed-upon date; however, the specific PCs, and thus the specific characteristics of the mortgages underlying those PCs, that will be delivered to fulfill the trade obligation are not known, *i.e.,* "announced," at the time of the trade, but only subsequently when the trade is to be settled.

Any two (or more) market participants may be involved as parties to a TBA trade. Counterparties to a particular trade may include: mortgage originator to dealer, dealer to dealer, dealer to investor, institution to institution, or parties dealing through an electronic trading system – anonymous or not. 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, broker-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 (for example, Freddie Mac), the type of PC (for example, 30-year fixed rate), the coupon of the PC, the quantity and the settlement month, all of which is similar to the manner in which U.S. Treasury securities are quoted. Each type of PC has a single designated settlement date in each month, and 48 hours before the settlement date, the parties identify the PCs to be delivered to fulfill the trade obligation. During 2002 and 2001, we issued approximately $434.0 billion and $329.9 billion, respectively, of PCs that were eligible to be delivered to settle TBA trades, representing approximately 81 percent and 87 percent, respectively, of our total PC issuances.

Lenders use the TBA market to hedge the risk of fluctuations in mortgage interest rates after they "lock in" 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. 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 that trade with any of our other existing PCs that meet the generic terms of the TBA trade.

We also use the TBA market to hedge cash 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 hedge 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.

These uses of the TBA market by lenders and Freddie Mac increase the liquidity of mortgage investments and improve the distribution of investment capital available for residential mortgage financing, thereby helping us accomplish our statutory mission.

Resecuritization

We resecuritize PCs and non-Freddie Mac mortgage-related securities into single-class securities and multi-class securities (collectively, "Structured Securities"). We also resecuritize Structured Securities into other 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 and non-agency mortgage-related securities. The non-agency mortgage-related securities may be backed by mortgages originated using underwriting standards that are less stringent than our normal criteria. By issuing these securities, we seek to provide liquidity to alternative segments of the mortgage market. *See* "MD&A – RISK MANAGEMENT – Credit Risk – *Mortgage Credit Risk* – Mortgage Credit Risk Management Strategies – *Portfolio Diversification"* for more information concerning the additional credit risk related to these transactions.

Multi-Class Structured Securities

We issue multi-class Structured Securities that divide the cash flows of the underlying PCs or non-Freddie Mac 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 REMICs. A multi-class Structured Security may include short-, intermediate-, and long-term classes, classes that are paid different allocations of principal and interest from the underlying PCs or other securities according to specified criteria (such as principal-only, or PO, strips, or interest-only, or IO, strips, or securities with fixed- or variable-rate coupons) and residual classes that receive any cash flow not required to be distributed to the other classes of the REMIC. Some

multi-class Structured Securities are structured to provide investors with more predictable cash flows than a typical PC, while other multi-class Structured Securities generate less predictable cash flows.

The issuance of multi-class Structured Securities backed directly or indirectly by PCs improves the demand for and value of PCs and ultimately reduces mortgage rates. Issuing multi-class Structured Securities generally does not generate additional management and guarantee income for us or expose us to additional credit risk. We typically collect a fee upon the formation of each multi-class Structured Security based on the dollar amount and type of structure issued. We may purchase previously issued multi-class Structured Securities for our retained portfolio, although we currently do not invest in REMIC residual classes. Some of the multi-class Structured Securities in our retained portfolio are less liquid than PCs. Consequently, it may be more difficult to sell these assets at their estimated fair value. We also may issue multi-class Structured Securities with the intent of purchasing and retaining one or more classes that meet our portfolio investment needs and selling the other classes.

Portfolio Investment

We manage a large and diversified retained mortgage portfolio through a disciplined strategy of long-term capital deployment. We apply extensive mortgage market expertise and a deep understanding of this asset class to support prudent and timely asset selection while managing our interest-rate risk. We invest in mortgage-backed securities issued by GSEs or governmental agencies, which we refer to as agency securities, non-agency mortgage-related and asset-backed securities, and whole mortgage loans.

We issue debt principally to finance our purchases of mortgage-related securities and mortgage loans for our retained portfolio. We issue a mixture of debt of various maturities, and the debt is either callable (that is, redeemable at our option at one or more times before its scheduled maturity) or non-callable. We use this funding mix to manage our interest-rate risk through the flexibility to closely match the interest obligations on our debt with the expected cash inflows from our mortgage-related investments. We also manage interest-rate risk and reduce funding costs by using a variety of derivatives. *See* "MD&A — RISK MANAGEMENT — Interest-Rate Risk and Other Market Risks" for more information. We also manage interest-rate risk by actively restructuring mortgage-related securities cash flows and retaining a portion of these restructured cash flows as Structured Securities.

In 2002 and 2001, our retained portfolio grew by 14 percent and 27 percent, respectively. At both December 31, 2002 and December 31, 2001, our retained portfolio represented approximately 43 percent of our total mortgage portfolio.

Debt Securities

We issue three main categories of debt: short-term debt; medium- and long-term debt; and subordinated debt.

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 with 1-, 3- and 6-month maturities weekly. (Prior to 2004, we also auctioned Reference Bills with 2-month maturities weekly.) We auction Reference Bills 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.

Medium- and Long-Term Debt. We issue medium- and long-term debt primarily through our medium-term note program and our global debt facility. Each of these programs accommodates a variety of structures, including callable and non-callable fixed-rate securities, zero coupon securities and variable-rate securities. Through our Reference Notes® securities program, we sell large issues of medium- and 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. We primarily issue securities denominated in U.S. dollars, although we may issue securities denominated in various other currencies, particularly euros. We publish an annual financing calendar that is intended to provide clarity and transparency with regard to the timing of our offerings of Reference Notes and settlement dates for issuances.

The investor base for our medium- and long-term debt is predominantly institutional. However, we also conduct weekly offerings of Freddie*Notes*SM securities, a medium- and long-term debt program designed to meet the 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. During 2001 and 2002, we completed four offerings of Freddie SUBS that provided approximately $5.5 billion in net proceeds. At December 31, 2002, the sum of our core capital, loan loss reserves and Freddie SUBS outstanding was 4.2 percent of total assets. *See* "MD&A — VOLUNTARY COMMITMENTS" and our Internet web site (www.freddiemac.com) for additional information about these commitments.

PC Market-Making and Support Activities

Securities Sales and Trading Group, or SS&TG

We make markets in PCs and Structured Securities by distributing these securities to, and trading these securities with, various counterparties, including mortgage sellers, institutional investors and securities dealers. We manage and conduct these trading activities primarily through a business unit we call SS&TG. SS&TG buys, sells and exchanges our PCs and Structured Securities in various financial transactions (including forward sales, dollar rolls and reverse repurchase transactions that provide further liquidity to this market). SS&TG transacts in such securities in large volumes to ensure that there is a reliable market for them. SS&TG also regularly purchases mortgage-related securities on behalf of our retained portfolio. This sourcing activity leverages SS&TG's daily purchases of mortgage-related securities through its direct trading relationships with mortgage sellers and investors.

We manage market risks associated with SS&TG's securities positions primarily through forward purchases and sales of PCs and Structured Securities as well as the purchase and sale of mortgage pass-through securities of Fannie Mae and Ginnie Mae. To accomplish this objective, we also may use U.S. Treasury securities, agency debt securities, Eurodollar futures and options to buy or sell agency debt and mortgage-related securities. To manage institutional credit risk, SS&TG analyzes and monitors the financial condition and trading positions of all counterparties and establishes trading limits consistent with these reviews.

SS&TG also assists in the distribution of PCs and Structured Securities to institutional investors and other market participants. Distribution activities may include participation in dealer auctions of these securities, resecuritization of outstanding PCs and Structured Securities, participation in dealer syndicates for underwritten offerings of Structured Securities and other transactions.

Market Support Activities

We support the liquidity and depth of the market for PCs through various activities, including purchasing and selling PCs through the retained portfolio, actively trading PCs through SS&TG, participating with external money management firms to buy and sell PCs, marketing to dealers and investors the relative merits of trading and investing in PCs, 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 our PCs. In 2003, we adopted certain strategies that were specifically directed at improving our mortgage security performance. For more information on these activities, *see* "SUBSEQUENT EVENTS — Mortgage Security Performance."

Regulation and Governmental Relationships

Regulation

Freddie Mac and Fannie Mae are currently subject to oversight by three agencies of the federal government:

- The U.S. Department of Housing and Urban Development, or HUD;
- OFHEO, a separate office within HUD, created by the GSE Act; and
- The U.S. Department of the Treasury, or Treasury.

See "— Legislative and Regulatory Environment — Voluntary SEC Reporting" below for information concerning the SEC's future oversight of us and "SUBSEQUENT EVENTS — Legislative Developments" for recent proposals that could significantly change the structure or scope of regulatory oversight of the GSEs.

HUD. We are subject to HUD oversight in three main areas: housing goals, fair lending and new program approval.

Housing Goals. The GSE Act requires the Secretary of HUD to establish three goals related to our financing of:

- Housing for low- and moderate-income families, which we refer to as the Low- and Moderate-Income Goal;
- Housing located in central cities, rural areas and other underserved areas, which we refer to as the Underserved Areas Goal; and
- Housing for low-income families in low-income areas and for very-low-income families, including a dollar amount for multifamily housing, which we refer to as the Special Affordable Goal.

We seek to purchase most single-family and multifamily mortgages in support of affordable housing through our standard mortgage purchase programs and under the same credit standards as our other mortgage purchases. We met each of the affordable housing goals in 2001 and 2002. In December 2003, HUD notified us that it would not renew for 2004 certain incentives under the affordable housing goals that contributed significantly to our achievement of the goals in 2001 and 2002. *See* "SUBSEQUENT EVENTS — Regulatory Developments" and "MD&A — OTHER REGULATORY MATTERS — Housing Goals" for more information on our housing goals.

HUD could compel Freddie Mac to submit a housing plan to meet the housing goals if we fail, or if HUD finds a substantial probability that we will fail, to meet any of the goals. HUD also has the authority to issue a cease and desist order and to assess civil money penalties against Freddie Mac 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.

Fair Lending. Our mortgage purchase activities are subject to federal anti-discrimination law. In addition, the GSE Act requires the Secretary of HUD to adopt regulations prohibiting discriminatory practices in the mortgage purchase activities of both GSEs and periodically to review and comment on our underwriting and appraisal guidelines for consistency with the Fair Housing Act and 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, or ECOA; 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 ECOA 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 or programs that we engaged in before the date the GSE Act was enacted; or
- Represents a material expansion 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, but has not to date imposed limits on our mortgage programs under these regulations. 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. The GSE Act created OFHEO as a separate office within HUD, substantially independent of the Secretary of HUD. OFHEO is headed by the Director, who is appointed by the President of the United States and confirmed by the Senate for a five-year term. The Director has exclusive regulatory authority for ensuring our adequate capitalization and safe and sound operation in accordance with the GSE Act. Among other matters, the GSE Act subjects both Freddie Mac and Fannie Mae to certain minimum, critical and risk-based capital standards issued by OFHEO. *See* "MD&A — LIQUIDITY AND CAPITAL RESOURCES — Capital Resources" for a discussion of OFHEO's oversight and these capital standards.

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 performs its debt securities approval function by coordinating GSE debt offerings with Treasury funding activities. Under that authority, we provide the Secretary of the Treasury with monthly reports about our debt security issuances.

Regulations Affecting Mortgage Loans, Mortgage-Related Securities and Debt Securities

Our purchases of mortgage loans and issuances of mortgage-related and debt securities are 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 for these securities. Among the legislative and regulatory provisions applicable to these entities are:

- Regulatory capital requirements for federally insured depository institutions and regulated bank holding companies;
- Limitations on investments by federally insured depository institutions in certain types of mortgage securities; and
- Legislation and regulations regarding the subprime lending activities of federally insured depository institutions.

Legislative and Regulatory Environment

Our Congressional charter provides us with special attributes such as:

- Exemption from Securities Act and Exchange Act 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 for our mortgage-related and debt securities;
- Discretionary authority of the Secretary of the Treasury to purchase obligations issued by us up to a maximum of $2.25 billion principal balance outstanding at any one time; and
- Exemption from state and local taxes, except real property tax on real estate that we own.

These special attributes, combined with our financial strength and the efficiency we bring to the market, help us to develop and maintain the liquid markets that are essential to fulfilling our Congressional mandate.

We could be required to or may find it advisable to change the nature or extent of our business activities if our various exemptions and special attributes were modified or eliminated, new or additional fees or substantive regulation of our business activities were imposed, our relationship to the federal government were altered or eliminated, or the Freddie Mac Act or other federal legislation bearing on us were significantly amended. Any of these changes could materially adversely affect the scope of our activities, financial condition and results of operations. Any amendments to the Freddie Mac Act, including repeal of any of our exemptions, would require legislative action. In addition, our business also could be adversely affected by any modification, reduction or repeal of the federal income tax deductibility of mortgage interest payments. For further discussion of legislative proposals that could affect regulatory oversight of our business activities, *see* "SUBSEQUENT EVENTS — Legislative Developments."

Voluntary SEC Reporting. On July 12, 2002, we announced an agreement, as a result of a consensus among the Treasury, the Office of Management and Budget, the SEC, OFHEO and us, to initiate a filing process with the SEC committing us to the ongoing SEC financial reporting requirements applicable to publicly traded companies under the Exchange Act. Exchange Act reporting encompasses filing with the SEC annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K. We will complete our voluntary registration with the SEC after we return to timely financial reporting and will become subject to these SEC reporting requirements when our registration statement is declared effective by the SEC. *See* "EXPLANATORY NOTE" for information regarding our efforts to return to timely financial reporting.

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 governing publicly traded companies under the Exchange Act.

These actions do not affect the SEC exemption that Congress provided for our equity, debt and mortgage-related securities in our Congressional charter. As part of our July 12, 2002 announcement, the SEC provided written confirmation that our securities will continue to be exempt from the securities offering registration requirements of the Securities Act and certain other provisions of the federal securities laws. *See* "SUBSEQUENT EVENTS — Legal Proceedings" for information regarding OFHEO's staff report that includes a recommendation to possibly implement a mandatory disclosure regime similar to that required for companies with securities registered under the Securities Act and the Exchange Act.

Predatory Lending. We have instituted a comprehensive set of anti-predatory lending policies intended to prevent the purchase or assignment of mortgage loans with unacceptable terms or conditions or resulting from unacceptable practices. In accordance with these policies, we will not purchase:

- Mortgages originated with single-premium credit insurance;
- Mortgages with terms that exceed either the annual percentage rate or the points and fees threshold under the Home Ownership and Equity Protection Act of 1994, or HOEPA; or
- Subprime mortgages with prepayment penalty terms that exceed three years.

In addition, we require our servicers to report all borrower credit information, including monthly mortgage payments. In 2003, we also announced that, beginning on August 1, 2004, we no longer would invest in subprime loans originated on or after that date that contain mandatory arbitration clauses.

In 2003, several states enacted laws aimed at predatory lending practices, generally with regard to loans exceeding thresholds based on annual percentage rates or financing costs. These loans are typically referred to as "high-cost home loans." The high-cost home loan thresholds trigger state law liabilities for subsequent purchasers or assignees of such loans that may be broader than liabilities imposed upon such purchasers or assignees under HOEPA. Currently, we do not purchase high-cost home loans in the states of Arkansas, Georgia, Illinois, Kentucky, Maine, 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.

Capital Requirements and Capital Distribution Rules. The GSE Act establishes our capital standards, and OFHEO has issued regulations that set our minimum, critical and risk-based capital requirements.

OFHEO is required to classify Freddie Mac's capital adequacy at least quarterly. OFHEO has never classified Freddie Mac as other than "adequately capitalized," the highest possible classification. *See* "MD&A — LIQUIDITY AND CAPITAL RESOURCES — Capital Resources" for additional information regarding OFHEO's capital rules.

We may pay a dividend on our common or preferred stock without prior OFHEO approval only if our payment would not decrease our total capital to an amount less than our risk-based capital level and would not decrease our core capital to an amount less than our minimum capital level. If our total capital were to fall below the risk-based capital level, but our core capital equaled or exceeded the minimum capital level, we would be prohibited from making a capital distribution (which includes dividend payments, common stock repurchases and preferred stock redemptions) that would decrease our core capital to an amount less than the minimum capital level. If our core capital were to fall below the minimum capital level, we would be able to make a capital distribution only if the Director determined that the distribution satisfied certain statutory standards. Under these circumstances, we would be prohibited from making any capital distribution that would decrease our core capital to less than the critical capital level. *See* "SUBSEQUENT EVENTS — Regulatory Developments" for further information relating to the reporting of dividends to OFHEO.

In addition to the preceding requirements, the Director has authority, under certain conditions, to require us to submit for the Director's approval a capital restoration plan or to restrict our activities, either of which also could affect adversely our ability to make capital distributions. *See* "SUBSEQUENT EVENTS — Regulatory Developments" for information concerning the framework OFHEO has established for monitoring our capital until we are able to resume timely financial reporting. In connection with the legislative proposals being considered by Congress, the Director's authority to set capital levels may be expanded. *See* "SUBSEQUENT EVENTS — Legislative Developments" below. *See* "MD&A — LIQUIDITY AND CAPITAL RESOURCES — Capital Resources" for further detail relating to the Director's authority in capital matters.

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 lease from the partnership. We also have offices in 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. 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.

Litigation and claims resolution are subject to many uncertainties and are not susceptible to accurate prediction. We are now subject to various legal proceedings, including regulatory and judicial investigations and civil litigation, arising from the restatement. For information on these proceedings, *see* "SUBSEQUENT EVENTS — Legal Proceedings."

SUBSEQUENT EVENTS

This section discusses certain events occurring after December 31, 2002.

Board of Directors and Management

On June 9, 2003, Freddie Mac announced that the Board of Directors had named (i) Gregory Parseghian as Chief Executive Officer and President and (ii) Paul Peterson as Executive Vice President and Chief

Operating Officer. The Board also elected Shaun F. O'Malley as non-executive Chairman of the Board and appointed Executive Vice President — Finance, Martin Baumann, to the additional position of Chief Financial Officer. Freddie Mac also announced (i) the resignation of Leland C. Brendsel as Chairman and Chief Executive Officer and from the Board of Directors, (ii) the resignation of Vaughn Clarke, formerly Executive Vice President and Chief Financial Officer and (iii) the termination of David Glenn, formerly President and Chief Operating Officer and his resignation from the Board of Directors.

In a letter dated August 22, 2003, OFHEO directed Freddie Mac's Board of Directors to replace the company's Chief Executive Officer and President, Gregory Parseghian, and to commence a search for his successor. In addition, OFHEO directed that the Board replace Freddie Mac's Executive Vice President and General Counsel, Maud Mater. Vice President and Deputy General Counsel Joan Donoghue was appointed to serve as Acting General Counsel until a General Counsel is named.

On October 29, 2003, Freddie Mac announced that it had made several changes to its senior management and organizational structure, including the appointments of (i) David Andrukonis as Senior Vice President and Chief Enterprise Risk Officer, (ii) Margaret Colon as Senior Vice President and Chief Administrative Officer, (iii) Nazir Dossani as Senior Vice President, Investments and Capital Markets, (iv) Mike May as Senior Vice President, Mortgage Sourcing, Operations and Funding, (v) Jerry Weiss as Senior Vice President and Chief Compliance Officer, (vi) John Woods as Senior Vice President and Principal Accounting Officer and (vii) Jerome Lienhard as Senior Vice President of Debt and Equity Financing.

On December 4, 2003, Freddie Mac announced that the Board of Directors had elected Richard Karl Goeltz as a member of the Board. Mr. Goeltz's term will expire on the date of the next annual meeting of shareholders. He is a former Vice Chairman and Chief Financial Officer of American Express Corporation.

On December 7, 2003, Freddie Mac announced that the Board of Directors had appointed Richard F. Syron as Chairman and Chief Executive Officer. Mr. Syron's appointment became effective on December 31, 2003. Mr. Syron, 60, previously served as 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. Earlier, he served as assistant to then-Federal Reserve Chairman Paul Volcker, and as Deputy Assistant Secretary of the Treasury.

Mr. Syron replaced Shaun F. O'Malley as Chairman of the Board of Directors. Mr. O'Malley assumed the role of Presiding Director. George Gould, the former Presiding Director, continues to chair the Board's Governance Committee.

Legal Proceedings

Class Action Lawsuits. On June 9, 2003, Freddie Mac and certain former executive officers were named as defendants in a securities class action lawsuit alleging violations of federal securities laws and regulations. This action was filed in the U.S. District Court for the Southern District of New York. The plaintiffs claimed that the defendants disseminated materially false and misleading statements to the market and failed to disclose material information concerning, among others, the following matters: (1) the lack of adequate internal accounting controls and personnel expertise; (2) the failure to follow accounting rules that require derivative securities to be marked to market; (3) the use of accounting techniques to lower earnings results in good times and lift results when business conditions deteriorated; and (4) providing investigators with altered records to conceal improper accounting techniques. These allegations covered the period from January 27, 2003 through June 9, 2003. The plaintiffs sought unspecified compensatory damages, costs and expenses.

Subsequent to the filing of that initial lawsuit, additional class action lawsuits relating to the same matters were filed against Freddie Mac and certain former executive officers. These lawsuits included slightly different allegations, covered different class periods (which begin on dates ranging from January 1, 2000 to January 27, 2003, and end on dates ranging from June 6, 2003 to August 22, 2003), and sought unspecified compensatory damages, costs and expenses. Among these later lawsuits was one filed by the Ohio Public Employees Retirement System and the State Teachers Retirement System of Ohio, and another by the West Virginia Investment Management Board and the Central States, Southeast and Southwest Areas Pension Fund. The

latter suit also named Gregory Parseghian, Freddie Mac's former Chief Executive Officer and President, as a defendant and included allegations that he, as well as Leland Brendsel, David Glenn and Vaughn Clarke, engaged in insider trading. Two of these class action lawsuits were filed by separate participants in Freddie Mac's Thrift/401(k) Savings Plan against the company, certain individuals, and the company's Retirement Committee alleging Employee Retirement Income Security Act, or ERISA, violations. In particular, the plaintiffs claimed that the defendants breached their fiduciary duty because Freddie Mac stock was an imprudent investment for the Thrift/401(k) Savings Plan. The two ERISA lawsuits have now been consolidated as a single suit.

Many of the lawsuits described above, which had been filed in either the U.S. District Court for the Eastern District of Virginia or the U.S. District Court for the Southern District of New York, were voluntarily dismissed by the plaintiffs. The dismissal of those suits and the consolidation of the ERISA suits reduces the locations of the pending lawsuits to three jurisdictions — the U.S. District Court for the Southern District of New York, with two cases pending (one class action and the shareholder derivative action discussed below), the U.S. District Court for the Southern District of Ohio, with two cases pending (the consolidated ERISA action and the action filed by the Ohio Public Employees Retirement System and the State Teachers Retirement System of Ohio) and the U.S. District Court for the Eastern District of Virginia, with one case pending (the shareholder derivative action discussed below).

On January 15, 2004, the plaintiffs in the securities class action in the Southern District of Ohio filed an amended complaint, incorporating information disclosed in Freddie Mac's restatement. The basis of the claims remains the same, although the class period alleged now ranges from July 15, 1999 to June 6, 2003.

On February 18, 2004, the Judicial Panel on Multidistrict Litigation transferred the action filed by the Ohio Public Employees Retirement System and the State Teachers Retirement System of Ohio to the United States District Court for the Southern District of New York for coordinated or consolidated pretrial proceedings with the actions pending there. We expect that the other pending cases will also be transferred to the Southern District of New York.

Shareholder Derivative Lawsuits. On July 1, 2003, certain former and current members of the Board of Directors of Freddie Mac were named as defendants in a shareholder derivative action alleging breach of fiduciary duty. The current members of the Board of Directors were subsequently dismissed as defendants from this lawsuit with the consent of the plaintiff. The remaining individual defendants in this suit are Messrs. Brendsel and Glenn, Vaughn Clarke and John Gibbons (both former Chief Financial Officers) and Gregory Parseghian. Freddie Mac is named as a nominal defendant in that action, which is still pending in the U.S. District Court for the Southern District of New York. A similar lawsuit was filed against Messrs. Brendsel, Glenn, Clarke, Gibbons and Parseghian and Freddie Mac in the U.S. District Court for the Eastern District of Virginia on December 11, 2003.

Freddie Mac anticipates that additional lawsuits relating to the matters described above may be filed.

SEC Formal Investigation. On June 11, 2003, Freddie Mac announced that it had been informed by the staff of the SEC that the SEC had commenced a formal investigation. Freddie Mac received a subpoena from the SEC on June 11, 2003 requesting document production and testimony. In addition, Gregory Parseghian, PwC (Freddie Mac's current independent auditors) and a former member of the Board of Directors also received subpoenas for documents and testimony. Beginning in August 2003, the SEC subpoenaed documents and began to take witness testimony from certain present and former Freddie Mac employees and directors, as well as third parties. Freddie Mac is fully cooperating with the SEC and will continue to do so.

OFHEO Investigation. On June 7, 2003, OFHEO directed Freddie Mac and its Board of Directors to take certain actions to address the issues surrounding the restatement. OFHEO also announced that it had deployed a special investigative team to review accounting practices and controls relevant to the restatement process at Freddie Mac and to investigate employee misconduct. As part of this investigation, OFHEO submitted to Freddie Mac multiple requests for documents, and it also subpoenaed certain current Freddie Mac employees and directors, as well as former employees, requesting testimony and documents. In July 2003, OFHEO began to conduct interviews in which it took sworn testimony from certain Freddie Mac employees and directors, external third parties and former employees.

On October 23, 2003, OFHEO announced that it had entered into a consent order with David Glenn, in which Mr. Glenn agreed to cooperate fully with OFHEO's special examination and also with any supervisory and/or enforcement proceeding initiated by OFHEO, to pay a civil money penalty of $125,000, and not to participate in any manner in the conduct of the affairs of Freddie Mac or Fannie Mae without prior OFHEO approval.

On December 10, 2003, Freddie Mac announced that it had entered into a consent order and settlement generally resolving certain matters with OFHEO relating to the restatement. Under the terms of the consent order, we are undertaking remedial actions relating to many of the same areas as our remediation program, including governance, corporate culture, internal controls, accounting practices, disclosure and oversight. In addition, the company has paid a civil money penalty in the amount of $125 million. The text of the consent order detailing the remediation steps agreed to with OFHEO is available on Freddie Mac's web site, www.freddiemac.com.

Separately on the same date, OFHEO released its staff report on its investigation of matters relating to the restatement. The report, which is available on OFHEO's website, www.ofheo.gov, included recommendations by the staff to the Director to consider increasing OFHEO's regulation of our activities, for example, by setting restrictions on the growth of our retained portfolio, or by requiring that we hold a capital surplus until we produce timely and certified financial statements, or possibly implementing a mandatory disclosure regime similar to that required for companies with securities registered under the Securities Act and the Exchange Act. Depending on the manner in which such recommendations were implemented, the adoption of one or more of them could have an adverse effect on our financial results. As discussed in "— Regulatory Developments" below, the Director has acted upon the report's recommendation regarding a capital surplus.

On December 17, 2003, OFHEO filed administrative Notices of Charges against Messrs. Brendsel and Clarke seeking to have them pay civil money penalties, to have them make restitution to the company in the amount of the bonuses paid to them in 2000 and 2001, to prohibit Mr. Brendsel from pursuing or accepting any payments from the company that exceed the payments to which he would be entitled if he had been terminated for cause under his employment agreement, and to prohibit Mr. Clarke from pursuing or accepting any payments from the company that exceed the payments to which he would be entitled if he had been terminated for loss of confidence by the company. OFHEO also issued an administrative Notice of Charges against Freddie Mac to require the company to convert Mr. Brendsel's termination to a termination for cause under his employment contract, to convert Mr. Clarke's termination to a termination for loss of confidence, to prohibit the company from making any payments to Mr. Brendsel that would exceed the payments to which he would be entitled if he had been terminated for cause under his employment contract, and to prohibit the company from making any payments to Mr. Clarke that would exceed the payments to which he would be entitled if he had been terminated for loss of confidence by the company. Prior to the issuance of these administrative Notices of Charges, the Board of Directors had advised OFHEO that Freddie Mac has existing contractual obligations to both former executives, which it is required to perform unless those obligations are superseded by valid authority, and that the company intends to comply fully with any valid and effective order that OFHEO may issue.

U.S. Attorney's Criminal Investigation. On June 11, 2003, Freddie Mac was informed that the U.S. Attorney's Office in Alexandria, Virginia had opened a criminal investigation involving the company. As part of its investigation, the U.S. Attorney's Office has made requests for documents and information, interviewed certain Freddie Mac employees and possibly other parties, and taken testimony before the grand jury. Freddie Mac is cooperating in all respects with this investigation.

At present, it is not possible for us to predict the outcome of the civil litigation, the administrative proceedings or the investigations described above or reasonably to estimate the amount of loss (or range of possible loss) that might result from adverse results or settlements of these matters, or their effect on our financial condition and results of operations.

Legislative Developments

Several Members of Congress have introduced bills to change Freddie Mac's and Fannie Mae's regulatory oversight. Management believes it is possible that additional bills may be introduced by other

Members of Congress. At this time, management cannot predict with certainty whether or in what form any of these bills will be enacted.

Each of these bills includes provisions that would change the location of the safety and soundness regulator for Freddie Mac and Fannie Mae. Each bill would also enhance certain of the safety and soundness regulator's supervisory and enforcement authorities over Freddie Mac and Fannie Mae and transfer certain other authorities from the Secretary of HUD to the new regulatory agency.

On May 7, 2003, Representatives Shays and Markey introduced a bill that would repeal Freddie Mac's and Fannie Mae's exemption from registering their securities with the SEC. Representatives Shays and Markey introduced a similar bill in 2002.

As previously noted, Freddie Mac and Fannie Mae are exempt by federal statute from taxation by state, county, municipal or local authorities (except for taxes on real property). On May 15, 2003, Representative Stark introduced a bill that would eliminate this state and local tax exemption.

On September 10, 2003, Representative Paul introduced a bill that would repeal various aspects of the special status accorded to Freddie Mac, Fannie Mae and any Federal Home Loan Bank under federal law.

Regulatory Developments

OFHEO. On January 29, 2004, OFHEO announced the creation of a framework for monitoring our capital due to the temporarily higher operational risk 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 ensure that appropriate levels of capital are maintained. The full text of the letter establishing the framework is available on OFHEO's web site, www.ofheo.gov.

While OFHEO's framework includes stringent monitoring and imposes restrictions on share repurchases, we do not expect it to adversely affect our disciplined growth strategy or require us to raise additional capital.

OFHEO's oversight of Freddie Mac's actions is intended to ensure that any growth is reasonable given market conditions and our capital position. OFHEO will monitor Freddie Mac's estimated capital position on a weekly basis. 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 we had unreasonably deviated from the framework established in the letter, OFHEO would require us to submit a remedial plan or to take other remedial steps.

In addition, 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 or the redemption of any preferred stock. 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 information on the amount of the dividend, the rationale for the payment and the impact on our 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 resumption of timely financial reporting that complies with GAAP and other factors described in the letter.

Management believes that this framework will provide OFHEO with a mechanism to ensure that we manage our business with continued prudence and appropriate levels of capital, taking into account that we are not currently able to produce timely financial statements.

HUD. On December 24, 2003, HUD notified Freddie Mac that it would not renew for 2004 certain incentives under the affordable housing goals that had contributed significantly to our achievement of the goals since 2001. HUD's action effectively raises each of the goals for 2004 and will require an increased level of effort on our part to meet them. Freddie Mac remains committed to meeting the goals, and is taking a number of actions to achieve this objective.

On February 2, 2004, the President submitted the Administration's proposed budget for fiscal year 2005, which includes a request that a total of $6.25 million be assessed against Freddie Mac and Fannie Mae on a

combined basis to fund HUD's oversight and compliance activities related to them. Such assessment authority would have to be created by an act of Congress.

Other. Freddie Mac has received inquiries from the Internal Revenue Service, or IRS, in connection with its regular audits of the company's tax returns for prior years, some of which relate to matters connected with the restatement. In addition, the Department of Labor, or DOL, has advised the company that it has opened an investigation of Freddie Mac's Thrift/401(k) Savings Plan. Freddie Mac has responded to the DOL's requests for the production of certain plan-related material. The DOL also is conducting interviews with certain individuals who have responsibilities with respect to the Thrift/401(k) Savings Plan.

On February 5, 2004, the Board of Governors of the Federal Reserve System, or the Federal Reserve, proposed certain revisions to its policy on payments system risk. Among other things, the proposal would require GSEs to fully fund payments of interest on, and redemptions of, GSE securities by the Federal Reserve Banks before the Federal Reserve Banks make payments to the record holders of those securities. The proposal would also require the GSEs, if they incur intraday overdrafts with the Federal Reserve Banks, to pay additional penalty fees on those overdrafts to the same extent as institutions that do not have access to the Federal Reserve's discount window. The Federal Reserve has requested public comment on this proposal and does not currently intend to implement it until at least July 2006. If we do not make any changes to our payment processes, then this proposal (if adopted) would require us to pay penalty fees to the Federal Reserve. Based on 2003 overdraft activity, we estimate these penalty costs to be less than $10 million. However, we expect to modify our payment processes to reduce or eliminate our exposure to these fees prior to July 2006.

Mortgage Security Performance

During 2003, the price performance of, and demand for, our PCs relative to comparable Fannie Mae securities weakened considerably and we implemented certain strategies to address that development. Although we cannot assure success, Freddie Mac is committed to creating PCs that more closely match market characteristics and supporting the market for its PCs and is evaluating additional strategies to improve their price performance. From time to time, these strategies may involve trade-offs between the guarantee fee pricing of our securities, investment returns on our securities that we hold, and security performance relative to both portfolio investment decisions and securitization and resecuritization activities. For example, in the second half of 2003, we provided guarantee fee price adjustments to partially offset weaknesses in prevailing security prices. The effect of these adjustments on our future results will depend substantially on whether security price performance improves or deteriorates.

During 2003, Freddie Mac's efforts to support PC price performance included the purchase by the retained portfolio of TBA PCs and both the purchase and sale of other agency securities, including the sale of Fannie Mae securities. While some purchases of PCs may result in an expected return on equity, or ROE, substantially below our normal thresholds, this strategy is not expected to have a material effect on the performance of our retained portfolio overall. The sale of Fannie Mae securities facilitates the funding of TBA PC purchases and the management of incremental funding and interest-rate risk that may result from these purchases, and contributes to a more favorable balance in the supply of PCs relative to Fannie Mae securities.

In connection with this initiative, Freddie Mac expects to solicit offers of TBA PCs directly from dealers on a frequent basis. However, there may be substantial variability in the volume of weekly purchases and in the total amount of TBA PCs purchased under this initiative in any quarter. Freddie Mac may increase, reduce, modify or discontinue this initiative and any or all of its other price performance support activities at any time. If the price performance of, and demand for, our PCs is not comparable to Fannie Mae securities, this could have a material adverse effect on the profitability of Freddie Mac.

Affordable Housing Initiatives

From time to time, Freddie Mac enters into transactions on an unusually large scale or with non-standard terms in order to advance our progress toward meeting the affordable housing goals set by HUD. We entered into two transactions of this type during 2003. One of the largest affordable housing transactions involved the acquisition of approximately $6 billion of multifamily mortgages from Washington Mutual Bank, FA and Washington Mutual Bank (collectively, "WaMu") during September and October 2003. Among other

provisions, the transaction contained a number of contractual incentives, including the payment of fees to WaMu totaling $100 million. Similarly, in December 2003, Freddie Mac agreed to acquire from Citibank, NA and its affiliates a portfolio of multifamily mortgages that could total as much as $5 billion. The transaction, which involves deliveries of mortgages in 2003 and 2004, included a number of contractual incentives, including payment of fees to Citibank of approximately $24 million in 2003 and up to an additional $41 million in 2004. Freddie Mac paid these fees to encourage WaMu and Citibank to enter into these transactions in part because HUD regulations offered incentives to encourage the acquisition of the type of mortgages involved. However, as noted above under "Regulatory Developments," HUD has notified Freddie Mac that it will not renew for 2004 the incentives under the housing goals for the acquisition of the particular type of mortgages involved in the WaMu and Citibank transactions.

Tax Contingencies

Recent Tax Court Rulings. In 1998, the IRS issued to Freddie Mac a Statutory Notice asserting 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 U.S. Tax Court, or Court, to contest the deficiencies. In the third quarter of 1999, the IRS issued a Statutory Notice for Freddie Mac's tax years 1987 to 1990, and Freddie Mac filed a petition in the Court. Subsequently, the Court combined the 1985 to 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.

In September 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 of whether Freddie Mac's intangibles are amortizable using as the adjusted basis the higher of (i) the regular adjusted cost basis or (ii) the fair market value on January 1, 1985. On September 29, the Court ruled favorably for Freddie Mac on the question of 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 to date 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.

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 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 Treatment of Linked Swaps. As discussed in "FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA — NOTE 1: RESTATEMENT," in August and September of 2001, Freddie Mac entered into a series of nine sets of paired transactions known as "Linked Swaps." Freddie Mac has reported and paid tax treating each pair of Linked Swaps as a single integrated transaction for federal income tax purposes. There is a risk, however, that the IRS could challenge Freddie Mac's tax treatment of 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.

In addition, two additional swaps were executed in November 2001. Although the facts and circumstances surrounding these swaps were different from the Linked Swaps, Freddie Mac also reported and paid tax treating these swaps as a single integrated transaction for federal income tax purposes. We believe there are no significant tax exposures related to these swaps for the periods covered by the restatement.

SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to shareholders during the fourth quarter of 2002 or during 2003.

MARKET PRICE FOR THE COMPANY'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

Market Information

Our common stock, par value $0.21 per share, is listed on the New York Stock Exchange, or the NYSE, and the Pacific Stock Exchange, or the PSE, 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, 2002, there were 687,375,999 shares outstanding of our common stock.

Table 3 sets forth the high and low sale prices of our common stock for each quarter during the fiscal years 2003, 2002 and 2001.

Table 3 — Quarterly Common Stock Information

	Closing Sale Prices[1]	
	High	Low
Quarter Ended 2003		
December 31	$59.07	$53.28
September 30	55.71	48.10
June 30	61.32	47.35
March 31	64.73	50.80
Quarter Ended 2002		
December 31	$63.50	$53.98
September 30	64.85	54.67
June 30	67.66	60.42
March 31	68.60	61.00
Quarter Ended 2001		
December 31	$70.79	$63.31
September 30	69.57	60.80
June 30	69.89	60.15
March 31	67.68	60.00

(1) The principal market is the NYSE, and prices are based on the Composite Tape. Our common stock is also listed on the PSE.

As of February 12, 2004, the closing price for our common stock was $63.71 per share.

Dividends

Table 4 sets forth the dividend per common share that we have paid for each quarter during fiscal years 2003, 2002 and 2001.

Table 4 — Dividends Per Common Share

	Regular Cash Dividend Per Share
Quarter Ended 2003	
December 31	$.26
September 30	.26
June 30	.26
March 31	.26
Quarter Ended 2002	
December 31	$.22
September 30	.22
June 30	.22
March 31	.22
Quarter Ended 2001	
December 31	$.20
September 30	.20
June 30	.20
March 31	.20

Each stockholder is entitled to receive dividends that may be declared by our Board of Directors out of legally available funds. We have historically paid dividends to our stockholders in each quarter. Our Board of Directors intends to retain this policy of providing dividends quarterly, but further dividends will depend upon earnings, financial condition and other factors relevant at the time our Board of Directors considers our dividend policy. *See* "FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA — NOTE 10: REGULATORY CAPITAL" for additional information regarding dividends.

Holders

As of February 12, 2004, we had approximately 2,870 common stockholders of record. Based on the number of requests for proxies, we estimate that approximately 247,000 additional common stockholders held shares through banks, brokers and nominees as of February 12, 2004.

Securities Authorized for Issuance under Equity Compensation Plans

Table 5 provides information about Freddie Mac common stock that may be issued upon the exercise of options, warrants and rights under Freddie Mac's existing equity compensation plans as of December 31, 2002. Freddie Mac stockholders have approved the 1995 Directors' Stock Compensation Plan, the 1995 Stock Compensation Plan, as amended and restated, the 1995 Employee Stock Purchase Plan and the terms of the 1990 Stock Compensation Plan.

Table 5 — Securities Authorized for Issuance under Equity Compensation Plans

Plan Category	(a) Number of securities to be issued upon exercise of outstanding options, warrants and rights	(b) Weighted-average exercise price of outstanding options, warrants and rights	(c) Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))
Equity compensation plans approved by stockholders	10,590,702[1]	$43.42[1]	11,542,876[2]
Equity compensation plans not approved by stockholders	None	N/A	None

(1) Includes 359,227 restricted stock units, or RSUs, issued under the 1995 Directors' Stock Compensation Plan and the 1995 Stock Compensation Plan and options to purchase 1,000,370 shares under the Employee Stock Purchase Plan.
(2) Includes 3,837,324 shares available for issuance under the 1995 Employee Stock Purchase Plan. No shares are available for issuance under the 1990 Stock Compensation Plan.

SELECTED FINANCIAL DATA[1][2]

	At or for the Year Ended December 31,		
	2002	2001	2000
	(dollars in millions, except share-related amounts)		
Income Statement Data			
Net interest income	$ 8,886	$ 6,992	$ 3,758
Income before cumulative effect of change in accounting principles, net of taxes	10,090	3,115	3,666
Cumulative effect of change in accounting principles, net of taxes	—	43	—
Net income	$ 10,090	$ 3,158	$ 3,666
Earnings per common share before cumulative effect of change in accounting principles, net of taxes			
Basic	$ 14.23	$ 4.19	$ 5.04
Diluted	14.18	4.17	5.01
Earnings per common share after cumulative effect of change in accounting principles, net of taxes			
Basic	$ 14.23	$ 4.25	$ 5.04
Diluted	14.18	4.23	5.01
Dividends per common share	0.88	0.80	0.68
Weighted average common shares outstanding — diluted (in thousands)	695,116	695,973	695,307
Balance Sheet Data			
Total assets	$ 752,249	$ 641,100	$ 462,803
Debt Securities, net due within one year	244,429	264,227	183,374
Debt Securities, net due after one year	415,662	311,013	244,732
Subordinated borrowings, due after one year	5,605	3,128	144
Miscellaneous liabilities[3]	52,914	40,489	14,252
Minority interest in consolidated subsidiaries	2,309	2,619	2,944
Stockholders' equity	31,330	19,624	17,357
Portfolio Balances[4]			
Retained portfolio (unpaid principal balances)[5]	$ 567,272	$ 497,639	$ 392,298
Total PCs issued and Structured Securities that are backed by non-Freddie Mac mortgage-related securities[6][7]	1,090,624	961,511	838,323
Total mortgage portfolio (unpaid principal balances)	1,316,609	1,150,723	975,612
Ratios			
Return on average assets[8]	1.4%	0.6%	0.9%
Return on common equity[9]	47.2	20.2	39.0
Return on total equity[10]	39.6	17.1	30.2
Dividend payout ratio on common stock[11]	6.2	18.9	13.6
Equity to assets ratio[12]	3.7	3.4	2.9

(1) We adopted the provisions of SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities" and the provisions of Emerging Issues Task Force, or EITF, 99-20 "Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets," as of January 1, 2001 and April 1, 2001, respectively. *See* "FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA — NOTE 2: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES" for more information.

(2) *See* "MD&A — QUARTERLY SELECTED FINANCIAL DATA" for a reconciliation of previously reported to restated/revised results by selected consolidated statements of income captions.

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

(6) Includes $8.6 billion, $13.1 billion and $16.0 billion of Structured Securities backed by Ginnie Mae Certificates at December 31, 2002, 2001 and 2000, respectively. Reported totals are based upon UPB. Also includes approximately $5 billion and $3 billion at December 31, 2002 and 2001, respectively, of housing authority bonds that were issued by third parties to fund the origination of multifamily mortgage loans and for which Freddie Mac provided a credit guarantee.

(7) Reported UPB of Structured Securities relates only to that portion of issued Structured Securities that is backed by non-Freddie Mac mortgage-related securities.

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

(9) 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).

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

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

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

RESTATEMENT RESULTS

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

Summary of Restatement Results

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

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

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

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

Restatement Effect on Volatility of Income

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

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

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

Restatement Effect on Interest-Rate Risk Measures

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

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

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

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

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

Restatement Effect on Regulatory Capital

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

Table 8 — Estimated Regulatory Minimum Capital Surplus[1]

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

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

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

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

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

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

Restatement Background and Remediation Program

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

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

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

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

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

Summary of Accounting Corrections and Changes by Category

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

Table 9 — Net Cumulative Income (Expense) Impact Through December 31, 2002[1]

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

(1) *See* "— QUARTERLY SELECTED FINANCIAL DATA" for a reconciliation of previously reported to restated/revised results by selected consolidated statements of income captions.
(2) Represents the net cumulative impact of (i) accounting changes we elected to make related to stock-based compensation and (ii) enhancements to the methodology used to estimate the lives used in the amortization of certain premiums and discounts.
(3) Virtually all of the $2.6 billion tax impact represents an increase in deferred taxes not currently payable. *See* "FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA — NOTE 1: RESTATEMENT" for more information.
(4) Included in 2002 results is $82 million of net income related to events occurring in 2003 but affecting 2002. The $82 million of net income consists of $155 million of tax benefit attributable to favorable Court rulings occurring in 2003 offset by $73 million in additional expense, net of tax, related to adjustments in reserves and accruals due to events occurring in 2003.

FINANCIAL HIGHLIGHTS

2002, 2001 and 2000 Performance

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

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

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

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

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

CRITICAL ACCOUNTING POLICIES

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

Fair Value

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

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

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

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

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

Table 10 — Assets and Liabilities Recorded at Fair Value

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

Transfers of Financial Assets

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

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

Table 11 summarizes securitization activity in 2002 and 2001.

Table 11 — Securitization Activity

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

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

Hedge Accounting

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

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

A portion of our derivative portfolio is designated in fair value and cash flow hedge accounting relationships. For a derivative qualifying as a cash flow hedge, we report changes in the fair value of these instruments in a separate component of "Accumulated other comprehensive income (loss), net of taxes" to the extent the hedge is effective. For a derivative qualifying as a fair value hedge, we report changes in the fair value of the derivative along with the changes in the fair value of the hedged item attributable to the risk being hedged in the consolidated statements of income. When the hedge is terminated or redesignated, the fair value adjustment to the carrying amount of the hedged asset or liability is amortized to earnings as a component of the hedged item's interest income or expense over the remaining life of the hedged item using the effective yield method. If a derivative no longer qualifies as a cash flow or fair value hedge, we discontinue hedge accounting prospectively. We continue to carry the derivative on the consolidated balance sheets at fair value and record subsequent fair value gains and losses in the consolidated statements of income as "Derivative gains (losses)" until the derivative is terminated or redesignated. Thus, not qualifying for hedge accounting may introduce material income statement volatility. *See Table 39* for additional information regarding derivatives in hedge accounting relationships.

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

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

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

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

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

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

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

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

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

Table 12 — Loan Loss Reserves

	December 31,	
	2002	2001
	(dollars in millions)	
Beginning balance	$ 224	$ 229
Provision for credit losses	128	32
Charge-offs	(171)	(129)
Recoveries[1]	84	92
Charge-offs, net	(87)	(37)
Ending balance	$ 265	$ 224

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

Premiums and Discounts

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

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

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

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

EITF 99-20 requires that we recognize as interest income (throughout the life of a retained interest) the excess of all estimated cash flows attributable to the retained beneficial interest of our initial investment using the effective yield method. We update our estimates of expected cash flows periodically and recognize changes in calculated effective yield on a prospective basis.

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

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

CONSOLIDATED RESULTS OF OPERATIONS

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

Table 13 summarizes our financial performance for the periods presented.

Table 13 — Summary of Consolidated Results

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

Net Interest Income

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

2002 versus 2001

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

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

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

(1) Combined rate/volume changes are allocated to the individual rate and volume changes based on their relative size.
(2) May not sum due to rounding.

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

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

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

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

2001 versus 2000

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

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

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

(1) Combined rate/volume changes are allocated to the individual rate and volume changes based on their relative size.
(2) May not sum due to rounding.

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

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

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

Analysis of Quarterly Results

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

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

	1Q 2001	2Q 2001	3Q 2001	4Q 2001	2001
	(dollars in millions)				
Net interest income	$1,295	$1,518	$2,158	$2,021	$6,992
Fully taxable-equivalent adjustment	57	63	59	58	237
Net interest income (fully taxable-equivalent basis)	$1,352	$1,581	$2,217	$2,079	$7,229
Net interest yield (fully taxable-equivalent basis)	1.14%	1.23%	1.63%	1.43%	1.37%

	1Q 2002	2Q 2002	3Q 2002	4Q 2002	2002
	(dollars in millions)				
Net interest income	$2,414	$2,123	$2,079	$2,270	$8,886
Fully taxable-equivalent adjustment	66	65	66	55	252
Net interest income (fully taxable-equivalent basis)	$2,480	$2,188	$2,145	$2,325	$9,138
Net interest yield (fully taxable-equivalent basis)	1.59%	1.38%	1.32%	1.34%	1.40%

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

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

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

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

- **Amortization of hedging gains and losses**. Certain derivative contracts are accounted for as cash flow hedges of forecasted debt issuances (primarily pay-fixed swaps and Eurodollar futures), while other derivative contracts are accounted for as fair value hedges of existing debt (primarily receive-fixed swaps). In both cases, termination of the hedge relationship results in the associated deferred hedging gain or loss being amortized into net interest income. Amortization related to terminated cash flow hedges is included in "Income (expense) related to derivatives," while amortization related to terminated fair value hedges is included in interest expense on long-term debt. For further information concerning our accounting policies related to cash flow and fair value hedge relationships, *see* "FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA — NOTE 2: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — Derivatives — Accounting for Derivatives under SFAS 133." As a result of increased long-term debt issuances and declining interest rates during 2002, we terminated pay-fixed swaps, triggering amortization of deferred hedging losses.

- **Interest expense related to amounts due to Participation Certificate investors**. As a result of the payment remittance cycle associated with Gold PCs, which is described in "FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA — NOTE 2: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — Due to Participation Certificate Investors," interest expense related to amounts due to PC investors will increase during periods of high prepayments and decrease during periods of low prepayments. Because of changes in interest rates and mortgage prepayment rates, interest expense related to amounts due to PC investors fluctuated from period to period in 2001 and 2002.

- **Debt funding mix**. As discussed in "— CONSOLIDATED BALANCE SHEETS ANALYSIS — Total Debt Securities, Net," we use our derivative portfolio to address differences between outstanding debt and our funding needs. Because of declining interest rates in 2002, the expected lives of assets held in the retained portfolio decreased, reducing the need from an asset/liability management perspective for long-term debt. However, the volume of long-term debt issued is generally determined by our commitment to our Reference Notes securities calendar. To shorten the effective duration of our debt and thereby manage the funding mismatch created by the decline in interest rates, we terminated certain pay-fixed swaps and entered into receive-fixed swaps. Receive-fixed swaps effectively convert a fixed-rate debt payment into a variable-rate payment.

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

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

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

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

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

Non-Interest Income

Management and Guarantee Income

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

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

Table 18 — Management and Guarantee Income

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

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

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

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

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

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

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

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

Table 19 — Quarterly Management and Guarantee Income

	1Q 2001	2Q 2001	3Q 2001	4Q 2001
	(dollars in millions)			
Management and guarantee income	$ 347	$ 340	$ 396	$ 309
Average outstanding PCs[1]	$556,597	$571,456	$607,169	$623,866
Management and guarantee rate (in basis points)	24.9	23.8	26.1	19.8

	1Q 2002	2Q 2002	3Q 2002	4Q 2002
	(dollars in millions)			
Management and guarantee income	$ 372	$ 385	$ 370	$ 389
Average outstanding PCs[1]	$640,816	$686,180	$708,003	$716,770
Management and guarantee rate (in basis points)	23.2	22.4	20.9	21.7

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

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

Gains (Losses) on Guarantee Asset and Guarantee Obligation

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

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

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

Table 20 — Attribution of Change in Fair Value

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

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

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

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

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

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

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

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

	1Q 2001	2Q 2001	3Q 2001	4Q 2001
		(dollars in millions)		
Gains (losses) on guarantee asset	$(261)	$24	$(454)	$(98)
Gains (losses) on guarantee obligation	(181)	41	190	153

	1Q 2002	2Q 2002	3Q 2002	4Q 2002
		(dollars in millions)		
Gains (losses) on guarantee asset	$(213)	$(658)	$(890)	$(415)
Gains (losses) on guarantee obligation	146	156	62	228

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

Derivative Gains (Losses)

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

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

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

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

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

Table 22 — Derivatives Not in Hedge Accounting Relationships

	1Q 2001		2Q 2001		3Q 2001		4Q 2001		2001
	Notional	Gain (Loss)	Notional	Gain (Loss)	Notional	Gain (Loss)	Notional	Gain (Loss)	Gain (Loss)
	(dollars in billions)								
Call swaptions	$83.0	$ —	$88.9	$(0.7)	$ 96.0	$ 1.8	$ 97.1	$(1.0)	$ 0.1
Put swaptions	29.8	(0.1)	56.2	0.2	70.4	(0.6)	84.2	1.0	0.5
Receive-fixed swaps	46.8	0.3	61.4	(1.1)	130.1	6.3	131.6	(3.7)	1.8
Pay-fixed swaps	81.9	(1.4)	72.6	1.7	110.7	(7.2)	100.3	2.7	(4.2)
Subtotal		(1.2)		0.1		0.3		(1.0)	(1.8)
Other[1]		0.1		(0.2)		0.1		(0.1)	(0.1)
Total		$(1.1)		$(0.1)		$ 0.4		$(1.1)	$(1.9)

	1Q 2002		2Q 2002		3Q 2002		4Q 2002		2002
	Notional	Gain (Loss)	Notional	Gain (Loss)	Notional	Gain (Loss)	Notional	Gain (Loss)	Gain (Loss)
	(dollars in billions)								
Call swaptions	$106.6	$(1.0)	$129.0	$ 1.7	$120.9	$ 5.3	$131.4	$(0.6)	$ 5.4
Put swaptions	91.4	(0.2)	88.4	(1.3)	73.3	(0.5)	129.9	(0.6)	(2.6)
Receive-fixed swaps	82.3	(0.4)	54.2	2.0	70.2	4.1	65.4	—	5.7
Pay-fixed swaps	63.4	0.8	49.2	(1.9)	55.3	(2.9)	43.4	0.2	(3.8)
Subtotal		(0.8)		0.5		6.0		(1.0)	4.7
Other[1]		(0.2)		0.4		0.4		0.6	1.2
		$(1.0)		$ 0.9		$ 6.4		$(0.4)	$ 5.9

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

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

Hedge Accounting Gains (Losses)

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

Hedge accounting gains were $187 million in 2002, compared to hedge accounting losses of $294 million in 2001. Hedge ineffectiveness in both years related primarily to our fair value hedge relationships. Hedge accounting gains (losses) will vary from period to period based on the notional amount of derivatives accounted for in hedge relationships and the extent to which differences in the characteristics or terms of the derivative and the hedged item result in fair value or cash flow changes that do not exactly offset.

Gains (Losses) on Investment Activity

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

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

Table 23 — Gains (Losses) on Investment Activity

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

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

- **Gains (Losses) on Trading Securities.** Gains (losses) on trading securities represent changes in the fair value of our trading position, which includes trading securities held, forward commitments to purchase or sell trading securities, and Treasury and agency debt security "short sale" transactions (also referred to as "securities sold, not yet purchased") executed for asset/liability management purposes. The trading position consists of security transactions executed in connection with our PC market-making and support activities and certain securities held in the retained portfolio, including securities transferred into trading at the beginning of 2001. Specifically, we transferred approximately $36 billion of securities to the trading category on January 1, 2001 in conjunction with the implementation of SFAS 133, resulting in an unrealized loss of approximately $275 million being recorded to earnings. Excluding this loss, gains (losses) on trading securities were driven by the balance of our trading position and changes in market prices during each period.

- **Gains (Losses) on PCRs.** As explained in "FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA — NOTE 2: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — Participation Certificate Residuals," PCRs associated with certain PCs and Structured

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

- The realization of cash flows; and
- Changes in the amount and timing of future cash flows and in market discount rates. Net cash payments on PCRs we receive reduce the valuation of PCRs since those cash flows are reported in the income statement (primarily within net interest income) and not as a direct reduction of the recorded investment. Realization of cash flows and decreases in interest rates, which reduced the expected lives of the associated securities, accounted for the reported loss in 2002. In 2001, the loss was primarily due to the realization of cash flows.

- **Gains (Losses) on Sale of Mortgage Loans and Available-for-Sale Securities.** Gains (losses) on the sale of mortgage loans and available-for-sale securities were primarily attributable to sales of PCs and Structured Securities, as well as Treasury and agency debt securities purchased for asset/liability management purposes.

- **Security Impairments.** We record impairment losses on our investment portfolio when we have concluded that a decrease in the fair value of a security is other than temporary. Impairment losses recognized in 2002, 2001 and 2000 were related to certain investments in manufactured housing securities, corporate bonds and IO securities, with the primary driver being impairments of IO securities. Impairment losses on IO securities totaled $568 million, $325 million and $44 million in 2002, 2001 and 2000, respectively.

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

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

- **Mortgage LOCOM Adjustments.** We record mortgage loans classified as "held-for-sale" in accordance with SFAS 65, "Accounting for Certain Mortgage Banking Activities," at LOCOM, with changes in the valuation of our held-for-sale portfolio recorded to this caption. LOCOM losses recorded to the LOCOM valuation account become realized when we either:

  - Sell the loans, in which case the loss is recorded to "Gains (losses) on sale of mortgage loans and available-for-sale securities";
  - Transfer the loans from the held-for-sale category to held-for-investment; or
  - Securitize the loans and classify the resulting mortgage-related security as available-for-sale.

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

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

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

Gains (Losses) on Debt Retirement

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

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

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

Resecuritization Fees

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

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

Other Income

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

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

Non-Interest Expense

Credit-Related Expenses

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

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

Table 24 — Credit-Related Expenses

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

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

Salaries and Employee Benefits, Occupancy Expense and Other Expenses

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

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

Table 25 — Administrative Expenses

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

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

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

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

Housing Tax Credit Partnerships

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

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

Minority Interest in Earnings of Consolidated Subsidiaries

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

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

Income Tax Expense

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

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

Cumulative Effect of Change in Accounting Principles, Net of Taxes

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

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

CONSOLIDATED BALANCE SHEETS ANALYSIS

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

Table 26 — Summary Balance Sheets

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

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

Retained Portfolio

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

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

Cash and Investments

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

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

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

Guarantee Asset and Guarantee Obligation for Participation Certificates

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

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

Table 27 — Changes in Guarantee Asset and Guarantee Obligation

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

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

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

Derivative Assets and Liabilities, at Fair Value

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

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

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

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

Total Debt Securities, Net

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

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

Due to Participation Certificate Investors

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

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

Total Stockholders' Equity

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

Table 28 — Total Stockholders' Equity

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

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

AVERAGE BALANCE SHEETS AND RATE/VOLUME ANALYSIS

Table 29 reflects an analysis of net interest income and presents average balances and related yields earned on assets and rates paid on liabilities. Average balance sheet information is presented because we believe end-of-period balances may not always be representative of activity throughout the periods presented. We also believe that the rate/volume analysis may be helpful in understanding how changes in business volumes and yields influenced our financial results, particularly "Net interest income on earning assets." For most components of the average balances a daily weighted average balance is calculated for the period. When daily weighted average balance information is not available, a simple monthly average balance is calculated. In addition, "Net interest income/yield (fully taxable equivalent basis)" is presented on this table. Taxable equivalent adjustments to interest income involve the conversion of tax-exempt sources of interest income to the equivalent amounts of interest income that would be necessary to derive the same net return if the investments had been subject to income taxes using our incremental tax rate (35 percent).

Table 29 — Average Balance Sheets and Rate/Volume Analysis

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

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

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

CONSOLIDATED FAIR VALUE BALANCE SHEETS

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

Table 30 — Consolidated Fair Value Balance Sheets[1]

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

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

Overview

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

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

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

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

We report assets and liabilities that are not financial instruments (such as our property, plant and equipment and deferred taxes), as well as certain financial instruments that are not covered by the SFAS 107 disclosure requirements (such as pension liabilities), at their GAAP carrying amounts in the FVBS. We believe these items do not have a significant impact on Freddie Mac's overall financial prospects or fair value results.

Key Components of Changes in FVBS Net Assets

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

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

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

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

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

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

Discussion of Fair Value Results

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

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

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

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

VOLUME STATISTICS

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

Table 31 — Volume Statistics[1]

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

(1) Based on UPB.
(2) Based on our total mortgage portfolio, except these amounts exclude Structured Securities backed by Ginnie Mae Certificates.
(3) Includes Structured Securities backed by non-agency securities, which are typically backed by subprime mortgages.
(4) The percentage of mortgages that were credit-enhanced was 20% and 28% for the years ended December 31, 2002 and 2001, respectively. Credit enhancements include loans for which the lender or a third party has retained primary default risk by pledging collateral or agreeing to accept losses on loans that default. In some cases, the lender's or the third party's risk is limited to a specific level of losses at the time the credit enhancement becomes effective.
(5) Amount excludes Structured Securities backed by non-Freddie Mac mortgage-related securities.
(6) Excludes sales of non-Freddie Mac mortgage-related securities and liquidations of Structured Securities that are backed by Ginnie Mae Certificates.
(7) Includes issuances of mortgage-related securities in which the cash flows are structured into various classes, the majority of which qualify for treatment as REMICs under the Internal Revenue Code.

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

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

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

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

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

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

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

LIQUIDITY AND CAPITAL RESOURCES

Liquidity

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

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

Depending on market conditions and the mix of our derivatives employed in connection with our ongoing risk management activities, our derivative portfolio can be either a net source or a net use of cash. For example, depending on the prevailing interest-rate environment, interest-rate swap agreements could cause us to either make interest payments to the counterparty or receive interest payments from the counterparty.

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

Debt Securities

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

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

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

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

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

Equity Securities

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

Liquid Investments

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

The cash and investments portfolio consists principally of cash and cash equivalents, asset-backed securities, corporate debt securities, and other marketable assets that can be readily converted to cash. The non-mortgage investments in this portfolio may expose us to institutional credit risk and the risk that the investments will decline in value due to market-driven events such as credit downgrades or changes in interest rates and other market conditions. *See* "— RISK MANAGEMENT — Credit Risk — *Institutional Credit Risk*" for more information.

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

Table 32 — Investments

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

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

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

Under our charter, the Secretary of the Treasury has discretionary authority to purchase our obligations up to a maximum of $2.25 billion principal balance outstanding at any one time. This authority has never been exercised, and would not be a meaningful source of liquidity to meet our obligations if it were exercised. *See* "BUSINESS — Regulation and Governmental Relationships" for more information.

Capital Resources

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

Capital Transactions

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

Table 33 — Total Capitalization

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

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

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

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

Table 34 — Summary of Core Capital

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

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

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

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

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

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

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

Table 35 — Preferred Stock

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

(1) Optional redemption on or after dates indicated.
(2) Optional redemption on March 31, 2003 and on March 31 every two years thereafter.
(3) Optional redemption on March 31, 2003 and on March 31 every year thereafter.
(4) Optional redemption on June 30, 2003 and on June 30 every two years thereafter.
(5) Optional redemption on December 31, 2004 and on December 31 every five years thereafter.
(6) No preferred stock was redeemed in 2003.

Capital Adequacy

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

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

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

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

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

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

When Freddie Mac is classified as adequately capitalized, we can pay a dividend on our common or preferred stock without prior OFHEO approval so long as our payment would not cause us to fail to meet either our risk-based capital requirement or our minimum capital requirement. If Freddie Mac were classified as undercapitalized, we would be prohibited from making capital distributions that would cause us to fail to meet our minimum capital requirement. We also would be required to submit a capital restoration plan for OFHEO's approval. If Freddie Mac were classified as significantly undercapitalized, we would be able to make a capital distribution only if OFHEO determined that the distribution satisfied certain statutory standards. Under these circumstances, we would be prohibited from making any capital distribution that would cause us to fail to meet our critical capital requirement, and OFHEO also could take action to limit our growth, require us to acquire new capital or restrict us from activities that create excessive risk. We also would be required to submit a capital restoration plan for OFHEO's approval. If Freddie Mac were classified as critically undercapitalized, OFHEO would be required to appoint a conservator for the company unless OFHEO made a written finding that it should not do so and the Secretary of the Treasury concurred in that determination.

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

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

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

Table 36 — Regulatory Capital Requirements

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

(1) Minimum and critical capital requirements are based on amended reports to OFHEO that correct results included in our November 21, 2003 Information Statement Supplement. The impact of this change on the restated regulatory minimum capital surplus was a decrease of $1 million and $7 million as of December 31, 2002 and 2001, respectively, as compared to those results presented in our November 21, 2003 Information Statement Supplement.
(2) Core capital consists of the par value of outstanding common stock (common stock issued less common stock held in treasury), par value of outstanding perpetual preferred stock, additional paid in capital and retained earnings, as determined in accordance with GAAP.
(3) Risk-based and total capital amounts are those calculated by OFHEO prior to the restatement of our 2002 financial results.
(4) Total capital includes "core capital" and general reserves for mortgage and foreclosure losses.

RISK MANAGEMENT

We are subject to three main business risks:

- operational risk;
- interest-rate and other market risks; and
- credit risk.

Management of these risks is based upon the principle that business areas have direct responsibility for risk management activities subject to oversight by an independent risk function. The level of our effectiveness in managing risks affects both the level and stability of our earnings and long-term value.

In October 2003, we established an Enterprise Risk Oversight, or ERO, function which is led by a Chief Enterprise Risk Officer currently reporting to our Chief Executive Officer. The ERO function oversees our interest-rate and other market risks as well as credit risk functions. Operational Risk Oversight, or ORO, is led by an Operational Risk Officer currently reporting to the Chief Financial Officer. Business area risk management and line personnel manage these risks on a day-to-day basis. ERO and ORO are responsible for providing independent oversight of these business area risk management activities to ensure that there is an effective internal control framework in place. The Chief Enterprise Risk Officer and Operational Risk Officer provide advice to senior management on key issues and provide independent reporting to the Risk and Audit Committees of the Board of Directors.

Operational Risk

Operational risk is defined as the risk that financial loss could result from failures or inadequacies involving people, processes, technology or external events. It is inherent in every aspect of business operations, and can result from a range of factors including human judgments, process or system failures, or business interruptions.

The five major operational risks significant to Freddie Mac are:

- People Risk — the risk of loss related to the management of people, including inadequate staffing or expertise, training or supervision, key person dependencies and employee theft or fraud.
- Process Risk — the risk of loss arising from inadequate controls over transaction execution, model risk, or vendor management risk.
- Technology Risk — the risk of loss due to deficiencies in systems design, systems implementation, systems security, or other systems operations.
- External Event Risk — the risk of loss due to external events such as catastrophes, natural disasters, external fraud or theft.
- Reporting and Disclosure Risk — the risk of loss related to inaccurate or incomplete reporting or disclosure to our stakeholders, including financial statements, offering documents for equity, debt or mortgage-related securities, and regulatory disclosures.

Our management of each of these operational risks is discussed under "Management of Freddie Mac's Operational Risks" below.

Internal Control Weaknesses

The factors contributing to the need for the recently completed restatement and the errors and corrections made are discussed in "— RESTATEMENT RESULTS — Restatement Background and Remediation Program" and "FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA — NOTE 1: RESTATEMENT." In addition, our independent auditors have identified and communicated to management and the Audit Committee certain deficiencies in internal controls. These deficiencies were characterized by

PwC as "material weaknesses" (as defined under standards established by the AICPA) in internal controls during the period from 2000 through 2002, and were categorized by PwC as follows:

- Deficiencies in the effectiveness of corporate governance and management oversight;
- Inadequate resources with requisite accounting and financial reporting expertise and unenforced accountability in our accounting departments;
- Involvement by Market Risk Oversight, at the direction of senior management, in activities that were incompatible with its oversight and independent control duties; and
- Inadequate independent monitoring controls over valuation of financial instruments.

To ensure that these deficiencies and the principal factors that contributed to the need for the restatement are properly addressed, management is implementing a comprehensive remediation program, under the direction and oversight of the Governance Committee of the Board of Directors. The magnitude of the efforts and the scope of remediation activities are considerable. During the period of the restatement, our resources and skill sets in accounting policy and accounting operations did not increase commensurately with the increased complexity of our activities. Actions have begun to be taken to address cultural issues and adequacy of accounting resources. However, staffing requirements in both the accounting policy and accounting operations areas are considerable. In the interim, Freddie Mac has placed extensive reliance on external consultants to fill the vacant positions. Significant efforts continue to hire and train the requisite number of qualified staff.

Our accounting systems infrastructure has not been sufficient given the volume and complexity of our operations. The result during the years affected by the restatement was processes that were highly reliant on manual activities and that lacked the appropriate management information systems to effectively report our financial results. Existing weaknesses in infrastructure (*e.g.*, lack of business line subledgers, high reliance on spreadsheet-based tools, manual work-around solutions, labor-intensive reconciliations, and limited management information systems) were compounded during the restatement process. To complete the restatement, corrections of numerous errors led to further increases in manual, off-line processes and a corresponding increase in the time required to complete the financial reporting process for each period. Ad hoc reporting was developed to support analysis of financial results. We are using similar off-line processes and reports to prepare our 2003 financial statements. Our remediation plan will integrate these off-line processes and reports into automated applications during 2004 with a goal of reducing the time-to-close to a level consistent with SEC requirements as soon as practicable. Multi-year enhancements will, however, be required to bring our accounting systems infrastructure to market standards.

In the area of process risk, during the years affected by the restatement, we made numerous errors in estimating the fair value of our derivatives and securities. As part of our remediation activities, we have taken steps to review and validate virtually all pricing methodologies and strengthened verification processes. While manual controls are robust, our valuation processes remain labor-intensive, and this may affect the timing of the preparation of our 2003 financial statements. Developing the infrastructure to support timely valuation of financial instruments will be a significant undertaking for us.

Finally, the complexity of our accounting process has been compounded with the need to implement a number of new accounting standards in 2003. *See* "FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA — NOTE 2: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES" for more information concerning new accounting standards. Focus on restatement activities delayed the analysis of the requirements of these standards until late in 2003. Implementation of these standards will require increased staffing and additional operations support for our process to prepare our 2003 financial statements. *See* "— RESTATEMENT RESULTS — Restatement Background and Remediation Program" for more information concerning our remediation program. In addition to the redesign of financial reporting processes, under the terms of our consent order with OFHEO, we are undertaking remedial actions relating to many of the same areas as the remediation plan. *See* "SUBSEQUENT EVENTS — Legal Proceedings — OFHEO Investigation" for more information.

As part of the remediation program, we are strengthening our resources and personnel dedicated to accounting, control, and financial reporting. In addition to efforts taken to address specific control issues, we

have increased resources and corporate focus on enhanced tools and processes for operational risk management. In October 2003, we hired a Chief Compliance Officer, a new position currently reporting directly to the Chief Executive Officer. We have also retained experts to assist us in designing and implementing exemplary disclosure processes and practices and corporate governance principles and practices. Finally, a formal review of internal controls over financial reporting is underway. *See* "EXPLANATORY NOTE" regarding the scope of our past evaluation and assessment of the effectiveness of disclosure controls and procedures and internal controls over financial reporting. The efforts described above are expected to cause a significant increase in our administrative expenses for periods subsequent to 2002 due to the increased accounting, auditing and consulting resources retained by us, as well as related restatement and remediation expenses. In 2003, the estimated costs of these resources and related restatement and remediation expenses totaled approximately $120 million, and we anticipate incurring additional costs at a comparable or greater level in 2004. In addition, as discussed in "SUBSEQUENT EVENTS — Legal Proceedings," we entered into a consent order with OFHEO in December 2003 and paid a civil money penalty of $125 million, which we will record as a component of administrative expenses in 2003 and also incurred estimated legal expenses of approximately $47 million for investigations related to the restatement. *See* "— CONSOLIDATED RESULTS OF OPERATIONS — Non-Interest Expense" for historical levels of administrative expenses.

Overview of Operational Risk Management

Our management of operational risk is based on the principle that operational risk should be managed directly by our business areas, subject to oversight by an independent risk oversight function. Under this principle, operational risks should be:

- understood by the business units;
- measured, aggregated and assessed on a regular basis;
- effectively communicated to senior management; and
- managed within appropriate standards and limits.

We manage operational risk through business-specific controls that range from appropriate governance and management oversight to documented policies and procedures for our business processes. A senior management committee is responsible for oversight of risks, while business area risk management and line personnel manage and monitor operational risk on a continuous basis as part of our daily operations.

We use firm-wide risk management tools, including a self-assessment process, to report and analyze operational risks, controls, issues, and action plans. On a periodic basis, managers in each business area complete a self-assessment of operational risks and controls, based on the *Internal Control-Integrated Framework* adopted by the Committee of Sponsoring Organizations, or COSO. In addition, internal audit and external parties perform reviews or audits to validate the effectiveness of key controls and the level of operational risk in our business processes.

Prior to the restatement, in 2002, we began executing a multi-year plan developed to enhance operational risk management, which included establishing the ORO function to provide independent oversight of operational risk.

Management of Freddie Mac's Operational Risks

People risk. People risk is a significant risk for Freddie Mac because of the complexity of our business and the skills needed by key personnel. We use retention programs for critical talent and training to mitigate people risk. In 2003, we significantly increased our senior-level accounting expertise and financial reporting staff, though significant effort continues in the recruiting for both staff level and key vacant senior management positions such as officer vacancies for market risk and credit risk oversight.

Process risk. Process risk includes transaction execution risk, model risk, and vendor management risk. Transaction execution risk is the risk arising from a failure to develop or follow appropriate internal processes for executing our business transactions. Proper transaction execution depends on quality data and internal operations. Our efforts to mitigate this risk range from maintaining appropriate policies and

procedures to delegations of authority, which establish levels of review and approval as well as dollar limits for business transactions.

Model risk is the risk that business decisions are made using model results that are incorrect. Model risk is an important area for us because of our significant use of business and financial models. We seek to mitigate model risk by validating inputs and assumptions, model code and theory, and model outputs.

Vendor management risk is the risk that we will suffer an operational loss, a loss of intellectual property, a breach of confidentiality, or other business harm because of our reliance on external parties to perform or assist us in performing critical business functions and processes. Freddie Mac currently outsources to external parties certain key functions, including processing functions for trade capture and interest-rate and other market risk management analytics and pricing information (BlackRock Financial Management, Inc.), processing functions for mortgage loan underwriting (Electronic Data Systems Corporation, or EDS), and back office support (Bear Stearns Securities Corp.). We may enter into similar outsourcing relationships with other vendors 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 as determined by us, our financial condition or results of operations could be adversely affected, perhaps materially. We seek to mitigate this risk through detailed vendor requirements, including business continuity planning, monitoring, and oversight.

Technology risk. Technology risk includes systems security and systems implementation risks. Systems security risk is the risk of loss due to unauthorized access to computer systems. This risk is mitigated by computer security measures and applications, corporate information access policies, and periodic access reviews to ensure only authorized personnel have access to our systems. Systems implementation risk is the risk of loss due to new or modified systems that fail to meet operational requirements and result in a business interruption or failure. To mitigate this risk, we have established corporate requirements for system implementations and monitor implementations for these requirements.

External event risk. External event risk is the risk that a catastrophic event, such as a terrorist event, natural disaster, breach of physical security or external fraud or theft, results in a significant business disruption and an inability to process transactions through normal business processes. To mitigate this risk, we maintain and test a comprehensive business continuity plan and locate backup facilities for critical business processes and systems away from, although in the same metropolitan area as our main offices.

Reporting and disclosure risk. Reporting and disclosure risk is the risk that materially inaccurate or incomplete financial reports or offering documents are prepared and distributed to our investors in our equity, debt and mortgage-related securities or to our regulators, or that financial reports are not produced on a timely basis. For the years covered by the restatement, we corrected numerous errors in complying with GAAP in connection with the preparation of our financial statements. We also engaged in an extensive review of our valuation methodologies and results, corrected valuation and other errors that were identified in the restatement and enhanced the accuracy of the market pricing data we use when determining fair values. For further information, *see* "FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA — NOTE 1: RESTATEMENT." We are conducting a comprehensive review of internal controls over financial reporting to formally evaluate controls, identify potential gaps and establish remediation plans where needed. We have also established mitigating controls and procedures to address control weaknesses, including a comprehensive review in 2003 of our accounting policies and enhancements to disclosure practices. Although significant efforts have been made in this area, we are not yet able to produce timely financial reports. Extensive plans have been developed and implementation is underway to enhance our controls over financial reporting and to accelerate the time required to produce financial reports. *See* "— Internal Control Weaknesses," above.

Interest-Rate Risk and Other Market Risks

We are exposed to the risk that changes in the level of interest rates or in other market factors will adversely affect our cash flows, the fair value of net assets and/or future earnings. We actively manage interest-rate risk and other related market risks and take a disciplined approach to risk management. Our disciplined approach to risk management and our active deployment of capital are essential to generating fair value growth for shareholders in a wide range of interest-rate environments. Our interest-rate risk exposure results primarily from uncertainty related to the amount and timing of mortgage prepayments associated with mortgage loans and mortgage-related securities held in our retained portfolio and the potential mismatch in the duration of our assets and liabilities. To a lesser extent, we are also exposed to interest-rate risk through our credit guarantee activities.

Our fair value of net assets represents management's estimation of the fair value of our existing net assets. It does not include an estimate of our net assets as an ongoing concern or potential sources of value such as goodwill or other intangibles. The fair value of our financial instruments reflects an assessment of the present value of expected future cash flows at a given point in time. To the extent that market conditions change, the expected future cash flows may differ from our estimates. As a result, changes in our fair value of net assets may, over time, be different than our realized cash flows. Also, because we have a long-term investment horizon, changes in fair value due to changes in mortgage-to-debt spreads will not significantly affect year-to-year cash flows.

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, or prepayment risk, and the resulting potential mismatch in the timing of our receipt of cash flows on our assets and our obligation to make payments on our liabilities. For virtually all of our mortgage 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 derivatives, to mitigate the interest-rate risk that mortgage investments may prepay faster or slower than expected.

Types of Interest-Rate Risk and Other Market Risks. The types of interest-rate risk and other market risks that we are exposed to through our retained portfolio are described below.

- **Duration and Convexity Risk.** The magnitude of our interest-rate risk is directly related to the effective duration and convexity of our portfolio of assets, liabilities and derivatives. Duration is a measure of a financial instrument's price sensitivity to changes in interest rates, while convexity is a measure of how much duration itself changes as interest rates move. We actively manage duration and convexity risk through asset selection and structuring (*i.e.*, 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 purchasing both option-based and non-option-based interest-rate derivatives. To mitigate mortgage prepayment risk and therefore interest-rate risk, we maintain 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 management limits (*see* "— *Interest-Rate Risk Management and Use of Derivatives* — Use of Derivatives — Adjust Funding Mix" below). Although duration and convexity risks have 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. Similarly, 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 (also known as implied volatility) and the volatility actually realized.

We monitor duration and convexity risk against limits and reporting thresholds established by senior management and the Board of Directors. Our interest-rate sensitivity is estimated and reported through 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.

- **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. 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 included in our PMVS measures.
- **Volatility Risk.** Volatility risk is the risk that changes in the market's expectation of future 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 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 and option-based derivatives relative to our fixed-rate 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. *See* "— Duration and Convexity Risk" above for further discussion of implied and realized volatility.
- **Basis Risk.** Basis risk is the risk that interest rates in different markets 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 fund and hedge mortgage investments with agency debt and London Interbank Offered Rate, or LIBOR, and Treasury-based interest rate derivatives. The basis risk arising from funding retained portfolio investments with agency debt, which we do not actively manage, is discussed below in "Mortgage-to-Debt Spread Risk." We also incur basis risk when we use LIBOR or Treasury-based instruments in our funding or risk management activities. We monitor the fair value fluctuations associated with these basis risks and manage this exposure by adjusting our mix of LIBOR and Treasury-based instruments and company 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 of mortgage assets for PMVS and duration gap measures. To mitigate prepayment model risk, we perform extensive monthly error

tracking and sensitivity analysis to facilitate informed asset selection and risk management decisions. However, period-to-period returns can be affected by differences between prepayments forecasted by the models and actual prepayments or the integrity of data used in the models and risk management systems.

- **Mortgage-to-Debt Spread Risk.** Mortgage-to-debt spread risk is the risk that an increase in the spread between the interest rate on mortgage assets and debt used to finance these investments will, in the short term, adversely affect our cash flows, fair value of net assets and/or future earnings. Mortgage-to-debt spread risk is inherent to any mortgage investor that uses debt to finance mortgage purchases, as is the case with our retained portfolio and those of other large mortgage investors.

  We consider mortgage-to-debt spread risk in our asset purchase activities by establishing thresholds for expected ROE for new asset purchases. Once mortgage assets have been purchased for the retained portfolio, we generally hold a substantial portion of these assets for the long-term, with an objective of realizing the expected initial ROE on those assets over this time frame. Therefore, we do not take actions attempting to manage or hedge period-to-period fluctuations in the fair value of the existing retained portfolio resulting from changes in mortgage-to-debt spreads. We do not believe such fluctuations will significantly affect the long-term return on our existing retained portfolio.

- **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. The exchange rate risk is completely hedged when the debt's principal and the swap's notional amounts and the timing of the payments are identical. In some market conditions, we use short-term currency hedges until permanent hedges are secured. Our exposure to foreign currency risk is minimal because only a small percentage of our debt is denominated in foreign currencies (approximately 6 percent as of December 31, 2002) and because the vast majority of the currency-risk exposure arising from debt issuances is eliminated when hedges are established for the entire debt maturity. Foreign currency swaps also expose us to institutional credit risk, which we discuss under "— Credit Risk — *Institutional Credit Risk*."

Credit Guarantee Activities. The fair value of the existing credit guarantee portfolio fluctuates with changes in interest rates and credit expectations. We do not hedge changes in the fair value of our existing credit guarantee portfolio, other than the interest-rate exposure related to net buy-ups (upfront payments made by us which increase the guarantee fee that we will receive in connection with our PC guarantee). We also hedge expected gains (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 annual fair value results, we believe that changes in the fair value of our existing guarantee portfolio are not a good indication of long-term fair value expectations because such changes do not reflect the strong probability that over time replacement business will largely replenish guarantee fee income lost because of prepayments.

Interest-Rate Risk Management and Use of Derivatives

Our disciplined approach to interest-rate risk management utilizes a variety of asset and liability related strategies that frequently involve the use of derivative transactions. The primary ways in which we use derivatives to manage interest-rate risk are discussed below under "— Use of Derivatives." Our management

of interest-rate risk also involves asset-related strategies through which we seek to invest in mortgage assets that are less sensitive to prepayment risk. These strategies include the creation of Structured Securities from assets held in our retained portfolio, the sale of some of these securities, and the retention of those classes that are expected to optimize our risk or return profile.

Interest-rate risk management activities can significantly affect the level and timing of our net income due to a variety of factors. These factors include the amount of prepayment risk hedged at the time mortgage assets are purchased versus the amount hedged over time through rebalancing actions, the risk tolerances that management deems advisable at various times and changes in the cost of rebalancing transactions. Although risk management activities may be highly effective when viewed from an economic perspective, they may contribute to volatility in earnings under GAAP, particularly when derivatives are not in qualifying hedge accounting relationships. *See* "FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA — NOTE 1: RESTATEMENT" for information concerning certain capital markets transactions, which had an accounting effect disproportionate to the risk management effect.

Summary of Derivative Positions. The net fair value of our derivatives was a net asset balance of $9,426 million at December 31, 2002 and a net liability balance of $648 million at December 31, 2001. This includes certain commitments to purchase and sell mortgage loans, mortgage-related securities and agency debt that we treat as derivative instruments. In our consolidated balance sheets, derivative instruments are presented in "Derivative assets, at fair value" and "Derivative liabilities, at fair value." *Table 37* summarizes our derivative positions at December 31, 2002 and December 31, 2001.

Table 37 — Total Derivative Portfolio

	Notional Balance	Net Asset (Liability) at Fair Value[1]
	(dollars in millions)	
As of December 31, 2002		
Interest-rate derivatives[2]	$ 969,080	$9,169
Commitments[3]	191,563	253
Subtotal	1,160,643	9,422
Credit derivatives[4]	17,301	4
Total	$1,177,944	$9,426
As of December 31, 2001		
Interest-rate derivatives[5]	$1,038,206	$ (537)
Commitments[3]	121,588	(111)
Subtotal	1,159,794	(648)
Credit derivatives[4]	10,984	—
Total	$1,170,778	$ (648)

(1) The fair values of derivatives (netted by counterparty) are presented as "Derivative assets, at fair value" and "Derivative liabilities, at fair value" on our consolidated balance sheets. Collateral was held on approximately 90% of the exposure to derivative counterparty risk as of December 31, 2002 and 96% of the exposure as of December 31, 2001. *See Table 38* for more information about our derivative counterparty credit exposure.
(2) Includes a prepayment management agreement entered into during 2002. *See* "— Types of Derivatives" for more information concerning the nature of the prepayment management agreement.
(3) Commitments to purchase and sell mortgage loans, mortgage-related securities and various debt securities that are subject to the requirements of SFAS 133 and accordingly must be recorded at fair value on the consolidated balance sheets.
(4) Consists of certain credit risk-sharing agreements that are subject to the requirements of SFAS 133 and accordingly must be recorded at fair value on the consolidated balance sheets. *See* " — Credit Risk — *Mortgage Credit Risk* — Mortgage Credit Risk Management Strategies" for more information.
(5) Of the nine Linked Swap pairs, six remained outstanding at December 31, 2001 with a notional amount of $60 billion. These six remaining Linked Swap pairs were terminated during 2002. *See* "FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA — NOTE 1: RESTATEMENT" for further information.

Types of Derivatives. We use derivatives that are common in the financial markets to conduct our risk management activities. Substantially all of our derivative positions fall into the following four categories (*see Table 40* for notional balances for each of these derivative types):

- 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 as discussed further below.

Forward Purchase and Sale Commitments. We routinely enter into forward purchase and sale commitments for mortgage loans, mortgage-related securities and agency debt. Some of these commitments are 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 prepay 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 our corporate objective that prepayment experience on Freddie Mac PCs be consistent with market norms. In 2002, we required that certain mortgage pools 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 have also offered an incentive through an adjusted guarantee fee level 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. At December 31, 2002, approximately $117.2 billion of the mortgages underlying PCs included in Freddie Mac's total mortgage portfolio (*see Table 1*) were subject to this type of agreement. Amounts due to us under this type of agreement will be reported as a component of our management and guarantee income. Other contractual incentives and penalties based on sellers' prepayment experience on outstanding and new PCs are being developed.

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 effectively 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 economic equivalent of these various funding structures. For example, the combination of a short-term debt instrument and a pay fixed-swap is the 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 swap) is the economic equivalent of callable debt. The ability to either issue debt or synthetically create the 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. On a less frequent basis, we also use derivatives to hedge foreign currency exposure associated with foreign currency denominated debt issuances, such as our €Reference Notes securities program. Through the use of derivatives, we are able to mitigate essentially all currency risk at the time of issuance.

Adjust Funding Mix. We undertake frequent 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.

Derivative-Related Risks

Our use of derivatives exposes us to 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. Over-the-counter, or OTC, derivatives, however, expose us to counterparty credit risk because transactions are executed and settled between two parties. When an OTC derivative has a market value above zero at a given date (*i.e.,* an asset reported as "Derivative Assets" on the consolidated balance sheets), then the counterparty could potentially be obligated to deliver cash and/or securities having that market value to satisfy its obligation to us under the derivative. Credit risk arises from the possibility that the counterparty will not be able to deliver the amount owed. We are also subject to derivative market liquidity risk arising from possible difficulties in meeting our need for derivatives.

Derivative Counterparty Credit Risk. 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;
- Continuous monitoring of counterparties;
- Diversification of counterparties, which is discussed under "— Derivative Market Liquidity Risk";
- Master netting agreements and collateral agreements;
- Active credit rebalancing; 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 ensure 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 on a regular basis. Additional reviews are completed when market conditions or events affecting an individual counterparty occur.

Derivative Counterparties. Our standards for entering into derivative agreements include rigorous internal credit and legal reviews. Our derivative counterparties carry external credit ratings among the highest available from the major rating agencies. All of these counterparties are major financial institutions and are experienced market-makers 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. 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 loss can be netted with the gain 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 the current exposure. Our collateral agreements require most counterparties to post collateral for the amount of our net exposure to them, taking into consideration posting thresholds. 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 their valuations. As described further below, this time lag in posting collateral can affect our net uncollateralized exposure to derivative counterparties. All of our collateral is held by a third-party custodian.

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 or 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 38 summarizes our exposure to counterparty credit risk in our interest-rate derivatives. This table is useful in understanding our credit risk related to our OTC derivative portfolio.

Table 38 — Derivative Counterparty Credit Exposure

	December 31, 2002					
Rating[1]	**Number of Counterparties**[2]	**Notional**	**Total Exposure at Fair Value**[3]	**Exposure, Net of Collateral**[4]	**Weighted Avg. Contractual Maturity (in years)**	**Collateral Posting Threshold**[5]
			(dollars in millions)			
AAA	2	$ 2,438	$ 386	$ 386	4.4	Mutually agreed upon
AA+	1	609	299	13	25.5	$10 million or less
AA	3	97,229	1,161	104	4.3	$10 million or less
AA−	9	205,769	3,764	307	4.9	$10 million or less
A+	8	214,833	2,922	183	4.6	$1 million or less
A	2	83,776	1,559	48	3.7	$1 million or less
A−	2	1,655	21	3	1.8	$1 million or less
Subtotal	27	606,309	$10,112	$1,044	4.5	
Other derivatives[6]		245,552				
Prepayment management agreement[7]		117,219				
Commitments		191,563				
Credit derivatives[8]		17,301				
Total derivatives		$1,177,944				

	December 31, 2001					
Rating[1]	**Number of Counterparties**[2]	**Notional**	**Total Exposure at Fair Value**[3]	**Exposure, Net of Collateral**[4]	**Weighted Avg. Contractual Maturity (in years)**	**Collateral Posting Threshold**[5]
			(dollars in millions)			
AAA	2	$ 27,858	$ —	$—	4.7	Mutually agreed upon
AA+	1	616	83	—	26.2	$10 million or less
AA	5	203,155	331	12	5.3	$10 million or less
AA−	10	259,012	632	52	4.6	$10 million or less
A+	2	76,445	61	—	5.6	$1 million or less
A	2	91,807	678	—	4.8	$1 million or less
BBB+	1	88	2	1	7.5	Full posting required
Subtotal	23	658,981	$1,787	$65	5.0	
Other derivatives[6]		379,225				
Commitments		121,588				
Credit derivatives[8]		10,984				
Total derivatives		$1,170,778				

(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" and "Derivative liabilities, 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) Consists primarily of exchange-traded contracts. Exchange-traded derivatives 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.
(7) *See* "— Interest-Rate Risk Management and Use of Derivatives" for additional information concerning the nature of the prepayment management agreement.
(8) *See* "— CREDIT RISK — *Mortgage Credit Risk* — Mortgage Credit Risk Management Strategies" for additional information about credit derivatives.

Our exposure to OTC derivative counterparties varies from period to period depending on changes in interest rates, foreign currency exchange rates and the amount of derivatives held. Our uncollateralized exposure to OTC derivative counterparties, after applying netting agreements and collateral, increased to

$1,044 million as of December 31, 2002, from $65 million as of December 31, 2001. This increase in uncollateralized exposure was due to the following four factors:

- A significant increase in uncollateralized exposure to AAA-rated counterparties, which typically are not required to post collateral given their low risk profile;
- Differences between fair value estimates used by our derivative counterparties in determining collateral to be posted and our restated estimates of derivative fair values used in our financial reporting. *See* "FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA — NOTE 1: RESTATEMENT" for a discussion of the corrections to our estimates of derivative fair values;
- Market movements during the time period between when a derivative is marked to fair value and the date we receive the related collateral. Our derivative counterparties typically post collateral one to three business days after we request collateral; and
- Exposure below the posting thresholds of our derivative counterparties.

As indicated in *Table 38*, approximately 90 percent of our counterparty credit exposure was collateralized at December 31, 2002. In the extremely unlikely event that all of our OTC derivative counterparties were to have defaulted simultaneously on December 31, 2002, the maximum loss to us would have been $1,044 million.

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 derivative counterparties will increase under certain adverse market conditions. We regularly perform severe market stress tests to evaluate the potential additional uncollateralized exposure to each of our OTC derivative counterparties. We use conservative assumptions about default and recovery rates for each counterparty to estimate the potential increase in exposure.

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 Market Liquidity Risk. Derivative market liquidity risk refers to the risk that we may not be able to enter into 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 ensure continuous access to derivative markets, we use a variety of products and transact with many different derivative counterparties. In addition to OTC derivatives, we also use exchange-traded derivatives, asset securitization activities, callable debt, and Reference Notes to rebalance our portfolio.

To ensure that derivative transactions can be replaced if a counterparty defaults, we limit our duration and convexity exposure to each counterparty. As of December 31, 2002, the five largest counterparties, based on notional amount outstanding, each with an independent credit rating of "A" or better, represented 52 percent of our OTC derivatives.

Interest-Rate Derivative Tables

Table 39 shows the notional amount for each of our principal hedge accounting categories under SFAS 133 and the corresponding impact of those positions on our financial statements. The application and effectiveness of our hedging strategies can materially affect stockholders' equity and the timing of our recognition of earnings.

As *Table 39* shows, a significant portion of our derivatives was not designated in hedge accounting relationships at December 31, 2002 and 2001.

Table 39 — Summary of the Effect of Derivatives on Selected Consolidated Financial Statement Captions

Description	Consolidated Balance Sheet December 31, 2002			Consolidated Balance Sheet December 31, 2001		
	Notional Amount[1]	Fair Value (Pre-Tax)[2]	AOCI[3] (Net of Tax)	Notional Amount[1]	Fair Value (Pre-Tax)[2]	AOCI[3] (Net of Tax)
	(dollars in millions)					
Fair value hedges	$ 144,665	$ 9,032	$ —	$ 83,406	$ 914	$ —
Cash flow hedges	119,999	(8,421)	(5,465)	332,939	(4,412)	(2,737)
No hedge designation[4][5]	913,280	8,815	—	754,433	2,850	—
Subtotal of open derivative positions[3]	1,177,944	9,426	(5,465)	1,170,778	(648)	(2,737)
Balance related to closed derivatives[3]	—	—	(4,412)	—	—	(2,020)
Total	$1,177,944	$ 9,426	$(9,877)	$1,170,778	$ (648)	$(4,757)

Description	Consolidated Statements of Income Year Ended December 31, 2002		Year Ended December 31, 2001	
	Hedge Accounting Gains (Losses)[6]	Derivative Gains (Losses)[3][7]	Hedge Accounting Gains (Losses)[6]	Derivative Gains (Losses)[3][7]
	(dollars in millions)			
Fair value hedges	$241	$ —	$(280)	$ —
Cash flow hedges	(54)	103	(14)	42
No hedge designation[4][5]	—	5,838	—	(1,899)
Total	$187	$5,941	$(294)	$(1,857)

(1) Of the nine Linked Swap pairs, six remained outstanding at December 31, 2001 with a notional amount of $60 billion. These remaining six Linked Swap pairs were terminated during 2002. *See* "FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA — NOTE 1: RESTATEMENT" for further information.
(2) The fair values of derivatives (netted by counterparty) are presented as "Derivative assets, at fair value" and "Derivative liabilities, at fair value" on our consolidated balance sheets.
(3) 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 derivative contracts are recorded in AOCI, net of taxes. Net realized gains and losses on closed (*i.e.*, terminated or redesignated) cash flow hedges for which the related forecasted transaction has not been determined probable of not occurring are also classified in AOCI.
(4) 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 $147 billion and $85 billion at December 31, 2002 and 2001, respectively), fair value gains and losses are reported as "Gain (loss) in investment activity" on our consolidated statements of income and therefore, those fair value gains and losses are not included above.
(5) Includes credit derivatives. *See* "— Credit Risk — *Mortgage Credit Risk* — Mortgage Credit Risk Management Strategies" for more information.
(6) "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* "FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA — NOTE 12: DERIVATIVES".
(7) Includes gains or losses reclassified from AOCI as a result of the termination of cash flow hedge designations.

Effect on Financial Statements. The funding strategy of hedging the variability of cash flows from forecasted issuances of debt with pay-fixed swaps described above is defined as a cash flow hedge under SFAS 133. At December 31, 2002, $120.0 billion notional amount of derivative contracts was designated in cash flow hedge relationships, including $91.2 billion notional amount of pay-fixed swaps and $27.4 billion notional amount of commitments. The current fair value of the derivatives included in cash flow hedging relationships is recorded on the balance sheet as a derivative asset or derivative liability. 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 recorded in the stockholders' equity section of our consolidated balance sheets in AOCI. The effective portion of the derivative generally offsets, on a cumulative basis, the cumulative change in the present value of the hedged forecasted item's cash flows.

As of December 31, 2002, the 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 occurred since SFAS 133 was implemented on January 1, 2001 (net of amounts previously reclassified to earnings through

December 31, 2002) was a loss of approximately $9.9 billion on an after-tax basis. This amount was recorded in AOCI as described above and in *Table 39*.

The $9.9 billion in hedging losses related to cash flow hedges was composed of approximately $5.5 billion in net unrealized derivatives losses on open hedges and approximately $4.4 billion in net realized derivatives losses on closed hedges. The $5.5 billion in unrealized fair value losses on existing cash flow hedges can change substantially due to future changes in interest rates. For example, a decrease in LIBOR generally will increase the amount of unrealized losses recorded in AOCI. An increase in LIBOR generally will decrease unrealized losses or create an unrealized gain to be recorded in AOCI, depending on the magnitude of the rate movement. The increase in unrealized fair value losses on open hedges recorded in AOCI generally should be offset by a reduction in future borrowing costs on related forecasted debt issuances. Conversely, decreases in unrealized losses on pay-fixed swaps generally should be offset by a comparable increase in future borrowing costs.

The remaining portion of the $9.9 billion in hedging losses recorded in AOCI at December 31, 2002 related to $4.4 billion of realized losses on terminated cash flow hedge relationships. Terminated cash flow hedges involve derivatives that have been closed or are no longer designated in cash flow hedge relationships. Fluctuations in prevailing market interest rates have no impact on the realized portion of AOCI relating to losses on terminated cash flow hedges. Therefore, the $4.4 billion in realized losses 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 loss associated with the forecasted transaction will be reclassified into earnings immediately.

Assuming no changes in interest rates or other factors affecting derivative valuations, we estimate that approximately $3.9 billion (net of taxes) of the $9.9 billion of hedging losses (of which $4.4 billion is realized and $5.5 billion is unrealized) in AOCI at December 31, 2002 will be reclassified into earnings in the year ended December 31, 2003. Even though changes in interest rates may cause significant fluctuations in unrealized losses recorded in AOCI and realized losses that are reported in income, these changes should not have a significant effect on our effective funding costs subject to these hedges.

To qualify for cash flow hedge accounting treatment, hedged forecasted issuances of debt must be considered probable. In addition, SFAS 133 imposes a variety of operational requirements that must be met. To the extent that a cash flow hedge relationship fails to qualify for hedge accounting, recognition of related losses included in AOCI would be accelerated.

Table 40 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 by us 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 for counterparties to determine the payments owed between us and our counterparties under the contract. 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, interest-rate swaps have fair values that are a small percentage of their notional amount.

Table 40 — Changes in Derivative Notional Amounts

	Year Ended December 31, 2002			
	Notional or Contractual Amount[1]			
	Beginning Balance	New Contracts	Maturities/ Terminations	Ending Balance
	(dollars in millions)			
Interest-rate swaps				
Pay-fixed	$ 250,461	$ 60,381	$ (175,084)	$ 135,758
Receive-fixed	186,957	136,360	(173,920)	149,397
Basis (floating to floating)	5,353	10,338	(10,750)	4,941
Option-based	408,453	195,927	(314,713)	289,667
Futures	162,987	680,174	(614,750)	228,411
Foreign-currency swaps	23,995	28,698	(9,006)	43,687
Subtotal	$1,038,206	$1,111,878	$(1,298,223)	851,861
Prepayment management agreement[2]				117,219
Commitments				191,563
Credit derivatives[3]				17,301
Total				$1,177,944

	Year Ended December 31, 2001					
	Notional or Contractual Amount[1]					
	Beginning Balance[4]	New Contracts	Maturities/ Terminations	Subtotal	Money Managers[5]	Ending Balance[6]
	(dollars in millions)					
Interest-rate swaps						
Pay-fixed	$143,442	$ 222,723	$ (116,007)	$ 250,158	$ 303	$ 250,461
Receive-fixed	126,473	273,638	(213,562)	186,549	408	186,957
Basis (floating to floating)	7,082	4,491	(6,220)	5,353	—	5,353
Option-based	123,684	435,937	(151,527)	408,094	359	408,453
Futures	22,517	911,223	(772,569)	161,171	1,816	162,987
Foreign-currency swaps	10,865	13,852	(722)	23,995	—	23,995
Forward contracts	1,250	4,150	(5,400)	—	—	—
Subtotal	$435,313	$1,866,014	$(1,266,007)	$1,035,320	$2,886	1,038,206
Commitments						121,588
Credit derivatives[3]						10,984
Total						$1,170,778

(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) *See* "— Interest-Rate Risk Management and Use of Derivatives — Types of Derivatives" for additional information concerning the prepayment management agreement.
(3) *See* "— Credit Risk — *Mortgage Credit Risk* — Mortgage Credit Risk Management Strategies" for additional information on credit derivatives.
(4) As a result of our change from settlement date to trade date accounting for derivative instruments as of January 1, 2001, the beginning balance as of January 1, 2001 decreased from the ending balance as of December 31, 2000 by $1.8 billion.
(5) Ending balances for interest-rate derivatives held by our money managers are shown separately in this table because the activity related to these interest-rate derivatives is not available in 2001.
(6) Of the nine Linked Swap pairs, six remained outstanding at December 31, 2001 with a notional amount of $60 billion. These remaining six Linked Swap pairs were terminated during 2002. *See* "FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA — NOTE 1: RESTATEMENT" for further information.

The total notional amount of our interest-rate derivatives (excluding the prepayment management agreement, commitments and credit derivatives) decreased by $186.3 billion from December 31, 2001 to December 31, 2002. This decrease in notional amount was due primarily to the following three factors:

- A reduction in our use of pay-fixed swaps in response to declining interest rates;
- A reduction in our use of option-based derivatives; and
- Our efforts to close out offsetting derivative positions with various counterparties.

Table 41 summarizes the change in derivative fair values for the periods presented. *See* "— CRITICAL ACCOUNTING POLICIES — Fair Value" for a discussion of how changes in fair values affect our reported financial results. Further detail on derivative assets, which represent our exposure to our derivative counterparties, is provided in *Table 38*.

Table 41 — Changes in Interest-Rate Derivative Fair Values[1]

	Year Ended December 31,	
	2002	2001
	(dollars in millions)	
Beginning balance — Net asset (liability)	$ (537)	$ 630
Less: exchange-traded derivatives[2]	89	42
Adjusted beginning balance	(626)	588
Changes in fair value[3]	4,822	(3,242)
Fair value of new contracts when entered into during the period	2,390	1,664
Contracts realized or otherwise settled during the period	1,793	364
Subtotal	8,379	(626)
Plus: exchange-traded derivatives activity and fair value changes[2]	790	89
Ending balance — Net asset (liability)	$ 9,169	$ (537)

(1) This table excludes commitments to purchase and sell mortgage loans, mortgage-related securities and various debt securities and credit derivatives.
(2) The fair value changes for exchange-traded derivatives are excluded because their fair values are determined by the individual exchanges and not by us.
(3) Activity related to interest-rate derivatives held by our money managers is not available in 2001. The change in fair value of $2 million for these interest-rate derivatives between December 31, 2001 and 2002 is included herein.

Table 42 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. This information is useful in understanding how the fair values have changed over time. 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 42* 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 42 — Derivative Fair Values and Maturities

	As of December 31, 2002					
			Fair Value[2]			
	Notional Amount	Total Fair Value[1]	Less than 1 year	1 to 3 Years	Greater than 3 and up to 5 Years	Greater than 5 years
			(dollars in millions)			
Interest-rate swaps						
Pay-fixed	$ 135,758	$(13,178)	$ (167)	$ (522)	$(2,359)	$(10,130)
Receive-fixed	149,397	7,097	222	910	1,339	4,626
Basis (floating to floating)	4,941	(10)	1	(18)	(1)	8
Option-based	289,667	9,416	3,020	3,189	1,901	1,306
Futures	228,411	790	707	79	4	—
Foreign-currency swaps	43,687	5,054	2,439	1,218	330	1,067
Prepayment management agreement[3]	117,219	—	—	—	—	—
Commitments	191,563	253	253	—	—	—
Subtotal	1,160,643	9,422	$6,475	$4,856	$ 1,214	$ (3,123)
Credit derivatives[4]	17,301	4				
Total	$1,177,944	$ 9,426				

	As of December 31, 2001					
			Fair Value[2][5]			
	Notional Amount	Total Fair Value[1]	Less than 1 year	1 to 3 Years	Greater than 3 and up to 5 Years	Greater than 5 years
			(dollars in millions)			
Interest-rate swaps						
Pay-fixed	$ 250,461	$(10,113)	$ (296)	$(1,864)	$(2,739)	$(5,214)
Receive-fixed	186,957	4,157	306	854	1,573	1,424
Basis (floating to floating)	5,353	(89)	—	(1)	(24)	(64)
Option-based	408,453	5,609	1,373	1,622	1,158	1,456
Futures	162,987	(37)	(13)	(13)	(11)	—
Foreign-currency swaps	23,995	(64)	(83)	64	(33)	(12)
Commitments	121,588	(111)	(111)	—	—	—
Subtotal	1,159,794	(648)	$1,176	$ 662	$ (76)	$(2,410)
Credit derivatives	10,984	—				
Total	$1,170,778	$ (648)				

(1) The fair values for futures are directly derived from quoted market prices. Fair values of other derivatives are derived primarily from valuation models.
(2) Fair value is categorized based on the years from the date presented until the contractual maturity of the derivative.
(3) *See* "— Interest-Rate Risk Management and Use of Derivatives — Types of Derivatives" for additional information concerning the nature of the prepayment management agreement.
(4) *See* "— Credit Risk — Mortgage Credit Risk — Mortgage Credit Risk Management Strategies" for more information about our credit derivatives.
(5) Of the nine Linked Swap pairs, six remained outstanding at December 31, 2001 with a notional amount of $60 billion. These remaining six Linked Swap pairs were terminated during 2002. *See* "FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA — NOTE 1: RESTATEMENT" for further information.

The total fair value of our derivatives increased by $10.1 billion from a net liability position of $0.6 billion as of December 31, 2001 to a net asset position of $9.4 billion as of December 31, 2002. The increase was primarily due to the increase in the fair value of our received-fixed swaps and foreign-currency swaps, partially offset by a decrease in the fair value of our pay-fixed swap position. The increase in fair value of our receive-

fixed swaps and foreign currency swaps was a result of a decline in interest rates and a significant appreciation of the euro relative to the U.S. dollar in 2002.

Table 43 provides a summary of the contractual terms of our pay-fixed and receive-fixed swaps. This table provides information that can be used to assess the effect of interest-rate swaps on net interest yield. It shows how the cash flows of our contractual debt have been effectively altered using swaps to better match mortgage cash flows and provide more stable funding costs.

Table 43 — Contractual Terms of Pay-Fixed and Receive-Fixed Swaps

	December 31, 2002					
	Pay-Fixed/ Receive-Variable			Receive-Fixed/ Pay-Variable		
	Notional	Pay Rate	Receive Rate[1]	Notional	Pay Rate[1]	Receive Rate
	(dollars in millions)					
Swaps						
Maturity less than 1 year	$ 19,950	4.95%	1.52%	$ 18,116	1.45%	2.69%
Maturity 1 to 3 years	7,566	6.21	1.52	29,104	2.10	4.08
Maturity greater than 3 and up to 5 years	27,075	5.22	1.58	20,278	2.38	4.81
Maturity in excess of 5 years	38,153	6.40	1.50	41,680	2.04	5.51
Subtotal	92,744			109,178		
Forward-starting swaps[2]						
Maturity 1 to 3 years	—	—	—	2,646	—	2.65
Maturity greater than 3 and up to 5 years	54	4.15	—	2,533	—	5.69
Maturity in excess of 5 years	42,960	6.63	—	35,040	—	5.43
Subtotal	43,014			40,219		
Total	$135,758			$149,397		

	December 31, 2001					
	Pay-Fixed/ Receive-Variable			Receive-Fixed/ Pay-Variable		
	Notional	Pay Rate	Receive Rate[1]	Notional	Pay Rate[1]	Receive Rate
	(dollars in millions)					
Swaps[3]						
Maturity less than 1 year	$ 17,352	6.12%	2.25%	$ 21,029	2.03%	5.51%
Maturity 1 to 3 years	51,524	5.40	2.15	24,462	2.47	5.38
Maturity greater than 3 and up to 5 years	82,816	5.76	2.13	35,767	2.41	6.01
Maturity in excess of 5 years	70,641	6.57	2.13	52,331	2.36	6.24
Subtotal	222,333			133,589		
Forward-starting swaps[2]						
Maturity 1 to 3 years	49	3.95	—	5,055	—	6.45
Maturity greater than 3 and up to 5 years	—	—	—	24,645	—	5.32
Maturity in excess of 5 years	28,079	7.30	—	23,668	—	5.93
Subtotal	28,128			53,368		
Total	$250,461			$186,957		

(1) The weighted-average rate payable and receivable is as of the date indicated. Because the rates of the swaps are floating, these rates may change as prevailing interest rates change. The variable legs of these swaps are generally based on LIBOR or Euro Interbank Offered Rate, or EURIBOR.

(2) 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. These swaps are categorized based on the contractual maturity from the date indicated.

(3) Of the nine Linked Swap pairs, six remained outstanding at December 31, 2001 with a notional amount of $60 billion. These remaining six Linked Swap pairs were terminated during 2002. *See* "FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA — NOTE 1: RESTATEMENT" for further information.

As of December 31, 2002, the notional amount of our receive-fixed swaps was moderately higher than the notional amount of pay-fixed swaps. The notional amount of our net receive-fixed swap position was $13.6 billion, representing $149.4 billion of receive-fixed swaps less $135.8 billion of pay-fixed swaps. As shown in *Table 43*, the net receive-fixed swap position effectively results in payments at rates similar to short-term debt.

Measurement of Interest-Rate Risk

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). The LIBOR yield curve is used to estimate PMVS. The effects on portfolio market value from changes in the LIBOR yield curve are the same as those that would result from comparable changes in the Treasury yield curve.

- PMVS-L shows the estimated loss in pre-tax portfolio market value, expressed as a percentage of our fair value of net assets attributable to common stockholders (measured as FVBS 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 curve increases or decreases by 50 basis points). The periodic disclosure reflects the average of the daily PMVS-L estimates for a given reporting period (a month, quarter or year).

  We believe the use of an immediate 50 basis point shift in interest rates is a conservative estimate of interest-rate risk. This estimate does not take into account any rebalancing actions that we would typically take to reduce risk exposure.

- PMVS-YC shows the estimated loss in pre-tax portfolio market value, expressed as a percentage of our fair value of net assets attributable to common stockholders, from an immediate adverse 25 basis point change in the slope of the LIBOR yield curve. The periodic disclosure 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. 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 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-bearing assets and liabilities (including short-term interest-bearing assets and 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 guarantee-related items, including net buy-ups (upfront payments made by us which increase the guarantee fee that we will receive in connection with our PC guarantee) and expected gains/losses due to net interest from security program cycles. In calculating the expected loss in portfolio market value and duration gap, management does 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 management believes the expected benefits from replacement business provide an adequate hedge against interest-rate changes.

- *Other assets with minimal interest-rate sensitivity.* Other assets, primarily including non-financial instruments such as fixed assets and REO, are not included in the calculation of the expected loss in portfolio market value or duration gap because of the minimal impact they would have on both PMVS and duration gap.

However, the fair values of these two items are included in the estimate of the 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 measures provide useful estimates of key interest-rate risk exposures. These estimates are determined using models that involve assumptions made by management in its best judgment. In addition, in the case of PMVS, daily calculations are based on an estimate of FVBS net assets since a complete FVBS is currently produced only on an annual basis. Accordingly, while we believe that PMVS and duration gap are useful risk management tools, they should be understood as estimates rather than precise measurements. Management's objective is to provide quarterly estimates of the FVBS net assets for quarterly 2004 financial results subject to meeting our objective to return to timely financial reporting. *See* "EXPLANATORY NOTE" for more information.

Calculation of PMVS Measures. We calculate PMVS-L and PMVS-YC every business day. The 25 basis point change in slope for the PMVS-YC measure is obtained by shifting the 2-year and 10-year LIBOR rates by an equal amount (12.5 basis points), but in opposite directions. LIBOR rate shifts between the 2-year and 10-year points are interpolated in a linear fashion. For each of PMVS-L and PMVS-YC, the more adverse loss on a pre-tax basis under both scenarios is then expressed as a percentage of the after-tax fair value of net assets attributable to common stockholders. These percentages represent the PMVS-L and PMVS-YC data points for the day. The reported monthly PMVS-L and PMVS-YC figures are an average of the daily figures. *See Table 7* under "— RESTATEMENT RESULTS — *Restatement Effect on Interest-Rate Risk Measures*" for certain restated monthly PMVS figures. Neither PMVS-L nor PMVS-YC includes the effect on fair value of any rebalancing actions, despite the fact that we undertake frequent rebalancing actions that would reduce our exposure to loss in fair value relative to potential losses the PMVS measure estimates.

Table 44 provides estimated PMVS-L and PMVS-YC as of December 31, 2002 and December 31, 2001 (PMVS-YC disclosure was initiated as of March 31, 2001). To supplement the PMVS-L results based on an assumed 50 basis point shift in LIBOR rates, *Table 44* also provides year-end PMVS-L estimates assuming an immediate 100 basis point shift in LIBOR rates. 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 44*, the PMVS-L results based on a 100 basis point shift in the LIBOR curve are disproportionately higher than the PMVS-L results based on a 50 basis point shift in the LIBOR curve.

Table 44 — Portfolio Market Value Sensitivity Assuming Shifts of the LIBOR Yield Curve on Stated Dates

	Portfolio Market Value Sensitivity			Potential Dollar Loss in Portfolio Market Value (millions)		
	PMVS-YC	PMVS-L		PMVS-YC	PMVS-L	
	25 bp	50 bp	100 bp	25 bp	50 bp	100 bp
As of:						
December 31, 2002	1.9%	1.3%	4.2%	$356	$236	$ 764
December 31, 2001 (as restated)	0.2%	2.3%	8.4%	23	323	1,161
December 31, 2001 (as reported)	0.3%	2.2%	8.8%	36	262	1,031

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 protect the fair value of our stockholders' equity from large changes in interest rates.

Table 45 shows that the low PMVS-L average 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.

As discussed above, PMVS-YC is determined by shifting the slope of the LIBOR yield curve between the 2-year and 10-year points. We use derivatives across the entire yield curve in hedging our exposure to interest-rate risk. As liquidity and market conditions change, particularly in the 10-year sector, our use of derivatives may, from time to time, result in an increase in PMVS-YC. For example, our use of derivatives resulted in a significant decrease in overall interest-rate risk as measured by PMVS-L but also caused a small increase in PMVS-YC as of December 31, 2002.

Table 45 — Derivative Impact on PMVS

	Before Derivatives	After Derivatives	Effect of Derivatives
As of December 31, 2002			
PMVS-L (50bp)	19.2%	1.3%	17.9%
PMVS-YC (25bp)	0.9%	1.9%	(1.0)%
As of December 31, 2001			
PMVS-L (50bp)	14.2%	2.3%	11.9%
PMVS-YC (25bp)	0.2%	0.2%	0.0%

Calculation of Duration Gap Measure. 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-bearing assets and expressed in months. Our duration gap is publicly disclosed monthly and is the average of each day's calculated duration gap.

Table 46 — Duration Gap

Monthly Average	Duration Gap (in months)
December 2002	0
December 2001	1

Credit Risk

We are subject 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. We are subject to credit risk on our total mortgage portfolio, which is described in *Table 47*.

Table 47 — Composition of Total Mortgage Portfolio[(1)(2)]

	Year Ended December 31,			
	2002		2001	
	Dollars in Millions	% of Total Mortgage Portfolio	Dollars in Millions	% of Total Mortgage Portfolio
Mortgage loans	$ 63,886	5%	$ 62,792	5%
Freddie Mac mortgage-related securities[(3)]				
Outstanding PCs and Structured Securities[(4)]	729,225	55	631,150	55
PCs and Structured Securities in the retained portfolio	341,287	26	308,427	27
Other PCs and Structured Securities held by Freddie Mac[(5)]	20,112	2	21,934	2
Total PCs issued and Structured Securities backed by non-Freddie Mac mortgage-related securities[(7)]	1,090,624	83	961,511	84
Non-Freddie Mac mortgage-related securities[(6)]				
Agency mortgage securities	83,707	6	76,827	7
Non-agency mortgage securities	78,392	6	49,593	4
Total non-Freddie Mac mortgage-related securities	162,099	12	126,420	11
Total mortgage portfolio	$1,316,609	100%	$1,150,723	100%

(1) Based on the UPB. *See Table 2* for a reconciliation of the retained portfolio based on UPB to "Retained portfolio" on the consolidated balance sheets.
(2) Excludes mortgage loans and mortgage-related securities traded but not yet settled.
(3) Includes $8.6 billion and $13.1 billion of Structured Securities backed by Ginnie Mae Certificates for December 31, 2002 and 2001, respectively. Also includes approximately $5 billion and $3 billion at December 31, 2002 and 2001, respectively, of housing authority bonds that were issued by third parties to fund the origination of multifamily mortgage loans and for which Freddie Mac provided a credit guarantee.
(4) Reported UPB of Structured Securities relates only to that portion of issued Structured Securities that is backed by non-Freddie Mac mortgage-related securities.
(5) Represents PCs held by Freddie Mac in connection with PC market-making and support activities, which are reflected in the "Investments" caption on the consolidated balance sheets.
(6) *See Table 63* for additional detail on our non-Freddie Mac mortgage-related securities.

Our total mortgage portfolio consists of mortgage loans, Freddie Mac mortgage-related securities (including both PCs and Structured Securities backed by non-Freddie Mac mortgage-related securities held by third parties and PCs and Structured Securities backed by non-Freddie Mac mortgage-related securities held by us) and non-Freddie Mac mortgage-related securities that are held by us.

Mortgage Credit Risk

Mortgage credit risk is the risk that we will not receive timely payments of principal and interest due from mortgage borrowers because of borrower defaults. This could result in losses if we are unable to collect amounts due through the sale of the underlying property, restructuring of the mortgage loan or the use of other loss mitigation activities. 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 consist of four primary activities:

- Establishing and enforcing sound underwriting and quality control standards to evaluate the credit quality of the mortgage loans we securitize and purchase;
- Obtaining credit enhancements on higher-risk mortgages to secure partial protection against the risk of credit losses;
- Monitoring and managing portfolio diversification; and
- Executing loss mitigation activities to resolve non-performing loans and reduce our overall exposure to credit losses.

Underwriting and Quality Control Standards. We seek to ensure that the mortgages we securitize and purchase are protected by the borrower's willingness and ability to repay the mortgage obligation and by adequate equity in the underlying property. Automated underwriting software tools, such as Loan Prospector®, and other quantitative credit risk management tools are used to evaluate and monitor mortgage credit risk for single-family mortgages. Loan Prospector combines LTV ratios, credit scores and other mortgage and borrower characteristics to generate credit risk classifications. These statistically based risk assessments increase our ability, and the ability of mortgage lenders, to distinguish among single-family loans based on their likelihood of default.

From 2000 through 2002, Loan Prospector was used to evaluate approximately 60 percent 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. We also manage the quality of our single-family mortgage purchases by monitoring mortgage seller/servicers' compliance with our underwriting standards through quality control reviews, on-site audits and investigations of situations involving possible fraud. Particular focus is placed on performing quality control reviews of mortgage loans identified as high-risk. Mortgage seller/servicers represent and warrant to us that mortgages are originated in compliance with our underwriting standards. We may require the seller/servicer to repurchase or accept losses on certain loans that do not comply with our underwriting standards.

For multifamily mortgages, we have an intensive underwriting process in which personnel from one of our regional offices underwrite nearly every mortgage we purchase. Our underwriting process includes physical inspections of properties as well as assessments of the local market, the borrower, the property manager, the property's historical and projected financial performance and the property's physical condition. 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 LTV ratios above 80 percent at the time of purchase be covered by (i) mortgage insurance or (ii) 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. Mortgages covered by MI and these other credit protections are referred to as credit-enhanced mortgages. Proceeds received from these credit enhancements are applied to offset credit losses related to individual mortgage loans that default.

Table 48 shows the credit-enhanced portion of our total mortgage portfolio (excluding non-Freddie Mac mortgage-related securities and securities issued by us that are backed by Ginnie Mae Certificates).

Table 48 — Credit-Enhanced Percentage of the Total Mortgage Portfolio[1]

	December 31,	
	2002	2001
Credit-enhanced[2]	27%	35%

(1) Based on the total mortgage portfolio excluding non-Freddie Mac mortgage-related securities and that portion of issued Structured Securities that is backed by Ginnie Mae Certificates. Non-Freddie Mac mortgage-related securities are excluded from this table because they expose us primarily to institutional credit risk or are rated by one or more rating agencies. 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 minimus. *See Table 63* for additional information about our non-Freddie Mac mortgage-related securities.

(2) Credit enhancements include loans for which the lender or a third party has retained primary default risk by pledging collateral or agreeing to accept losses on loans that default. In 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) that was credit-enhanced decreased from 2001 to 2002. This decrease was primarily due to a high level of refinance loans acquired in 2002, which tend to have lower LTV ratios and therefore do not require credit enhancements. Our ability and desire to expand the credit-enhanced portion of our total mortgage portfolio 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 on credit-enhanced business.

Primary loan-level mortgage insurance, or primary MI, is the most prevalent type of credit enhancement protecting our total mortgage portfolio and is obtained and paid for by borrowers on a loan level basis for single-family mortgages. Primary MI transfers a significant portion of the credit risk associated with the mortgage to the insurer. Beginning in the second quarter of 2002, we revised our reporting for mortgages covered by primary MI so that they are now included in our credit-enhanced portfolio. We believe this presentation provides a more comprehensive depiction of the credit enhancement that we have on our total mortgage portfolio (excluding non-Freddie Mac mortgage-related securities and that portion of issued Structured Securities that is backed by Ginnie Mae Certificates) than the previous measure, which excluded mortgages covered by primary MI from the credit-enhanced category. This change has been retroactively applied to previous periods for comparability purposes.

After primary MI, pool insurance is the next most prevalent type of credit enhancement protecting our total mortgage portfolio (excluding non-Freddie Mac mortgage-related securities and that portion of issued Structured Securities that is backed by Ginnie Mae Certificates). With pool insurance, a mortgage insurer provides insurance on a pool of loans up to a stated aggregate loss limit. Our pool insurance contracts typically cover losses ranging between about 0.70 percent and 1.60 percent of the aggregate original UPB 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 reinsurance (an indemnity arrangement in which we pass all or a portion of the mortgage credit risk to another insurer), collateral (including cash or high-quality marketable securities) pledged by a lender, and recourse agreements (under which we may require a lender to repurchase loans that default).

For multifamily mortgages, we occasionally utilize credit enhancements to mitigate risk. The types of credit enhancements used for multifamily loans include recourse, third-party guarantees or letters of credit, purchases of senior participations in mortgages 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 foreclose on more than one property owned by the borrower to mitigate credit losses. With a cross-collateralization provision, borrowers are required to use cash flows from more than one property to ensure the timely payment of principal and interest for the mortgage on any property.

While the use of credit enhancements reduces our exposure to mortgage credit risk, it increases our exposure to institutional credit risk, which is the risk that the provider of the credit enhancement may not meet its contractual obligations. *See* "— *Institutional Credit Risk*" for more information.

Portfolio Diversification. As part of our credit risk management practices, we monitor certain mortgage loan characteristics such as product mix, LTV ratios and geographic concentration, which may affect the default experience on our mortgage portfolio.

Product Mix. *Table 49* presents the distribution of total PCs issued and Structured Securities backed by non-Freddie Mac mortgage-related securities.

Table 49 — Product Distribution of Total PCs Issued and Structured Securities backed by non-Freddie Mac Mortgage-Related Securities[(1)(6)]

	December 31,			
	2002		2001	
	Dollars in Millions	% of Total	Dollars in Millions	% of Total
Total PCs issued and Structured Securities backed by non-Freddie Mac mortgage-related securities				
30-year fixed-rate[(2)]	$ 696,803	64%	$ 676,283	71%
15-year fixed-rate	262,606	24	185,971	19
ARMs/floating-rate[(3)]	66,627	6	47,977	5
Alternative collateral deals[(4)]	24,454	2	17,113	2
Balloon/resets[(5)]	22,501	2	13,589	1
Structured Securities backed by Ginnie Mae Certificates	8,561	1	13,102	1
Total single-family	1,081,552	99	954,035	99
Multifamily	9,072	1	7,476	1
Total PCs issued and Structured Securities backed by non-Freddie Mac mortgage-related securities[(6)]	$1,090,624	100%	$ 961,511	100%

(1) Excludes mortgage loans and mortgage-related securities traded but not yet settled.
(2) Also includes 20-year fixed-rate mortgages.
(3) Includes ARMs with 1-,3-, 5-, 7- and 10-year initial fixed-rate periods.
(4) Includes Structured Securities backed by non-agency mortgage-related securities, which are typically backed by subprime mortgage loans.
(5) 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.
(6) Reported UPB of Structured Securities relates only to that portion of issued Structured Securities that is backed by non-Freddie Mac mortgage-related securities.

Product mix affects the credit risk profile of our mortgage portfolio. In general, 15-year fixed-rate mortgages exhibit the lowest default rate among the types of single-family mortgages 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.

Alternative collateral deals primarily include Structured Securities that we issue that are backed by non-agency mortgage-related securities whose underlying assets are subprime mortgages. The subprime segment of the mortgage market primarily serves borrowers with a higher risk of default. Although default rates on subprime mortgages are typically the highest among single-family mortgage loans, we participate in the subprime market segment in order to help standardize lending practices, increase the availability of mortgage credit and reduce the costs of homeownership for a broader spectrum of borrowers. Our charter does not limit

our participation in this market segment to any greater extent than it limits our other activities. However, as part of our comprehensive risk management system we have established internal limits on our subprime exposure. In addition, we mitigate our subprime credit exposure through significant credit enhancements.

We participate in the subprime market segment in two ways. First, we guarantee securities backed by subprime mortgages. These securities have previously been significantly credit-enhanced, and we obtain "shadow ratings" on these securities, which assess the risks of the securities without regard to the benefit of our guarantee. At the time of purchase these securities were rated at least "BBB" (based on the S&P rating scale) by at least one nationally recognized credit rating agency. These securities are included in the "Alternative collateral deals" portion of our total mortgage portfolio shown in *Table 49*. We purchase some of these guaranteed securities as investments for our retained portfolio. Second, 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. 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 63*.

LTV Ratios. Our principal safeguard against credit losses for mortgage loans in our single-family, non-credit-enhanced portfolio is provided by the borrowers' equity in the underlying properties. Mortgage loans with higher LTV ratios (lower levels of borrower equity) at the time of purchase are also protected by credit enhancements, since our charter requires that loans with LTV ratios above 80 percent at the time of purchase be covered by MI 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 the LTV ratio at the date of mortgage origination and the estimated current LTV ratio, which compares the current UPB of the mortgage to the estimated current market value of the property underlying the mortgage. Historical experience has shown that defaults are less likely to occur on mortgages with lower estimated current LTV 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.

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) by original and estimated current LTV ratio ranges is shown in *Tables 50* and *51*, respectively.

Table 50 — Original LTV Ratio Range[1]

	December 31,		
	2002	2001	2000
<= 70%	36%	33%	33%
Above 70% to 80%	43	43	41
Above 80% to 90%	11	13	14
Above 90% to 95%	8	10	10
Above 95%	2	1	2
Total	100%	100%	100%
Average original LTV ratio	72%	74%	74%

(1) LTV ratios are shown for 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 $1,084 billion, $964 billion and $847 billion at December 31, 2002, 2001 and 2000, respectively.

Table 51 — Estimated Current LTV Ratio Range[1] [2] [3]

	December 31,		
	2002	2001	2000
<= 70%	64%	65%	68%
Above 70% to 80%	22	21	18
Above 80% to 90%	9	9	9
Above 90% to 95%	3	3	3
Above 95%	2	2	2
Total	100%	100%	100%
Average estimated current LTV ratio	61%	61%	60%

(1) LTV ratios are shown for the single-family mortgage portfolio (excluding non-Freddie Mac mortgage-related securities, alternative collateral deals and that portion of Structured Securities that is backed by Ginnie Mae Certificates).
(2) 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.
(3) The methodology for adjusting property values was revised effective with 2002 reporting. Market value adjustments are applied to new purchases after two quarters instead of after four quarters. Prior periods have been revised for comparability purposes.

Geographic Concentration. We seek to mitigate the potential adverse effect of changing local and regional economic conditions on our credit results by maintaining a geographically diverse mortgage portfolio. *Table 52* shows 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 portfolio's geographic distribution was relatively constant from 2001 to 2002, and remains broadly diversified across these five regions.

Table 52 — Geographic Concentration of the Total Mortgage Portfolio[1]

	December 31,			
	2002		2001	
	Dollars in Millions	% of Total Mortgage Portfolio	Dollars in Millions	% of Total Mortgage Portfolio
By Region[2]				
West	$ 294,681	26%	$ 263,921	26%
Northeast	264,843	23	238,605	24
North central	244,509	21	207,313	21
Southeast	200,476	18	176,846	17
Southwest	141,440	12	124,516	12
	$1,145,949	100%	$1,011,201	100%

(1) Based on the total mortgage portfolio, excluding non-Freddie Mac mortgage-related securities and that portion of Structured Securities that is backed by Ginnie Mae Certificates.
(2) *See* "FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA — NOTE 18: CONCENTRATION OF CREDIT RISK" for a description of these regions.

Loss Mitigation Activities. Despite our rigorous underwriting standards, some mortgage loans will become non-performing due to changes in general economic conditions, changes in the financial status of individual borrowers or other factors.

Table 53 summarizes our non-performing assets. The increase in our non-performing assets from 2000 through 2002 was primarily driven by the softening economy and an increase in unemployment.

Table 53 — Non-Performing Assets

	December 31,		
	2002	2001	2000
	(dollars in millions)		
Troubled debt restructurings, or TDRs[1]	$ 2,164	$1,617	$1,389
Serious delinquencies[2]	7,231	5,352	3,754
Non-accrual loans[3]	47	44	9
Subtotal[4]	9,442	7,013	5,152
REO, net	594	447	358
Total	$10,036	$7,460	$5,510

(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 UPB of mortgage loans. *See* "FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA — NOTE 6: LOAN LOSS RESERVES" 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. Includes seriously delinquent loans in alternative collateral deals which totaled $2,290 million, $1,052 million and $529 million for 2002, 2001 and 2000, respectively. *See* the discussion related to alternative collateral deal delinquencies following *Table 55*.
(3) Non-accrual loans are loans for which interest income is recognized only on a cash basis. Only multifamily mortgage loans that are 90 days or more delinquent are classified as non-accrual. 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, except when management believes the collection of principal and interest is doubtful. We establish reserves for uncollectible interest that are estimated using statistical models, which quantify accrued but unpaid interest at the balance sheet date. Loans placed on non-accrual status are considered part of our impaired loan population.
(4) For 2002, $483 million was included in net interest income and management and guarantee income related to these loans. Had these loans been current, we would have recorded $45 million of additional net interest income and additional management and guarantee income.

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 proceeding to foreclosure and, ultimately, mitigate our total credit losses by eliminating a portion of the costs related to foreclosed properties. *Table 54* summarizes the different types of single-family foreclosure alternatives.

Table 54 — Single-Family Foreclosure Alternatives[1]

	December 31,		
	2002	2001	2000
	(number of loans)		
Foreclosure Alternatives			
Repayment plans	32,672	28,956	16,295
Loan modifications	7,951	5,107	3,920
Forbearance agreements	2,798	3,103	2,998
Pre-foreclosure sales[2]	1,531	1,222	1,291
Foreclosure alternatives	44,952	38,388	24,504

(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) This amount includes third party sales and other foreclosure alternatives.

The increase in foreclosure alternatives from 2000 through 2002 was primarily driven by the increase in single-family delinquencies. Repayment plans, the most common type of foreclosure alternative, mitigate our credit losses because they assist borrowers in returning to compliance with the original terms of their mortgages. Loan modifications, the second most common type of foreclosure alternative, involve changing the terms of a mortgage and therefore are a more favorable alternative during a declining mortgage rate environment, such as we experienced during 2001 and 2002. In some cases, a mortgage may go through a foreclosure alternative more than once or may go through more than one type of foreclosure alternative.

We continue to strengthen our single-family loss mitigation activities by developing default management tools designed to help single-family servicers manage non-performing loans more effectively. These innovations include Early Indicator®, a system that estimates the probability that delinquent loans will be resolved or advance through to a loss-producing state. In addition, we use Servicer Performance Profile reports to evaluate the performance of our mortgage servicers based on their management of performing and non-performing loans.

We typically require multifamily servicers to closely manage mortgage loans they have sold us in order to mitigate potential losses. Approximately once a year, 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 which gives the borrower an opportunity to bring the loan current and allows the borrower to retain ownership of the property. Since mortgage 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 ensure compliance with our standards.

Other Credit Risk Management Activities. We also participate in other activities such as risk-based pricing, 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, help us manage purchase quality, and/or otherwise ensure adequate returns.

In accordance with our *Single-Family Seller/Servicer Guide* or as otherwise agreed with seller/servicers, certain mortgages are subject to delivery fees in addition to periodic management and guarantee fees (swap transactions) or stated price (cash transactions). These fees represent up-front pricing terms based on credit risk factors including the mortgage product type, loan purpose and/or other attributes.

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.

We have also entered into risk-sharing agreements that are accounted for as derivatives in accordance with SFAS 133. In part because the agreements contractually may result in payments by us 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 SFAS 133. 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. The total notional amount of mortgage loans subject to these agreements was approximately $17.3 billion at December 31, 2002. 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" line on the consolidated balance sheets and totaled approximately $4 million in assets at December 31, 2002.

Although these arrangements are part of our overall credit risk management strategy, they are not considered to be credit enhancements for purposes of describing our portfolio characteristics (*see Table 48* — Credit-Enhanced Percentage of the Total Mortgage Portfolio). This is because risk-based pricing fees are determined at the time of delivery (rather than being received by us only if there is a credit event), and the financial incentive and credit derivative agreements may result in payments by us to the seller/servicer.

Credit Performance. The effectiveness of our credit risk management activities is reflected primarily 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). We may incur a credit loss when a borrower fails to make a mortgage payment, or is delinquent, and we either institute a foreclosure alternative or foreclose on the property. *See "— Mortgage Credit Risk Management Strategies —*

Loss Mitigation Activities" for more information. Credit losses are offset in some cases by payments received from credit enhancements. Several key statistics that affect our credit losses are detailed in the tables below.

Delinquencies. Table 55 summarizes the delinquency performance of our single-family and multifamily mortgage portfolios. *Table 56* and *Table 57* provide a more detailed analysis of single-family delinquencies, by geographic region and year of origination.

Table 55 — Delinquency Performance[1]

	Year Ended December 31,		
	2002	2001	2000
Single-family[2]			
Non-credit-enhanced portfolio			
Delinquency rate	0.29%	0.30%	0.29%
Total number of delinquent loans	21,426	20,133	17,294
Credit-enhanced portfolio[3][4]			
Delinquency rate	2.06%	1.29%	0.84%
Total number of delinquent loans	58,288	41,449	28,005
Total portfolio[3]			
Delinquency rate	0.77%	0.62%	0.49%
Total number of delinquent loans	79,714	61,582	45,299
Multifamily[5]			
Total portfolio			
Delinquency rate	0.13%	0.15%	0.04%
Net carrying value of delinquent loans (in millions)	$ 49	$ 44	$ 9

(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) Subsequent to the announcement of our restatement results in our November 21, 2003 Information Statement Supplement, we revised the results for the delinquency statistics for the credit-enhanced portfolio. The impact of this change on delinquency rate was a decrease of 0.01% and 0.09% for the years ended December 31, 2002 and 2001, respectively. The impact of this change on total number of delinquent loans was a decrease of 143 loans and 2,900 loans for the same periods, respectively.
(5) Based on net carrying value of mortgages 60 days or more delinquent or in foreclosure.

The single-family total portfolio delinquency rate increased by 0.15 percent from year-end 2001 to 0.77 percent at December 31, 2002. This increase was driven by the single-family credit-enhanced delinquency rate, which increased by 0.77 percent from year-end 2001 to 2.06 percent at December 31, 2002. The increase in the credit-enhanced delinquency rate was primarily due to rising delinquencies in alternative collateral deals. Alternative collateral deals typically experience delinquency rates that are significantly higher than prime conventional loans, but the securities that we guarantee in these deals are significantly credit enhanced. The single-family total portfolio delinquency rate excluding these alternative collateral deals was 0.53 percent, 0.50 percent and 0.42 percent for the years ended December 31, 2002, 2001 and 2000, respectively. The multifamily delinquency rate was 0.13 percent at December 31, 2002, down slightly from 0.15 percent at December 31, 2001.

Table 56 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 56 — Single-Family — Non-Credit-Enhanced Delinquencies — By Region[(1)(2)]

	Year Ended December 31,		
	2002	2001	2000
Northeast	0.30%	0.37%	0.37%
Southeast	0.35	0.31	0.28
North central	0.28	0.26	0.22
Southwest	0.28	0.25	0.22
West	0.23	0.29	0.30
Total	0.29%	0.30%	0.29%

(1) Based on the number of mortgages 90 days or more delinquent or in foreclosure.
(2) *See* "FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA — NOTE 18: CONCENTRATION OF CREDIT RISK" for a description of these regions.

While total non-credit-enhanced delinquency rates were relatively unchanged, regional delinquency trends varied, reflecting the different regional impacts of the softening economy in 2002. The southeast, southwest and north central regions had increasing delinquency rates, while the northeast and west had declining delinquency rates.

Table 57 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 57 — Single-Family — Mortgage Portfolio and Non-Credit-Enhanced Delinquencies — By Year of Origination

	December 31,					
	2002		2001		2000	
	Percent of Single-Family Balance[(1)]	Non-Credit-Enhanced Delinquency Rate	Percent of Single-Family Balance[(1)]	Non-Credit-Enhanced Delinquency Rate	Percent of Single-Family Balance[(1)]	Non-Credit-Enhanced Delinquency Rate
Year of Origination						
Pre-1995	8%	0.50%	14%	0.48%	21%	0.44%
1995	1	0.79	2	0.66	4	0.51
1996	2	0.70	4	0.61	6	0.47
1997	3	0.54	5	0.37	8	0.23
1998	11	0.28	19	0.20	27	0.12
1999	8	0.46	15	0.29	21	0.13
2000	3	0.95	8	0.42	13	0.06
2001	26	0.19	33	0.04	—	—
2002	38	0.05	—	—	—	—
Total	100%	0.29%	100%	0.30%	100%	0.29%

(1) 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.

Our portfolio distribution by origination year was affected by heavy refinance volumes in recent years. As of December 31, 2002, almost two-thirds of our single-family mortgage portfolio consisted of mortgage loans originated in 2001 or 2002. Mortgage loans originated in 1999 and earlier, which represent only about one-third of our single-family mortgage portfolio, are in their peak default periods as evidenced by delinquency rates which are generally higher than the overall portfolio delinquency rate. Mortgages in our single-family portfolio that were originated in 2000, a year in which mortgage originations were largely purchase money mortgages rather than refinancings, are generally of weaker credit quality and have experienced higher than average early defaults and delinquency rates, but only represent 3 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 58* provides detail on our credit loss performance, including REO activity, charge-offs and credit losses.

Table 58 — Credit Loss Performance

	Year Ended December 31,		
	2002	2001	2000
	(dollars in millions)		
REO			
REO balances:			
Single-family	$ 593	$ 446	$ 356
Multifamily	1	1	2
Total	$ 594	$ 447	$ 358
REO activity (number of units):[1]			
Beginning property inventory	5,713	4,564	5,617
Properties acquired	13,520	10,091	9,531
Properties disposed	(12,011)	(8,942)	(10,584)
Ending property inventory	7,222	5,713	4,564
Average holding period (in days)[2]	186	187	189
REO operations expense (income):			
Single-family	$ (13)	$ 6	$ (5)
Multifamily	—	1	1
Total	$ (13)	$ 7	$ (4)
CHARGE-OFFS			
Single-family:			
Foreclosure alternatives, gross	$ 46	$ 33	$ 27
Recoveries[3]	(17)	(12)	(13)
Foreclosure alternatives, net	29	21	14
REO acquisitions, gross	124	95	96
Recoveries[3]	(65)	(77)	(39)
REO acquisitions, net	59	18	57
Single-family totals:			
Charge-offs, gross	170	128	123
Recoveries[3]	(82)	(89)	(52)
Single-family charge-offs, net	88	39	71
Multifamily:			
Multifamily totals:			
Charge-offs, gross	1	1	1
Recoveries[3]	(2)	(3)	(5)
Multifamily charge-offs, net	(1)	(2)	(4)
Total Charge-offs:			
Charge-offs, gross	171	129	124
Recoveries[3]	(84)	(92)	(57)
Charge-offs, net	$ 87	$ 37	$ 67
CREDIT LOSSES (GAINS)[4]			
Single-family	$ 75	$ 45	$ 66
Multifamily	(1)	(1)	(3)
Total	$ 74	$ 44	$ 63
In basis points:[5]			
Single-family	0.7	0.5	0.8
Multifamily	—	—	—
Total	0.7	0.5	0.8

(1) Includes single-family and multifamily REO properties.
(2) Represents weighted average holding period for single-family and multifamily REO properties, based on REO balances.
(3) Includes recoveries of charge-offs primarily resulting from foreclosure alternatives and REO acquisitions on loans where the primary 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) Equal to REO operations expense (income) plus Charge-offs, net.
(5) Calculated as credit losses (gains) 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 very strong credit performance during 2002, driven by effective risk management and the sustained strength of the single-family housing market. The following discussion provides additional detail on key credit loss-related statistics and results.

When we foreclose on a property, it becomes 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 2002, both in terms of dollar amount and number of properties held. The single-family REO balance was $593 million at December 31, 2002, up from $446 million and $356 million at December 31, 2001 and 2000, respectively. The increase in the single-family REO balance during 2002 is consistent with rising delinquency rates and general softening in the economy. Although REO inventories increased, single-family REO income (expense) improved from an expense of $6 million in 2001 to income of $13 million in 2002, largely due to strong house-price growth and credit enhancement recoveries. 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, 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 from $39 million in 2001 to $88 million in 2002, largely due to increased REO acquisitions as described above. Charge-offs, net are reflected on our consolidated balance sheets as a reduction in loan loss reserves. (*See Table 61* — Loan Loss Reserves Activity for more information.)

Credit losses remained relatively low in 2002 for both single-family and multifamily mortgage portfolios. Single-family credit losses totaled $75 million, or 0.7 basis points of the average total mortgage portfolio, in 2002. This represents a slight increase from the historically low levels of single-family credit losses experienced in 2001 ($45 million or 0.5 basis points) and is in line with credit losses experienced in 2000 ($66 million or 0.8 basis points). Multifamily experienced a credit gain of $1 million in 2002, unchanged from 2001 and down slightly from a gain of $3 million in 2000.

Table 59 and *Table 60* 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. The southeast, north central and southwest regions experienced the largest increases in REO acquisitions in 2002 compared to 2001, while the northeast and west regions experienced only modest increases or declined slightly.

Table 59 — REO Activity by Region[1]

	Year Ended December 31,		
	2002	2001	2000
	(number of units)		
REO Inventory			
Properties in inventory — beginning of period	5,713	4,564	5,617
Properties acquired by region:			
Northeast	1,683	1,784	2,343
Southeast	3,533	2,398	1,831
North central	3,180	1,959	1,435
Southwest	2,435	1,513	1,110
West	2,689	2,437	2,812
Total properties acquired	13,520	10,091	9,531
Properties disposed by region:			
Northeast	(1,798)	(1,959)	(2,627)
Southeast	(3,012)	(1,895)	(1,789)
North central	(2,420)	(1,577)	(1,414)
Southwest	(2,019)	(1,150)	(1,175)
West	(2,762)	(2,361)	(3,579)
Total properties disposed	(12,011)	(8,942)	(10,584)
Properties in inventory — end of period	7,222	5,713	4,564

(1) *See* "FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA — NOTE 18: CONCENTRATION OF CREDIT RISK" for a description of these regions.

Table 60 — Single-Family Charge-offs and Recoveries by Region[1] [2]

	Year Ended December 31,		
	2002	2001	2000
	(dollars in millions)		
Northeast			
Charge-offs	$ 27	$ 25	$ 6
Recoveries	(10)	(6)	(16)
Charge-offs, net	17	19	(10)
Southeast			
Charge-offs	42	20	35
Recoveries	(19)	(16)	(9)
Charge-offs, net	23	4	26
North central			
Charge-offs	31	12	32
Recoveries	(18)	(14)	(8)
Charge-offs, net	13	(2)	24
Southwest			
Charge-offs	28	41	19
Recoveries	(14)	(39)	(5)
Charge-offs, net	14	2	14
West			
Charge-offs	42	30	31
Recoveries	(21)	(14)	(14)
Charge-offs, net	21	16	17
Total			
Charge-offs	170	128	123
Recoveries	(82)	(89)	(52)
Charge-offs, net	$ 88	$ 39	$ 71

(1) *See* "FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA — NOTE 18: CONCENTRATION OF CREDIT RISK" for a description of these regions.
(2) Includes recoveries of charge-offs primarily resulting from foreclosure alternatives and REO acquisitions on loans where the primary 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.

Loan Loss Reserves. Table 61 summarizes our loan loss reserves activity.

Table 61 — Loan Loss Reserves Activity

	Year Ended December 31,		
	2002	2001	2000
	(dollars in millions)		
Total loan loss reserves:			
Beginning balance	$224	$229	$217
Provision for credit losses	128	32	79
Charge-offs	(171)	(129)	(124)
Recoveries[1]	84	92	57
Charge-offs, net	(87)	(37)	(67)
Ending balance	$265	$224	$229
Charge-offs, net to total mortgage portfolio[2]	0.8bp	0.4bp	0.8bp
Coverage ratio (reserves to charge-offs, net)	3.0	6.1	3.4

(1) Includes recoveries of charge-offs primarily resulting from foreclosure alternatives and REO acquisitions on loans where the primary 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.
(2) 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 our 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 losses on "Mortgages held for investment" in the retained portfolio and mortgages underlying PCs held by third parties that have never previously been accounted for as sales by us under SFAS 125/140 and which, therefore, do not have a recognized guarantee obligation.

The fair value of expected credit losses relating to PCs that have been accounted for as sales by us under SFAS 125/140 are reflected in the "Guarantee obligation for Participation Certificates, at fair value" caption on our consolidated balance sheets.

Setting the level of loan loss reserves requires significant judgment and we evaluate loan loss reserve levels regularly. (*See* "FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA — NOTE 2: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES" for further discussion on reserve model assumptions).

Loan loss reserves are increased through periodic charges to the provision for credit losses and decreased by charges-offs, net. 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 61*, the provision for credit losses and total loan loss reserves increased in 2002. This increase was primarily due to an increase in expected losses on multifamily mortgage loans driven by higher vacancy rates and a decrease in the net operating income of multifamily properties in certain areas.

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. The model used to determine credit loss sensitivity through December 31, 2002 was based on OFHEO's mortgage default and prepayment model described in OFHEO's April 1999 risk-based capital proposal. The regulatory loss severity model was utilized to generate expected loss exposure using certain house-price assumptions, given that varying house prices can yield significantly different credit exposure. The credit risk sensitivity analysis assesses the increase in the present value of expected single-family mortgage portfolio losses over 10 years to an instantaneous 5 percent decline in house prices nationwide, followed by a return to more normal growth in house prices based on historical experience.

The amounts below represent calculations using the OFHEO-based model. The credit-risk sensitivity results as of December 31, 2002 show an increase in credit losses of $278 million after receipt of credit enhancements, a slight decrease from results as of December 31, 2001.

Table 62 — Credit Risk Sensitivity — Net Present Value of Increase in Credit Losses[1]

	Before Receipt of Credit Enhancements[2]	After Receipt of Credit Enhancements[3]
	(dollars in millions)	
As of:		
December 31, 2002	$ 881	$ 278
December 31, 2001	$ 940	$ 301

(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.

Effective for the first quarter of 2003, we began using an internally developed Monte Carlo simulation-based model to generate our credit risk sensitivity analyses. However, we continued to utilize a credit risk scenario assuming an instantaneous 5 percent decline in house prices nationwide, followed by a return to more normal growth in house prices based on historical experience. The credit losses are once again measured over a ten-year horizon. The model underlying the new process is used for internal evaluation of mortgage credit risk and is the same as the model underlying the computation of fair value associated with retained interests in

guarantee assets and guarantee obligations in transfers of financial assets that qualify as sales under SFAS 140. This model is also utilized to value the guarantee portfolio for purposes of the company's FVBS. There are slight differences between the implementation of the model for credit risk sensitivities and SFAS 140 / FVBS valuation, driven primarily by the level of detail of key portfolio data. However, using the SFAS 140/FVBS process to produce these results would have minimal impact on the credit sensitivity results. Credit risk sensitivity results as of year-end 2002 and as of the end of each quarter in 2003 based on the new approach are presented in "— VOLUNTARY COMMITMENTS."

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 insurers;
- Issuers or guarantors of, 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/or represent and warrant that mortgages were originated in compliance with our standards (*see "— Mortgage Credit Risk — Mortgage Credit Risk Management Strategies — Credit Enhancements"* for more information). This includes mortgage seller/servicers who have agreed to repurchase or accept losses on certain loans that default or do not comply with our standards. To protect us against this risk, we require servicers to meet minimum net worth, insurance and other eligibility requirements, and we institute remedial actions against mortgage seller/servicers that fail to comply with our standards. These actions include transferring mortgage servicing to other qualified servicers or terminating our relationship with the mortgage seller/servicer. Due to the large number of firms competing in the mortgage servicing market, we have not experienced difficulty in finding replacement servicers to accept transfers of servicing on mortgages owned by us when servicers are unable or unwilling to meet our standards of performance.

We manage the credit quality of our multifamily mortgage purchases by establishing strict institutional eligibility requirements for mortgage seller/servicers that participate 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 ensure that they remain in compliance with our standards.

Mortgage 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 regularly monitoring our exposure to individual mortgage insurers. We 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 audits of mortgage insurers to ensure 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 MI and pool insurance coverage on single-family mortgages purchased during 2002 were rated "AA" or better by S&P. At December 31, 2002, there were 6 mortgage insurers, the largest being Mortgage Guarantee Insurance Corporation, that each provided more than 5 percent of our total MI coverage

(including primary MI and pool insurance) and accounted for approximately 96 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 or guarantors, or third parties providing credit enhancements, become insolvent. *Table 63* summarizes the credit characteristics of our non-Freddie Mac mortgage-related securities.

Table 63 — Credit Characteristics of Non-Freddie Mac Mortgage-Related Securities[1]

	December 31,			
	2002		2001	
	Dollars in Millions	% AAA Rated[2]	Dollars in Millions	% AAA Rated[2]
Agency mortgage securities:				
Fannie Mae	$ 78,829	100%	$ 71,128	100%
Ginnie Mae	4,878	100	5,699	100
Total agency mortgage securities	83,707	100	76,827	100
Non-agency mortgage-related securities:				
Single-family and other mortgage-related securities[3]	46,193	96	25,288	96
Commercial mortgage backed securities[4]	24,559	99	17,048	98
Mortgage revenue bonds[5]	7,640	81	7,257	81
Total non-agency mortgage securities	78,392	96	49,593	94
Total non-Freddie Mac mortgage-related securities	$162,099	98	$126,420	98

(1) *See Table 47* — Composition of Total Mortgage Portfolio for more information.
(2) Includes percentage of non-Freddie Mac mortgage-related securities rated "AAA" or equivalent. Credit rating of non-agency mortgage securities is designated by at least two nationally recognized credit rating agencies.
(3) Among other categories of securities, includes securities backed by subprime home equity loans, which are typically first-lien mortgages made to borrowers with a higher risk of default, and securities backed by manufactured housing loans.
(4) Consists of commercial mortgage securities backed by pools of loans including significant amounts of multifamily mortgages.
(5) Consists of obligations of state and political subdivisions.

Our non-Freddie Mac mortgage-related securities portfolio consists of both agency and non-agency mortgage securities. Agency mortgage securities, which are securities issued and/or guaranteed by Fannie Mae and Ginnie Mae, present minimal institutional credit risk exposure to us due to the high credit quality of the issuers and guarantors. Agency mortgage 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, 2002, we held approximately $84 billion of agency securities, representing approximately 6 percent of our total mortgage portfolio (*see Table 47* — Composition of Total Mortgage Portfolio for more information about our total mortgage portfolio).

Non-agency mortgage securities expose us to some institutional credit risk, which is mitigated through credit enhancements such as bond insurance. 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, 2002, we held approximately $78 billion of non-agency mortgage securities, representing approximately 6 percent of our total mortgage portfolio. Of this amount, 96 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 stringent investment guidelines and performing ongoing analysis to evaluate the creditworthiness of the issuers and servicers of these securities and the bond insurers that guarantee them. To assess the creditworthiness of 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 a write-down of the asset's carrying value and/or warrants divestiture.

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, predominately in our SS&TG business unit. 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 underwriting our counterparties and monitoring and managing our exposures. In some instances, we may also 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 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 a write-down of the asset's carrying value and/or warrants divestiture.

OTHER REGULATORY MATTERS

Housing Goals

The GSE Act requires the Secretary of HUD to establish three mortgage purchase goals for Freddie Mac and Fannie Mae:

- The low- and moderate-income goal;
- The underserved areas goal; and
- The special affordable goal.

See "BUSINESS — Regulation and Governmental Relationships — *Regulation* — HUD — *Housing Goals*" for definitions of these goals.

In October 2000, the Secretary issued final regulations establishing new affordable mortgage purchase goals for Freddie Mac and Fannie Mae for calendar years 2001 through 2003, which increased the affordable mortgage purchase goals in place relative to calendar years 1997 through 2000. The final rule increased the Low- and Moderate-Income Goal from the previous 42 percent to 50 percent; increased the Underserved Areas Goal from the previous 24 percent to 31 percent; and increased the Special Affordable Goal from the previous 14 percent to 20 percent, including an increase in the target for qualifying multifamily mortgage purchases from the previous $0.99 billion to $2.11 billion.

We met each of these goals in 2002 and 2001. Our purchases, as counted under HUD's regulations, are set forth in *Table 64* below. However, as discussed under "SUBSEQUENT EVENTS — Regulatory Developments," HUD has notified Freddie Mac that it will not renew for 2004 certain incentives under the housing goals that contributed significantly to our achievement of the goals since 2001. HUD's action effectively raises each of the goals for 2004, and will require an increased level of effort on our part to meet them.

Table 64 — Housing Goals

	Year Ended December 31,			
	2002		2001	
	Goal	Result	Goal	Result
	(dollars in billions)			
Low- and moderate-income goal	50%	51%	50%	53%
Underserved areas goal	31	32	31	32
Special affordable goal	20	21	20	23
Multifamily special affordable volume goal	$2.11	$5.01	$2.11	$4.72

Management views the purchase of mortgage loans benefiting low- and moderate-income families and neighborhoods as an integral part of our mission and business, and remains committed to fulfilling the needs of underserved borrowers and markets. We expect that we will continue to purchase the majority of the single-family and multifamily mortgages counted toward our performance under the housing goals through our standard purchase programs, in conformity with our customary mortgage underwriting standards. We will continue to expand anti-predatory lending and consumer credit education programs and to pilot products that reach creditworthy borrowers otherwise overlooked by traditional lending sources.

QUARTERLY SELECTED FINANCIAL DATA

Tables 65 and *66* reconcile previously reported to restated captions on the consolidated statement of income on a quarterly and annual basis. *Table 67* compares previously reported to restated consolidated balance sheet data for selected periods. *See* "FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA — NOTE 1: RESTATEMENT" for more information.

Table 65 — 2002 Quarterly Reconciliation of Previously Reported to Restated/Revised Figures

	1Q 2002	2Q 2002	3Q 2002	4Q 2002	Full-Year 2002
	(dollars in millions, except share-related amounts)				
Net interest income, as previously reported	$1,723	$1,560	$ 1,811	$1,683	$ 6,777
Impact of accounting errors and corrections:					
Security classification	—	—	—	—	—
Accounting for derivative instruments	147	14	(228)	(344)	(411)
Asset transfers and securitizations	183	238	206	345	972
Valuation of financial instruments	—	—	—	—	—
All other corrections	361	311	290	281	1,243
Other accounting changes[1]	—	—	—	305	305
Net interest income, as revised/restated	$2,414	$2,123	$ 2,079	$2,270	$ 8,886
Non-interest income, as previously reported	$ 623	$ 273	$ 390	$1,362	$ 2,648
Impact of accounting errors and corrections:					
Security classification	(180)	723	416	(49)	910
Accounting for derivative instruments	(902)	1,153	7,162	(294)	7,119
Asset transfers and securitizations	(55)	(500)	(1,064)	(204)	(1,823)
Valuation of financial instruments	89	(170)	31	(37)	(87)
All other corrections	(225)	(267)	(240)	(253)	(985)
Other accounting changes	—	—	—	—	—
Non-interest income, as revised/restated	$ (650)	$1,212	$ 6,695	$ 525	$ 7,782
Non-interest expense, as previously reported	$ (294)	$ (245)	$ 40	$ (543)	$(1,042)
Impact of accounting errors and corrections:					
Security classification	—	—	—	—	—
Accounting for derivative instruments	(49)	(49)	(47)	(27)	(172)
Asset transfers and securitizations	—	—	—	—	—
Valuation of financial instruments	—	—	—	—	—
All other corrections	(3)	(101)	(322)	(203)	(629)
Other accounting changes[2]	(8)	(6)	(4)	(4)	(22)
Non-interest expense, as revised/restated	$ (354)	$ (401)	$ (333)	$ (777)	$(1,865)
Income tax expense, as previously reported	$ (639)	$ (478)	$ (703)	$ (799)	$(2,619)
Impact of accounting errors and corrections	176	(485)	(2,076)	291	(2,094)
Income tax expense, as revised/restated	$ (463)	$ (963)	$(2,779)	$ (508)	$(4,713)
Income before cumulative effect of change in accounting principles, net of taxes, as previously reported	$1,413	$1,110	$ 1,538	$1,703	$ 5,764
Impact of accounting errors and corrections:					
Security classification	(180)	723	416	(49)	910
Accounting for derivative instruments	(804)	1,118	6,887	(665)	6,536
Asset transfers and securitizations	128	(262)	(858)	141	(851)
Valuation of financial instruments	89	(170)	31	(37)	(87)
All other corrections	133	(57)	(272)	(175)	(371)
Other accounting changes[3]	(8)	(6)	(4)	301	283
Tax impact of accounting corrections and changes	176	(485)	(2,076)	291	(2,094)
Income before cumulative effect of change in accounting principles, net of taxes, as revised/restated	947	1,971	5,662	1,510	10,090
Cumulative effect of change in accounting principles, net of taxes	—	—	—	—	—
Net income as revised/restated	$ 947	$1,971	$ 5,662	$1,510	$10,090
Diluted earnings per common share after cumulative effect of change in accounting principles, net of taxes, as previously reported[4]	$ 1.94	$ 1.50	$ 2.13	$ 2.38	$ 7.95
Effect of adjustments	(0.67)	1.24	5.93	(0.28)	6.23
Diluted earnings per common share after cumulative effect of change in accounting principles, net of taxes, as revised/restated[4]	$ 1.27	$ 2.74	$ 8.06	$ 2.10	$ 14.18

(1) Represents the impact of enhancements to the methodology used to estimate the lives used in the amortization of certain premiums and discounts.
(2) Represents the impact of accounting changes Freddie Mac made related to stock-based compensation.
(3) Represents the net impact of (i) accounting changes Freddie Mac made related to stock-based compensation and (ii) enhancements to the methodology used to estimate the lives used in the amortization of certain premiums and discounts.
(4) 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 due to rounding.

Table 66 — 2001 Quarterly Reconciliation of Previously Reported to Restated Figures

	1Q 2001	2Q 2001	3Q 2001	4Q 2001	Full-Year 2001
	(dollars in millions, except share-related amounts)				
Net interest income, as previously reported	$ 976	$1,190	$ 1,438	$ 1,876	$ 5,480
Impact of accounting errors and corrections:					
Security classification	—	—	—	—	—
Accounting for derivative instruments	(95)	(41)	42	89	(5)
Asset transfers and securitizations	296	159	236	34	725
Valuation of financial instruments	—	—	—	—	—
All other corrections	118	210	442	22	792
Other accounting changes	—	—	—	—	—
Net interest income, as restated	$ 1,295	$1,518	$ 2,158	$ 2,021	$ 6,992
Non-interest income, as previously reported	$ 445	$ 357	$ 299	$ 429	$ 1,530
Impact of accounting errors and corrections:					
Security classification	284	(455)	1,420	(770)	479
Accounting for derivative instruments	(765)	(345)	854	(1,281)	(1,537)
Asset transfers and securitizations	(449)	204	(52)	(186)	(483)
Valuation of financial instruments	(555)	230	(440)	280	(485)
All other corrections	(171)	(126)	(393)	40	(650)
Other accounting changes	—	—	—	—	—
Non-interest income, as restated	$(1,211)	$ (135)	$ 1,688	$(1,488)	$(1,146)
Non-interest expense, as previously reported	$ (246)	$ (244)	$ (253)	$ (322)	$(1,065)
Impact of accounting errors and corrections:					
Security classification	—	—	—	—	—
Accounting for derivative instruments	(68)	(55)	(57)	(49)	(229)
Asset transfers and securitizations	—	—	—	—	—
Valuation of financial instruments	—	—	—	—	—
All other corrections	(40)	7	(75)	41	(67)
Other accounting changes[1]	(1)	(9)	(10)	(11)	(31)
Non-interest expense, as restated	$ (355)	$ (301)	$ (395)	$ (341)	$(1,392)
Income tax expense, as previously reported	$ (343)	$ (389)	$ (452)	$ (619)	$(1,803)
Impact of accounting errors and corrections	425	63	(585)	561	464
Income tax expense, as restated	$ 82	$ (326)	$(1,037)	$ (58)	($1,339)

Table 66 (continued)

	1Q 2001	2Q 2001	3Q 2001	4Q 2001	Full-Year 2001
	(dollars in millions, except share-related amounts)				
Income before cumulative effect of change in accounting principles, net of taxes, as previously reported	$ 832	$ 914	$1,032	$1,364	$ 4,142
Impact of accounting errors and corrections:					
Security classification	284	(455)	1,420	(770)	479
Accounting for derivative instruments	(928)	(441)	839	(1,241)	(1,771)
Asset transfers and securitizations	(153)	363	184	(152)	242
Valuation of financial instruments	(555)	230	(440)	280	(485)
All other corrections	(93)	91	(26)	103	75
Other accounting changes[1]	(1)	(9)	(10)	(11)	(31)
Tax impact of accounting corrections and changes[2]	425	63	(585)	561	464
Income (loss) before cumulative effect of change in accounting principles, net of taxes, as restated	(189)	756	2,414	134	3,115
Cumulative effect of change in accounting principle, net of taxes, as previously reported	5	—	—	—	5
Impact of accounting errors and corrections:					
Security classification	445	—	—	—	445
Accounting for derivative instruments	(486)	—	—	—	(486)
Asset transfers and securitizations	—	(53)	—	—	(53)
Valuation of financial instruments	160	—	—	—	160
All other corrections	(7)	—	—	—	(7)
Other accounting changes	—	—	—	—	—
Tax impact of cumulative effect of change in accounting principles[2]	(39)	18	—	—	(21)
Cumulative effect of change in accounting principles, net of taxes, as restated	78	(35)	—	—	43
Net income (loss), as restated	$ (111)	$ 721	$2,414	$ 134	$ 3,158
Diluted earnings per common share after cumulative effect of change in accounting principles, net of taxes, as previously reported[3]	$ 1.13	$ 1.24	$ 1.40	$ 1.87	$ 5.64
Effect of adjustments	(1.36)	(0.28)	1.98	(1.76)	(1.41)
Diluted earnings (loss) per common share after cumulative effect of change in accounting principles, net of taxes, as restated[3]	$(0.23)	$ 0.96	$ 3.38	$ 0.11	$ 4.23

(1) Represents the impact of accounting changes Freddie Mac made related to stock-based compensation.
(2) Represents the net impact of (i) accounting changes Freddie Mac made related to stock-based compensation and (ii) enhancements to the methodology used to estimate the lives used in the amortization of certain premiums and discounts.
(3) Earnings per share is computed independently for each quarter. 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 due to rounding.

Table 67 — Previously Reported and Restated Selected Balance Sheet Captions

	1Q 2002		2Q 2002		3Q 2002		4Q 2002	
	As Previously Reported	As Restated	As Previously Reported	As Restated	As Previously Reported	As Restated	As Previously Reported	As Revised
	(dollars in millions)							
Retained portfolio	$527,640	$539,993	$524,904	$541,368	$542,415	$555,910	$583,269	$589,722
Cash and investments	84,802	115,115	80,372	116,210	96,471	140,360	86,598	135,037
Total assets	646,397	672,126	644,013	674,341	681,980	719,371	721,739	752,249
Total debt securities, net	603,446	620,145	601,363	619,112	623,267	640,315	648,894	665,696
Total liabilities	630,532	650,222	626,079	647,807	659,414	685,662	697,110	718,610
Minority interest in consolidated subsidiaries	—	2,533	—	2,455	—	2,400	—	2,309
Total stockholders' equity	15,865	19,371	17,934	24,079	22,566	31,309	24,629	31,330

	1Q 2001		2Q 2001		3Q 2001		4Q 2001	
	As Previously Reported	As Restated	As Previously Reported	As Restated	As Previously Reported	As Restated	As Previously Reported	As Revised
	(dollars in millions)							
Retained portfolio	$421,754	$430,778	$442,549	$452,615	$474,886	$484,876	$494,259	$503,666
Cash and investments	50,055	65,345	64,296	83,981	66,547	92,497	82,933	120,527
Total assets	497,839	508,549	537,590	550,673	571,907	592,859	617,340	641,100
Total debt securities, net	461,338	462,851	496,712	501,528	534,434	542,595	565,071	578,368
Total liabilities	485,018	489,115	523,610	531,204	557,401	568,345	601,967	618,857
Minority interest in consolidated subsidiaries	—	2,865	—	2,784	—	2,702	—	2,619
Total stockholders' equity	12,821	16,569	13,980	16,685	14,506	21,812	15,373	19,624

SUBSEQUENT ACCOUNTING REVISIONS

Subsequent to the announcement of our restatement results in our November 21, 2003 Information Statement Supplement, we made a revision to the classification of certain investments as of December 31, 2002 and December 31, 2001 as detailed below in *Table 68*. These reclassifications relate to the composition of the security holdings of our external money managers and had no effect on total cash and investments or total assets as of December 31, 2002 and 2001.

Table 68 — Reconciliation of Certain Balance Sheet Captions

	December 31, 2002		
	As Previously Revised[1]	Subsequent Revisions	As Revised
	(dollars in millions)		
Cash and investments:			
Cash and cash equivalents	$ 10,792	$ —	$ 10,792
Investments:			
Mortgage-related securities[2]	32,363	3	32,366
Participation Certificate residuals, at fair value[2]	—	8	8
Non-mortgage-related securities:			
Available-for-sale, at fair value	66,419	—	66,419
Trading, at fair value	2,556	(147)	2,409
Total non-mortgage-related securities	68,975	(147)	68,828
Securities purchased under agreements to resell and Federal funds sold	22,907	136	23,043
Cash and investments	$135,037	$ —	$135,037

	December 31, 2001		
	As Previously Revised[1]	Subsequent Revisions	As Revised
	(dollars in millions)		
Cash and investments:			
Cash and cash equivalents	$ 3,464	$ —	$ 3,464
Investments:			
Mortgage-related securities[2]	27,666	(472)	27,194
Participation Certificate residuals, at fair value[2]	—	20	20
Non-mortgage-related securities:			
Available-for-sale, at fair value	54,810	—	54,810
Trading, at fair value	1,087	452	1,539
Total non-mortgage-related securities	55,897	452	56,349
Securities purchased under agreements to resell and Federal funds sold	33,500	—	33,500
Cash and investments	$120,527	$ —	$120,527

(1) The "As Previously Revised" column reflects the restatement results in Freddie Mac's Information Statement Supplement dated November 21, 2003.
(2) The "Participation Certificate residuals, at fair value" that related to mortgage-related investments in the cash and investments portfolio had previously been combined with the "Mortgage-related securities" balances.

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).

Description	Comments	Status
1. *Periodic Issuance of Subordinated Debt:*		
• We will issue publicly traded and externally rated Freddie SUBS on a semi-annual basis.		• We did not issue any Freddie SUBS in 2003. As a result of not having timely consolidated financial statements, our ability to issue subordinated debt may be limited.
• Freddie SUBS will be issued in an amount such that "Voluntary Commitments' capital" will equal or exceed 4 percent of on-balance sheet assets and 0.45 percent of off-balance sheet mortgage securities by October 2003. Voluntary Commitments' capital is defined as the sum of core capital (effectively equal to Stockholders' equity less AOCI), loan loss reserves and Freddie SUBS outstanding.	• At December 31, 2002, the ratio of Voluntary Commitments' capital to total assets was 4.2 percent.	• As of December 31, 2002, we met this commitment.
	• We cannot determine the ratio of Voluntary Commitments' capital to total assets for any period in 2003 with specificity until we release the consolidated financial statements for such periods.	• We plan to update this commitment following the release of our 2003 consolidated financial statements.
2. *Liquidity Management and Contingency Planning:*		
• 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.	• 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, liquidate our non-mortgage investments as well as mortgage-related investments held by SS&TG, which are a component of "Cash and Investments" as reported on our consolidated balance sheet. 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.)	• As of December 31, 2002, we met this commitment.

VOLUNTARY COMMITMENTS (continued)

Description	Comments	Status
• In implementing this commitment, we will maintain at least 5 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.	• 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, corporate bonds, asset-backed securities, commercial paper and certain securities purchased under agreements to resell (reverse repos). This calculation does not include investments or reverse repos held by SS&TG or as part of our external money manager program. This calculation also excludes Treasury securities and reverse repos held for economic hedging purposes. • We cannot determine the percentage of on-balance sheet assets in liquid, marketable, non-mortgage securities for any period in 2003 with specificity until we release the consolidated financial statements for such periods.	• As of December 31, 2002, we met this commitment. • We plan to update this commitment following the release of our 2003 consolidated financial statements.
3. *Interest-Rate Risk Disclosures* 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.	*See* "MD&A — RESTATEMENT RESULTS — Restatement Effect on Interest-Rate Risk Measures" for more information concerning the impact of the restatement of our financial results on our interest-rate risk sensitivity disclosures, including PMVS.	The monthly average PMVS-L for December 2002 was 2.3 percent. 2003's monthly average PMVS results and related disclosures are provided in our Monthly Volume Summary, which is available on our website, www.freddiemac.com.

Description	Comments	Status
4. *Credit Risk Disclosures:* Freddie Mac 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 Freddie Mac over a 10-year period assuming an immediate 5 percent decline in house prices followed by a resumption of the same long-term trend in house-price appreciation as in the base case.	Effective with March 31, 2003 results, Freddie Mac switched from an OFHEO-based model to the model that is used for our internal evaluation of mortgage credit risk. The OFHEO-based model used a single economic scenario, while the internal model uses an average of results from numerous economic scenarios, including some less probable, but higher loss scenarios. As a result, the model change has increased the sensitivity of credit losses to the house price shock. Prior periods were not restated, but for comparison purposes, results for December 31, 2002 are provided using both models. *See* "RISK MANAGEMENT — Credit Risk — *Credit Risk Sensitivity*" for more information.	Freddie Mac's quarterly credit risk sensitivity results are as follows: As of: Before Receipt of Credit Enhancements / After Receipt of Credit Enhancements (dollars in millions) 12/31/03 $926 $533 09/30/03 $947 $537 06/30/03 $931 $493 03/31/03 $933 $493 12/31/02* $948 $449 * Results for December 31, 2002 using the old model were $881 million before receipt of credit enhancements and $278 million after receipt of credit enhancements.
5. *Public Disclosure of Annual Rating:* Freddie Mac 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.	Freddie Mac has a "risk-to-the-government" credit rating of "AA−" from S&P. Moody's has assigned the company 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 Freddie Mac's financial condition.	As of November 21, 2003, S&P affirmed its rating of "AA-" for risk-to-the-government and Moody's confirmed its "A-" Bank Financial Strength Rating; however, Moody's rating is under review for downgrade. A comparable rating from Fitch has not yet been disclosed publicly.

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 (the "company"), and its subsidiaries at December 31, 2002 and 2001, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2002 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, which 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, 2002 and 2001. As described in Note 17, 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 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 17.

As discussed in Note 2, the company adopted the provisions of Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities" and 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," as of January 1, 2001 and April 1, 2001, respectively. The company also retroactively adopted the provisions of Statement of Financial Accounting Standards No. 123, "Accounting for Stock-based Compensation" as of January 1, 1995, pursuant to the provisions of Statement of Financial Accounting Standards No. 148, "Accounting for Stock-Based Compensation — Transition and Disclosure — an amendment of FASB Statement No. 123."

As discussed in Note 1, the company has restated its consolidated financial statements as of December 31, 2001 and 2000 and for each of the two years in the period ended December 31, 2001, which financial statements were previously audited by other independent auditors who have ceased operations.

PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP
McLean, Virginia

February 17, 2004

FREDDIE MAC
CONSOLIDATED STATEMENTS OF INCOME

	Year Ended December 31,		
	2002 (Revised)	2001 (Restated)	2000 (Restated)
	(dollars in millions, except share-related amounts)		
Interest income			
Mortgage loans	$ 4,290	$ 4,385	$ 4,177
Mortgage-related securities in the retained portfolio	30,039	26,847	20,536
Cash and investments	4,147	4,136	4,469
Total interest income	38,476	35,368	29,182
Interest expense			
Short-term debt	(4,303)	(9,056)	(10,492)
Long-term debt	(21,025)	(17,466)	(14,639)
Total interest expense on debt securities	(25,328)	(26,522)	(25,131)
Due to Participation Certificate investors	(1,236)	(1,027)	(352)
Total interest expense	(26,564)	(27,549)	(25,483)
Income (expense) related to derivatives	(3,026)	(827)	59
Net interest income	8,886	6,992	3,758
Non-interest income			
Management and guarantee income (includes interest on Guarantee asset of $242, $252 and $234)	1,516	1,392	1,252
Gains (losses) on "Guarantee asset for Participation Certificates, at fair value"	(2,176)	(789)	(1,197)
Gains (losses) on "Guarantee obligation for Participation Certificates, at fair value"	592	203	443
Derivative gains (losses)	5,941	(1,857)	1,483
Hedge accounting gains (losses)	187	(294)	—
Gains (losses) on investment activity	1,812	191	492
Gains (losses) on debt retirement	(674)	(356)	13
Resecuritization fees	276	135	15
Other income	308	229	146
Non-interest income	7,782	(1,146)	2,647
Non-interest expense			
Provision for credit losses	(128)	(32)	(79)
REO operations income (expense)	13	(7)	4
Salaries and employee benefits	(593)	(537)	(433)
Occupancy expense	(42)	(35)	(35)
Housing tax credit partnerships	(160)	(121)	(104)
Minority interests in earnings of consolidated subsidiaries	(184)	(208)	(231)
Other expenses	(771)	(452)	(357)
Non-interest expense	(1,865)	(1,392)	(1,235)
Income before income tax expense and cumulative effect of change in accounting principles	14,803	4,454	5,170
Income tax expense	(4,713)	(1,339)	(1,504)
Income before cumulative effect of change in accounting principles, net of taxes	10,090	3,115	3,666
Cumulative effect of change in accounting principles, net of taxes of $24	—	43	—
Net income	$ 10,090	$ 3,158	$ 3,666
Preferred stock dividends	(234)	(217)	(179)
Net income available to common stockholders	$ 9,856	$ 2,941	$ 3,487
Basic earnings per common share before cumulative effect of change in accounting principles, net of taxes	$ 14.23	$ 4.19	$ 5.04
Cumulative effect of change in accounting principles, net of taxes	—	0.06	—
Basic earnings per common share after cumulative effect of change in accounting principles, net of taxes	$ 14.23	$ 4.25	$ 5.04
Diluted earnings per common share before cumulative effect of change in accounting principles, net of taxes	$ 14.18	$ 4.17	$ 5.01
Cumulative effect of change in accounting principles, net of taxes	—	0.06	—
Diluted earnings per common share after cumulative effect of change in accounting principles, net of taxes	$ 14.18	$ 4.23	$ 5.01
Weighted average common shares outstanding (thousands)			
Basic	692,727	692,603	692,097
Diluted	695,116	695,973	695,307
Dividends per common share	$ 0.88	$ 0.80	$ 0.68

The accompanying notes are an integral part of these financial statements.

FREDDIE MAC
CONSOLIDATED BALANCE SHEETS

	December 31, 2002 (Revised)	December 31, 2001 (Restated)
	(dollars in millions)	
Assets		
Retained portfolio		
Mortgage loans:		
Held for investment, at amortized cost	$ 57,483	$ 58,313
Reserve for losses on mortgage loans held for investment	(177)	(103)
Held for sale, at lower of cost or market value	6,635	4,409
Mortgage loans, net of reserve	63,941	62,619
Mortgage-related securities:		
Available-for-sale, at fair value (includes $367 and $167 pledged as collateral that may be repledged)	496,265	398,921
Trading, at fair value (includes $89 and $136 pledged as collateral that may be repledged)	29,104	41,400
Participation Certificate residuals, at fair value	412	726
Total mortgage-related securities	525,781	441,047
Retained portfolio	589,722	503,666
Cash and Investments		
Cash and cash equivalents	10,792	3,464
Investments:		
Mortgage-related securities:		
Trading, at fair value (includes $2 and $6 pledged as collateral that may be repledged)	32,366	27,194
Participation Certificate residuals, at fair value	8	20
Non-mortgage-related securities:		
Available-for-sale, at fair value (includes $350 and $125 pledged as collateral that may be repledged)	66,419	54,810
Trading, at fair value (includes $62 and $25 pledged as collateral that may be repledged)	2,409	1,539
Total non-mortgage-related securities	68,828	56,349
Total mortgage-related and non-mortgage-related securities	101,202	83,563
Securities purchased under agreements to resell and Federal funds sold	23,043	33,500
Cash and investments	135,037	120,527
Accounts and other receivables, net	10,611	8,714
Derivative assets, at fair value	10,393	1,996
Guarantee asset for Participation Certificates, at fair value	2,445	3,156
Real estate owned, net	594	447
Other assets	3,447	2,594
Total assets	$752,249	$641,100
Liabilities and stockholders' equity		
Debt securities, net		
Senior debt:		
Due within one year	$244,429	$264,227
Due after one year	415,662	311,013
Subordinated debt, due after one year	5,605	3,128
Total debt securities, net	665,696	578,368
Due to Participation Certificate investors	35,080	27,375
Accrued interest payable	7,286	6,043
Guarantee obligation for Participation Certificates, at fair value	1,427	1,155
Derivative liabilities, at fair value	967	2,644
Reserve for guarantee losses on Participation Certificates	88	121
Other liabilities	8,066	3,151
Total liabilities	718,610	618,857
Commitments and contingencies (Notes 2, 13, 14 and 19)		
Minority interests in consolidated subsidiaries	2,309	2,619
Stockholders' equity		
Preferred stock, at redemption value	4,609	4,596
Common stock, $0.21 par value, 726,000,000 shares authorized, 725,882,280 shares issued and 687,375,999 shares and 695,303,770 shares outstanding, respectively	152	152
Additional paid-in capital	744	671
Retained earnings	24,955	15,710
Accumulated other comprehensive income (loss), net of taxes, related to:		
Available-for-sale securities	12,217	4,200
Cash flow hedge relationships	(9,877)	(4,757)
Total accumulated other comprehensive income (loss), net of taxes	2,340	(557)
Treasury stock, at cost, 38,506,281 shares and 30,578,510 shares, respectively	(1,470)	(948)
Total stockholders' equity	31,330	19,624
Total liabilities and stockholders' equity	$752,249	$641,100

The accompanying notes are an integral part of these financial statements.

FREDDIE MAC
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

	Year Ended December 31,					
	2002 (Revised)		2001 (Restated)		2000 (Restated)	
	Shares	Amount	Shares	Amount	Shares	Amount
	(dollars and shares in millions)					
Preferred stock, at redemption value						
Balance, beginning of year	92	$ 4,596	64	$ 3,195	64	$ 3,195
Preferred stock issuances	6	300	28	1,401	—	—
Preferred stock redemptions	(6)	(287)	—	—	—	—
Preferred stock, end of year	92	4,609	92	4,596	64	3,195
Common stock, par value						
Balance, beginning of year	726	152	726	152	726	152
Common stock, end of year	726	152	726	152	726	152
Additional paid-in capital						
Balance, beginning of year — as previously reported						474
Beginning balance adjustment						150
Balance, beginning of year — as restated		671		624		624
Stock-based compensation, net of $35 million, $32 million and $21 million tax effect		65		60		39
Income tax benefit from employee stock option exercises		16		30		28
Preferred stock issuance costs		(2)		(13)		—
Common stock issuances		(6)		(30)		(67)
Additional paid-in capital, end of year		744		671		624
Retained earnings						
Balance, beginning of year — as previously reported						9,736
Beginning balance adjustment						576
Balance, beginning of year — as restated		15,710		13,326		10,312
Net income		10,090		3,158		3,666
Preferred stock dividends declared		(234)		(217)		(179)
Common stock dividends declared		(611)		(557)		(473)
Retained earnings, end of year		24,955		15,710		13,326
Accumulated other comprehensive income (loss), net of taxes (AOCI)						
Balance, beginning of year — as previously reported						(1,166)
Beginning balance adjustment						(5,356)
Balance, beginning of year — as restated		(557)		1,084		(6,522)
Changes in unrealized gains (losses) related to available-for-sale securities, net of reclassification adjustment		8,017		3,116		7,606
Changes in unrealized gains (losses) related to cash flow hedge relationships, net of reclassification adjustment		(5,120)		(2,117)		—
Cumulative effect of change in accounting principle		—		(2,640)		—
AOCI, end of year		2,340		(557)		1,084
Treasury stock, at cost						
Balance, beginning of year	31	(948)	33	(1,024)	31	(866)
Common stock issuances	(1)	33	(2)	76	(4)	100
Common stock repurchases	9	(555)	—	—	6	(258)
Treasury stock, end of year	39	(1,470)	31	(948)	33	(1,024)
Total stockholders' equity		$31,330		$19,624		$17,357
Comprehensive income						
Net income		$10,090		$ 3,158		$ 3,666
Changes in AOCI, net of reclassification adjustment		2,897		(1,641)		7,606
Total comprehensive income		$12,987		$ 1,517		$11,272

The accompanying notes are an integral part of these financial statements.

FREDDIE MAC
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year Ended December 31,		
	2002 (Revised)	2001 (Restated)	2000 (Restated)
	(dollars in millions)		
Cash flows from operating activities			
Net income	$ 10,090	$ 3,158	$ 3,666
Adjustments to reconcile net income to net cash provided by (used for) operating activities:			
Cumulative effect of change in accounting principles (pre-tax)	—	(67)	—
Hedge accounting (gains) losses	(187)	294	—
Derivative (gains) losses	(5,941)	1,857	(1,483)
Asset amortization — premiums, discounts and hedging basis adjustments	(404)	(645)	(327)
Debt amortization — premiums and discounts on long-term debt and hedging basis adjustments	1,272	547	766
Losses (gains) on debt retirement	674	356	(13)
Provision for credit losses	128	32	79
(Gains) losses on investment activity	(1,735)	(38)	(306)
(Decrease) increase in deferred income taxes	2,690	(245)	620
Purchases of held-for-sale mortgages	(136,845)	(84,799)	(25,030)
Sales of held-for-sale mortgages	130,605	80,324	24,899
Repayments of held-for-sale mortgages	1,097	262	79
Net (increase) decrease in trading securities	7,170	2,535	(4,512)
Change in accounts and other receivables, net	(2,286)	(850)	(3,412)
Change in amounts due to Participation Certificate investors, net	7,705	20,879	289
Change in accrued interest payable	344	1,237	1,424
Change in Guarantee asset for Participation Certificates, at fair value	711	(381)	698
Change in Guarantee obligation for Participation Certificates, at fair value	272	378	(222)
Change in Participation Certificate residuals, at fair value	326	(9)	76
Other, net	1,309	(2,528)	1,791
Net cash provided by (used for) operating activities	16,995	22,297	(918)
Cash flows from investing activities			
Purchases of available-for-sale securities	(451,613)	(387,603)	(191,796)
Proceeds from sales of available-for-sale securities	176,928	104,966	33,839
Proceeds from maturities of available-for-sale securities	182,955	141,699	88,284
Purchases of held-for-investment mortgages	(13,656)	(13,735)	(11,333)
Repayments of held-for-investment mortgages	13,372	13,197	7,767
Proceeds from sales of REO	980	771	883
Net decrease (increase) in securities purchased under agreements to resell and Federal funds sold	10,457	(24,084)	10,325
Derivative premiums and terminations, net	(4,343)	(2,202)	(110)
Net cash used for investing activities	(84,920)	(166,991)	(62,141)
Cash flows from financing activities			
Proceeds from issuance of short-term debt	2,048,131	2,455,070	2,310,039
Repayments of short-term debt	(2,100,103)	(2,362,620)	(2,326,370)
Proceeds from issuance of long-term debt	269,386	205,213	93,653
Repayments of long-term debt	(140,449)	(150,240)	(13,340)
Repayments of minority interest in consolidated subsidiaries	(350)	(325)	(302)
Proceeds from issuance of preferred stock, net of issuance costs	298	1,388	—
Redemption of preferred stock	(287)	—	—
Proceeds from issuance of common stock	27	46	33
Repurchases of common stock	(555)	—	(258)
Payment of cash dividends on preferred stock and common stock	(845)	(774)	(652)
Net cash provided by financing activities	75,253	147,758	62,803
Net increase (decrease) in cash and cash equivalents	7,328	3,064	(256)
Cash and cash equivalents at beginning of period	3,464	400	656
Cash and cash equivalents at end of period	$ 10,792	$ 3,464	$ 400
Supplemental cash flow information			
Cash paid for:			
Interest	$ 20,867	$ 18,324	$ 13,665
Derivative interest carry (U.S. dollar denominated)	4,366	244	1,202
Income taxes	2,491	977	977
Non-cash investing and financing activities			
Transfers from held-for-sale mortgages to available-for-sale securities	2,910	362	—
Transfers from mortgage loans to REO	1,197	910	851
Transfers from available-for-sale securities to trading securities	—	36,336	—

The accompanying notes are an integral part of these financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1: RESTATEMENT

On November 21, 2003, Freddie Mac (the "company") announced the results of its restatement of 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").

Factors Contributing to the Need for the Restatement

The company announced the need to restate its financial results in January 2003. In connection with that announcement, the outside directors of Freddie Mac's Board of Directors retained Baker Botts L.L.P. ("Baker Botts") as its independent investigative counsel to review the facts and circumstances relating to certain of the accounting errors identified during the restatement process. In June 2003, Freddie Mac reported on Baker Botts' preliminary findings presented to the Audit Committee and the Board of Directors as to the factors contributing to the need for the restatement. In July 2003, Freddie Mac released the Baker Botts report and on November 18, 2003 Freddie Mac released a supplemental Baker Botts report.

The factors contributing to the need for the restatement were lack of sufficient accounting expertise and internal control and management weaknesses as a consequence of which Freddie Mac personnel made numerous errors in applying generally accepted accounting principles in the United States ("GAAP"). In addition, certain capital market transactions were executed and certain accounting policies were implemented with a view to their effect on earnings in the context of Freddie Mac's goal of achieving steady earnings growth, and the disclosure processes and disclosures in connection with those transactions and policies did not meet the standards that would have been required of Freddie Mac had it been a Securities and Exchange Commission ("SEC") registrant. Certain reserve account and other adjustments, which were known departures from GAAP but were not considered to be material at the time, also were made with a view to their effect on earnings. As noted in the Baker Botts report, in most cases Freddie Mac believed at the time that the accounting for the transactions, policies and adjustments that Baker Botts reviewed were appropriate and reached these conclusions after consultations with its previous independent auditor.

The net cumulative effect of the restatement through December 31, 2002 was an increase to the company's net income of $5.0 billion, which includes a net cumulative increase of $4.4 billion for 2000, 2001 and 2002 and $0.6 billion related to periods prior to 2000. While the net cumulative effect of the restatement provided a significant increase in net income, 2001's net income decreased by $1.0 billion compared to previously reported results, primarily due to unrealized losses on derivatives not in qualifying hedge accounting relationships.

Freddie Mac is subject to various legal proceedings, including regulatory and judicial investigations and civil litigation, arising from the restatement. *See* "NOTE 14: LEGAL CONTINGENCIES" for further information.

Remediation Activities

To ensure that the principal factors that contributed to the need for the restatement are properly addressed, management is implementing a comprehensive remediation program, under the direction and oversight of the Governance Committee of the Board of Directors. This program includes initiatives relating to corporate culture, governance, accounting staffing and expertise, accounting policies, processes and controls as well as financial reporting and disclosure. In addition, on December 10, 2003, Freddie Mac announced that it had entered into a consent order and settlement generally resolving certain matters with the Office of Federal Housing Enterprise Oversight ("OFHEO") relating to the restatement. Under the terms of the consent order, Freddie Mac is undertaking additional remedial actions, relating to governance, corporate culture, internal controls, accounting practices, disclosure and oversight.

Separately, on the same date, OFHEO released its staff report on its investigation of matters relating to the restatement. The report included recommendations by the staff to the Director of OFHEO ("Director") to consider increasing OFHEO's regulation of Freddie Mac's activities, for example, by setting restrictions on

the growth of the company's retained portfolio, by requiring that Freddie Mac hold a capital surplus until it produces timely and certified financial statements, or by possibly implementing a mandatory disclosure regime similar to that required for companies with securities registered under the Securities Act and Exchange Act. Depending on the manner in which such recommendations were implemented, the adoption of one or more of them could have an adverse effect on Freddie Mac's financial results.

On January 29, 2004, the Director acted upon the report's recommendation regarding a capital surplus by creating a framework for monitoring Freddie Mac's capital due to the temporarily higher operational risk arising from Freddie Mac'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 ensure that appropriate levels of capital are maintained. *See* "NOTE 14: LEGAL CONTINGENCIES" for further information concerning OFHEO's actions.

Summary of Accounting Corrections and Changes By Category

Table 1.1 summarizes the net cumulative impact of the changes to net income through December 31, 2002. Management has classified the accounting errors and related corrections that have been addressed by the restatement into the five categories listed in *Table 1.1* below. The five error categories involve subjective judgments by management regarding classification of amounts and particular accounting errors that may fall within more than one category. While such classifications are not required under GAAP, management believes these classifications may assist investors in understanding the nature and impact of the corrections made in completing the restatement. The descriptions of the five classifications provide only a summary of primary accounting issues and are not a comprehensive discussion of accounting errors and corrections. In addition, management made changes in its accounting for two other matters as reported in the "Other Accounting Changes" caption in *Table 1.1.*

Table 1.1: Net Cumulative Income (Expense) Impact Through December 31, 2002

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

(1) Represents the net cumulative impact of (i) accounting changes Freddie Mac elected to make related to stock-based compensation and (ii) enhancements to the methodology used to estimate the lives used in the amortization of certain premiums and discounts.
(2) Virtually all of the $2.6 billion tax impact represents an increase in deferred taxes not currently payable.

As shown in *Table 1.1*, the net cumulative effect of the restatement (including subsequent events and other accounting changes) through December 31, 2002 was an increase to Freddie Mac's net income of $5.0 billion. This includes net cumulative increases of $4.4 billion for 2000, 2001 and 2002 and $0.6 billion for periods prior to 2000. In the detailed discussion below, Freddie Mac has separately quantified the impact of correcting various accounting errors on its 2002, 2001 and 2000 financial statements. The impact of corrections to Freddie Mac's net income for periods prior to 2000 is shown in the aggregate in this section and reflected in the company's consolidated financial statements as an adjustment to the beginning balance of its retained earnings as of January 1, 2000. The $0.6 billion net cumulative increase in net income for periods prior to 2000 was driven primarily by the impact of correcting the accounting for certain transfers of Mortgage Participation

Certificates ("PCs") and resecuritized PCs and non-Freddie Mac mortgage-related securities ("Structured Securities") (*see "Accounting Errors — Asset Transfers and Securitizations* — Accounting for Transfers of Mortgage Loans, PCs and Structured Securities" below), partially offset by the impact of corrections related to the accounting classification of certain investment securities (*see "Security Classification"* below).

Accounting Corrections

Security Classification. Freddie Mac is required to classify its investments in one of three categories — held-to-maturity, available-for-sale or trading — primarily based on management's investment intention at the time the company acquires a security. The company reports held-to-maturity securities at amortized cost on the balance sheet, while marking available-for-sale securities to fair value through Stockholders' equity and marking trading securities to fair value through the income statement. During the restatement period, Freddie Mac engaged in transactions involving securities in the held-to-maturity category that management accounted for as financings, but should have accounted for as sales. Because management has concluded that it should account for such transactions as sales, GAAP requires management to reclassify all securities previously classified as held-to-maturity into the available-for-sale category and to discontinue use of the held-to-maturity accounting classification for all securities until at least 2004, approximately two years after the last transaction giving rise to this error. As a result, for accounting purposes, Freddie Mac has reclassified all of its held-to-maturity securities to the available-for-sale category for each restated period and recorded all unrealized gains and losses at each reporting period to the Stockholders' equity section of the balance sheet, specifically through Accumulated other comprehensive income ("AOCI").

During the restatement period, management also transferred mortgage-related securities that it had designated for accounting purposes as trading into both the held-to-maturity and available-for-sale classifications when it should have retained the trading classification for these securities. To correct this error, management has reversed the misclassification and recorded unrealized gains and losses on the securities in earnings for the appropriate period.

Accounting for Derivative Instruments. As part of management's ongoing risk management activities, Freddie Mac uses derivatives to manage the interest-rate risk associated with its financial assets and liabilities. Management believes the accounting issues associated with derivatives identified in the restatement have not affected the performance of the company's derivative financial instruments, or derivatives, from a risk management perspective. As part of the restatement, management has corrected several errors in the company's accounting for derivatives. These corrections consisted of removing from earnings previously reported gains and losses related to hedged items for a portion of the company's fair value hedges and recording in earnings previously deferred gains and losses for a portion of the company's cash flow hedges. These errors were the result of the following factors:

- Management had accounted for some of the company's cash market instruments as derivatives that did not meet the GAAP accounting definition of a derivative, and as a result incorrectly applied hedge accounting.
- Management did not adequately test and document a significant portion of the hedge accounting relationships the company previously determined to be "effective" for hedge accounting purposes.

In addition, Freddie Mac incorrectly accounted for certain commitments to purchase and sell mortgage-related securities, including those executed in conjunction with intracompany transactions. To correct these errors, management has properly accounted for the commitments as derivatives and has either recorded the change in fair value of commitments to earnings or to Stockholders' equity (to the extent the commitment was effective as a cash flow hedge). Furthermore, Freddie Mac has eliminated the financial statement effect of the intracompany transactions.

Asset Transfers and Securitizations. Freddie Mac issues PCs to enhance the liquidity of the underlying mortgages in the secondary mortgage market. Whenever the company sells such securities, GAAP requires Freddie Mac to record the guarantee fee stream as a retained interest (*i.e.*, the guarantee asset) and the associated obligation, including its guarantee of payments of principal and interest to security holders, as a liability (*i.e.*, the guarantee obligation), which Freddie Mac failed to do. To correct this error, management has recorded the guarantee asset and guarantee obligation for PCs and Structured Securities sold by the company during the restatement period and included these amounts in the determination of gain or loss on

sale. Subsequent to the sale, the company has reported the guarantee asset and obligation at fair value with changes included in earnings. In addition, as part of the restatement, management corrected its accounting for securitization transactions involving IO securities, primarily to record previously unrecognized IOs and to apply proper security classification and impairment accounting to those securities.

Valuation of Financial Instruments. During the restatement period, management made numerous errors in estimating the fair value of the company's derivatives and securities. Management concluded that the reported fair values of its option-based derivatives portfolio (*e.g.*, call options on interest-rate swaps, put options on interest-rate swaps, interest-rate caps and floors) for certain periods within the restatement did not incorporate all relevant market pricing data. Therefore, management revised fair values for these options to incorporate such data. In addition, management also corrected errors in estimating the fair value of the company's securities, which principally occurred due to the use of models that failed to incorporate all relevant market data and consider key contractual terms of securities as well as process errors involving model input and application of pricing methodologies.

As part of the restatement, the company engaged in an extensive review of its valuation methodologies and results. Based on this review, management corrected valuation and other errors identified during its review and enhanced the accuracy of the market pricing data it uses when determining fair values. In addition to the corrections affecting the financial statements, management has incorporated the results of this re-valuation in Freddie Mac's consolidated fair value balance sheets as of December 31, 2002 and 2001. *See* "NOTE 17: FAIR VALUE DISCLOSURES" for more information.

All Other Corrections. During the course of the restatement process, management identified numerous other accounting policies and practices requiring correction. These changes touch on many aspects of Freddie Mac's consolidated financial statements, and its restated results reflect these corrections. In addition, Freddie Mac previously reported several accounting corrections it had deemed immaterial through earnings in the periods in which it discovered the errors. As part of the restatement process, the company is now recording these corrections in the periods to which they relate. In addition, certain accruals and reserves recorded in the fourth quarter of 2002 were revised for events occurring subsequent to December 31, 2002 that met the requirements for adjustment under GAAP.

Other Accounting Changes

In addition to corrections made in connection with the restatement, management changed the company's accounting related to stock-based compensation by selecting the retroactive restatement transition method for stock awards granted on or after January 1, 1995 and, in the fourth quarter of 2002, enhanced its methodology for estimating the underlying lives used in the amortization of certain premiums and discounts.

Table 1.2 — Annual Reconciliation of Previously Reported to Restated Figures

	Year Ended		
	2002	2001	2000
	(dollars in millions, except share-related amounts)		
Net interest income, as previously reported	$ 6,777	$ 5,480	$ 2,838
Impact of accounting errors and corrections:			
Security classification	—	—	—
Accounting for derivative instruments	(411)	(5)	283
Asset transfers and securitizations	972	725	510
Valuation of financial instruments	—	—	—
All other corrections	1,243	792	127
Other accounting changes[1]	305	—	—
Net interest income, as revised/restated	$ 8,886	$ 6,992	$ 3,758
Non-interest income, as previously reported	$ 2,648	$ 1,530	$ 1,631
Impact of accounting errors and corrections:			
Security classification	910	479	640
Accounting for derivative instruments	7,119	(1,537)	817
Asset transfers and securitizations	(1,823)	(483)	(1,002)
Valuation of financial instruments	(87)	(485)	626
All other corrections	(985)	(650)	(65)
Other accounting changes	—	—	—
Non-interest income, as revised/restated	$ 7,782	$(1,146)	$ 2,647
Non-interest expense, as previously reported	$(1,042)	$(1,065)	$ (923)
Impact of accounting errors and corrections:			
Security classification	—	—	—
Accounting for derivative instruments	(172)	(229)	(225)
Asset transfers and securitizations	—	—	4
Valuation of financial instruments	—	—	—
All other corrections	(629)	(67)	(73)
Other accounting changes[2]	(22)	(31)	(18)
Non-interest expense, as revised/restated	$(1,865)	$(1,392)	$(1,235)
Income tax expense, as previously reported	$(2,619)	$(1,803)	$ (999)
Impact of accounting errors and corrections	(2,094)	464	(505)
Income tax expense, as revised/restated	$(4,713)	$(1,339)	$(1,504)
Income before cumulative effect of change in accounting principles, net of taxes, as previously reported	$ 5,764	$ 4,142	$ 2,547
Impact of accounting errors and corrections:			
Security classification	910	479	640
Accounting for derivative instruments	6,536	(1,771)	875
Asset transfers and securitizations	(851)	242	(488)
Valuation of financial instruments	(87)	(485)	626
All other corrections	(371)	75	(11)
Other accounting changes[3]	283	(31)	(18)
Tax impact of accounting corrections and changes	(2,094)	464	(505)
Income before cumulative effect of change in accounting principles, net of taxes, as revised/restated	10,090	3,115	3,666
Cumulative effect of change in accounting principle, net of taxes, as previously reported	—	5	—
Impact of accounting errors and corrections:			
Security classification	—	445	—
Accounting for derivative instruments	—	(486)	—
Asset transfers and securitizations	—	(53)	—
Valuation of financial instruments	—	160	—
All other corrections	—	(7)	—
Other accounting changes	—	—	—
Tax impact of cumulative effect of change in accounting principle[3]	—	(21)	—
Cumulative effect of change in accounting principle, net of taxes, as restated	—	43	—
Net income (loss), as restated	$10,090	$ 3,158	$ 3,666
Diluted earnings per common share after cumulative effect of change in accounting principles, net of taxes, as previously reported[4]	$ 7.95	$ 5.64	$ 3.40
Effect of adjustments	6.23	(1.41)	1.61
Diluted earnings per common share after cumulative effect of change in accounting principles, net of taxes, as revised/restated[4]	$ 14.18	$ 4.23	$ 5.01

(1) Represents the impact of enhancements to the methodology used to estimate the lives used in the amortization of certain premiums and discounts.
(2) Represents the impact of accounting changes Freddie Mac made related to stock-based compensation.
(3) Represents the net impact of *(i)* accounting changes Freddie Mac made related to stock-based compensation and *(ii)* enhancements to the methodology used to estimate the lives used in the amortization of certain premiums and discounts.
(4) Earnings per share is computed independently for each quarter 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 due to rounding.

Table 1.3 — Effects of Restatement Adjustments on the Beginning Balance of Stockholders' Equity on January 1, 2000[1]

	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Preferred Stock, at Redemption Value	Common Stock, Additional Paid-in Capital and Treasury Stock	Total Stockholders' Equity
			(dollars in millions)		
Impact of accounting errors and corrections:					
Security classification	$ (774)	$(8,403)	$ —	$ —	$(9,177)
Accounting for derivative instruments	(174)	(12)	—	—	(186)
Asset transfers and securitizations	1,331	183	—	—	1,514
Valuation of financial instruments	—	—	—	—	—
All other corrections	694	(8)	—	4	690
Total accounting errors[1]	1,077	(8,240)	—	4	(7,159)
Other accounting changes[2]	(66)	—	—	77	11
Total Adjustments	1,011	(8,240)	—	81	(7,148)
Tax impact of accounting corrections and changes[3]	(435)	2,884	—	69	2,518
Subtotal: Beginning balance adjustment	576	(5,356)	—	150	(4,630)
Stockholders' equity, beginning balance, net of taxes, as *previously reported*	9,736	(1,166)	3,195	(240)	11,525
Stockholders' equity, beginning balance, net of taxes, as *restated*	$10,312	$(6,522)	$3,195	$ (90)	$ 6,895

(1) The restatement affects periods prior to 2000. The impact of the restatement on periods prior to 2000 is reflected as an adjustment to the opening balance of retained earnings as of January 1, 2000.
(2) Represents the cumulative impact of accounting changes Freddie Mac made related to stock-based compensation.
(3) The adjustment to Additional paid-in capital represents the income tax benefit from employee stock option exercises that management previously recorded on a cumulative basis in 2001 because the company had determined that the impact on current and prior periods to be immaterial. However, because the periods prior to 2001 are being restated, the cumulative adjustment has been reversed and instead reflected in the proper years. This correction has no impact on cumulative pre-tax income.

Detailed Discussion of Accounting and Disclosure Errors and Other Accounting Changes

The following discussion summarizes Freddie Mac's:

I. Accounting errors;

II. Other accounting changes;

III. Tax-related adjustments;

IV. Errors in computing Freddie Mac's 2001 Consolidated Fair Value Balance Sheet;

V. Other errors in the Consolidated Financial Statements.

Where applicable, each discussion addresses the effects of the accounting error or change on Income (expense) before taxes and AOCI.

I. Accounting Errors

Security Classification

Under Statement of Financial Accounting Standards ("SFAS") 115, "Accounting for Certain Investments in Debt and Equity Securities" ("SFAS 115"), securities are required to be classified as held-to-maturity, available-for-sale or trading primarily based on the company's intent. Held-to-maturity securities are reported at amortized cost, available-for-sale securities are marked to fair value through stockholders' equity and trading securities are marked to fair value through earnings. Freddie Mac has concluded that a majority of its securities were erroneously classified under SFAS 115. These errors primarily related to sales of securities classified as held-to-maturity and invalid transfers from the trading category. The sales of held-to-maturity securities resulted from, among other reasons, certain transactions that were accounted for as financings but should have been accounted for as sales under SFAS 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities" and, prior to April 1, 2001, SFAS 125, "Accounting for

Transfers and Servicing of Financial Assets and Extinguishments of Liabilities" (collectively, "SFAS 125 / 140").

In certain transactions (referred to internally as Coupon Trade-Up Giant ("CTUG") as well as J-6 and J-7), Freddie Mac resecuritized trading securities and then inappropriately classified the retained beneficial interests from those trading securities as either held-to-maturity or available-for-sale. In addition, Freddie Mac erroneously transferred securities from the trading category to either held-to-maturity or available-for-sale. This adjustment also includes the effect of correcting the cost basis of certain securities as described throughout this section and the impact on income for trading securities and AOCI for available-for-sale securities resulting from carrying these securities at fair value.

To correct these errors, certain held-to-maturity and available-for-sale securities have been reclassified as trading and all remaining held-to-maturity securities have been reclassified as available-for-sale, and recorded at fair value which has resulted in cumulative increases of $1.7 billion and $2.7 billion in Freddie Mac's pre-tax income and pre-tax AOCI, respectively. Additional detail regarding the impact of correcting these errors is set forth in *Table 1.4*.

Table 1.4 — Security Classification — Summary of Financial Impacts

	Cumulative Effect from Inception — 12/31/1999	2000	2001	2002	Total
	(dollars in millions)				
Income (expense) before taxes	$ (774)	$ 640	$ 924	$ 910	$1,700
AOCI before taxes[1]	$(8,401)	$8,950	$2,562	$(442)	$2,669

(1) AOCI adjustment for periods prior to 2000 relates to the reclassification of securities from held-to-maturity to available-for-sale.

Accounting for Derivative Instruments

Embedded Options Hedging Strategy. Upon the adoption of SFAS 133, "Accounting for Derivative Investments and Hedging Activities" on January 1, 2001, Freddie Mac implemented an accounting hedge strategy in which a combination of interest-rate options, swaps and other derivatives were designated as hedges of the changes in fair value of the options embedded in mortgage assets. Because of the security reclassifications discussed above and because securities classified as trading are not eligible for hedge accounting under SFAS 133, Freddie Mac was required to reverse part of the embedded options hedging strategy. In addition, SFAS 133 requires contemporaneous documentation of hedge effectiveness and how it is measured. In the context of the restatement, Freddie Mac concluded that there were errors in identifying and measuring the accounting effectiveness of the hedges employed. As a result, Freddie Mac has concluded that the documentation and testing performed to determine whether the embedded options hedging strategy qualified for hedge accounting under SFAS 133 were inadequate and therefore, the application of hedge accounting in connection with the embedded options hedging strategy did not comply with GAAP. Freddie Mac has corrected this error by reversing the hedge accounting entries recorded for this strategy, including removing gains and losses on the hedged item previously recorded in earnings as part of hedge accounting.

The cumulative effect of correcting the errors described above on Freddie Mac's pre-tax income was an increase of $6.5 billion. The cumulative decrease of $3.9 billion in pre-tax AOCI shown below represents the effect of reversing the portion of the $6.5 billion that was originally recorded as an adjustment to the basis of hedged available-for-sale securities. This AOCI reversal is necessary because the $3.9 billion had previously been recorded in the carrying amount of available-for-sale securities, which were subsequently marked to fair

value under SFAS 115 in AOCI. Additional detail regarding the impact of correcting these errors is set forth in *Table 1.5*.

Table 1.5 — Embedded Options Hedging Strategy — Summary of Financial Impacts

	Cumulative Effect from Inception — 12/31/1999	2000	2001	2002	Total
		(dollars in millions)			
Income (expense) before taxes	—	—	$(169)	$ 6,671	$ 6,502
AOCI before taxes	—	—	$(162)	$(3,783)	$(3,945)

Pay-Fixed Swaps – SFAS 133 Transition. Effective December 1, 2000, Freddie Mac combined $86 billion notional amount of pay-fixed swaps and $36 billion notional amount of receive-fixed swaps and designated them in cash flow hedges. This combination, which was undertaken as part of the company's SFAS 133 transition strategy, had the effect of reducing the SFAS 133 transition adjustment to AOCI on January 1, 2001 from $3.2 billion in unrealized losses to $2.5 billion in unrealized losses on an after-tax basis.

On January 1, 2001, in connection with Freddie Mac's implementation of SFAS 133, $75 billion of the original $86 billion notional amount of pay-fixed swaps were redesignated in new cash flow hedge relationships and the majority of the $36 billion notional amount of receive-fixed swaps were redesignated in fair value hedge relationships as part of the SFAS 133 transition. Freddie Mac has concluded that the cash flow hedge relationships for $66 billion of the $75 billion notional amount of pay-fixed swaps redesignated on January 1, 2001 were not valid under SFAS 133 because they failed to meet the requirements for documenting the assessment of hedge accounting effectiveness. Freddie Mac has corrected this error by recognizing in earnings, for each period after January 1, 2001, the change in fair value of the derivatives. In addition, Freddie Mac should have amortized during 2001 and 2002 the deferred gains and losses on the $66 billion of pay-fixed swaps recorded at the time of SFAS 133 implementation. Accordingly, Freddie Mac has corrected this aspect of the error by amortizing the deferred losses previously recorded in AOCI at January 1, 2001 as additional interest expense in 2001 and 2002.

The cumulative effect of correcting these errors was a decrease to pre-tax income and an increase to pre-tax AOCI of $3.8 billion. Additional detail regarding the impact of correcting these errors is set forth in *Table 1.6*.

Table 1.6 — Pay-Fixed Swaps — SFAS 133 Transition — Summary of Financial Impacts

	Cumulative Effect from Inception — 12/31/1999	2000	2001	2002	Total
		(dollars in millions)			
Income (expense) before taxes	—	—	$(2,151)	$(1,676)	$(3,827)
AOCI before taxes	—	—	$ 2,151	$ 1,676	$ 3,827

Transactions Cleared Through the Government Securities Clearing Corporation, or GSCC. Prior to the fourth quarter of 2000, Freddie Mac typically entered into synthetic forward contracts by purchasing (or selling) Treasury or agency debt securities and simultaneously executing repurchase (or resale) agreements. Freddie Mac executed these synthetic forward contracts using a single counterparty for both the purchase (or sale) and repurchase (or resale) agreements, with settlement occurring directly between Freddie Mac and its counterparty on a net basis. Freddie Mac properly viewed these transactions as derivatives that qualified for hedge accounting treatment. In the fourth quarter of 2000, Freddie Mac began to clear and settle these agreements through the GSCC and continued to use the same accounting. The use of the GSCC facilitated Freddie Mac's ability to enter into these two transactions with different counterparties, which reduced transaction costs and provided the benefits of GSCC margining while still retaining the ability to net settle the trades. However, the unintended effect of the changes to the transaction structuring was that the transactions no longer qualified as derivatives under GAAP. As a result of correcting these errors, Freddie Mac's balance sheet reflects the components of these transactions on a gross basis rather than reflecting each pair as a single,

net transaction. In addition, because Freddie Mac had viewed these transactions as derivatives and applied hedge accounting, previously deferred hedging gains (losses) have been reversed and recorded in income.

The cumulative effect of correcting this error was an increase to pre-tax income through December 31, 2002 of $768 million and an increase in pre-tax AOCI of $404 million. Additional detail regarding the impact of correcting this error is set forth in *Table 1.7*.

Table 1.7 — Transactions Cleared Through the Government Securities Clearing Corporation — Summary of Financial Impacts

	Cumulative Effect from Inception — 12/31/1999	2000	2001	2002	Total
		(dollars in millions)			
Income (expense) before taxes	—	$(3)	$ 284	$487	$768
AOCI before taxes	—	$20	$(214)	$598	$404

Real Estate Investment Trust ("REIT") Hedges. 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 billion of perpetual, step-down preferred stock issued to outside investors. The REITs used these funds to purchase real estate mortgage investment conduit ("REMIC") securities from Freddie Mac.

The REIT preferred stock was initially characterized as equity securities of the REIT subsidiaries and reported as minority interest on Freddie Mac's consolidated balance sheets and minority interest in earnings of consolidated subsidiaries on Freddie Mac's consolidated statements of income. In the fourth quarter of 1998, Freddie Mac changed its reporting for the REIT preferred stock so that it was reported on the balance sheet as part of debt securities, with dividends included in long-term debt expense. Because the preferred stock was then reported as debt, it could be, and was, used as a hedged item for hedge accounting purposes.

Freddie Mac has concluded that the 1998 change to debt accounting was in error. Freddie Mac has corrected this error by recording the REIT preferred stock on the consolidated balance sheet as minority interest. As minority interest, the REIT preferred stock is not eligible for hedge accounting treatment. Accordingly, Freddie Mac has corrected this error by reversing hedging gains and losses related to the REIT preferred stock. The cumulative effect of correcting this error on Freddie Mac's pre-tax income was an increase of $583 million. In addition to its effect on cumulative pre-tax income, correction of this error also resulted in the reclassification of the related dividends from long-term debt expense to minority interest in earnings of consolidated subsidiaries with no effect on net income. The cumulative effect of this reclassification was to remove $1.1 billion of expense from net interest income and to include this $1.1 billion of expense in minority interest in earnings of consolidated subsidiaries.

Additional detail regarding the impact of correcting this error is set forth in *Table 1.8*.

Table 1.8 — REIT Hedges — Summary of Financial Impacts

	Cumulative Effect from Inception — 12/31/1999	2000	2001	2002	Total
		(dollars in millions)			
Net interest income (expense) before taxes	$ 525	$ 231	$ 208	$ 184	$ 1,148
Minority interest in earnings of consolidated subsidiaries	$(525)	$(231)	$(208)	$(184)	$(1,148)
Income (expense) before taxes	—	$ 144	$ 56	$ 383	$ 583
AOCI before taxes	—	—	—	—	—

Forward Purchase and Sale Commitments. Freddie Mac routinely enters into forward purchase and sale commitments for mortgage securities and mortgage loans. As discussed below, Freddie Mac has concluded that its accounting practices with respect to certain commitments, including transactions executed between its business units, were not in accordance with GAAP.

Third Party Transactions. Freddie Mac did not recognize the effects of forward commitments in its consolidated financial statements for certain trades. With respect to commitments executed prior to 2001, Freddie Mac has concluded that it should have recorded changes in the fair values of commitments to acquire available-for-sale securities to AOCI in accordance with Emerging Issues Task Force ("EITF") 96-11, "Accounting for Forward Contracts and Purchased Options to Acquire Securities Covered by FASB Statement No. 115" ("EITF 96-11").

For commitments executed in 2001 and 2002, Freddie Mac concluded that substantially all mortgage-related forward purchase and sale commitments were derivatives under SFAS 133. For these commitments, Freddie Mac should have recorded the change in fair value of the forward purchase and sale commitments to AOCI to the extent they qualified for hedge accounting under SFAS 133. To the extent the trades did not qualify for hedge accounting treatment, the change in fair value should have been recorded to current period earnings.

For commitments to purchase or sell trading securities, Freddie Mac appropriately recognized the effects of these trades in earnings. However, Freddie Mac did so by accounting for such trades as trading securities on a trade date basis. Freddie Mac has concluded that these trades should have been accounted for as derivatives in all periods. To correct this error, Freddie Mac has reversed the effects of trade date accounting and reported the fair values of such trades as derivative assets or liabilities.

Intracompany Transactions. Freddie Mac recorded all activity related to its PC market-making and support activities, including intracompany transactions with the retained portfolio, as trading positions. However, Freddie Mac failed to properly account for transfers of these securities in accordance with SFAS 115 resulting in the following errors:

- Freddie Mac should have eliminated the financial statement effects of marking intracompany trades to fair value.
- Securities acquired with the intent of holding them in the retained portfolio should not have been marked to fair value through income as trading securities, but instead should have been marked to fair value through AOCI as available-for-sale securities.
- Securities acquired in the trading portfolio but subsequently transferred to the retained portfolio and classified as available-for-sale or held-to-maturity securities were not valid transfers under SFAS 115. The correction of this error is described and measured in "*Security Classification*."

Other Purchase and Sale Commitments. Freddie Mac has concluded that it incorrectly accounted for the forward commitments to sell and purchase PCs involved in a resecuritization transaction for approximately $30 billion (referred to internally as CTUG) entered into as part of its SFAS 133 transition strategy, as discussed under "*Security Classification*" above. Specifically, Freddie Mac inappropriately executed and erroneously accounted for the forward sale commitments in 2000 under SFAS 80, "Accounting for Futures Contracts" ("SFAS 80"), as a hedge of held-to-maturity PCs in the retained portfolio and did not account for the offsetting forward purchase commitment. Both the forward sale commitments and the forward purchase commitments should have been marked to fair value through earnings because neither transaction met hedge accounting requirements; the correction of this error had no net impact on 2000 net income. In addition, Freddie Mac erroneously accounted for the forward purchase commitments in 2001 as hedged items in its embedded options hedging strategy. These forward purchase commitments met the definition of a derivative, and therefore, did not qualify as hedged items under SFAS 133. The correction of the purchase commitment is included in "Embedded Options Hedging Strategy."

The cumulative effect of correcting these errors was an increase of $495 million in pre-tax income and a decrease in pre-tax AOCI of $732 million. Additional detail regarding the impact of correcting these errors is set forth in *Table 1.9*.

Table 1.9 — Forward Purchase and Sale Commitments — Summary of Financial Impacts

	Cumulative Effect from Inception — 12/31/1999	2000	2001	2002	Total
		(dollars in millions)			
Income (expense) before taxes	$ (2)	$(228)	$ (79)	$ 804	$ 495
AOCI before taxes	$(12)	$ 28	$(265)	$(483)	$(732)

Linked Swaps. In August and September of 2001, Freddie Mac entered into nine pairs of "linked" interest-rate swap transactions with an effective notional amount after considering leverage terms of $180 billion ("Linked Swaps"). Each pair consisted of a pay-fixed swap and a receive-fixed swap entered into contemporaneously with a single counterparty with terms that were largely offsetting. For financial accounting purposes, Freddie Mac inappropriately separately accounted for each of the swap transactions within the pairs of Linked Swaps. These transactions and the related, inappropriate accounting effected a reduction in Operating Earnings, a non-GAAP supplemental performance measure Freddie Mac previously used. As a result of these transactions and the related inappropriate accounting, previously reported Operating net interest income, or Operating NII, was reduced by an estimated $400 million in the third and fourth quarters of 2001. As of December 31, 2001, as a result of these transactions, Freddie Mac expected Operating NII to increase by an estimated $400 million over the original remaining life of the swaps, which had maturity dates ranging from August 2004 to September 2006. The effect of the transactions on GAAP net interest income ("GAAP NII") during 2001 was essentially the same as the effect on Operating NII, but the net effect on GAAP net income was different than the Operating Earnings effect due to the impact of hedge accounting.

Freddie Mac has concluded that each pair of Linked Swap transactions should be viewed as a unit (*i.e.*, combined derivative) and accounted for together under SFAS 133 due to a number of factors, including: that the transactions were executed with the same counterparty and in contemplation of each other; the accounting effect was disproportionate to the risk management effect; and after considering the effect of other hedge accounting corrections related to the restatement (*see* "Embedded Options Hedging Strategy" above). This error has been corrected by reversing the hedge accounting entries for the Linked Swaps. In addition, hedge accounting was reversed for certain other derivatives that were designated in the same fair value hedges of debt as several of the receive-fixed components of the Linked Swaps. The cumulative effect of correcting this error on Freddie Mac's pre-tax income was an increase of $283 million. (This amount excludes the effect of the portion of Linked Swaps that were designated in fair value hedges in connection with Freddie Mac's embedded options hedging strategy, which are included in the amounts reported in connection with that error described previously in this section.) In addition, correction of this error required Freddie Mac to reverse hedge accounting adjustments originally recorded related to the pay-fixed swap components designated in cash flow hedges, resulting in a $283 million increase to pre-tax AOCI.

Two additional swaps with a notional amount of $4 billion were executed in November 2001 with largely offsetting terms. However, these swaps were executed on different days with different counterparties. In general, the facts and circumstances surrounding the additional swaps executed in November 2001 were different than the Linked Swaps and therefore, hedge accounting was not reversed for these derivatives.

However, Freddie Mac did reclassify the interest accruals from net interest income to non-interest income (*i.e.*, for the Linked Swaps and the two additional swaps executed in November 2001). The amount of recorded interest expense reclassified to non-interest income totaled $405 million and $217 million in 2001 and 2002, respectively. These reclassifications had no impact on cumulative net income for the restatement period.

Additional detail regarding the impact of correcting this error is set forth in *Table 1.10*.

Table 1.10 — Linked Swaps — Summary of Financial Impacts

	Cumulative Effect from Inception — 12/31/1999	2000	2001	2002	Total
		(dollars in millions)			
Income (expense) before taxes	—	—	$422	$(139)	$283
AOCI before taxes	—	—	$249	$ 34	$283

Mortgage Security Hedges. Beginning in 1999, Freddie Mac designated forward sales of to be announced ("TBA") securities as accounting hedges of the fair value of certain mortgage-related securities held by the company. Freddie Mac has concluded that some of these hedges failed to qualify for hedge accounting treatment under SFAS 80 and SFAS 133 because:

- The TBA forward sale commitment designated in the hedge relationship was not properly identified;
- The securities identified as the hedged items were not eligible as hedged items because they were classified as trading under SFAS 115; or
- There was not proper documentation of hedge effectiveness testing.

Freddie Mac has corrected these errors by reversing the effects of hedge accounting treatment. The cumulative effect of correcting these errors was an increase to pre-tax income of $91 million. Additional detail regarding the impact of correcting these errors is set forth in *Table 1.11*.

Table 1.11 — Mortgage Security Hedges — Summary of Financial Impacts

	Cumulative Effect from Inception — 12/31/99	2000	2001	2002	Total
		(dollars in millions)			
Income (expense) before taxes	$4	$(28)	$70	$45	$91
AOCI before taxes	—	$ (3)	$ 3	—	—

Agency Forward Agreements. Upon its adoption of SFAS 133, Freddie Mac implemented an accounting hedge strategy in which agency forward agreements were designated as hedges of existing long-term Freddie Mac debt. Freddie Mac's agency forward agreements are essentially cash-settled forward contracts on a specified agency security. For agency forward agreements using Freddie Mac debt, Freddie Mac has concluded that it failed to properly test for hedge accounting effectiveness. As a result, these agreements failed to qualify for hedge accounting treatment.

Freddie Mac has corrected this error by reversing the hedge accounting treatment of these agreements and related amortization. The cumulative effect of correcting this error was an increase to pre-tax income of $57 million. Additional detail regarding the impact of correcting this error is set forth in *Table 1.12*.

Table 1.12 — Agency Forward Agreements — Summary of Financial Impacts

	Cumulative Effect from Inception — 12/31/1999	2000	2001	2002	Total
		(dollars in millions)			
Income (expense) before taxes	—	—	$72	$(15)	$57
AOCI before taxes	—	—	—	—	—

Government National Mortgage Association ("Ginnie Mae") Asset Swap Hedge. From July 2001 to June 2002, and from October 2002 through December 2002, Freddie Mac designated a pay-fixed, amortizing swap of approximately $0.8 billion notional amount as a fair value hedge under SFAS 133 of certain Ginnie Mae Certificates. Freddie Mac has concluded that the documentation and testing required to ensure that these

hedges were effective for accounting purposes was inadequate. Therefore, the changes in fair value of the Ginnie Mae Certificates recorded due to hedge accounting were reversed from earnings. Freddie Mac also concluded that some of the prices originally used to value the swap were incorrect. Freddie Mac has adjusted each of the affected periods to reflect the correct fair value of the swap.

The cumulative effect of correcting these errors on Freddie Mac's pre-tax income was an increase of $16 million. Additional detail regarding the impact of correcting these errors is set forth in *Table 1.13*.

Table 1.13 — Ginnie Mae Asset Swap Hedge — Summary of Financial Impacts

	Cumulative Effect from Inception — 12/31/1999	2000	2001	2002	Total
		(dollars in millions)			
Income (expense) before taxes	—	—	$(1)	$17	$16
AOCI before tax	—	—	—	—	—

Call Swaptions. Prior to 2001, Freddie Mac designated a portion of its call swaptions as hedges of long-term debt. Premiums paid to enter into these call swaptions were deferred and amortized into earnings over the term of the option in accordance with GAAP. As part of the restatement, Freddie Mac has concluded that these were ineffective hedges and therefore, deferral of changes in the option's intrinsic value and amortization of option premiums paid was incorrect. Correction of this error required Freddie Mac to reverse the deferred gains and losses related to the hedged debt, record the change in fair value of these instruments through earnings each period, and adjust the cumulative SFAS 133 transition adjustment as of January 1, 2001.

The cumulative effect of correcting these errors was an increase in pre-tax income of $12 million. Additional detail regarding the impact of correcting these errors is set forth in *Table 1.14*.

Table 1.14 — Call Swaptions — Summary of Financial Impacts

	Cumulative Effect from Inception — 12/31/1999	2000	2001	2002	Total
		(dollars in millions)			
Income (expense) before taxes	$(253)	$1,032	$(763)	$(4)	$12
AOCI before taxes	—	—	—	—	—

Cash Flow Hedges — 2002 Corrections. Freddie Mac made two adjustments as part of its previously released fourth quarter 2002 financial results to correct for the cumulative effect of errors related to certain cash flow hedges. These adjustments were made on a cumulative basis because Freddie Mac determined the impact on current and prior periods to be immaterial. However, because the periods prior to the fourth quarter of 2002 are being restated, these cumulative adjustments have been reversed and recorded in the appropriate prior quarters. These corrections have no impact on cumulative pre-tax income or pre-tax AOCI for the restatement, but they do affect quarter-to-quarter results. The two adjustments are as follows:

- In the fourth quarter of 2002, Freddie Mac determined that certain cash flow hedge relationships were not valid under SFAS 133 because they failed to meet the requirements for hedge accounting effectiveness. The impact of the fourth quarter 2002 adjustment, which has been allocated to other affected quarters, was a decrease to income before taxes of $94 million.

- The second adjustment in the fourth quarter of 2002 was an increase in income before taxes of $83 million related to the correction of the carrying amount of AOCI resulting from cash flow hedges under SFAS 133. This adjustment was needed to correct the amortization of deferred gains/losses related to terminated or redesignated cash flow hedges during 2001 and 2002.

The cumulative effect of correcting these errors on pre-tax income and pre-tax AOCI was zero. Additional detail regarding the impact of correcting these errors is set forth in *Table 1.15*.

Table 1.15 — Cash Flow Hedges — 2002 Corrections — Summary of Financial Impacts

	Cumulative Effect from Inception — 12/31/1999	2000	2001	2002	Total
		(dollars in millions)			
Income (expense) before taxes	—	—	$ 37	$(37)	—
AOCI before taxes	—	—	$(37)	$ 37	—

Forward Settling and Written Swaption Trades. From November 1999 to January 2000, Freddie Mac sold $10 billion notional amount of put swaptions held in its derivative portfolio with future settlement dates longer than normal market conventions. More specifically, the settlement dates for these specific put swaptions coincided with the beginning of each quarter starting with the first quarter of 2000 through the first quarter of 2001. Freddie Mac inappropriately accounted for the sale of these put swaptions on a settlement-date basis as opposed to a trade-date basis. This resulted in the gains associated with these transactions, which were measured as the difference between the cash proceeds and the carrying value of the put swaption on settlement date, being recorded to earnings on the date of settlement; the carrying value at settlement date was net of amortization of the original option premium which continued to be amortized between trade date and settlement date. As part of the restatement, Freddie Mac has concluded that the resulting gains should instead be recorded on the trade date and have reversed the amortization expense taken between trade date and settlement date.

In addition, during 2000, Freddie Mac wrote $20 billion notional amount of options (mainly swaptions) and received premiums of $245 million. Certain of the premiums received were inappropriately amortized as an increase to net interest income of $155 million in 2000. The remaining fair value change of the written options was recorded to earnings as part of derivative gains (losses). As part of the restatement, Freddie Mac has concluded that the amortization of the premiums received should have been recorded through derivative gains (losses). Therefore, the increases to net interest income described above have been reclassified as increases to derivative gains (losses).

The cumulative effect of correcting these errors on pre-tax income and pre-tax AOCI was zero. Additional detail regarding the impact of correcting these errors is set forth in *Table 1.16*.

Table 1.16 — Forward Settling and Written Swaption Trades — Summary of Financial Impacts

	Cumulative Effect from Inception — 12/31/1999	2000	2001	2002	Total
		(dollars in millions)			
Income (expense) before taxes	$77	$(42)	$(35)	—	—
AOCI before taxes	—	—	—	—	—

Asset Transfers and Securitizations

Accounting for Transfers of Mortgage Loans, PCs and Structured Securities. Freddie Mac executes a variety of transactions that involve the transfer of its PCs and Structured Securities. The company transfers mortgage loans and PCs to third parties primarily through its Guarantor and Cash Window Programs. Freddie Mac also purchases and sells PCs in the secondary market after the securities are originally formed. Additionally, Freddie Mac issues Structured Securities backed by PCs and other mortgage-backed securities held in portfolio or that are provided to the company by third parties.

Freddie Mac has concluded that it erroneously applied SFAS 125 (effective through March 31, 2001) and SFAS 140 (effective from April 1, 2001 through December 31, 2002) and other GAAP guidance issued before SFAS 125 in accounting for transfers of mortgage loans, PCs and Structured Securities that qualified as sales. Specifically, Freddie Mac did not record as retained interests the guarantee fee receivable under the guarantee contract associated with its transferred assets as required by GAAP, except for upfront cash paid for

buy-up fees. (For information on buy-up fees, *see* "NOTE 2: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES.") Instead, the cash flows received from its guarantee contracts were recognized into earnings as received. Additionally, Freddie Mac did not value its obligation under the guarantee contract when measuring the gain or loss on the asset sale. Instead, expense related to the obligation was accrued over the life of the guarantee contract as incurred.

In order to correct these errors, Freddie Mac has recognized the fair value of its contractual right to receive guarantee fees (referred to as a "guarantee asset") as a retained interest in the transfers of mortgage loans, PCs and Structured Securities that qualify as sales. In addition, the company has recognized the fair value of the corresponding guarantee obligation as a reduction of the sales proceeds. Specifically, the difference between cash received less the fair value of obligations incurred upon sale and the cost basis allocated to the sold PC or Structured Security was recorded as the gain or loss at the date of sale. In order to account for these components after the date of sale, Freddie Mac has elected to record the on-going change in fair value of the guarantee asset and guarantee obligation as part of current period earnings.

During the restatement period, Freddie Mac has concluded that it accounted for repurchases of its mortgage-related securities incorrectly in that:

- Cash flows associated with the guarantee contract related to securities held by the company were incorrectly classified as management and guarantee income, and
- The company's previous accounting did not consider the effect of PC or Structured Securities repurchases on the guarantee asset and guarantee obligation. To correct these errors, Freddie Mac has reclassified the management and guarantee income on securities it holds to net interest income. In addition, for repurchased securities for which a guarantee asset and guarantee obligation have been established, Freddie Mac has extinguished the guarantee obligation and reclassified the guarantee asset, after considering any related diminution in value attributable to the guarantee obligation, to the PC or Structured Security balance as Participation Certificate residuals ("PCRs"). As with the guarantee asset and guarantee obligation, PCRs continue to be marked to fair value through earnings.

During the restatement, Freddie Mac also determined that it incorrectly accounted for buy-up fees, which represent upfront cash payments the company made to its counterparties in Guarantor program transactions to increase the guarantee fee rate. Freddie Mac identified that the accounting during the restatement period was incorrect because it:

- Netted buy-ups and buy-downs (buy-down fees represent cash received from counterparties to reduce the guarantee fee rate);
- Stopped reporting the change in fair value of buy-up fees as a component of AOCI as required under SFAS 125 for financial assets with significant prepayment risk on April 1, 2001, the effective date of EITF 99-20, "Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interest in Securitized Financial Assets," ("EITF 99-20"), thereby avoiding recording impairments of these assets;
- Used an incorrect amortization method, including allocating buy-up and buy-down fee amortization between net interest income and management and guarantee fee income; and
- Failed to follow an acceptable impairment valuation method.

As a result of corrections made during the restatement, buy-ups and buy-downs are accounted for as follows:

- Buy-ups and buy-downs are accounted for separately;
- All buy-ups are accounted for at fair value, with all changes thereto reflected in earnings;
- Buy-ups that relate to PCs held by third parties are classified as guarantee assets, while buy-ups that relate to PCs and certain Structured Securities held in portfolio are classified as PCRs;

- Cash flows received on buy-ups that relate to PCs held by third parties are recognized in earnings as management and guarantee fees, while cash flows received on buy-ups that relate to PCs held in portfolio are recognized in earnings as interest income;
- Buy-downs that relate to PCs held by third parties are amortized into earnings as management and guarantee fees; and
- Buy-downs that relate to PCs held in portfolio are extinguished and recognized as basis adjustments to the carrying value of purchased PCs (where such adjustments are amortized into earnings as interest income).

The cumulative effect of correcting the referenced errors on Freddie Mac's pre-tax income was an increase of $502 million and an increase in pre-tax AOCI of $476 million. Additional detail regarding the impact of correcting these errors is set forth in *Table 1.17*.

Table 1.17 — Accounting for Transfers of Mortgage Loans, PCs and Structured Securities — Summary of Financial Impacts

	Cumulative Effect from Inception — 12/31/1999	2000	2001	2002	Total
		(dollars in millions)			
Income (expense) before taxes	$1,452	$(477)	$ 393	$(866)	$502
AOCI before taxes	$ 183	$ 307	$(138)	$ 124	$476

Accounting for IO Securities and Certain Asset Securitizations. Freddie Mac invests in IO securities, which are held in its retained portfolio. IO securities represent only the interest portion of cash flows of mortgage-related securities that pay both principal and interest (*i.e.*, excludes principal cash flows). During the restatement period, Freddie Mac classified IO securities in both the available-for-sale and trading category under SFAS 115. Although declines in market value for available-for-sale securities are typically recorded through AOCI, decreases in IO fair value are often considered accounting impairments and must be measured and recorded through earnings in accordance with EITF 93-18, "Recognition of Impairment for an Investment in a Collateralized Mortgage Obligation Instrument or in Mortgage-Backed Interest Only Certificate ("EITF 93-18") (prior to March 31, 2001) and EITF 99-20 (after March 31, 2001). The company has concluded it did not properly calculate and record fair value impairments on its IO portfolio. For periods prior to and ended March 31, 2001, the error was due to not measuring impairments. To correct this error, decreases in fair value that met the EITF 93-18 definition of impairment were recorded as a reduction in the cost basis of the security with a corresponding loss recorded through "Gain (losses) on investment activity." An adjustment was also made to interest income to adjust the amount of amortization income recognized as a result of the change in the security cost basis.

For periods after March 31, 2001, impairments were measured and recorded under EITF 99-20. However, the population of IO securities to which EITF 99-20 was applied was not complete or accurate due to the following four issues:

Securitizations Executed in the First Quarter of 2001. In two securitization transactions executed in the first quarter of 2001 (internally referred to as J-8 and J-9), Freddie Mac combined IOs and other collateral into synthetic principal and interest securities through two securitization entities. In each case, Freddie Mac held all or substantially all of the new securities issued by the new securitization entities and inappropriately accounted for the securities issued by these entities. The transactions had the effect of reducing the losses on the IOs that otherwise would have resulted in a decrease in earnings upon implementation of EITF 99-20, which became effective on April 1, 2001. Freddie Mac has concluded that the entities created to effect the securitization did not qualify as qualifying special purpose entities under SFAS 125 and must be consolidated. Accordingly, to correct this error, the IO collateral together with other collateral held by the entities should have been accounted for separately. The IO collateral associated with one of these transactions was later erroneously reclassified from available-for-sale to trading. Therefore, the correction presented below appropriately reflects an available-for-sale classification throughout the restatement period and includes the effect of

recognizing the changes in fair value of the securities, absent any related impairments, through AOCI as opposed to earnings.

Security Purchases in the Third and Fourth Quarters of 2002. In two additional transactions executed in the third and fourth quarters of 2002, Freddie Mac purchased 100 percent of the securities issued by two special purpose entities. However, because the company concluded that these entities must be consolidated under the requirements of EITF Topic D-14, "Transactions Involving Special-Purpose Entities" ("EITF Topic D-14"), the collateral held by these entities, which included IOs, should have been separately accounted for and subject to impairment and other requirements of EITF 99-20.

REMIC Purchases in January 2002. In January 2002, Freddie Mac purchased from an unaffiliated dealer 100 percent of two REMICs. In both cases, Freddie Mac participated in the design of the REMIC structuring. Similar to the transaction described above, the company erroneously accounted for the REMIC securities rather than the underlying collateral, which had the effect of reducing income since a portion of the REMIC securities held were IO securities and other securities held had the impact of shifting earnings to future periods. Freddie Mac has concluded that the accounting for these transactions should be applied to the aggregate collateral supporting the REMICs as opposed to the securities issued by the REMIC structure. The correction to account for the collateral primarily involved the reversal of IO accounting originally applied to these REMIC securities under EITF 99-20 and the recognition of income based on the attributes of the collateral underlying the REMIC structure.

Certain IO and PO Purchases. In addition to the specific transactions described above, Freddie Mac has concluded that in certain circumstances during the restatement period, individual IO and principal only ("PO") securities (*i.e.*, securities excluding interest cash flows) purchased simultaneously should have been combined and treated as a whole security. This correction resulted in the reversal of IO impairment accounting for these securities.

The cumulative effect of correcting the errors described above on Freddie Mac's pre-tax income was a decrease of $235 million and an increase to pre-tax AOCI of $12 million. Additional detail regarding the impact of correcting these errors is set forth in *Table 1.18*.

Table 1.18 — Accounting for IO Securities and Certain Asset Securitizations — Summary of Financial Impacts

	Cumulative Effect from Inception — 12/31/1999	2000	2001	2002	Total
		(dollars in millions)			
Income (expense) before taxes	$(19)	$(8)	$(231)	$23	$(235)
AOCI before taxes	—	—	$ 7	$ 5	$ 12

Accounting for Dollar Rolls and Similar Transactions. Dollar rolls are transfers of financial assets Freddie Mac generally executes during periods of short-term imbalances in the liquidity of the MBS market. These transactions typically consist of:

- A forward sale of a TBA security to a third party for delivery in the current month, and
- A concurrent forward purchase of a similar, but not identical, PC or MBS for delivery in a future month. These transactions were also executed in reverse (*i.e.*, forward purchase was executed for delivery in the current month with a concurrent forward sale for delivery in a future month). Dollar roll and other similar security transfer transactions executed by Freddie Mac's retained portfolio were historically accounted for as financing transactions under SFAS 125/140. The company has concluded that financing treatment for the majority of these transactions was incorrect because the transactions were structured in ways that did not meet the requirements of SFAS 125/140 to be considered financing transactions. This is because such transactions either were inadequately collateralized or involved the delivery of a PC or MBS in the current month that was not substantially the same as the PC or MBS delivered back to Freddie Mac in the future month.

To correct the accounting for retained portfolio dollar rolls and other similar security transfer transactions, the following adjustments were made:

- The effects of financing treatment were reversed which resulted in the removal of short-term debt and mortgage-related assets and associated interest income and expense.
- The transactions were recorded as purchases and sales, which involved the recognition of gains and losses on sales activity and premiums and discounts on purchase activity in the appropriate periods.
- The forward commitments associated with the security purchase or sale were recorded as a derivative under SFAS 133. The effect of this correction is captured in the "*Accounting for Derivative Instruments* — Forward Purchase and Sale Commitments" section.
- All securities were reclassified from held-to-maturity to available-for-sale because dollar roll transactions were executed with collateral classified as held-to-maturity under SFAS 115. The effect of this error is included in the "*Security Classification*" section.

The cumulative effect on Freddie Mac's pre-tax income of reversing financing accounting and recording these transactions as sales and purchases was a decrease of $86 million. Additional detail regarding the impact of correcting the error described above is set forth in *Table 1.19*.

Table 1.19 — Accounting for Dollar Rolls and Similar Transactions — Summary of Financial Impacts

	Cumulative Effect from Inception — 12/31/1999	2000	2001	2002	Total
	(dollars in millions)				
Income (expense) before taxes	$(102)	$(3)	$27	$(8)	$(86)
AOCI before taxes	—	—	—	—	—

Special Purpose Entities. In May 1998, Freddie Mac transferred credit risk to a special purpose entity (internally referred to as "MODERNs") in a reinsurance transaction. This entity issued to third parties $243 million of credit-linked securities, which were not recorded in Freddie Mac's financial statements since the entity was not consolidated. However, under the consolidation guidance of EITF Topic D-14, the company has now concluded it must consolidate this entity which will have the effect of increasing both assets and liabilities. Due to redemptions and pay downs of the securities, the effect on Freddie Mac's balance sheet as of December 31, 2002 and 2001 was to increase total assets and liabilities to $41 million and $44 million, respectively.

Cash Collateral on Derivative Contracts. In the ordinary course of business, Freddie Mac enters into interest-rate swap transactions with highly rated counterparties. Under the swap and security agreements that govern such transactions, most of the counterparties are required to post collateral. This collateral is often posted in the form of cash. Under SFAS 125/140, cash collateral must be recorded as an asset on Freddie Mac's balance sheet with an offsetting liability to return that collateral. For the years 1999, 2000, and 2001, and through June 30, 2002, the company erroneously understated its balance sheets for cash collateral provided by its derivative counterparties. As part of the restatement, Freddie Mac has corrected its quarterly balance sheets for the respective periods through increases in cash and cash equivalents and other liabilities ranging from $0.9 billion to $3.3 billion.

Valuation of Financial Instruments

Freddie Mac estimates the fair value of its derivatives and securities for risk management purposes as well as financial accounting and reporting purposes. Under GAAP, fair value is defined as the amount at which an asset (liability) could be bought and sold between willing parties, that is, other than in a forced or liquidation sale. GAAP specifies that quoted market prices in active markets are the best evidence of fair value. If a quoted market price is not available, the estimate of fair value should be based on the best information available in the circumstances and should incorporate assumptions that market participants would

use in their estimates of values. The use of different pricing models and assumptions could produce materially different estimates of fair value. *See* "NOTE 17: FAIR VALUE DISCLOSURES" for more information.

Option-Based Derivatives. In 2001 and 2002, Freddie Mac designated the entire fair value of its option-based derivatives portfolio as hedges under SFAS 133. *See "Accounting for Derivative Instruments* — Embedded Options Hedging Strategy" above for a description and quantification of the hedge accounting corrections related to option-based derivatives during 2001 and 2002.

To estimate fair values for option-based derivatives, Freddie Mac used option-pricing models incorporating volatility assumptions. Freddie Mac's implementation of the models failed to incorporate all relevant pricing information available in the market as required under GAAP. First, the fair value of option-based derivatives was misstated at December 31, 2000 because the company inappropriately applied constant volatility assumptions as of an earlier date (*i.e.*, November 20, 2000) instead of available contemporaneous market-implied volatilities in the option-pricing model. This had the effect of understating the original fair value of the option-based derivatives by approximately $550 million, which was recorded on January 1, 2001 as part of adopting SFAS 133 in the previously reported financial statements. Second, the fair values of option-based derivatives were misstated during 2001 and 2002 because Freddie Mac failed to incorporate market information about changes in volatilities for out-of-the-money swaptions. The volatility estimates historically used were generally designed to be consistent in methodology with the models used to value the hedged prepayment option in mortgage-related securities.

Correction of these errors resulted in a cumulative net increase to pre-tax income of $361 million. The restated fair values include market-implied volatility inputs to the extent these were available. Additional detail regarding the impact of correcting these errors is set forth in *Table 1.20*.

Table 1.20 — Option-Based Derivatives — Summary of Financial Impacts

	Cumulative Effect from Inception — 12/31/1999	2000	2001	2002	Total
		(dollars in millions)			
Income (expense) before taxes	—	$626	$(225)	$(40)	$361
AOCI before taxes	—	—	—	—	—

Securities. Under SFAS 115, securities are required to be classified as held-to-maturity, available-for-sale, or trading primarily based on the company's intent. Held-to-maturity securities are reported at amortized cost, available-for-sale securities are marked to fair value through stockholders' equity, and trading securities are marked to fair value through earnings. As discussed in "*Security Classification*" above, all of Freddie Mac's securities are recorded at fair value as a result of the restatement.

As part of the restatement, Freddie Mac identified numerous errors in estimating the fair value of its investments in securities. In certain instances, the company used models that failed to consider all relevant facts including available market data. For example, the method used to value certain manufactured housing bonds failed to acknowledge significant market price deterioration in 2002, resulting in an overstatement of fair value which has been recognized as an impairment. Also, the method used to value mortgage revenue bonds where prices were not readily available utilized price movements on proxy securities. However, because these proxy securities had different call provisions and other contractual terms, their use in the fair value estimation for Freddie Mac's mortgage revenue bonds led to an overstatement of fair value during the restatement period.

In other cases, process errors involving erroneous inputs into otherwise reasonable models resulted in misstatements of fair value. The fair values of certain PCs and Structured Securities were misstated due to model input errors, including the use of inaccurate price spreads for seasoned securities. In addition, the fair values of other securities were misstated due to process errors, including the use of incorrect interest calculations as well as the use of outdated prices or constant trade prices instead of period-end fair values.

Finally, Freddie Mac made errors in valuing certain investments in Treasury securities. Instead of using observable market prices, the company estimated the value of these investments using models. These errors resulted in the overstatement of fair value.

Correction of these errors resulted in increases or decreases to investments in securities, with offsetting impacts to AOCI for available-for-sale securities and to current period earnings for trading securities. The table below reflects the results of the valuation error corrections after correction of the security classification errors (as discussed in "*Security Classification*" above).

The corrections resulted in a cumulative net decrease to pre-tax income of $147 million and a decrease to pre-tax AOCI of $268 million. Additional detail regarding the impact of correcting these errors is set forth in *Table 1.21*.

Table 1.21 — Securities — Summary of Financial Impacts

	Cumulative Effect from Inception — 12/31/1999	2000	2001	2002	Total
		(dollars in millions)			
Income (expense) before taxes	—	—	$(100)	$ (47)	$(147)
AOCI before taxes	—	$(105)	$ 48	$(211)	$(268)

All Other Accounting Corrections

Income Classification of Spot-Forward Difference on Certain Trading Securities. In conjunction with Freddie Mac's PC market-making and support activities, the company often funds long-term mortgage securities in its trading portfolio with short-term debt. This creates an asset/liability funding mismatch, which is generally hedged by entering into forward sales of mortgage-related securities. Since the settlement of these forward sale trades takes place weeks or months in the future, the sales price ("forward" price) is discounted from the current value ("spot" price) of the security. This discount (spot-forward difference) is generally equal to the net interest income earned over the commitment period based on the difference between the security coupon and current short-term rates.

Because the spot-forward difference between the trading security and forward sale commitment resulted in a loss being recorded to other income while the recognition of interest income on the held position resulted in an offsetting increase in net interest income, Freddie Mac historically reclassified the implied effect of the spot-forward difference on trading securities from other income to net interest income. In the restatement period, Freddie Mac has concluded that this reclassification was an error. Although this error had no effect on net income, the reclassification adjustments to net interest income and other income are detailed in *Table 1.22*.

Table 1.22 — Income Classification of Spot-Forward Difference on Certain Trading Securities — Summary of Financial Impacts

	Cumulative Effect from Inception — 12/31/1999	2000	2001	2002	Total
		(dollars in millions)			
Net interest income (expense) before taxes	$ 251	$ 103	$ 431	$ 938	$ 1,723
Other income (expense) before taxes	$(251)	$(103)	$(431)	$(938)	$(1,723)
Income (expense) before taxes	—	—	—	—	—
AOCI before taxes	—	—	—	—	—

Mortgage Loan Accounting Based on Lower of Cost or Market Value ("LOCOM"). Through Freddie Mac's Cash Window Program, the company purchases mortgage loans under purchase commitments entered into with lenders that are classified as "held-for-sale" until sold to third parties or transferred to Freddie Mac's retained portfolio in the form of mortgage loans or mortgage-related securities. SFAS 65, "Accounting for Certain Mortgage Banking Activities" ("SFAS 65"), requires mortgage loans classified as held-for-sale to be reported at the lower of cost or market, with losses reported through earnings. In measuring the write-down to fair value, the fair value change of open mortgage loan purchase commitments and all outstanding forward sale commitments needs to be considered. Freddie Mac failed to perform a LOCOM test as required by SFAS

65. The cumulative effect of correcting this error was a decrease to pre-tax income of $180 million and a cumulative decrease to pre-tax AOCI of $28 million.

Additional detail regarding the impact of correcting these errors is set forth in *Table 1.23*.

Table 1.23 — Mortgage Loan Accounting Based on LOCOM — Summary of Financial Impacts

	Cumulative Effect from Inception — 12/31/1999	2000	2001	2002	Total
		(dollars in millions)			
Income (expense) before taxes	$(72)	$(15)	$(101)	$ 8	$(180)
AOCI before taxes	—	—	$ 25	$(53)	$ (28)

Asset Amortization. In accordance with SFAS 91, "Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases" ("SFAS 91"), premiums, discounts and other deferred adjustments associated with mortgage loans and securities for which Freddie Mac will recover substantially all of its aggregate recorded investment upon prepayment are generally amortized into net interest income over the estimated lives of the mortgage loans and securities using the effective interest method (*see* "NOTE 2: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES" for further details). Additionally, certain items related to the securitization process are deferred and amortized into income using the effective interest method (*e.g.*, prepaid guarantee fees such as buy-downs). During the restatement, Freddie Mac corrected the income recognition related to these components primarily in the four areas outlined below.

Secondary Impacts Resulting From Corrections in the Cost Basis of Certain Securities. Several accounting corrections described in this section had the effect of changing the cost basis of certain securities. The most significant effect was driven by intracompany transactions (*see "Accounting for Derivative Instruments* — Forward Purchase and Sales Commitments" for further detail). As a result of these corrections, the original deferred premiums and discounts to be amortized were corrected which resulted in a cumulative increase to pre-tax income of $217 million. The other income statement effects resulting from intracompany transactions are included in the section entitled "*Accounting for Derivative Instruments* — Forward Purchase and Sale Commitments" above.

Amortization Reserve. As permitted under SFAS 91, Freddie Mac uses actual prepayment experience as well as estimates of expected future prepayments to determine the constant yield needed to apply the effective yield method. As required by SFAS 91, when estimates change, the net investment in the security should be adjusted to the amount that would have existed had the new effective yield been applied since the acquisition of the security. The security's cost basis should be adjusted to the new balance with a corresponding charge to net interest income for that reporting period. Historically, when estimated prepayments changed, the company properly recorded the cumulative adjustment to the cost basis of the security, but the offsetting entry was inappropriately deferred on the balance sheet in a reserve account (referred to internally as the "Amortization Reserve") as opposed to being correctly recorded in earnings, which was a known departure from GAAP but which was not deemed to be material at the time, and which was made with a view toward its effect on earnings. The cumulative effect on pre-tax income of correcting this error was an increase of $11 million. The annual effects on pre-tax income for 2000, 2001 and 2002 were decreases of $74 million, $109 million and $22 million, respectively.

First Quarter 2002 Adjustment. Freddie Mac also identified that amortization results recorded in the first quarter of 2002 were derived from prepayment expectations that inappropriately incorporated interest-rate projections that were not supportable. As a result, interest income was understated by $132 million in the first quarter of 2002. In the second quarter of 2002, Freddie Mac utilized supportable interest-rate projections, which effectively reversed the impact of the $132 million related to the first quarter of 2002. This had the effect of overstating interest income for second quarter 2002, but had no cumulative effect. As part of the restatement, Freddie Mac has utilized appropriate

interest-rate projections, thereby correcting amortization results for both the first and second quarters of 2002.

Other Corrections. As part of the restatement, Freddie Mac identified and corrected certain other data and process errors, including correcting security level assumptions used to project expected cash flows, which changed the timing of premium and discount amortization as well as deferred fee recognition. Additionally, certain deferred fees were amortized using a straight-line methodology as opposed to an effective yield process as required by SFAS 91. The cumulative effect on pre-tax income of correcting these items was an increase of $159 million.

The cumulative effect of correcting these errors was an increase of $492 million in pre-tax income and a decrease to pre-tax AOCI of $56 million. Additional detail regarding the impact of correcting these errors is set forth in *Table 1.24*.

Table 1.24 — Asset Amortization — Summary of Financial Impacts

	Cumulative Effect from Inception — 12/31/1999	2000	2001	2002	Total
		(dollars in millions)			
Income (expense) before taxes	$177	$(54)	$187	$182	$492
AOCI before taxes	—	—	$ 15	$(71)	$(56)

Loan Loss Reserves and Credit-Related Accounting. Historically, Freddie Mac has maintained a "Reserve for losses on mortgage loans held for investment" to provide for credit losses on mortgage loans and PCs held in its retained portfolio and a "Reserve for losses on Participation Certificates" to provide for credit losses on mortgage loans underlying all PCs either held by third parties or held by Freddie Mac. The "Reserve for losses on mortgage loans held for investment" and the "Reserve for losses on Participation Certificates" are collectively referred to as "Loan loss reserves."

Beginning in the second quarter of 2002 and continuing as part of the restatement process in 2003, Freddie Mac completed a detailed review of its loan loss reserve and credit loss accounting policies, methods and processes. As a result of this work, the company has corrected both the population of loans and mortgage-related securities against which Loan Loss Reserves are held as well as the level of Loan Loss Reserves needed for the defined population of mortgage assets. The population of loans against which Loan Loss Reserves are held was corrected in accordance with SFAS 115, SFAS 125/140 and other GAAP guidance due to the nature of Freddie Mac's mortgage guarantee and investment portfolio management activities. The level of Loan Loss Reserves held for the re-defined population was corrected to adjust for errors in the application of SFAS 5, "Accounting for Contingencies" ("SFAS 5") and SFAS 114, "Accounting by Creditors for Impairment of a Loan" ("SFAS 114") as well as the errors in the calculation or aggregation of divisional Loan Loss Reserve estimates. More specifically, the three primary areas that drove these corrections are outlined below:

Reduction of SFAS 5 Loan Population due to the application of SFAS 125/140 and other GAAP guidance. As discussed in "*Asset Transfers and Securitizations* — Accounting for Transfers of Mortgage Loans, PCs and Structured Securities" above, Freddie Mac is now recognizing a guarantee obligation at fair value on the date of sale for certain transactions involving its PCs and Structured Securities. Therefore, it is no longer necessary to hold loan loss reserves against these PCs and Structured Securities given that the guarantee obligation includes an estimate of expected future credit losses. As a result, during the restatement period, the company has removed the Loan Loss Reserves estimated and held for all PCs and Structured Securities for which there is a PCR or guarantee obligation recorded and outstanding.

Reduction of SFAS 5 Loan Population due to the application of SFAS 115. As described above, Freddie Mac historically established loan loss reserves for the credit loss incurred on loans securing PCs it holds. In connection with the correction of the accounting for credit guarantees more broadly as it relates to SFAS 125/140 (*see* "*Asset Transfers and Securitizations* — Accounting for Transfers of Mortgage Loans, PCs and Structured Securities" above) and other GAAP guidance, Freddie Mac concluded that the establishment of loan loss reserves for the credit risk in PCs it holds would not be acceptable under SFAS 115.

Therefore, the portion of the Loan Loss Reserve balances related to PCs the company holds was removed. Furthermore, as required by SFAS 115, any impairment in the security values determined to be other-than-temporary should be recorded as a reduction in the security's basis with a corresponding charge to earnings. During the restatement, Freddie Mac concluded that no impairments under SFAS 115 needed to be recorded.

Errors in Estimating Loan Loss Reserves. As mentioned above, during second and third quarters 2002, Freddie Mac performed a detailed review of its Loan Loss Reserve policies, methodologies and processes. Based on this review, the company concluded its Loan Loss Reserves were inappropriately maintained in excess of the amounts permitted by GAAP in the amount of $246 million. Freddie Mac determined at the time that the overstatement of Loan Loss Reserves related primarily to periods prior to 1999. Initially, Freddie Mac recorded the reduction in Loan Loss Reserves as an aggregate adjustment to current period earnings in the third quarter of 2002, rather than allocating the adjustments among the relevant prior periods in which they arose and restating the financial statements for those periods. However, as part of the restatement, Freddie Mac reversed the one-time $246 million adjustment recorded to third quarter 2002 earnings and restated prior period results to reflect this adjustment in the correct periods, resulting in no impact to income on a cumulative basis.

As part of the restatement process, Freddie Mac identified and corrected additional accounting errors related to Loan Loss Reserves and credit accounting, including errors in estimating losses on restructured mortgages.

The cumulative effect of correcting these errors was an increase in pre-tax income of $158 million. Additional detail regarding the impact of correcting these errors is set forth in *Table 1.25*.

Table 1.25 — Loan Loss Reserves and Credit-Related Accounting — Summary of Financial Impacts

	Cumulative Effect from Inception — 12/31/1999	2000	2001	2002	Total
		(dollars in millions)			
Income (expense) before taxes	$554	$3	$10	$(409)	$158
AOCI before taxes	—	—	—	—	—

Reserve Adjustments, Other Contributions and Accruals. As part of the restatement, Freddie Mac has made pre-tax corrections for adjustments related to civil lawsuits (excluding potential litigation risk due to this restatement process), other contingencies as well as other discretionary contributions and asset impairments. Certain of these adjustments were not considered to be material at the time and were made with a view to their effect on earnings. Based upon the review of contemporaneous documentation in place and other relevant factors, Freddie Mac has now concluded that these adjustments were in error.

The cumulative effect of correcting these errors was a decrease to pre-tax income of $55 million. Additional detail regarding the impact of correcting these errors is set forth in *Table 1.26*.

Table 1.26 — Reserve Adjustments, Other Contributions and Accruals — Summary of Financial Impacts

	Cumulative Effect from Inception — 12/31/1999	2000	2001	2002	Total
		(dollars in millions)			
Income (expense) before taxes[1]	$71	$(12)	$(38)	$(76)	$(55)
AOCI before taxes	—	—	—	—	—

(1) Amounts exclude reclassifications from interest expense to income tax expense of $71 million for the cumulative effect through 1999, and $14 million, $37 million and $(30) million for the years ended December 31, 2000, 2001, and 2002, respectively, resulting in a net cumulative reclassification of $92 million.

Miscellaneous. In addition to the adjustments individually described above in "*All Other Accounting Corrections*," Freddie Mac has identified other accounting policies and practices that required correction. These corrections touch on many aspects of the company's financial statements and have been reflected in its restated results. The cumulative effect of correcting all of these errors was a decrease to pre-tax income of

$124 million and a decrease to pre-tax AOCI of $2 million. Additional detail regarding the impact of correcting these errors is set forth in *Table 1.27*.

Table 1.27 — Miscellaneous — Summary of Financial Impacts

	Cumulative Effect from Inception — 12/31/1999	2000	2001	2002	Total
		(dollars in millions)			
Income (expense) before taxes	$(104)	$53	$(27)	$(46)	$(124)
AOCI before taxes	$ (7)	$ 6	$ 28	$(29)	$ (2)

II. Other Accounting Changes

Accounting for Certain Premiums and Discounts

Premiums and discounts related to mortgage-related assets arise when such investments are acquired at prices above or below the outstanding contractual principal value of the assets. These amounts are amortized into interest income over the estimated weighted average lives of the underlying mortgages using the effective interest method as prescribed by SFAS 91. In the fourth quarter of 2002, Freddie Mac improved its estimate of the expected weighted average lives of mortgage-related assets in the company's retained portfolio. This change in estimate included enhancements to the prepayment model used in the determination of weighted average lives and to other formulas used to calculate interest income under the effective interest method. In addition, Freddie Mac refined its method for collecting the mortgage asset data that are inputs to its amortization model for premiums and discounts.

These enhancements resulted in the recognition of an additional $305 million in income before taxes in the fourth quarter of 2002 and a decrease in pre-tax AOCI of $333 million and were recorded as a change in estimate in accordance with Accounting Principles Board ("APB") Opinion No. 20, "Accounting Changes" ("APB 20"). The adjustment to AOCI is necessary because a substantial portion of the $305 million increase to income was related to the amortization of basis adjustments associated with mortgage-related securities classified as available-for-sale. More specifically, a substantial portion of this income adjustment resulted in an increase in the carrying basis of available-for-sale securities, resulting in a corresponding decrease in unrealized gains reported through AOCI.

Stock-Based Compensation

Prior to 2002, Freddie Mac accounted for the company's stock-based compensation plans under the recognition and measurement provisions of APB 25, "Accounting for Stock Issued to Employees," or APB 25, and related interpretations. For option awards, no stock-based compensation cost was reflected in previously reported results because all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of the grant. In the second quarter of 2002, Freddie Mac elected to prospectively adopt the fair value method of accounting for its stock awards granted, modified or settled on or after January 1, 2002 under the guidance of SFAS 123, "Accounting for Stock-Based Compensation ("SFAS 123")". Freddie Mac adopted SFAS 123 for all of the company's stock-based compensation awards, including stock options, its employee stock purchase plan ("ESPP"), restricted stock and restricted stock units ("RSUs"). After the issuance of SFAS 148, "Accounting for Stock-Based Compensation Transition and Disclosure ("SFAS 148")", in December 2002, Freddie Mac selected the retroactive restatement transition method described in SFAS 148, which amended SFAS 123 to permit a retroactive restatement of prior years' financial statements for stock awards granted on or after January 1, 1995.

As a result, Freddie Mac has restated all prior periods presented to reflect the incremental impact of adopting SFAS 123 for awards granted, modified or settled on or after January 1, 1995 on compensation expense, additional paid-in capital and the opening balance of retained earnings. The company will continue to apply APB 25 to stock awards granted prior to January 1, 1995. In accordance with SFAS 123, Freddie Mac measures the fair value of a stock-based compensation award at the grant date and recognizes this amount as compensation expense over the vesting period on a straight-line basis.

Retroactive recognition of fair-value based stock compensation expense under SFAS 123/148 for grants between January 1, 1995 and December 31, 2001 resulted in a cumulative reduction to income before taxes through December 2002 of $137 million. This incremental expense from retroactively adopting SFAS 123 relates to stock options and the ESPP. Adoption of SFAS 123 resulted in no incremental expense related to restricted stock and RSU awards, which are effectively measured at fair value under both APB 25 and SFAS 123.

III. Tax-Related Adjustments

In addition to the accounting corrections and other accounting changes, Freddie Mac's restated results also include tax-related adjustments. These adjustments were driven by the following factors as outlined below:

Tax Adjustments

Tax adjustment due to accounting corrections and other accounting changes. As a result of the restatement, the cumulative effect on pre-tax income is an increase of $7.6 billion. In light of this increase in income, Freddie Mac's cumulative income tax expense is higher by approximately $2.6 billion based on its statutory federal income tax rate of 35 percent. The $2.6 billion tax impact relates almost entirely to an increase in deferred taxes payable, while approximately $15 million represents an increase in current taxes payable.

Tax adjustment due to tax corrections. Similar to the adjustments discussed as part of the "*Accounting Errors — All Other Accounting Corrections* — Reserve Adjustments, Other Contributions and Accruals," Freddie Mac made adjustments for the level of tax reserves that were not considered material at the time and were made with a view to their effect on earnings. Based upon review of contemporaneous documentation in place and other relevant factors, the company has now concluded that these adjustments were in error. As a result of the restatement, Freddie Mac has corrected certain accruals for tax contingencies, which had an impact of reducing tax expense by $16 million. Freddie Mac also made additional tax-related corrections, which had an impact of increasing tax expense by $31 million.

Tax Adjustments due to Subsequent Events

Tax adjustment due to recent U.S. Tax Court Rulings. As discussed in "NOTE 15: INCOME TAXES," on September 4, 2003 and September 29, 2003, the U.S. Tax Court ("Court") ruled favorably for Freddie Mac on two preliminary motions involving questions of law in the case. Based upon these rulings and the company's assessment of its reduced tax exposure, Freddie Mac has recorded a reduction to its tax reserves of $155 million in the fourth quarter of 2002; this reserve reduction decreased the company's income tax expense by $155 million.

Additional detail regarding the impact of all tax-related adjustments is set forth in *Table 1.28*.

Table 1.28 — Tax-Related Adjustments — Summary of Financial Impacts

	Cumulative Effect from Inception — 12/31/1999	2000	2001	2002	Total
		(dollars in millions)			
Income tax expense[1]	$364	$491	$(501)	$2,124	$2,478
AOCI before taxes	—	—	—	—	—

(1) In order to reconcile the total income tax expense of $2.478 billion, depicted above, to the income tax expense impact of $2.591 billion on *Table 1.1*, $113 million of additional income tax expense must be added which is primarily attributable to a reclassification from interest expense to income tax expense.

IV. Errors in Computing Freddie Mac's 2001 Consolidated Fair Value Balance Sheet ("FVBS")

The following table summarizes the net impacts of the restatement and other corrections on Freddie Mac's FVBS net assets at December 31, 2001. FVBS net assets at December 31, 2000 have not been restated and therefore are not comparable to the amounts presented for December 31, 2001.

Table 1.29 — Impact of Restatement and Other Corrections on 2001 FVBS Net Assets

	(dollars in billions)
FVBS net assets at December 31, 2001, as reported	$17.7
Net effect of 2001 errors (net of taxes)	
Derivatives	0.2
Mortgage-related investments	(0.1)
Minority interest in consolidated subsidiaries	0.1
Guarantee contracts	0.5
Other effects of restatement, net	(0.1)
Total impact	0.6
FVBS net assets at December 31, 2001, as restated	$18.3

In connection with the restatement of its financial statements, Freddie Mac reviewed the appropriateness of its valuation techniques and accounting policies and practices. As a result of this review, the company concluded that the fair values of certain components of its previously reported FVBS were incorrect. The following discussion explains these errors, which are detailed in the table above. Correction of these errors, together with certain balance sheet reclassifications, explain the changes in FVBS line items from previously reported to as-restated FVBS.

- Derivatives — Correction of various errors related to derivatives resulted in a change to FVBS net assets at December 31, 2001. Freddie Mac used models that incorporated volatility assumptions in order to establish fair values for option-based derivatives during the restatement period. Freddie Mac's implementation of the models failed to incorporate all relevant pricing information available in the market. The correction of these errors increased FVBS net assets at December 31, 2001, by $0.2 billion after taxes.

- Mortgage-related investments — Freddie Mac made the following types of errors in its accounting for mortgage-related investments. In some cases the company used incorrect principal balances in the calculation of fair value. In other instances, Freddie Mac made numerous errors in estimating the fair value of its mortgage investments. These errors included the use of models or pricing matrices that failed to consider certain relevant market data and inaccurate lockout provisions related to prepayments. Finally, the company failed to account for certain mortgage purchase and sale commitments at fair value. The correction of these errors decreased FVBS net assets at December 31, 2001 by $0.1 billion after taxes.

- Minority interest in consolidated subsidiaries — Freddie Mac owns majority interests in two REITs. This caption primarily represents minority interests that third parties hold in the company's majority-owned REIT subsidiaries in the form of REIT preferred stock. The valuation methodology used by Freddie Mac for pricing the REIT preferred stock was based on a potential tax event redemption that valued the amount at redemption based on a spread to certain Treasury rates and market implied volatilities. The Treasury rates used to calculate the estimated redemption price, however, were incorrect, causing Freddie Mac to overvalue the estimated redemption price. Correction of this error resulted in an increase to FVBS net assets of $0.1 billion after taxes at December 31, 2001.

- Pricing methodology and other corrections related to guarantee contracts — As part of the restatement, Freddie Mac revised the fair value of its guarantee contracts. The valuation process employed in 2001 was changed to incorporate additional benchmark market data regarding observed option-adjusted spreads on assets similar to the guarantee asset. Also, the company failed to incorporate available market data in estimating the future credit losses associated with

the guarantee obligation. Finally, additional errors were made in the aggregation of the unpaid principal balance of mortgage securities and other contractual portfolio data against which prices were applied. The correction of these errors resulted in a $0.5 billion after tax increase in FVBS net assets at December 31, 2001.

- Other effects of restatement, net — Freddie Mac restated the carrying values of a number of assets and liabilities that are presented at their recorded GAAP amounts in the 2001 FVBS. The modification of these balances, together with the related tax effects, resulted in a decrease in FVBS net assets of $0.1 billion at December 31, 2001.

As a result of the restatement, Freddie Mac made changes in the accounting classification and presentation of certain items in the financial statements for GAAP accounting purposes. In certain cases, these classification changes have a material impact on GAAP presentation. These classifications, however, have no impact on the FVBS net assets because they do not affect the way management measures fair value. For presentation purposes, all changes in GAAP classifications have been reflected in the presentation of fair values and comparable GAAP carrying amounts for items presented in the FVBS.

V. Other Errors in the Consolidated Financial Statements

Freddie Mac made numerous errors in the application of GAAP that impacted previously issued consolidated statements of income and the consolidated balance sheets as discussed throughout this note. These errors also impacted previously issued consolidated statements of cash flows. For instance, the consolidated statements of cash flows previously reflected numerous misclassifications between cash flow categories, primarily related to the treatment of cash flows associated with derivatives. Furthermore, Freddie Mac also did not meet the criteria for reporting business segments that are prescribed in SFAS 131, "Disclosures About Segments of an Enterprise and Related Information ("SFAS 131"). For example, Freddie Mac did not maintain, as required by SFAS 131, discretely available and reliable financial information that management used to allocate internal resources among business units. As a result, management has determined that the company has only one business segment for financial reporting purposes, rather than two as previously reported prior to the restatement. In addition, all notes related to the consolidated financial statements included in the Information Statement dated March 29, 2002 ("2001 Information Statement") were affected by the numerous errors noted above and should not be relied upon.

NOTE 2: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

General

Freddie Mac 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 not insured or guaranteed by the United States ("U.S.") or any agency or instrumentality of the U.S. other than Freddie Mac.

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 credit guarantee activities, Freddie Mac securitizes mortgage loans by issuing PCs to third party investors. Freddie Mac also resecuritizes mortgage-related securities that are issued by Ginnie Mae as well as non-agency entities. Securities issued through Freddie Mac's resecuritization activities are referred to as "Structured Securities." In each case, securitized mortgage-related assets that back PCs and Structured Securities that are held by third parties are not reflected as assets of Freddie Mac under GAAP. However, Freddie Mac does retain an obligation to provide the payment of principal and interest on issued PCs and Structured Securities, which may result in the recognition of an asset and obligation on the company's consolidated balance sheets.

Freddie Mac's financial reporting and accounting policies conform to GAAP.

Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect (i) the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and (ii) 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 pervasive in the company's financial statements is the determination of fair value for financial instruments required to be recorded at fair value under GAAP. The measurement of fair value is fundamental to the presentation of 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 the amount at which the instrument could be bought and sold between willing parties, in an active market and not in a forced or liquidation sale. Fair value is generally based on price quotations, where available. If prices are not readily 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.

Estimates are also used to determine the expected weighted average lives of mortgage-related assets in the retained portfolio, to assess the reserves for credit losses on mortgage loans and guarantee losses on PCs, to assess Freddie Mac's legal and tax contingencies, and to determine other matters that affect the reported amounts and disclosure of contingencies in the financial statements. In accordance with SFAS 5, contingencies that might result in gains are not recorded prior to realization; whereas, contingencies that result in losses must be accrued currently if the loss is both probable of occurring 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

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. 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 an asset 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 up to the amount of investment recorded.

The company consolidates its two majority-owned REITs, Home Ownership Funding Corporation and Home Ownership Funding Corporation II, and certain other special purpose entity structures. Generally, the company does not use special purpose entities in its credit enhancement and resecuritization transactions. The company also consolidates the accounts of majority-owned West*Mac Associates Limited Partnership, the owner and developer of Freddie Mac's company headquarters, and wholly-owned Ignition Mortgage Technology Solutions, Inc. The equity and net earnings attributable to the minority shareholder interests which relate to the company's subsidiaries are reported separately in the consolidated balance sheets as "Minority interest in consolidated subsidiaries" and in the consolidated statements of income as "Minority interest in earnings of consolidated subsidiaries," respectively.

The company regularly invests as a limited partner in qualified low-income housing tax credit 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 EITF Issue 94-1, "Accounting for Tax Benefits Resulting from Investments in Affordable Housing Projects" ("EITF 94-1"). Freddie Mac consolidates those investments over which it has the ability to exercise control and accounts for the non-consolidated investments using the equity method of accounting, in accordance with Statement of Position ("SOP") 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" and its share of partnership income or losses is reported in the consolidated statements of income as "Non-interest expense — 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 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 in an unrealized gain position is recorded as "Cash and cash equivalents."

In the statement of cash flows, cash flows related to the acquisition and termination of derivatives are generally classified in investing activities, without regard to whether they are intended as a hedge of another item. Cash flows from commitments (accounted for as derivatives under SFAS 133) that result in the acquisition or sale of mortgage loans or mortgage securities are classified in investing activities for available-for-sale securities or mortgage loans held for investment and operating activities for trading securities or mortgage loans held for sale. The periodic cash flows on derivatives, which are recorded on an accrual basis in "Income (expense) related to derivatives," are reported in operating activities. Cash flows related to guarantee fees, buy-up fees and buy-down fees are classified as operating activities, along with the cash flows related to the collection and distribution of payments on the mortgage loans underlying PCs. 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 in which case they are classified as investing activities. Cash flows related to the repayment of the original issue discount on short-term, zero-coupon debt are reported as operating activities.

Cash-Based Transfers of Financial Assets

Freddie Mac accounts for transfers of financial assets pursuant to the requirements of SFAS 140, and, prior to April 1, 2001, SFAS 125. If Freddie Mac determines that it surrenders control over assets that it transfers to a third party, Freddie Mac accounts for the transfers as sales to the extent its counterparty provides consideration other than beneficial interests in the transferred assets. Likewise, if Freddie Mac determines that it obtains control over assets that were transferred to it, it accounts for the transfers as purchases to the extent Freddie Mac provides consideration other than beneficial interests in exchange for the transferred assets.

If a transfer of financial assets qualifies as a sale, Freddie Mac continues to carry on its consolidated balance sheets any retained interests in financial assets that were securitized and/or resecuritized. 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 guarantee asset, or "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 resecuritization of PCs held in portfolio). These securities are accounted for pursuant to the requirements of SFAS 115. The carrying amounts of retained interests are determined by allocating the previous carrying amount of the transferred assets between assets sold and the retained interests based on their relative fair values at the date of transfer. Freddie Mac's accounting policy for recognized GAs is further described below.

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 consideration as proceeds of the sale. Accordingly, Freddie Mac recognizes the fair value of its recourse obligation to guarantee the timely payment of principal and interest of PCs and Structured Securities transferred in sale transactions. This recourse obligation, which is classified in Freddie Mac's consolidated balance sheets as "Guarantee obligation

for Participation Certificates, at fair value," is recorded as a reduction of proceeds in the calculation of the corresponding gain (loss) on the sale of transferred PCs and Structured Securities. (The referenced guarantee obligation is referred to below as a "GO.") 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."

Freddie Mac accounts for cash-based transfers of financial assets that do not qualify as sales as secured borrowings.

Other Transfers of Financial Assets

Freddie Mac executes several types of non-cash-based exchanges of financial assets that receive different accounting treatment under GAAP. Transfers of PCs that are issued through the Freddie Mac Guarantor Program do not trigger sale accounting recognition under SFAS 125 / 140. In Guarantor Program transactions, Freddie Mac issues PCs that are backed by mortgage loans delivered to it by third parties, and these third parties receive the PCs in exchange for the mortgage loans they delivered. Because Freddie Mac does not have the ability to freely pledge or exchange the transferred mortgage loans, it has not acquired control over the loans. Therefore, the company is considered neither a transferee of the mortgages nor a transferor of the PCs for GAAP purposes and the exchange of PCs for mortgages does not trigger sale accounting recognition under SFAS 125 / 140. The accounting for guarantee fees that relate to Guarantor transfers is discussed further below.

Freddie Mac also issues and transfers Structured Securities to third parties in exchange for PCs and other non-Freddie Mac mortgage-related securities. As with the Guarantor Program, 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. Freddie Mac receives a fee for issuing Structured Securities that is paid at the time of resecuritization. That portion of the transaction fee that relates to the estimated fair value of the company's future administrative responsibilities of issued Structured Securities is deferred and amortized into income on a straight-line basis. Further, and 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 into "Resecuritization fees."

In addition to PCs issued under its Guarantor Program and PCs issued from mortgage loans acquired in exchange for cash consideration ("Cash Window Purchases"), 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 it 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 transaction that qualifies as a sale is accounted for in the same manner as the cash-based transfers described above. The PC issuances and related transfers for the remaining portion are accounted for in a manner consistent with the accounting for PCs issued through the Guarantor Program.

Guarantee Fees, Buy-Up Fees and Buy-Down Fees

In return for providing its guarantee, Freddie Mac earns a management and guarantee fee ("Required G-Fee") that is paid to Freddie Mac over the life of an issued PC. Additionally, Freddie Mac occasionally receives upfront payments as additional compensation for its guarantee of loans with certain credit risk related characteristics. For PC transfers made in connection with Freddie Mac's Guarantor Program, it is also common for buy-up or buy-down fees ("Buy-Ups" or "Buy-Downs," respectively) to be exchanged between Freddie Mac and its counterparties upon issuance of the PC. Buy-Ups represent upfront payments that are made by Freddie Mac, which increase the Required 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 Required G-Fee that Freddie Mac will receive over the life of the PC in connection with its guarantee.

For PC transfers that qualify as sales under SFAS 125 / 140, Freddie Mac recognizes a GA, which reflects the retained interests in mortgages sold. The GA that is recognized in connection with Cash Window sales represents the fair value of the difference between (i) the aggregate coupon cash flows of securitized mortgage loans less servicing cash flows due to third party mortgage servicers and (ii) the coupon cash flows on the related PC, plus the fair value of certain credit enhancements other than primary mortgage insurance. Freddie Mac views 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. Freddie Mac accounts for GAs like investments in debt securities classified as trading under SFAS 115. All changes in the fair value of GAs, which are reported on Freddie Mac's consolidated balance sheets as a component of "Guarantee asset for Participation Certificates, at fair value," are reflected in earnings as a component of "Gains (losses) on 'Guarantee asset for Participation Certificates, at fair value.' " The GA consists of a variety of cash flows that are primarily recorded through "Management and guarantee income." *See* "NOTE 3: SECURITIZATION OF MORTGAGE-RELATED ASSETS" for a discussion of the attribution of GA-related cash flows.

Required G-Fees, as decreased in connection with upfront Buy-Down payments, that relate to PCs issued through the Guarantor Program (and that have not been previously transferred in a SFAS 125 / 140 sale transaction) are realized as income on an accrual basis in accordance with the guidance in EITF 85-20, "Recognition of Fees for Guaranteeing a Loan" ("EITF 85-20"). The Required G-Fees in these transactions are recognized over the corresponding guarantee period. Additionally, Freddie Mac recognizes a guarantee liability for estimated, guarantee-related credit losses in accordance with SFAS 5. The accounting for Buy-Up or Buy-Down payments made or received at PC issuance follows:

- 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 as a component of PCR (discussed further below).
- Buy-Down and credit fee amounts received at PC issuance 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 91.

If a PC is purchased by Freddie Mac, all recognized GAs are reclassified on Freddie Mac's consolidated balance sheets as a component of "Participation Certificate residuals, at fair value." (For details concerning the impact on the GO of a PC purchase, *see* "Guarantee Obligations" below). Additionally, the unamortized balance of Buy-Downs and credit fees received in connection with the original issuance of purchased PCs is extinguished and treated as a basis adjustment to the recognized value of purchased PCs. Such basis adjustments are then amortized into earnings pursuant to the requirements of SFAS 91.

Guarantee Obligations

When a transfer of PCs or Structured Securities qualifies as a sale, Freddie Mac recognizes a GO. Freddie Mac accounts for recognized GOs at fair value, with all changes in fair value reflected in Freddie Mac's consolidated statements of income as a component of "Gains (losses) on 'Guarantee obligation for Participation Certificates, at fair value.' "

The fair value of the GO is intended to reflect the estimated amount that Freddie Mac would be required to pay to a third party to be relieved of Freddie Mac's obligations under the guarantee contract. The components of this calculation include: (i) estimates of expected future credit losses using statistically based models that evaluate a variety of factors (such as default experience, loss severity trends, expected proceeds from primary mortgage insurance, etc.) 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, capital structure and regulatory oversight similar to those of Freddie Mac; (ii) estimates of the costs to administer the collection and distribution of payments on the mortgages underlying the PC; and (iii) expected net cash flows due to security program cycles.

The purchase of a PC by Freddie Mac prompts the extinguishment of a recognized GO pursuant to the requirements of SFAS 125 / 140. The de-recognition of a GO is reflected in earnings as "Gains (losses) on investment activity." The purchase of a PC that was previously included as part of a SFAS 125 / 140 sale also triggers a reduction in the fair value of the corresponding GA. This is because prior to the repurchase of a PC, the fair value of a GA does not consider the expected future cash outflows of the GO that a third party would otherwise have to assume if it purchased the GA from Freddie Mac. Therefore, after PC repurchase, a revaluation of the GA for impairment is necessary. Like the extinguishment of the GO, such a diminution in the value is reflected in earnings as "Gains (losses) on investment activity."

Participation Certificate Residuals

PCRs 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 PCR is recognized by Freddie Mac in connection with PCs or Structured Securities held by Freddie Mac that (i) previously went through a SFAS 125 / 140 sale (in which case, a GA and GO were previously established for the held PC or Structured Securities), (ii) were formed from Cash Window Purchases and that were never transferred to third parties or (iii) were purchased by Freddie Mac from third parties on the corresponding issue date of such PCs through the Guarantor Program.

Like a recognized GA, a PCR is accounted for like a debt security and is classified as either available-for-sale or trading under SFAS 115. PCRs relating to PCs or Structured Securities that previously went through a SFAS 125 / 140 sale are accounted for as trading under SFAS 115. PCRs relating to PCs held in portfolio that were formed from Cash Window Purchases and that were never transferred to third parties are accounted for like debt investments and generally are classified as available-for-sale under SFAS 115. The same treatment applies to PCRs that correspond to PCs purchased by Freddie Mac from third parties on the corresponding issue date of such PCs, except that any portions of these PCRs that relate to Buy-Ups paid by Freddie Mac are accounted for as trading investments.

All changes in the fair value of PCRs 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 PCRs that are accounted for as available-for-sale are reflected as a component of "Accumulated other comprehensive income (loss), net of taxes."

Recognized PCRs consist of a variety of cash flows that are primarily recorded through interest income. *See* "NOTE 3: SECURITIZATION OF MORTGAGE-RELATED ASSETS" for a discussion of the attribution of GA-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 passthrough 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 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 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." When the decision is made to retain the loan, the loans are transferred to the "held-for-investment" portfolio or they are securitized and classified as available-for-sale securities. Held for sale mortgages are included in the retained portfolio and reported at the lower of cost or market value, on a portfolio basis, with losses reported in "Gains (losses) on investment activity." The determination of any lower of cost or market value losses is done in the aggregate by considering all open loan purchase commitment positions and outstanding forward sales commitments to investors. If held for sale loans are transferred to the held for investment category, any related lower of cost or market value adjustment is made on an individual loan basis.

Freddie Mac determines the fair value of held for sale mortgage loans based on comparisons to actively traded mortgage-backed securities with similar characteristics, with an adjustment for credit and liquidity, as discussed below, related to an implied guarantee fee. Specifically, Freddie Mac aggregates mortgage loans into pools by product type, coupon and maturity and then converts the pools into notional mortgage-backed securities based on their specific characteristics. Freddie Mac then calculates fair values for these notional mortgage-based securities using the process that is described in "Securities" below. The fair value of the whole loans also includes an adjustment representing the additional cash flows on the mortgage coupon of the whole loan in excess of the coupon expected on the notional mortgage-backed securities. This adjustment is net of the related credit and other guarantee obligation components.

Mortgage loans that management intends 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 under SFAS 91. 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. For single-family mortgages, reserves for uncollectible interest are estimated using statistical models, which quantify accrued but unpaid interest at the balance sheet date. Freddie Mac reports this reserve as a reduction to the accrued loan interest balance in "Accounts and other receivables, net." For multifamily mortgages, the accrual of interest is generally discontinued and any existing accruals are reversed against interest income on loans that become 90 days past due as to principal or interest unless collection of both principal and interest is assured.

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). Consequently, the loan's effect on "Guarantee obligation for Participation Certificates, at fair value," or the "Reserve for guarantee losses on Participation Certificates" is removed as applicable and a new credit reserve is established, which is recorded in "Reserve for losses on mortgage loans held for investment."

Reserves for Losses on Mortgage Loans Held for Investment and Losses on PCs

Freddie Mac maintains its "Reserve for losses on mortgage loans held for investment" to provide for credit losses on mortgages included in its Retained Portfolio (excluding mortgage loans held for sale) and it maintains its "Reserve for guarantee losses on Participation Certificates" to provide for credit losses on mortgages underlying PCs held by third parties that have not previously been accounted for as sales by Freddie Mac under SFAS 125 / 140 (and which, therefore, have no recognized GO). The "Reserve for losses on mortgage loans held for investment" and "Reserve for guarantee losses on Participation Certificates" are referred to collectively as "Loan Loss Reserves."

The fair value of expected credit losses relating to PCs and Structured Securities included in transfers that were accounted for as sales by Freddie Mac under SFAS 125/140 are reflected in the "Guarantee obligation for Participation Certificates, at fair value."

The reserve for credit losses associated with the single-family held for investment loan portfolio (comprising loans backed by one-to-four family properties) and PC guarantees for which a GO has not been recognized is evaluated using the criteria of SFAS 5, which provides that large groups of homogenous loans should be evaluated for impairment on a collective basis. To establish a reserve under SFAS 5, impairments must be both (i) probable and (ii) reasonably estimable. The reserve for credit losses associated with the multifamily held-for-investment loan portfolio and issued PCs that were not transferred as part of a GAAP-based sale are evaluated pursuant to the requirements of SFAS 114 for those loans determined to be impaired based on the criteria described below. The remainder of the multifamily loan portfolio is evaluated for impairment using SFAS 5. The "Reserve for losses on mortgage loans held for investment" and the "Reserve for guarantee losses on Participation Certificates" are increased through charges to the "Provision for credit losses" and decreased by charge-offs, net of recoveries. Setting the level of reserves requires significant judgment and the resulting reserve levels are regularly evaluated by management.

Management estimates incurred credit losses on homogenous pools of single-family loans using statistically-based models that evaluate a variety of factors, resulting in a range of probable losses related to impaired single-family loans at the consolidated balance sheet date. The factors used to estimate incurred losses as of period-end include actual and estimated loss severity trends for similar loans; actual and estimated default experience; actual and estimated proceeds from primary mortgage insurance and other credit enhancements; actual and estimated pre-foreclosure real estate taxes and insurance; the year of the loan origination; geographic location; and estimated selling costs should the loan ultimately be foreclosed upon and sold. Management reviews the range of probable losses to determine the point within the range that represents the best estimate of incurred losses. Management also considers macroeconomic 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 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 estimates a range of incurred credit losses on the multifamily portfolio based on an individual review of each loan as well as an evaluation of loan-level and market-level risk characteristics of the portfolio in the aggregate to determine reserve needs. Management reviews the range of probable losses to determine the point within the range that represents the best estimate of incurred losses. The level of reserves is then adjusted to management's best estimate of incurred losses. Loans individually evaluated for impairment include loans that become 60 days past due for principal and interest, loans with observable collateral deficiencies, and loans whose contractual terms were modified due to credit concerns.

For both single-family and multifamily mortgages where the original terms of the 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 these are accounted for as troubled debt restructurings ("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 Loan loss reserves. 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 when the fair market value of the acquired asset (after deduction for estimated disposition costs and consideration of third party insurance or other credit enhancements) exceeds the carrying value of the mortgage (including accrued interest). REO gains are included in "REO operations income (expense)."

Securities

The company classifies mortgage-related securities and non-mortgage securities as available-for-sale or trading, as defined in SFAS 115. The company is not permitted to classify securities as held-to-maturity ("HTM"), as defined in SFAS 115, until at least January 1, 2004, due to invalid sales out of that portfolio in prior years. Securities classified as available-for-sale and trading are reported at fair value with changes in fair value included in "Accumulated other comprehensive income (loss), net of taxes" and "Gains (losses) on investment activity," respectively. Mortgage-related securities are recorded as part of the "Retained portfolio" except when they are purchased to support Freddie Mac's PC market-making and support activities, in which case they are recorded as part of "Investments".

The fair value of securities with readily available third-party market prices is based on market prices obtained from brokers and dealers, reliable third-party pricing service providers or direct market observations. For other securities, a market option-adjusted spread ("OAS") approach is used to estimate fair value. This OAS approach uses a model developed from market data and management judgment to estimate the OAS risk premium an investor would require as compensation for a given product's prepayment uncertainty and interest-rate volatility. Once an OAS has been determined, fair value is calculated by using the OAS as an input to Freddie Mac's interest-rate and prepayment models in order to determine the estimated net present value of projected cash flows. The remaining instruments are priced using other modeling techniques or by using other securities as proxies.

Effective January 1, 2002, Freddie Mac began recognizing the financial statement effects of non-derivative forward purchases and sales of securities on a trade date basis. Such accounting is required under SOP 01-6, "Accounting by Certain Entities (Including Entities with Trade Receivables) That Lend to or Finance the Activities of Others" ("SOP 01-6"), when the purchase and sale commitments are not accounted for as derivative financial instruments ("derivatives"). Under trade date accounting, forward purchases and sales are recorded as an increase or decrease to the security account on the trade date, with a corresponding increase to "Other liabilities" or "Accounts and other receivables, net", respectively. In the case of sales, the gain or loss is also recognized on the trade date. Prior to January 1, 2002, Freddie Mac recorded all security transactions on the settlement date. For non-derivative forward purchase commitments, accounting between trade date and settlement date was recorded pursuant to EITF 96-11. EITF 96-11 requires that changes in the fair value of commitments to acquire available-for-sale securities be recorded through "Accumulated other comprehensive income (loss), net of taxes" and changes in the fair value of commitments to acquire trading securities be recorded through earnings. The cumulative effect of transitioning from settlement date to trade date accounting was not material to the financial statements.

For most of the company's investments in securities, interest income is recognized using the 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 using the effective interest method in accordance with SFAS 91. The company uses actual prepayment experience and estimates of future prepayments to determine the constant yield needed to apply the effective interest method. In estimating future prepayments and cash flows, the company aggregates securities by similar characteristics of their underlying collateral such as origination date, coupon and maturity. For Structured Securities, estimates of future prepayments and cash flows also consider the characteristics of other security classes within the same structure. The company recalculates the constant effective yield based on changes in estimated prepayments as a result of changes in interest rates and actual prepayments versus anticipated prepayments. When the constant effective yield changes, an adjustment to interest income is made for the amount of premiums and discounts that would have been recorded if the new effective yield had been applied since the mortgage assets were acquired.

For certain of the company's investments in securities, interest income is recognized using the prospective effective interest method in accordance with EITF 99-20. The company specifically applies such guidance to beneficial interests (including undivided interests similar to beneficial interests) in securitized financial assets that (i) can contractually be prepaid or otherwise settled in such a way that the company may not recover substantially all of its recorded investment (such as interest-only strips) or (ii) are not of high credit quality at the effective date of EITF 99-20 (April 1, 2001) or at the company's acquisition date, if later. 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 retained interests over its initial investment 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. Prior to the company's implementation of EITF 99-20, the company recognized interest income for interest-only strips on the prospective effective interest method in accordance with EITF 89-4, "Accounting for a Purchased Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate" ("EITF 89-4").

Declines in fair value below the amortized cost basis of a security are recognized as impairment losses when such losses are considered to be "other-than-temporary" under SFAS 115. 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. Prior to the company's implementation of EITF 99-20, other-than-temporary impairment for such securities was defined under SFAS 115 or EITF 93-18, as applicable. Freddie Mac's adoption of EITF 99-20 on April 1, 2001, resulted in a cumulative $35 million after-tax decrease to net income.

Gains and losses on the sale of securities are included in "Gains (losses) on investment activity." The company uses the specific identification method for determining the cost of a security in computing the gain or loss.

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 (i) "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 (ii) "reverse dollar roll" transactions, which consist of simultaneous agreements with the same counterparty to purchase a security held by Freddie Mac and sell similar securities at a future date at an agreed-upon price. These transactions are accounted for as financings when the sale criteria of SFAS 125 / 140 are not satisfied. Freddie Mac's policy is to take possession of securities purchased under agreements to resell and reverse dollar roll transactions. Freddie Mac presents mortgage-related and non-mortgage-related securities pledged (that may be repledged) under repurchase agreements and dollar roll transactions parenthetically in the relevant securities captions in the consolidated balance sheets.

Debt Securities

Debt securities 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. Amortization of hedging-related basis adjustments is initiated upon the termination of the related hedge relationship whereas amortization of premiums, discounts and issuance costs begin 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 as of the balance sheet date. The company uses foreign currency swaps to hedge against the risk of changes in foreign currency exchange rates.

Freddie Mac adopted SFAS 145, "Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13, and Technical Corrections" ("SFAS 145"), in the second quarter of 2002. SFAS 145 eliminates the extraordinary treatment of gains and losses on debt extinguishments. Those gains and losses are now reported as "Non-interest income — Gains (losses) on debt retirement." Prior periods have been reclassified to conform to the new classification.

Derivatives

Generally, derivatives are financial instruments with little or no initial net investment and whose value is based upon an underlying asset, index, reference rate or other variable. Over-the-counter derivatives are privately negotiated contractual agreements that can be customized to meet specific needs. Exchange-traded derivatives are standardized contracts executed through organized exchanges. 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."

Accounting for Derivatives Under SFAS 133 — On January 1, 2001, Freddie Mac adopted SFAS 133, which required Freddie Mac to recognize all derivatives as either assets or liabilities on the consolidated balance sheets at fair value on a trade date basis.

A significant portion of the company's derivative portfolio is not designated in hedge accounting relationships. For most derivatives not qualifying as an accounting hedge, fair value gains and losses are reported as "Derivative gains (losses)" on 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" on the consolidated statements of income.

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"). For a derivative qualifying as a cash flow hedge, Freddie Mac reports changes in the fair value of these instruments in a separate component of "Accumulated other comprehensive income (loss), net of taxes" to the extent the hedge is effective. The remaining ineffective portion, representing the cumulative change in fair value of the derivative from inception of the hedge to the extent it is greater than the cumulative change in the fair value of the expected future cash flows on the hedged item, is reported as "Hedge accounting gains (losses)." Freddie Mac recognizes the effective portion of the cumulative changes in fair value as "Income (expense) related to derivatives" during the period(s) in which the hedged item affects earnings, unless occurrence of the forecasted transaction is probable of not occurring, in which case the amount in "Accumulated other comprehensive income (loss), net of taxes" is reclassified to earnings immediately. The effective portion of the cumulative changes in fair value associated with purchase and sale commitments accounted for as derivatives in cash flow hedges is recognized as interest income for assets held and "Gains (losses) on investment activity" for assets sold. 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.

For any component of a derivative that is excluded from hedge effectiveness assessment, Freddie Mac reports fair value gains and losses as "Income (expense) related to derivatives." The net income/expense

related to derivatives contracts currently accrued, which is derived primarily from interest rate swap contracts, is classified as "Income (expense) related to derivatives" (including derivatives not in hedge accounting relationships).

Freddie Mac's adoption of SFAS 133 on January 1, 2001, resulted in a cumulative $78 million after-tax increase to net income and a $2.6 billion after-tax reduction to "Accumulated other comprehensive income (loss), net of taxes."

Accounting for Derivatives Prior to 2001 — Prior to the adoption of SFAS 133, accrual accounting was applied when derivatives exhibited high correlation with the hedged item's effect on interest income or expense. In all other cases, hedge accounting, generally under the requirements of SFAS 80, was applied. When these financial instruments failed to meet such criteria, they were reported at fair value, with related gains or losses reported in "Other income."

When derivatives were accounted for under accrual accounting, generally applicable to interest-rate contracts, the net differential received or paid was recognized on an accrual basis and recorded in "Income (expense) related to derivatives." Net premiums paid to enter into derivatives as well as gains and losses on terminated derivatives, were deferred and amortized to interest income or expense. Unrealized changes in fair value were not recognized in the financial statements.

When non-option-based derivatives qualified for hedge accounting treatment, related fair value gains or losses were deferred as an adjustment to the carrying value of the hedged asset or liability. Upon termination of a hedge relationship, the deferred gain or loss was amortized over the remaining effective life of the asset or liability. Interest payments received or paid under derivatives qualifying as hedges were recognized on an accrual basis and recorded in "Income (expense) related to derivatives."

When option-based derivatives qualified for hedge accounting treatment, related intrinsic gains were deferred as an adjustment to the carrying value of the hedged asset or liability. Upon termination of a hedge relationship, any deferred intrinsic gain was amortized over the remaining effective life of the asset or liability. Premiums paid to enter into these option-based contracts were deferred and amortized to earnings over the term of the option period as "Income (expense) related to derivatives."

Upon termination of the option-based derivative, the difference between the remaining unamortized premium and the time value component of the option-based derivative's fair value was recorded in earnings as "Gains (losses) on investment activity."

For foreign-currency swaps, amounts received or paid, together with the hedged assets and liabilities that were also denominated in a foreign currency, were translated into U.S. dollars using foreign exchange spot rates as of the date of the balance sheet. Transaction gains and losses for both foreign-currency swaps and foreign-currency denominated assets and liabilities were reported in "Other income."

Real Estate Owned

Real estate owned 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 the REO are capitalized. Operating expenses on the properties, net of any rental or other income, are included in "REO operations income (expense)." 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, and are treated as a lower of cost or fair value adjustment to the basis of the property. The resulting REO allowance is included in the property's cost basis when the property is sold. 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 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 (i) 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 (ii) 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).

Stock-Based Compensation

In December 2002, the Financial Accounting Standards Board ("FASB") issued SFAS 148, which amends SFAS 123. 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. 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 effective January 1, 2002, in accordance with SFAS 123's original transition provision. However, Freddie Mac has elected to adopt SFAS 123 retroactively to January 1, 1995 as permitted by SFAS 148. 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 one year for the Employee Stock Purchase Plan. 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 stock-based options to purchase shares of Freddie Mac common stock, including options issued pursuant to the Employee Stock Purchase Plan ("ESPP"), is estimated using a Black-Scholes option-pricing model, taking into account the exercise price and expected life of the option, the current price 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.

For stock-based compensation granted prior to 1995, Freddie Mac continues to apply the provisions of 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 rights associated with stock options. No compensation expense was recognized for the Employee Stock Purchase Plan 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 128, "Earnings per Share" ("SFAS 128").

Comprehensive Income

Comprehensive income, as defined in SFAS 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 comprised of net income plus changes in the unrealized gains and losses on available-for-sale securities and on the effective portion of derivatives accounted for as cash flow hedges.

New Accounting Pronouncements

Accounting and Disclosure Requirements by Guarantors — In November 2002, the FASB published FASB Interpretation ("FIN") 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others" ("FIN 45"). FIN 45 requires additional disclosures about guarantee obligations and requires companies to recognize a liability at the inception of a guarantee representing the fair value of the obligation undertaken in issuing the guarantee.

On December 10, 2003, FASB published 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" (FSP 45-2). FSP 45-2 will affect the way Freddie Mac accounts for its guarantee obligations beginning on January 1, 2003. Specifically, the fair value of guarantee obligations recorded at initial sale or securitization of mortgage-related assets under SFAS 140 or FIN 45 will subsequently be amortized into earnings and changes in fair value will no longer be recorded in earnings. Freddie Mac will apply the above guidance on a prospective basis to guarantees issued or modified after December 31, 2002 as well as to existing guarantees recognized under SFAS 125/140 as of December 31, 2002 as described below.

These requirements will apply primarily to PCs issued under Freddie Mac's Guarantor Program and will require the company to recognize the fair value of the guarantee fee income stream as an asset and the fair value of the guarantee obligation as a liability on the execution date. Freddie Mac will subsequently measure the recognized GO to an amount that represents the greater of (i) a contingent liability amount required to be recognized by SFAS 5, or (ii) an unamortized GO balance as determined on a systematic and rational basis. FIN 45 is applicable to guaranteed mortgage-related securities issued on or after January 1, 2003. Additionally, the fair value of the GO for all guarantees recognized under SFAS 125/140 at December 31, 2002 will be the carrying value for purposes of applying thereafter the new subsequent measurement method of the GO.

Although the company has not completed its analysis of the impact, management believes that FIN 45 will have a material impact on Freddie Mac's future financial condition and results of operations.

See "NOTE 13: FINANCIAL GUARANTEES" for more information.

Consolidation of Variable Interest Entities — In January 2003, the FASB issued FASB Interpretation 46, "Consolidation of Variable Interest Entities" ("FIN 46"). FIN 46 provides guidance for determining when a company must consolidate the assets, liabilities and activities of a variable interest entity ("VIE"). A VIE is defined as an entity (i) that has a total equity investment at risk that is not sufficient to finance its activities without additional subordinated financial support from other parties, or (ii) 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. If an entity is a VIE, each variable interest holder must determine if its variable interest is significant and whether the company is the "primary beneficiary." Under FIN 46, an entity is considered the "primary beneficiary" and must consolidate a VIE when it absorbs a majority of expected losses or expected residual returns, or both. In addition, various disclosures are required about VIEs when an entity holds a "significant variable interest" in a VIE. In this case, significant variable interests are those in which Freddie Mac may be exposed to a significant portion of a VIE's expected losses / expected residual returns, which FIN 46 defines as a variability around the entity's expected returns or cash flows.

The provisions of FIN 46 are effective December 31, 2003, except for certain "non-special purpose entities (non-SPEs)," where FIN 46 is effective March 31, 2004.

The issuance of PCs and Structured Securities is not affected by the issuance of FIN 46, because a trust or other separate legal entity as defined by FIN 46 is not used to issue such securities. Management believes it

is reasonably possible that Freddie Mac will disclose or consolidate VIEs upon the adoption of FIN 46, which could have a material impact on the company's consolidated financial statements. *See* "NOTE 19: VARIABLE INTEREST ENTITIES" for further information.

SFAS 133 Amendment — In April 2003, the FASB issued SFAS 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities" ("SFAS 149"). SFAS 149 amends and clarifies the financial accounting and reporting for derivative instruments to incorporate decisions made by the FASB and the FASB's Derivatives Implementation Group subsequent to the original issuance of SFAS 133 and in connection with other FASB projects. In particular, SFAS 149 provides additional guidance on how to determine when a financial guarantee contract is not subject to SFAS 133, when a contract with an initial net investment qualifies as a derivative, when a contract qualifies for the regular-way securities trade exemption, when a mortgage loan commitment is scoped out of SFAS 133, and when a derivative contains a financing component that requires special reporting in the statement of cash flows. SFAS 149 is generally effective prospectively for contracts entered into or modified, and hedging relationships designated after June 30, 2003. Management does not expect the adoption of SFAS 149 to have a material effect on its financial condition or results of operations.

Financial Instruments with Characteristics of both Liabilities and Equity — In May 2003, the FASB issued SFAS 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity" ("SFAS 150"). SFAS 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity, and imposes certain additional disclosure requirements. The provisions of SFAS 150 are generally effective for financial instruments entered into or modified after May 31, 2003. Freddie Mac must apply the provisions of SFAS 150 to applicable financial instruments beginning October 1, 2003. Freddie Mac does not expect the adoption of SFAS 150 to have a material effect on its financial condition or results of operations.

NOTE 3: SECURITIZATION OF MORTGAGE-RELATED ASSETS

Types of Securitization Transactions Executed By Freddie Mac

Freddie Mac purchases residential mortgage loans originated by mortgage lenders, as well as mortgage-related securities. One of the means by which Freddie Mac funds purchases of mortgage loans is through the use of securitization-based financing. That is, Freddie Mac funds the purchases of such loans by issuing undivided interests in the purchased loans and transferring such interests to investors in exchange for cash consideration. Such undivided interests are commonly referred to as mortgage PCs.

Freddie Mac specifically issues and transfers PCs to third parties through one of three programs:

- *Cash Window Program* — Freddie Mac purchases mortgage loans from third parties for cash consideration. Freddie Mac then pools some of these mortgage loans, issues PCs backed by such pools and either sells the PCs for cash consideration (through an auction) or retains such securities in portfolio.

- *Guarantor Program* — Third parties transfer mortgage loans to Freddie Mac in exchange for PCs that Freddie Mac issues that are backed by such mortgage loans. PCs issued through the Guarantor Program are backed by either mortgage loans that relate to single-family properties or mortgage loans that relate to multifamily properties.

- *MultiLender Program* — Third parties transfer mortgage loans to Freddie Mac in exchange for PCs that are backed by such mortgage loans, as well as by mortgage loans that are delivered to Freddie Mac by other parties. Freddie Mac may itself contribute mortgage loans to pools backing these PCs.

Freddie Mac also sells PCs that are held in portfolio in resecuritized form. More specifically, Freddie Mac issues Structured Securities backed by investments in PCs and other mortgage-related securities and transfers such interests to investors 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 sell such interests to retail and institutional investors.

Freddie Mac guarantees the payment of principal and interest on all issued PCs and Structured Securities.

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 mortgage loans for which Freddie Mac paid cash consideration.

- Structured Securities retained by Freddie Mac in connection with the resecuritization of mortgage-related securities.

- Freddie Mac's contractual right to receive a negotiated fraction of the interest-related cash flows of securitized mortgage loans, which relates to Freddie Mac's guarantee and administration of payments of principal and interest on issued PCs. This retained, undivided interest is hereinafter referred to as a GA.

- PCRs, which relate to certain PCs and Structured Securities held by Freddie Mac and represent the fair value of the expected future cash flows of guarantee and bond administration cash flows that are contractually distinct from that of such corresponding securities.

Unpaid Principal Balances ("UPB") of PCs Issued and Structured Securities Backed by Non-Freddie Mac Mortgage-Related Securities

Table 3.1 below presents the UPB of PCs issued and Structured Securities backed by non-Freddie Mac mortgage-related securities as of December 31, 2002 and December 31, 2001.

Table 3.1 — PCs Issued and Structured Securities backed by non-Freddie Mac Mortgage-Related Securities[1]

	December 31,	
	2002	2001
	(dollars in billions)	
PCs and Structured Securities backed by non-Freddie Mac mortgage-related securities that are held by Freddie Mac[2]:		
Original issuance PCs[3]	$ 350	$ 323
Structured Securities backed by[5]:		
Ginnie Mae Certificates	1	2
Non-agency mortgage-related securities	11	6
PCs and Structured Securities backed by non-Freddie Mac mortgage-related securities that are held by Freddie Mac	362	331
PCs and Structured Securities backed by non-Freddie Mac mortgage-related securities that are held by third parties:		
Original issuance PCs	704	605
Structured Securities backed by[5]:		
Ginnie Mae Certificates	7	11
Non-agency mortgage-related securities	18	15
PCs and Structured Securities backed by non-Freddie Mac mortgage-related securities that are held by third parties	729	631
Total PCs issued and Structured Securities backed by non-Freddie Mac mortgage-related securities[4][6]	$1,091	$ 962

(1) Based on UPB.
(2) Includes both PCs held by Freddie Mac's retained portfolio and PCs held by Freddie Mac in connection with its PC market-making and support activities.
(3) Includes approximately $133 billion and $119 billion, at December 31, 2002 and 2001, respectively, of PCs for which corresponding PCRs were recognized.
(4) Includes approximately $5 billion and $3 billion at December 31, 2002 and 2001, respectively, of housing authority bonds that were issued by third parties to fund the origination of multifamily mortgage loans and for which Freddie Mac provided a credit guarantee on such issued securities.
(5) Reported UPB of Structured Securities relates only to that portion of issued Structured Securities that is backed by non-Freddie Mac mortgage-related securities.
(6) This amount excludes approximately $800 billion in UPB of Structured Securities backed by Freddie Mac mortgage-related securities as of December 31, 2002. These securities are excluded because this resecuritization activity does not increase Freddie Mac's guarantee-related exposure.

At December 31, 2002 and 2001, respectively, approximately 49 percent of total PCs and Structured Securities issued (excluding securities issued by Freddie Mac and backed by Ginnie Mae Certificates or non-agency mortgage-related securities as well as other securities guaranteed by Freddie Mac) had corresponding GAs, GOs or PCRs recognized on Freddie Mac's consolidated balance sheets.

Gains and Losses on Transfers of Freddie Mac PCs and Structured Securities That Are Accounted For As Sales

Freddie Mac recognized pre-tax gains of approximately $1.1 billion and $468 million for the years ended December 31, 2002 and 2001, respectively, on transfers of PCs and Structured Securities that were accounted

for as sales under SFAS 125 / 140 where retained interests related to guarantee activities are initially recognized or resulted from a resecuritization transaction.

Key Valuation Assumptions and Corresponding Sensitivity Analyses of Recognized GAs, GOs and PCRs

Recognized GAs

Fair values of recognized GAs were calculated using an expected cash flow approach that is consistent with Statement of Financial Accounting Concepts No. 7, "Using Cash Flow Information and Present Value in Accounting Measurements" ("CON 7"). More specifically, Monte Carlo simulations were used to project monthly prepayment, default and loss severity rates across 300 housing price and interest rate scenarios. Such inputs were, in turn, used to determine GA-related future cash flows associated with approximately 200,000 groups of mortgage loans that are distinguished based upon differing combinations of various loan attributes (these groups of loans are referred to as "Loan Groups"). Freddie Mac then discounted such cash flows using factors (i) that were derived from modeled forward interest rates (for each scenario path) and (ii) to which Freddie Mac applied an OAS that was implied from comparable agency IO securities. For periods prior to March 31, 2001, Freddie Mac applied an OAS of 150 basis points ("bps") in deriving appropriate discount rates, an adjustment management concluded was an appropriate premium based upon available IO price information from the referenced periods (to which the OAS was applied). For periods subsequent to March 31, 2001, as additional OAS data became available, Freddie Mac improved this estimate by beginning to apply an eight quarter trailing average OAS that was derived from spot IO prices (the trailing average OASs ranged from 250 to 500 bps between March 31, 2001 and December 31, 2002).

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. The derived fair value of recognized GAs also reflects estimated pool insurance benefits and other credit enhancements (except for proceeds received from primary mortgage insurance that are considered in the valuation of recognized GOs) less associated premiums to be paid by Freddie Mac on related credit enhancement policies executed at PC issuance.

The fair value of recognized GAs also reflects Buy Ups paid in connection with PCs issued through the Guarantor Program. At December 31, 2002 and 2001, the fair value of recognized GAs that is attributable to Buy Ups on Guarantor Swaps was approximately $389 million and $545 million, respectively.

Recognized GOs

While a recognized GO does not constitute a retained interest, Freddie Mac believes it is appropriate to disclose key assumptions used in deriving the fair value of such a liability, particularly given (i) a recognized GO's link to a corresponding GA and (ii) that the fair value of a GO constitutes a component part of the valuation of a PCR (where recognized PCR can be observed to equal the net fair value of a GA and GO). In this regard, and like that of recognized GAs, GO-related future cash flows associated with each referenced Loan Group were estimated using Monte Carlo simulation (*see* "NOTE 2: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES" for further discussion of cash flow components of recognized GOs). Additionally, and in deriving the present value of GO-related cash flows for each scenario for each Loan Group, Freddie Mac used a similar convention to that utilized to discount GA-related future cash flows. However, Freddie Mac did not apply an OAS to those discount factors that were used to derive the present value of GO-related future cash flows. This is because inclusion of an OAS would have produced discount rates higher than those utilized, which approximate a risk-free rate.

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 PCRs

PCRs relate to certain PCs and Structured Securities held in portfolio by Freddie Mac and represent the fair value of the future cash flows of guarantee contracts that specifically correspond to such PCs. 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 PCR is determined to be equal to the fair value of a GA less that of a corresponding GO. Accordingly, the fair value of recognized PCRs is determined in a manner that is reflective of the methodologies described above for recognized GAs and GOs.

The recognized fair value of PCRs also reflects Buy Ups that are paid in connection with PCs issued through the Guarantor Program to third parties and for PCs which Freddie Mac committed to purchase concurrently and in contemplation of the associated Guarantor Swap transaction. At December 31, 2002 and 2001, the fair value of recognized PCRs that is attributable to such Buy Ups was approximately $271 million and $428 million, respectively.

At December 31, 2002 and 2001, approximately $55 million and approximately $80 million of recognized PCRs, respectively, was attributable to PCRs classified as available-for-sale.

Table 3.2 summarizes the key assumptions that were used by Freddie Mac in fair value measurements of recognized GAs, GOs and PCRs.

Table 3.2 — Key Assumptions Utilized in Fair Value Measurements

	December 31,			
	2002		2001	
	GA, GO and PCR		GA, GO and PCR	
Assumptions	Range[5]	Mean[6]	Range[5]	Mean[6]
Internal rates of return[1]				
GA	5.9% - 15.7%	9.4%	5.3% - 17.5%	9.6%
GO	3.8% - 8.2%	6.0%	4.8% - 8.1%	6.6%
PCR	5.1% - 11.8%	7.4%	5.1% - 12.5%	7.9%
Prepayment rates[2]	8.8% - 54.6%	22.5%	9.7% - 53.7%	21.3%
Default rates[3]	0.1% - 8.1%	1.2%	0.0% - 8.1%	1.2%
Loss severity rates[4]	3.6% - 48.4%	22.9%	3.7% - 48.4%	22.6%

(1) With respect to GAs and GOs, 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 (i) 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 (ii) the calculated fair value of the GA and GO for each loan group. With respect to PCRs, 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).
(2) Scenario average Prepayment rates are simulated on a monthly frequency, although rates reported above represent a UPB weighted average of annualized values of such Prepayment rates.
(3) 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.
(4) Loss severity rates reported above represent the ratio of (i) the simple average of cumulative credit losses generated for each scenario to (ii) defaulted UPB for each Loan Group.
(5) The lowest value in each presented range represents the smallest first percentile IRRs, prepayment rates, default rates, and loss severity rates throughout 2002 and 2001. Likewise, the highest value in each range represents the highest of the 99th percentile IRRs, prepayment rates, default rates, and loss severity rates throughout 2002 and 2001.
(6) Reported values represent the weighted average value of all IRRs, prepayment rates, default rates, and loss severity rates throughout the 2002 and 2001 periods.

Weighted average lives ("WALs") of GAs and PCRs during 2001 and 2002 ranged between 1.52 – 8.07 years and 1.53 – 7.81 years, respectively, while the average, derived WAL of GAs and PCRs for the same periods was 4.88 and 4.95 years, respectively. Such derived WALs are reflective of prepayment speed assumptions cited in *Table 3.2* above.

A sensitivity analysis is provided in *Table 3.3* below that illustrates estimated changes in the fair value as of December 31, 2002 of recognized GAs, GOs, PCRs 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.
- 10% and 20% increases in loss severity rate assumptions.

Other Retained Interests that are included in the referenced sensitivity analysis are valued based upon observed market or matrix-based prices (where, in the case of the latter, prices for comparable securities, as adjusted for product-specific attributes, are used as basis to value such interests). As these interests are not model-valued, corresponding valuation assumptions are not provided in *Table 3.2* above.

Table 3.3 — Sensitivity Analysis

	As of December 31, 2002			
	PCR	GA	GO	Other Retained Interests[1]
	(dollars in millions)			
Fair value — asset (liability)	$ 420	$2,445	($1,427)	$ 1,226
Weighted average IRR assumptions:	6.7%	9.8%	4.5%	$ 5.1%
Impact on fair value of 100 bps upward change	$ (19)	$ (82)	$ 31	$ (34)
Impact on fair value of 200 bps upward change	$ (36)	$ (159)	$ 60	$ (61)
Impact on fair value of 100 bps downward change	$ 19	$ 85	$ (32)	$ 26
Impact on fair value of 200 bps downward change	$ 36	$ 162	$ (62)	$ 60
Weighted average prepayment rate assumptions:	24.7%	26.0%	26.0%	28.2%
Impact on fair value of 10% upward change	$ (22)	$ (141)	$ 82	$ (83)
Impact on fair value of 20% upward change	$ (43)	$ (266)	$ 152	$ (149)
Impact on fair value of 10% downward change	$ 23	$ 158	$ (96)	$ 91
Impact on fair value of 20% downward change	$ 49	$ 339	$ (211)	$ 221
Weighted average default rate assumptions:	1.1%	1.2%	1.2%	N/A[2]
Impact on fair value of 10% upward change	$ (25)	$ 11	$ (79)	N/A[2]
Impact on fair value of 20% upward change	$ (49)	$ 21	$ (157)	N/A[2]
Weighted average loss severity rate assumptions:	25.6%	22.2%	22.2%	N/A[2]
Impact on fair value of 10% upward change	$ (31)	$ 20	$ (106)	N/A[2]
Impact on fair value of 20% upward change	$ (62)	$ 40	$ (214)	N/A[2]

(1) Includes (a) IO securities that were issued by Freddie Mac as part of a resecuritization transaction for which sale accounting treatment was applied, (b) Freddie Mac securities that were (i) purchased at a premium (to par) of 10% or greater and (ii) associated with either a securitization or resecuritization transaction for which sale accounting treatment was applied and (c) Freddie Mac securities held in portfolio (i) for which securitized / resecuritized mortgage-related assets were not of high credit quality and (ii) associated with either a securitization or resecuritization transaction for which sale accounting treatment was applied.

(2) Sensitivities of reported fair value to changes in default and loss severity rates associated with Other Retained Interests for which a recognized PCR exists are captured in the corresponding column entitled "PCR." Otherwise, with respect to Other Retained Interests for which a PCR was not recognized, such securities are valued for financial statement purposes at the observed market price for such securities, prices of 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.

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, corresponding hedge transactions that were executed by Freddie Mac were not considered in determining the hypothetical effects summarized above. Results provided above should not be extrapolated to either (i) other sensitivity analyses in which changes in other assumptions are made or (ii) to other securities held by Freddie Mac.

Periodic Cash Flows On Executed Securitizations & Corresponding Retained Interests

Table 3.4 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 (where retained interests related to guarantee activities are 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 PCRs (as further discussed below);
- Receipts of payments of principal and interest on Other Retained Interests (as defined in *Table 3.3* above); and
- Amounts paid by Freddie Mac in connection with the process to repurchase delinquent mortgage loans that back PCs and Structured Securities.

Table 3.4 — Details of Cash Flows

	Year Ended December 31,	
	2002	2001
	(dollars in millions)	
Cash flows from:		
Transfers of Freddie Mac securities that were accounted for as sales	$241,214	$158,166
Cash flows received on retained interests:		
GAs[1]	771	751
PCRs[1]	288	263
Other retained interests	678	367
Purchases of delinquent or foreclosed loans[2]	(5,126)	(3,745)

(1) Such amounts specifically correspond to guarantee fee-related cash flows of recognized GAs and PCRs, as opposed to also reflecting cash flows received in connection with certain credit enhancements whose fair value is also reported as GAs or PCRs and certain GO-related cash flows whose value is reported as a component of recognized PCRs. Total cash flows received on recognized GAs during 2002 and 2001 were $820 million and $803 million, respectively. Total net cash flows received on recognized PCRs during 2002 and 2001 were $44 million and $155 million, respectively.

(2) Represents delinquent mortgage loans purchased out of securitized pools that back issued Freddie Mac securities.

Attribution of GA- and PCR-Related Cash Flows

As previously discussed, GAs and PCRs are financial assets accounted for on a fair value basis. Similar to other financial assets, cash flows received in connection with GAs and PCRs 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 as well as credit enhancements. In addition, Freddie Mac receives or pays other cash flows associated with PCRs 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 PCRs as a reduction of their respective recorded amounts, similar to a return of principal, the related income and expense amounts are recorded directly to 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." Therefore, the collection of these cash flows will reduce the period-end valuation of the GA even without consideration of changes in external market factors.

Recognized GAs — Guarantee Fee Related Cash Flows

Freddie Mac recorded $771 million, $751 million and $719 million of income associated with guarantee-related cash flows received during 2002, 2001 and 2000, respectively. These amounts were recorded to "Management and guarantee income." Of such amounts, approximately $242 million, $252 million and

$234 million, respectively, related to imputed interest. The remaining portion related to return of principal, which totaled $529 million, $499 million and $485 million for 2002, 2001 and 2000, respectively.

Recognized GAs — All Cash Flows

Freddie Mac recorded $820 million, $803 million and $777 million of income associated with the entire recognized GA during 2002, 2001 and 2000, respectively. These amounts primarily included cash related to contractual guarantee fees and thus most of this income was recorded to "Management and guarantee income" as discussed above. However, certain cash flows were related to proceeds from credit enhancements, which were recorded to credit-related income statement components. Of the total amounts, approximately $259 million, $273 million and $257 million, respectively, related to imputed interest while the remaining portions, which totaled $561 million, $530 million and $520 million, related to return of principal for 2002, 2001 and 2000, respectively.

Recognized PCRs

Freddie Mac recorded $288 million, $263 million and $236 million of income associated with guarantee-related cash flows received during 2002, 2001 and 2000, respectively. These amounts were recorded to interest income. Of these amounts, approximately $96 million, $93 million and $76 million during 2002, 2001 and 2000, respectively, related to imputed interest. The remaining portion related to return of principal, which totaled $192 million, $170 million and $160 million during 2002, 2001 and 2000, respectively.

Considering all cash flows related to recognized PCRs, such as guarantee-related cash flows as well as cash flows related to credit enhancements, credit-related expenses, the company's security program cycle and administrative expenses, the amount of imputed interest on PCRs was approximately $73 million, $76 million and $69 million during 2002, 2001 and 2000, respectively.

NOTE 4: 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 4.1 provides computations of Freddie Mac's basic and diluted earnings per common share.

Table 4.1 — Earnings Per Common Share — Basic and Diluted

	Year Ended December 31,		
	2002	2001	2000
	(dollars in millions and shares in thousands)		
Income before cumulative effect of change in accounting principles, net of taxes	$10,090	$ 3,115	$ 3,666
Cumulative effect of change in accounting principles, net of taxes of $24	—	43	—
Preferred stock dividends	(234)	(217)	(179)
Net income available to common stockholders[1]	$ 9,856	$ 2,941	$ 3,487
Weighted average common shares outstanding — basic	692,727	692,603	692,097
Dilutive potential common shares[2]	2,389	3,370	3,210
Weighted average common shares outstanding — diluted	695,116	695,973	695,307
Basic earnings per common share before cumulative effect of change in accounting principles, net of taxes	$ 14.23	$ 4.19	$ 5.04
Cumulative effect of change in accounting principles, net of taxes	—	0.06	—
Basic earnings per common share after cumulative effect of change in accounting principles, net of taxes	$ 14.23	$ 4.25	$ 5.04
Diluted earnings per common share before cumulative effect of change in accounting principles, net of taxes	$ 14.18	$ 4.17	$ 5.01
Cumulative effect of change in accounting principles, net of taxes	—	0.06	—
Diluted earnings per common share after cumulative effect of change in accounting principles, net of taxes	$ 14.18	$ 4.23	$ 5.01

(1) There is no earnings effect for dilutive potential common shares for years ended December 2002, 2001 and 2000.
(2) Effect of dilutive common equivalent shares outstanding equals incremental dilutive shares plus the weighted average of non-vested restricted shares and all restricted stock units, which are excluded from weighted average common shares outstanding — basic.

Options to purchase 2,513 thousand, 974 thousand and 876 thousand shares of common stock were excluded from the computation of diluted earnings per common share at December 31, 2002, 2001 and 2000, respectively, because the options' exercise price exceeded the average market price of the common shares for the years ended December 31, 2002, 2001 and 2000, respectively.

NOTE 5: RETAINED PORTFOLIO AND CASH AND INVESTMENTS PORTFOLIO

Table 5.1 summarizes amortized cost, estimated fair values and corresponding gross unrealized gains and 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 investments portfolio at December 31, 2002 and 2001, respectively.

Table 5.1 — Available-for-sale Securities

	December 31, 2002			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(dollars in millions)			
Retained portfolio				
Mortgage-related securities issued by:				
Freddie Mac	$316,464	$11,985	$ (454)	$327,995
Federal National Mortgage Association ("Fannie Mae")	79,203	2,770	(43)	81,930
Ginnie Mae	4,886	293	(4)	5,175
Other	71,104	2,755	(361)	73,498
Obligations of states and political subdivisions	7,424	337	(94)	7,667
Total mortgage-related securities	479,081	18,140	(956)	496,265
Investments				
Non-mortgage-related securities:				
Asset-backed securities	33,988	727	(21)	34,694
Corporate debt securities	9,742	385	(25)	10,102
Debt securities issued by the U.S. Treasury and other U.S. government corporations and agencies	12,153	344	(4)	12,493
Obligations of states and political subdivisions	6,639	2	—	6,641
Other	2,484	5	—	2,489
Total non-mortgage-related securities	65,006	1,463	(50)	66,419
Total available-for-sale securities	$544,087	$19,603	$(1,006)	$562,684

	December 31, 2001			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(dollars in millions)			
Retained portfolio				
Mortgage-related securities issued by:				
Freddie Mac	$267,848	$ 5,030	$ (897)	$271,981
Fannie Mae	70,048	1,311	(264)	71,095
Ginnie Mae	5,619	226	(4)	5,841
Other	42,447	777	(153)	43,071
Obligations of states and political subdivisions	6,993	96	(156)	6,933
Total mortgage-related securities	392,955	7,440	(1,474)	398,921
Investments				
Non-mortgage-related securities:				
Asset-backed securities	26,016	288	(29)	26,275
Corporate debt securities	9,542	160	(53)	9,649
Debt securities issued by the U.S. Treasury and other U.S. government corporations and agencies	1,783	22	(55)	1,750
Obligations of states and political subdivisions	4,284	3	(1)	4,286
Other	12,847	3	—	12,850
Total non-mortgage-related securities	54,472	476	(138)	54,810
Total available-for-sale securities	$447,427	$ 7,916	$(1,612)	$453,731

In 2002, Freddie Mac received proceeds of $176.9 billion from the sale of securities from its available-for-sale portfolio, resulting in gross realized gains of $1,575 million and gross realized losses of $257 million. This information regarding gains and losses was not available prior to 2002 and therefore is presented on a net basis for 2001 and 2000. In 2001 and 2000, Freddie Mac received proceeds of $105.0 billion and $33.8 billion, respectively from the sale of securities from its available-for-sale portfolio, resulting in net realized gains of $176 million and net realized losses of $12 million. The cost basis of the available-for-sale securities sold was determined using the specific identification method.

On January 1, 2001, Freddie Mac transferred $36.3 billion of securities from available-for-sale to trading in conjunction with the implementation of SFAS 133, resulting in gross unrealized gains of $105 million and gross unrealized losses of $384 million being recorded to earnings.

Table 5.2 summarizes the estimated fair values by major security type for trading securities at December 31, 2002 and 2001, respectively.

Table 5.2 — Trading Securities

	December 31, 2002 Fair Value	December 31, 2001 Fair Value
	(dollars in millions)	
Retained portfolio		
Mortgage-related securities issued by:		
Freddie Mac	$28,535	$40,592
Fannie Mae	519	722
Ginnie Mae	50	86
Total	29,104	41,400
Investments		
Mortgage-related securities issued by:		
Freddie Mac	$20,244	$20,220
Fannie Mae	11,029	6,099
Ginnie Mae	1,062	875
Other	31	—
Total	32,366	27,194
Non-mortgage related securities:		
Asset-backed securities	$ 96	$ 22
Debt securities issued by the U.S. Treasury and other U.S. government corporations and agencies	1,004	165
Mutual funds	540	1,194
Commercial paper	479	158
Corporate debt securities	229	—
Debt securities issued by foreign governments	4	—
Other	57	—
Total	2,409	1,539
Total trading securities	$63,879	$70,133

The portion of Gains (losses) on investment activity that relates to trading securities still held in the trading portfolio at December 31, 2002, 2001 and 2000 is $1,293 million, $359 million and $939 million, respectively.

At December 31, 2002, Freddie Mac held securities in its retained portfolio and investments portfolio issued by two highly-rated entities that individually exceed 10 percent of Freddie Mac's Stockholders' equity. *Table 5.3* details the name of these issuers, the aggregate fair value of the securities from each issuer and the aggregate fair value's percent of stockholders' equity.

Table 5.3 — Issuers greater than 10% Stockholders' Equity

	December 31, 2002 Fair Value	December 31, 2002 % Equity
	(dollars in millions)	
Fannie Mae[1]	$ 93,828	299%
Ginnie Mae	6,287	20
Total	$100,115	320%

(1) Includes mortgage-related securities of $93,478 million and agency debt securities of $350 million.

Table 5.4 summarizes, by major security type, the remaining contractual maturities of available-for-sale and trading non-mortgage-related securities, other than asset-backed securities at December 31, 2002.

Table 5.4 — Maturities

December 31, 2002	Less than 1 year	1 to 5 years	Greater than 5 and up to 10 years	Greater than 10 years	Total Amortized Cost	Total Fair Value
			(dollars in millions)			
AVAILABLE-FOR-SALE						
Retained portfolio						
Total mortgage-related securities[1]						
Amortized cost	—	—	—	—	$479,081	—
Fair value	—	—	—	—	—	$496,265
Investments						
Non-mortgage-related securities						
Asset-backed securities[1]:						
Amortized cost	—	—	—	—	$ 33,988	—
Fair value	—	—	—	—	—	$ 34,694
Corporate debt securities:						
Amortized cost	$1,714	$7,455	$464	$ 109	$ 9,742	—
Fair value	1,715	7,767	498	122	—	$ 10,102
Debt securities issued by the U.S. Treasury and other U.S. government corporations and agencies:						
Amortized cost	—	$7,966	$508	$3,679	$ 12,153	—
Fair value	—	8,060	513	3,920	—	$ 12,493
Obligations of states and political subdivisions:						
Amortized cost	$ 334	$ 246	$168	$5,891	$ 6,639	—
Fair value	335	246	168	5,892	—	$ 6,641
Others:						
Amortized cost	$2,240	—	$ 20	$ 224	$ 2,484	—
Fair value	2,240	—	25	224	—	$ 2,489
Total non-mortgage-related securities						
Amortized cost	—	—	—	—	$ 65,006	—
Fair value	—	—	—	—	—	$ 66,419
TRADING						
Retained portfolio						
Total mortgage-related securities[1]	—	—	—	—	—	$ 29,104
Investments						
Total mortgage-related securities[1]	—	—	—	—	—	$ 32,366
Non-mortgage-related securities						
Asset-backed securities[1]	—	—	—	—	—	$ 96
Debt securities issued by the U.S. Treasury and other U.S. government agencies	$ 16	$ 815	$ 98	$ 75	—	1,004
Mutual funds	200	340	—	—	—	540
Commercial paper	479	—	—	—	—	479
Corporate debt securities	15	179	—	35	—	229
Debt securities issued by foreign governments	4	—	—	—	—	4
Others	57	—	—	—	—	57
Total non-mortgage-related securities	—	—	—	—	—	$ 2,409

(1) Maturity information for mortgage-related securities and other asset-backed securities is not provided because their contractual maturity 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 related to available-for-sale securities.

Table 5.5 — Accumulated Other Comprehensive Income (Loss) Related to Available-for-Sale Securities

	Year Ended December 31,		
	2002	2001	2000
	(dollars in millions)		
Beginning balance	$ 4,200	$1,084	$(6,522)
Net unrealized investment gains during the period:			
Unrealized holding gains, net of tax expense of $4,583, $1,723 and $4,074, respectively	8,512	3,200	7,566
Reclassification adjustment for realized (gains) losses included in net income, net of tax (expense) benefit of $(267), $(45), and $22, respectively[1]	(495)	(84)	40
Ending balance	$12,217	$4,200	$ 1,084

(1) Includes impairment losses on securities where the decline in fair value is considered to be other than temporary of $422 million, $228 million and $54 million, net of tax at December 31, 2002, 2001 and 2000, respectively.

Secured Financing Transactions

Freddie Mac enters into several types of secured financing transactions, including interest-rate swap agreements, secured borrowings and secured lendings. Repurchase transactions are treated as secured borrowings, because Freddie Mac sells securities to a counterparty for cash and will purchase the same collateral back at a future date. Securities purchased under agreements to resell (reverse repurchase agreements) are effectively collateralized lending transactions in which Freddie Mac purchases a security with an agreement to sell back the same security at a specified time.

Freddie Mac's counterparties are required to post collateral for reverse repurchase transactions even though it is Freddie Mac's practice not to repledge assets held under a reverse repurchase agreement. Based on master agreements, the collateral can be repledged. At December 31, 2002 and 2001, the fair value amount of collateral held by Freddie Mac under secured lending transactions and available for repledging was $5,776 million and $2,754 million, respectively.

Freddie Mac is also required to post 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 pledged assets that the secured party can repledge and those that cannot be repledged.

Table 5.6 — Collateral Pledged

	December 31, 2002	December 31, 2001
	(dollars in millions)	
Assets pledged with ability for secured party to repledge (parenthetically disclosed on consolidated balance sheets)		
Available-for-sale	$ 717	$292
Trading	153	167
Subtotal	870	459
Assets pledged without ability for secured party to repledge		
Available-for-sale	627	255
Trading	8	11
Subtotal	635	266
Total assets pledged	$1,505	$725

Cash and Cash Equivalents

Table 5.7 summarizes the components of cash and cash equivalents for the years ended December 31, 2002 and 2001, respectively.

Table 5.7 — Cash and Cash Equivalents

	December 31,	
	2002	2001
	(dollars in millions)	
Interest-bearing[1]	$10,729	$3,387
Non-interest bearing	63	77
Total	$10,792	$3,464

(1) Includes collateral that Freddie Mac holds when its exposure to its derivative counterparties exceeds mutually agreed upon limits. Interest earned on the collateral at the contractual rate is paid to the counterparties, while Freddie Mac retains any interest earned above the contractual rate.

Mortgage Loans

Table 5.8 presents a detailed summary of mortgage loans in the retained portfolio.

Table 5.8 — Mortgage Loans Detail[1]

	December 31,	
	2002	2001
	(dollars in millions)	
Single-family:		
Conventional		
Fixed-rate	$33,816	$38,267
Adjustable-rate	1,321	1,073
Seconds	3	5
Total conventional	35,140	39,345
Federal Housing Administration ("FHA")/Department of Veteran Affairs ("VA") — fixed rate	710	964
Total single-family	35,850	40,309
Total multifamily	28,036	22,483
Total mortgages loans	$63,886	$62,792

(1) Based on UPB.

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, specifically, mortgage loans that have not been securitized and sold in accordance with SFAS 125 / 140. *See* "NOTE 3: SECURITIZATION OF MORTGAGE-RELATED ASSETS" for more information concerning Freddie Mac's GO.

Table 6.1 summarizes loan loss reserve activity during 2002 and 2001.

Table 6.1 — Detail of Loan Loss Reserves Balance

	December 31,					
	2002			2001		
	Reserves related to:			Reserves related to:		
	Retained Mortgages	PCs Outstanding	Total Loan Loss Reserves	Retained Mortgages	PCs Outstanding	Total Loan Loss Reserves
	(dollars in millions)					
Beginning balance	$ 103	$ 121	$ 224	$ 100	$ 129	$ 229
Provision for credit losses[1]	161	(33)	128	40	(8)	32
Charge-offs[1]	(171)	—	(171)	(129)	—	(129)
Recoveries	84	—	84	92	—	92
Ending balance	$ 177	$ 88	$ 265	$ 103	$ 121	$ 224

(1) It is Freddie Mac's practice to purchase mortgage loans from the pools that underlie PCs at the point the mortgage loan is identified as being 120 days past due. Upon repurchase, the unpaid principal balance associated with the loan is recorded on-balance sheet and the associated reserve balance is reclassified from Reserve for guarantee losses on PCs to Reserve for losses on mortgage loans held for investment. As a result, a transfer is reflected as a reduction of the provision associated with the off-balance sheet PCs with a corresponding increase to the provision associated with the retained mortgages. Given that all credit losses on off-balance sheet PCs are preceded by the purchase of a delinquent mortgage loan from the PC pool, all charge-offs or recoveries are found in the "Retained Mortgages" column above.

Impaired Loans

Total loan loss reserves, as presented in *Table 6.1*, consists of a specific valuation allowance related to impaired loans, which are presented in *Table 6.2* and an additional reserve for other probable losses, which equaled $240 million and $218 million as of December 31, 2002 and 2001, respectively. The population of impaired loans includes multifamily loans for which it is probable that the company will not receive all amounts contractually due, as well as all troubled debt restructurings (both single-family and multifamily). The company's recorded investment in impaired loans and the related valuation allowance are summarized in *Table 6.2*.

Table 6.2 — Impaired Loans[1]

	December 31,					
	2002			2001		
	Recorded Investment[2]	Specific Reserve	Net Investment	Recorded Investment[2]	Specific Reserve	Net Investment
	(dollars in millions)					
Impaired loans having:						
Related valuation allowance	$ 169	$ (25)	$ 144	$ 77	$(6)	$ 71
No related valuation allowance	2,077	—	2,077	1,612	—	1,612
Total	$2,246	$ (25)	$2,221	$1,689	$(6)	$1,683

(1) Single-family impaired loans include performing and non-performing troubled debt restructured loans. Multifamily impaired loans are defined as performing and non-performing TDR loans, loans 60 days or more delinquent and mortgage loans with real estate collateral values less than the outstanding UPB.

(2) "Recorded Investment" includes the unpaid principal balance of mortgage loans plus other basis adjustments, which are modifications to their carrying value. *See* "NOTE 2: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES" for more information.

For the years ended December 31, 2002, 2001 and 2000, the average recorded investment in impaired loans was $2,029 million, $1,577 million and $1,316 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 $22 million, $20 million and $17 million for the years ended December 31, 2002, 2001 and 2000, 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 (*see* "NOTE 2: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES" for more information). Gross interest income on impaired single-family loans totaled $129 million, $104 million and $86 million for the years ended December 31, 2002, 2001 and 2000, 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, 2002, 2001 and 2000.

Table 6.3 — Delinquency Performance[1]

	December 31,		
	2002	2001	2000
Delinquencies, end of period			
Single-family:[2]			
Credit-enhanced portfolio[3]	2.06%	1.29%	0.84%
Non-credit enhanced portfolio	0.29%	0.30%	0.29%
Total portfolio[3]	0.77%	0.62%	0.49%
Multifamily[4]	0.13%	0.15%	0.04%

(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. The average holding period of REO properties was less than one year for each of the three years ended December 31, 2002.

Table 7.1 — Real Estate Owned

	REO, Gross	Valuation Allowance	REO, Net
	(dollars in millions)		
Balance, December 31, 1999	$ 490	$(47)	$ 443
Additions	851	(53)	798
Dispositions and write-downs	(948)	65	(883)
Balance, December 31, 2000	393	(35)	358
Additions	910	(50)	860
Dispositions and write-downs	(798)	27	(771)
Balance, December 31, 2001	505	(58)	447
Additions	1,197	(70)	1,127
Dispositions and write-downs	(1,032)	52	(980)
Balance, December 31, 2002	$ 670	$(76)	$ 594

Freddie Mac recognized gains of $22 million, $12 million and $2 million on REO dispositions for the years ended December 31, 2002, 2001 and 2000, respectively, which are included in "REO operations income (expense)." *See* "NOTE 2: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES" for more information.

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, 2002 and 2001 for debt securities, as well as subordinated borrowings.

Table 8.1 — Total Debt Securities, Net[1]

	December 31,			
	2002		2001	
	Balance, Net	Effective Rate[2]	Balance, Net	Effective Rate[2]
	(dollars in millions)			
Senior debt, due within one year:				
Discount notes, medium-term notes, securities sold under agreements to repurchase, Federal funds purchased and other short-term debt securities	$194,044	1.58%	$245,722	2.51%
Current portion of long-term debt	50,385	4.74	18,505	5.73
Senior debt, due within one year	244,429	2.23	264,227	2.74
Senior debt, due after one year	415,662	4.87	311,013	5.69
Subordinated debt, due after one year	5,605	6.03	3,128	6.37
Senior and subordinated debt, due after one year	421,267	4.89%	314,141	5.70%
Total debt securities, net	$665,696		$578,368	

(1) Includes discounts, premiums 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 hedging-related basis adjustments. *See* "NOTE 2: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES" for more information.

Freddie Mac finances the purchase of mortgage loans and mortgage-related securities primarily through the issuance of Senior debt and Subordinated debt.

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 and medium-term notes as of December 31, 2002 and 2001, respectively. Approximately 99 percent and 97 percent of the UPB of these discount notes and medium-term notes outstanding as of December 31, 2002 and 2001, respectively, have been issued on a discounted basis, paying only principal at maturity. Discount notes and medium-term notes are unsecured general obligations. 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. *See* "NOTE 5: RETAINED PORTFOLIO AND CASH AND INVESTMENTS PORTFOLIO" for more information. Federal funds purchased are unsecuritized borrowings from commercial banks that are members of the Federal Reserve System.

Senior debt, due after one year (including current portion of long-term debt) primarily consisted of callable and non-callable fixed-rate securities, zero-coupon securities and variable-rate securities. As of December 31, 2002 and 2001, approximately 95 percent and 97 percent of the UPB of Senior debt, due after one year (including current portion of long-term debt) outstanding carried a fixed-rate or zero coupon, while the remaining UPB carried a variable-rate coupon.

Subordinated borrowings, which are reported on the consolidated balance sheets net of their unamortized discount, consist of fixed-rate capital debentures, zero-coupon capital debentures and Freddie SUBS®, which are subordinate to all of Freddie Mac's existing and future senior debt.

Table 8.2 provides additional information related to Freddie Mac's debt securities due within one year.

Table 8.2 — Total Debt Securities, Due Within One Year

	2002				
	As of December 31,		Average Outstanding During the Year		
	Balance, Net	Weighted Average Effective Rate[1]	Balance	Weighted Average Effective Rate[2]	Maximum Balance Outstanding at Any Month End
			(dollars in millions)		
Discount notes	$163,202	1.61%	$180,889	2.02%	$211,388
Medium-term notes	1,015	2.07	5,528	2.39	8,161
Securities sold under agreements to repurchase and Federal funds purchased	15,262	1.08	13,882	1.39	21,472
Other short-term debt securities	14,565				
Subtotal	194,044				
Current portion of long-term debt	50,385				
Total debt securities, due within one year	$244,429				

	2001				
	As of December 31,		Average Outstanding During the Year		
	Balance, Net	Weighted Average Effective Rate[1]	Balance	Weighted Average Effective Rate[2]	Maximum Balance Outstanding at Any Month End
			(dollars in millions)		
Discount notes	$219,656	2.44%	$191,478	4.26%	$219,656
Medium-term notes	6,730	2.91	9,150	4.98	13,638
Securities sold under agreements to repurchase and Federal funds purchased	4,548	1.52	5,029	3.15	8,096
Other short-term debt securities	14,788				
Subtotal	245,722				
Current portion of long-term debt	18,505				
Total debt securities, due within one year	$264,227				

	2000				
	As of December 31,		Average Outstanding During the Year		
	Balance, Net	Weighted Average Effective Rate[1]	Balance	Weighted Average Effective Rate[2]	Maximum Balance Outstanding at Any Month End
			(dollars in millions)		
Discount notes	$132,456	6.39%	$145,044	6.16%	$155,300
Medium-term notes	17,980	6.56	18,286	6.39	23,201
Securities sold under agreements to repurchase and Federal funds purchased	756	6.31	1,361	5.15	1,950
Other short-term debt securities	2,291				
Subtotal	153,483				
Current portion of long-term debt	29,891				
Total debt securities, due within one year	$183,374				

(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 hedging-related basis adjustments. *See* "NOTE 2: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES" for more information.

(2) 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 hedging-related basis adjustments. *See* "NOTE 2: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES" for more information.

A portion of Freddie Mac's long-term debt is callable. Callable debt gives Freddie Mac the option to redeem the debt security in whole or in part at either a specified call date or at any time on or after a specified call date. *Table 8.3* summarizes the maturities, balances and effective interest rates at December 31, 2002 for contractually callable debt by call period.

Table 8.3 — Callable Debt

First-Available Call Period Date	Maturity	Balance Outstanding[1]	Effective Rate[2]
		(dollars in millions)	
2003	2003 — 2022	$ 52,456	4.61%
2004	2004 — 2017	22,923	3.30
2005	2005 — 2017	19,817	3.06
2006	2006 — 2016	9,461	3.63
2007	2007 — 2012	12,591	4.05
Thereafter	2008 — 2032	58,020	5.59
Total		$175,268	4.49%

(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 $42,428 million).
(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 hedging-related basis adjustments. *See* "NOTE 2 — SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES" for more information.

Table 8.4 summarizes the contractual maturities of long-term debt securities (including current portion of long-term debt) and subordinated borrowings outstanding at December 31, 2002, assuming callable debt is (i) paid at scheduled maturity or (ii) redeemed at the first-available call date.

Table 8.4 — Senior and Subordinated Debt, Due After One Year (including current portion of long-term debt)

	Scheduled Maturity[1]	Assuming Callable Debt is Redeemed at First-Available Call Date[1]
	(dollars in millions)	
2003	$ 50,381	$ 95,667
2004	85,807	82,975
2005	78,352	60,378
2006	44,612	34,477
2007	39,933	35,160
2008	16,659	13,783
2009	21,538	19,218
2010	19,025	18,771
2011	20,324	19,808
2012	37,329	36,526
Thereafter	92,754	89,951
Total[1]	506,714	506,714
Net premiums, discounts, and hedging-related basis adjustments[2]	(35,062)	(35,062)
Senior and subordinated debt, due after one year, including current portion of long-term debt	$471,652	$471,652

(1) Represents unpaid principal balance of long-term debt securities and subordinated borrowings.
(2) Represents unamortized premiums, discounts, and hedging-related basis adjustments. It includes discounts of $46,345 million associated with callable and non-callable zero-coupon debt.

During 2002, Freddie Mac recognized a $674 million before-tax loss on the retirement of $20.3 billion principal amount of debt outstanding. During 2001, the company recognized a $356 million before-tax loss on the retirement of $4.7 billion principal amount of debt outstanding.

NOTE 9: STOCKHOLDERS' EQUITY

Preferred Stock

During 2002, Freddie Mac completed one preferred stock offering, raising approximately $300 million (*see Table 9.1* for more information). All 17 classes of preferred stock outstanding at December 31, 2002 have a par value of $1 per share, and are redeemable, on specified dates, at the company's option at their redemption price (or redemption value) 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, 2002.

Table 9.1 — Preferred Stock

	Issue Date	Shares Authorized	Shares Outstanding	Total Par Value	Redemption Price per Share	Total Outstanding Balance[1]	Redeemable On or After	NYSE Symbol[2]
		(shares and dollars in millions, except redemption price per share)						
1996 Variable-rate[3]	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	(9)
5%	March 23, 1998	8.00	8.00	8.00	50.00	400	March 31, 2003	FRE.prF
5.1%	September 23, 1998	8.00	8.00	8.00	50.00	400	September 30, 2003	FRE.prH
1998 Variable-rate[4]	September 23 and 29, 1998	4.40	4.40	4.40	50.00	220	September 30, 2003	FRE.prG
5.3%	October 28, 1998	4.00	4.00	4.00	50.00	200	October 30, 2000	(9)
5.1%	March 19, 1999	3.00	3.00	3.00	50.00	150	March 31, 2004	(9)
5.79%	July 21, 1999	5.00	5.00	5.00	50.00	250	June 30, 2009	FRE.prK
1999 Variable-rate[5]	November 5, 1999	5.75	5.75	5.75	50.00	288	December 31, 2004	FRE.prL
2001 Variable-rate[6]	January 26, 2001	6.50	6.50	6.50	50.00	325	March 31, 2003	FRE.prM
5.81%	March 23, 2001	3.45	3.45	3.45	50.00	172	March 31, 2011	FRE.prO
2001 Variable-rate[7]	March 23, 2001	4.60	4.60	4.60	50.00	230	March 31, 2003	FRE.prN
2001 Variable-rate[8]	May 30, 2001	4.02	4.02	4.02	50.00	201	June 30, 2003	FRE.prQ
6.0%	May 30, 2001	3.45	3.45	3.45	50.00	173	June 30, 2006	FRE.prP
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	(9)
Total		92.17	92.17	92.17		$4,609		

(1) Amounts stated at redemption value.
(2) Preferred Stock is listed on the New York Stock Exchange, unless otherwise noted.
(3) The dividend rate resets quarterly and is equal to the sum of the three-month London Interbank Offered Rate ("LIBOR") plus one percent divided by 1.377, and is capped at 9.00 percent.
(4) 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.
(5) 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.
(6) Dividend rate resets on April 1 every two years after April 1, 2003 based on the 2-year CMT rate plus .10 percent and is capped at 11.00 percent. Optional redemption on March 31, 2003 and on March 31 every two years thereafter.
(7) Dividend rate resets on April 1 every year based on the 12-month LIBOR rate minus .20 percent and is capped at 11.00 percent. Optional redemption on March 31, 2003 and on March 31 every year thereafter.
(8) Dividend rate resets on July 1 every two years after July 1, 2003 based on the 2-year CMT rate plus .20 percent and is capped at 11.00 percent. Optional redemption on June 30, 2003 and on June 30 every two years thereafter.
(9) Not listed on any exchange.

Dividends Declared

Table 9.2 summarizes the cash dividends declared per share on Freddie Mac's common and preferred stock.

Table 9.2 — Cash Dividends Declared

	Year Ended December 31,		
	2002	2001	2000
Common:	$0.88	$0.80	$0.68
Preferred:			
1996 Variable-rate	1.07	1.98	2.76
6.125%[1]	0.46	3.06	3.06
6.14%	3.07	3.07	3.07
5.81% (1997 issue)	2.91	2.91	2.91
5%	2.50	2.50	2.50
5.1% (1998 issue)	2.55	2.55	2.55
1998 Variable-rate	1.07	1.98	2.76
5.3%	2.65	2.65	2.65
5.1% (1999 issue)	2.55	2.55	2.55
5.79%	2.90	2.90	2.90
1999 Variable-rate	2.99	2.99	2.99
January 2001 Variable-rate	2.41	2.23	—
5.81% (2001 issue)	2.91	2.24	—
March 2001 Variable-rate	1.64	1.77	—
6%	3.00	1.75	—
May 2001 Variable-rate	2.24	1.31	—
5.7%	2.85	0.48	—
5.81% (2002 issue)	2.67	—	—

(1) The 6.125% preferred stock was redeemed at a price of $50.46 per share, which includes the face amount of $50.00 per share plus $0.46 of dividends that were accrued through February 24, 2002, the redemption date.

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 9.1 million outstanding shares in 2002, no outstanding shares in 2001 and 5.9 million outstanding shares in 2000. Common stock repurchases are done with the purpose of returning capital to the company's stockholders in the form of capital gains rather than dividends. As discussed in "NOTE 1: RESTATEMENT," 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 or the redemption of any preferred stock.

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 flowing 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 75 percent (up-rate scenario) and one in which they fall 50 percent (down-rate scenario). Changes in both scenarios are capped generally at 600 basis points. The risk-based capital requirement for Freddie Mac is the amount of "total capital" that would enable it to absorb the stress test losses in whichever scenario is more adverse, 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 preferred stock, additional paid-in capital and retained earnings as measured under GAAP.

The minimum capital standard requires Freddie Mac to hold an amount of core capital that generally equals or exceeds the sum of 2.50 percent of aggregate on-balance sheet assets, as measured under GAAP and 0.45 percent of other aggregate off-balance sheet obligations.

The critical capital standard requires Freddie Mac to hold an amount of core capital that generally equals or exceeds the sum of 1.25 percent of aggregate on-balance sheet assets, as measured under GAAP, and 0.25 percent of other aggregate off-balance sheet obligations.

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

To be classified as "adequately capitalized," Freddie Mac must meet both the risk-based and minimum capital standard. If Freddie Mac fails to meet the risk-based capital standard, it cannot be classified higher than "undercapitalized." If Freddie Mac fails to meet the minimum capital standard, it cannot be classified higher than "significantly undercapitalized." If Freddie Mac fails to meet the critical capital standard, it must be classified as "critically undercapitalized." OFHEO retains discretion to reduce Freddie Mac's capital classification by one level if OFHEO determines that 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 mortgages held or secured by Freddie Mac has decreased significantly.

When Freddie Mac is classified as adequately capitalized, the company can 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 level and would not decrease the company's core capital to an amount less than the minimum capital level.

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 level. Freddie Mac also would be required to submit a capital restoration plan for OFHEO approval, which could affect adversely its ability to make capital distributions.

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 affect adversely 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.

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

Factors that may significantly affect the adequacy of Freddie Mac's capital include changes in the economic environment, such as large interest-rate moves or house price declines. In particular, interest rate changes 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 are not.

Table 10.1 summarizes the company's regulatory capital requirements and surpluses at December 31, 2002 and 2001.

Freddie Mac's core capital and minimum and critical capital surpluses as presented in *Table 10.1* are based on restated net income for 2002 and 2001. However, Freddie Mac's total capital and risk-based capital surpluses as presented in *Table 10.1* do not reflect the effect of the restatement. OFHEO determined not to recalculate the risk-based capital amounts given that the minimum capital requirement remained the determining requirement for Freddie Mac's classification as adequately capitalized.

Table 10.1 — Regulatory Capital Requirements

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

(1) Minimum and critical capital requirements are based on amended reports to OFHEO that correct results included in Freddie Mac's November 21, 2003 Information Statement Supplement. The impact of this change on the restated regulatory minimum capital surplus was a decrease of $1 million and $7 million as of December 31, 2002 and 2001, respectively, as compared to those results presented in Freddie Mac's November 21, 2003 Information Statement Supplement.
(2) Core capital consists of the par value of outstanding common stock (common stock issued less common stock held in treasury), par value of outstanding perpetual preferred stock, additional paid in capital and retained earnings, as determined in accordance with GAAP.
(3) Risk-based and total capital amounts are those calculated by OFHEO prior to the restatement of Freddie Mac's 2002 financial results.
(4) Total capital includes "core capital" and general reserves for mortgage and foreclosure losses.

NOTE 11: STOCK-BASED COMPENSATION

Freddie Mac has three stock-based compensation plans under which grants are being made: the ESPP, the 1995 Stock Compensation Plan ("Employee Plan") and the 1995 Directors' Stock Compensation Plan ("Directors' Plan").

Common stock delivered under these plans may be shares currently held by Freddie Mac as treasury stock or shares purchased by Freddie Mac in the open market.

1995 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. During 2002, 2001 and 2000, the maximum market value of stock available for annual purchase was $20,000 per employee as determined on the subscription date. The purchase price is equal to 85% of the average price of the stock on the subscription (grant) date or the purchase (exercise) date, whichever is lower.

Table 11.1 provides a summary of activity related to the ESPP.

Table 11.1 — Summary of ESPP Activity

	Year Ended December 31,		
	2002	2001	2000
Shares pledged[1]	1,000,370	799,654	1,020,850
Fair value on grant date	$ 13.53	$ 18.15	$ 12.19
Shares purchased[1]	351,629	914,167	177,678
Purchase price	$ 51.74	$ 33.20	$ 33.87

(1) During each of the three years ended December 31, employees pledged to purchase shares on August 1 with the purchase occurring on July 31 of the following year.

The maximum number of shares of common stock that may be granted to employees under the ESPP is 12 million shares. At December 31, 2002, 8.2 million shares had been issued under the ESPP and 3.8 million shares remained available for grant. Grants under the ESPP will cease upon the earlier of exhausting the authorized share pool or December 31, 2004.

1995 Employee Plan: Under the stockholder-approved Employee Plan, Freddie Mac is permitted to grant to employees stock-based awards, including stock options with dividend rights, RSUs with dividend rights, restricted stock and stock appreciation rights ("SARs"). Such awards are generally forfeitable for at least one year after the date of grant, and Freddie Mac has the right to impose performance conditions with respect to any awards under the Employee Plan. To date, no SARs have been granted under the Employee Plan.

- Stock options granted under the Employee Plan 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 commencing on the grant date.

- Dividend 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 paid on the stock from the date the options were granted.

- A RSU entitles participants to receive one share of common stock at a specified future date. RSUs do not have voting rights, but do have dividend rights, which are paid to RSU holders as 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. The grant-date fair value of restricted stock and RSUs awarded is recognized as compensation expense on a straight-line basis over the restriction period.

The maximum number of shares of common stock that may be granted to employees under the Employee Plan is 33.6 million shares. At December 31, 2002, a total of 27.6 million shares had been issued and 6.0 million shares remained available for grant. Grants under the Employee Plan will cease upon the earlier of exhausting the authorized share pool or December 31, 2004.

1995 Directors' Plan: Under the Directors' Plan, Freddie Mac is permitted to grant stock options with dividend rights, restricted stock and RSUs with dividend rights to non-employee members of the Board of Directors ("Directors"). The accounting for stock options with dividend rights, restricted stock, and RSUs granted under the Directors' Plan is identical to that of the Employee Plan.

In 2002, newly elected or appointed Directors are granted stock options valued at $300,000 and zero dollars in their first and second year of service, respectively. For the third year of service and thereafter, Directors are granted stock options annually valued at $150,000 on the date of grant. These options have an exercise price equal to the fair value of the common stock at the date of grant, and may be exercised for a period of 10 years from the grant date. Also, new Directors are granted RSUs valued on the date of grant at $130,000 and zero dollars in their first and second year of service, respectively. For the third year of service and thereafter, Directors are granted RSUs annually valued at $65,000 on the date of grant. The vesting period for stock options and the restriction period for restricted stock and RSUs is generally 20% for each of five years following the grant date.

The maximum number of shares of common stock that may be granted to Directors under the Directors' Plan is 2.4 million shares. At December 31, 2002, a total of 0.7 million shares had been issued and 1.7 million shares remained available for grant. Grants under the Directors' Plan will cease upon the earlier of exhausting the authorized share pool or Freddie Mac's Annual Meeting of Stockholders in 2008.

Table 11.2 provides a summary of activity related to stock options under the Employee Plan and the Directors' Plan.

Table 11.2 — Employee Plan Stock Options Activity

	Year Ended December 31,					
	2002		2001		2000	
	Stock Options	Weighted Average Exercise Price	Stock Options	Weighted Average Exercise Price	Stock Options	Weighted Average Exercise Price
Outstanding, beginning of year	8,721,962	$37.56	9,035,859	$29.23	9,841,126	$23.11
Granted	1,686,285	64.12	1,444,846	67.18	2,016,305	42.75
Exercised	(997,127)	18.44	(1,588,118)	16.18	(2,338,494)	12.53
Forfeited or expired	(180,015)	51.52	(170,625)	46.31	(483,078)	41.92
Outstanding, end of year	9,231,105	$44.21	8,721,962	$37.56	9,035,859	$29.23
Options exercisable at year-end	4,508,095	$29.60	4,532,265	$23.29	5,212,961	$18.38
Weighted-average fair value of options granted during year		$28.13		$30.29		$19.76

Table 11.3 provides a summary of activity related to restricted stock and RSUs under the Employee Plan and the Directors' Plan.

Table 11.3 — Employee Plan Restricted Stock and RSU Activity

	Year Ended December 31,					
	2002		2001		2000	
	Restricted Stock	Restricted Stock Units	Restricted Stock	Restricted Stock Units	Restricted Stock	Restricted Stock Units
Outstanding, beginning of year	1,478,779	51,632	1,563,943	48,871	796,642	28,235
Granted[1]	—	325,902	367,902	28,289	1,101,050	23,733
Lapse of restrictions	(383,199)	(10,457)	(433,023)	(18,556)	(191,700)	(3,097)
Forfeited	(6,253)	(7,850)	(20,043)	(6,972)	(142,049)	—
Outstanding, end of year	1,089,327	359,227	1,478,779	51,632	1,563,943	48,871
Weighted-average fair value of awards granted during year	N/A	$ 64.22	$ 67.06	$ 65.02	$ 43.97	$44.28

(1) Prior to 2002, RSUs were granted under the Directors' Plan only. During 2002, 313,740 RSUs were granted under the Employee Plan and 12,162 RSUs were granted under the Directors' Plan.

Table 11.4 provides additional information for stock options outstanding under the Employee Plan and the Directors' Plan at December 31, 2002 by range of exercise prices.

Table 11.4 — Employee Plan and Directors' Plan Stock Options Outstanding

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Outstanding at December 31, 2002	Weighted Average Remaining Contract Life in Years	Weighted Average Exercise Price	Exercisable at December 31, 2002	Weighted Average Exercise Price
$9.00 to 14.99	396,352	0.8	$12.98	396,352	$12.98
15.00 to 24.99	2,116,849	2.6	18.21	2,116,849	18.21
25.00 to 34.99	622,989	4.4	34.15	622,989	34.15
35.00 to 44.99	1,482,569	7.1	41.54	415,021	41.75
45.00 to 54.99	976,368	6.2	47.30	543,092	47.35
55.00 to 64.99	2,370,654	8.4	63.12	384,951	61.02
65.00 to 67.99	1,265,324	8.2	67.73	28,841	67.17
	9,231,105	6.0	$44.21	4,508,095	$29.60

Compensation Expense: Compensation expense related to stock-based compensation plans charged to "Salaries and employee benefits" was $65.7 million, $61.2 million and $41.3 million for the years ended December 31, 2002, 2001 and 2000, respectively. Compensation expense is recognized for the ESPP, stock options, restricted stock, RSUs and dividend rights associated with both stock options and RSUs.

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.

Table 11.5 — Assumptions Used to Determine the Fair Value of Options

	Employee Stock Purchase Plan			Employee and Directors' Stock Compensation Plans		
	2002	2001	2000	2002	2001	2000
Dividend yield[1]	1.56%	1.21%	1.89%	—	—	—
Expected life	1 year	1 year	1 year	7 years	7 years	7 years
Expected volatility	21.0%	32.0%	46.0%	32.0%	32.0%	28.5%
Risk-free interest rate	1.75%	3.57%	6.09%	4.75%	5.00%	6.54%

(1) The dividend yield assumption is zero percent for the Employee Plan and Directors' Plan since options granted under these plans include dividend rights.

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 agreements that give the holder 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 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 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 over-the-counter 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:** Other derivatives used by Freddie Mac include a prepayment management agreement and certain credit risk-sharing agreements that are subject to the requirements of SFAS 133.

Hedging Activity

No hedge designation

A significant portion of the company's derivative portfolio is not designated in hedge accounting relationships. These derivatives are reported at their fair value as either "Derivative assets, at fair value" or "Derivative liabilities, at fair value" on the consolidated balance sheets with changes in fair value reported in "Derivative gains (losses)" on the consolidated statements of income. For the majority of interest-rate swaps that are not designated in hedge accounting relationships, their associated interest received or paid is recognized on an accrual basis and recorded in "Income (expense) related to derivatives," within "Net interest income." However, for certain transactions described in "NOTE 1: Restatement," the interest accruals related to these derivatives were recorded to "Non-interest 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" on the consolidated statements of income.

Fair value hedges

Fair value hedges represent hedges of exposure to changes in the fair value of a recognized fixed-rate asset, liability or firm commitment. Freddie Mac uses interest-rate swaps, futures, and forward contracts 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, and/or foreign currency fluctuations. These derivatives are often executed to manage interest-rate risk at an aggregate portfolio level. However, for accounting purposes, Freddie Mac links its fair value hedges to specific debt positions. Therefore, to maintain highly effective accounting hedges in this strategy, Freddie Mac frequently resets the amount of fixed-rate debt being hedged. To accomplish this, typically the accounting hedges are terminated at the time of the reset and the derivatives are contemporaneously redesignated in new hedge accounting relationships of fixed-rate debt.

Derivatives designated as fair value hedges are reported at their fair value as either "Derivative assets, at fair value" or "Derivative liabilities, at fair value" on the consolidated balance sheets. 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 2002 and 2001, hedge ineffectiveness related to fair value hedges was a net $241 million gain and $280 million loss, respectively, and was reported in "Hedge accounting gains (losses)." For 2002 and 2001, $103 million loss and $7 million loss, respectively have been 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.

Cash flow hedges

Cash flow hedges represent hedges of exposure to the variability in the cash flows of a recognized floating-rate asset or liability or a forecasted transaction. Freddie Mac uses interest-rate swaps, futures, options on futures, foreign-currency swaps and forward contracts 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.

The maximum length of time over which Freddie Mac hedges the exposure related to the variability in future cash flows on forecasted debt issuances is thirty years. However, over 90 percent of the AOCI balance at December 31, 2002, is attributable to cash flow hedges of the exposure related to the variability in future cash flows on forecasted debt issuances of 15 years or less.

Derivatives designated as cash flow hedges are reported at their fair value as either "Derivative assets, at fair value" or "Derivative liabilities, at fair value" with changes in fair value generally reported in AOCI on the consolidated balance sheets to the extent the hedge is effective. The remaining ineffective portion, representing the cumulative change in fair value of the derivative from inception of the hedge to the extent it is

greater than the cumulative change in the fair value of the expected future cash flows on the hedge item, is reported as "Hedge accounting gains (losses)" on the consolidated statements of income. For 2002 and 2001, hedge ineffectiveness related to cash flow hedges was a net $54 million loss and $14 million loss. No amounts have been excluded from the assessment of effectiveness for derivatives designated as cash flow hedges.

Under SFAS 133, AOCI amounts are reclassified to earnings as the associated hedged forecasted mortgage purchase transaction affects earnings. During 2002 and 2001, amounts reclassified into earnings also include after-tax gains of $103 million and $42 million, respectively, resulting from the determination that it was probable that forecasted transactions related to certain mortgage purchases and sales would not occur. As of December 31, 2002, the AOCI of $9.9 billion consisted of net unrealized losses of $5.5 billion and net realized losses from terminated cash flow hedges of $4.4 billion. The $5.5 billion related to open cash flow hedges of forecasted debt can change substantially due to future changes in interest rates and other market factors. Assuming no changes in interest rates or other factors affecting derivatives valuation, the company estimates that an after-tax loss (including net unrealized and realized losses) of approximately $3.9 billion of the $9.9 billion recorded in AOCI as of December 31, 2002 will be reclassified into earnings during 2003.

Table 12.1 presents the changes in AOCI related to derivative financial instruments designated as cash flow hedges.

Table 12.1 — Accumulated Other Comprehensive Income (Loss) Related to Cash Flow Hedge Relationships

	Year Ended December 31,	
	2002	2001
	(dollars in millions)	
Beginning balance[1]	$(4,757)	$ —
Cumulative effect of change in accounting principle, net of taxes of $1,422 for the year ended December 31, 2001	—	(2,640)
Net change in fair value related to cash flow hedging activities, net of taxes of $3,307 and $1,194 for the years ended December 31, 2002 and 2001, respectively[2]	(6,141)	(2,218)
Net reclassifications to earnings, net of taxes of $(551) and $(55) for the years ended December 31, 2002 and 2001, respectively	1,021	101
Ending balance[1]	$(9,877)	$(4,757)

(1) Represents the effective portion of the fair value of open derivatives in cash flow hedge relationships (*i.e.*, net unrealized gains and losses) and net realized gains and losses on closed (*i.e.*, terminated or redesignated) cash flow hedges.
(2) Includes periodic interest payments on open swaps designated as cash flow hedges.

NOTE 13: FINANCIAL GUARANTEES

Principal and Interest Guarantees of Mortgage-related Securities

As guarantor of PCs and Structured Securities, Freddie Mac guarantees (i) the scheduled principal payments on the outstanding underlying mortgages; (ii) the payment of interest calculated at the certificate rate times the beginning of month unpaid principal balance, regardless of unscheduled payments received during the month; and (iii) the unpaid principal balance of any foreclosed mortgage to PC and Structured Securities investors. To a much more limited extent, Freddie Mac provides similar guarantees on mortgage-related securities issued by other entities. Freddie Mac generally is paid a guarantee fee for assuming these credit risks. At December 31, 2002, the maximum potential amount of future principal payments Freddie Mac could be required to make under the company's guarantees of principal on mortgage-related securities owned by third parties was $720.5 billion for single-family properties and $8.7 billion for multifamily properties, respectively. Generally, the contractual terms of Freddie Mac's guarantees are 15 to 30 years; however, the actual term, may be significantly less than the contractual terms due to the prepayment characteristics of the mortgage loans underlying the guaranteed 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.

The Freddie Mac Act prohibits Freddie Mac from purchasing first-lien conventional single-family mortgages if the outstanding principal balance at the time of purchase exceeds 80 percent of the value of the property securing the mortgage unless Freddie Mac is provided one or more of the following credit protections: mortgage insurance from an approved mortgage insurer; a seller's agreement to repurchase or replace (for such periods and under such conditions as Freddie Mac may determine) any mortgage that has defaulted; or retention by the seller of at least a 10 percent participation interest in the mortgages. This requirement does not apply to multifamily mortgages or to mortgages insured by the FHA or partially guaranteed by the VA.

In the event Freddie Mac is required to make future payments under its guarantees, Freddie Mac will first pursue recovering these payments by proceeding against the underlying collateral of the loans. In the event that the principal amount of single-family loans exceeds the value of the underlying properties, then Freddie Mac has credit enhancements with maximum coverage totaling $33.0 billion in primary mortgage insurance, $4.1 billion in pool insurance and other credit enhancements, and $5.9 billion in recourse to lenders on single-family loans. In addition, $7.5 billion of the single-family loan principal guarantees relate to resecuritizations that involve Ginnie Mae Certificates, which are backed by the full faith and credit of the U.S. government. In the event that the principal amount of multifamily loans exceeds the value of the underlying properties, then Freddie Mac has maximum combined credit enhancements totaling $2.3 billion.

At December 31, 2002, Freddie Mac has recognized a liability of $1.4 billion in "Guarantee obligation for Participation Certificates, at fair value" for a portion of the guarantees (refer to "NOTE 2: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES" for further discussion). The remaining exposure has a $0.1 billion "Reserve for guarantee losses on Participation Certificates" for incurred credit losses at December 31, 2002.

For $3.7 billion of the $8.7 billion of guarantees on mortgage-related securities backed by multifamily properties, Freddie Mac also provides a guarantee of financing to the issuer of certain multifamily-related securities. *See* "NOTE 19 — VARIABLE INTEREST ENTITIES — Multifamily Credit-Enhanced Bond Trusts" for more information about these securities. In the event that the remarketing agent for the issuer is unable to immediately remarket securities that are put back to the issuer, Freddie Mac agrees to advance funds to the issuer to secure payment to the holders of the securities. The securities repurchased are then pledged to Freddie Mac as collateral for this financing until such time as the securities can be remarketed and the issuer can repay Freddie Mac. There have been no payments made to date by Freddie Mac under this guarantee.

Market Value Guarantees

Under its guaranteed maturity securities offerings, Freddie Mac issues Structured Securities with stated final maturities that are shorter than the stated maturity of the underlying mortgage loans. As part of the issuance of these securities, Freddie Mac effectively writes a cash-settled put option to the investor that allows the investor to be paid any outstanding principal on the stated final date primarily from the proceeds of an auction of those securities on the stated final date. To the extent that the auction proceeds are less than the outstanding principal on the stated final date, Freddie Mac is obligated to pay the difference. Such guarantees expose Freddie Mac to interest rate risk in addition to the credit risk described above. At December 31, 2002, the maximum potential amount of payments Freddie Mac could be required to make under these written put options was $13.3 billion. These guarantees are accounted for as derivatives at fair value pursuant to the provisions of SFAS 133. At December 31, 2002, the notional balance of these written put options was $13.3 billion and the fair value was a liability of $5.8 million. The longest remaining contractual maturity of any outstanding written put option, as of December 31, 2002, was 28 years.

Other Obligations Under Guarantees

Table 13.1 represents information about other guarantees extended by Freddie Mac at December 31, 2002.

Table 13.1 — Guarantees Extended by Freddie Mac

	Year Ended December 31, 2002	
	Maximum potential amount of future payments	Carrying Value
	(dollars in millions)	
Written put options	$ 564	$ 1
Swap payment guarantees	360	—
Servicing released premiums	137	—
Minimum revenue guarantees	85	35
Others	2	—
Total	$ 1,148	$ 36

Freddie Mac enters into written put options that require the company to purchase certain floating-rate mortgage-related securities at a specified date and at a specified interest rate spread over an interest rate index. These written put options are accounted for as derivative financial instruments in accordance with SFAS 133 and are recorded at fair value in the consolidated balance sheets. The longest remaining contractual maturity of any outstanding written put option, as of December 31, 2002, was less than 12 months.

Freddie Mac guarantees the performance of interest rate swap contracts in two circumstances. As part of a resecuritization transaction Freddie Mac transferred certain swaps and related assets to a third party. As part of this transfer, 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 remaining terms of these guarantees at December 31, 2002 are 30 years; 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.

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 guarantees run through 2007.

Minimum revenue guarantees relate to business transactions whereby Freddie Mac sold assets to unrelated entities and simultaneously guaranteed that the unrelated entity would generate certain minimum revenue thresholds related to those assets. To the extent that these minimum revenue amounts are not achieved, Freddie Mac agreed to pay any shortfall. These guarantees run through 2006.

Indemnifications

In connection with various business transactions, Freddie Mac provides standard representations and warranties to counterparties in contracts entered into in the normal course of business based on an assessment that the risk of loss would be remote. 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 and are not expected to occur. 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. There are no amounts reflected in the financial statements as of December 31, 2002 related to these indemnifications.

NOTE 14: 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.

Litigation and claims resolution are subject to many uncertainties and are not susceptible to accurate prediction. Freddie Mac is now subject to various legal proceedings, including regulatory and judicial investigations and civil litigation, arising from the restatement.

Class Action Lawsuits. On June 9, 2003, Freddie Mac and certain former executive officers were named as defendants in a securities class action lawsuit alleging violations of federal securities laws and regulations. The plaintiffs claimed that the defendants disseminated materially false and misleading statements to the market and failed to disclose material information concerning, among others, the following matters:

- the lack of adequate internal accounting controls and personnel expertise;
- the failure to follow accounting rules that require derivative securities to be marked to market;
- the use of accounting techniques to lower earnings results in good times and lift results when business conditions deteriorated; and
- providing investigators with altered records to conceal improper accounting techniques.

These allegations covered the period from January 27, 2003 through June 9, 2003. The plaintiffs sought unspecified compensatory damages, costs and expenses.

Subsequent to the filing of that initial lawsuit, additional class action lawsuits relating to the same matters were filed against Freddie Mac and certain former executive officers. These lawsuits included slightly different allegations, covered different class periods (which begin on dates ranging from January 1, 2000 to January 27, 2003, and end on dates ranging from June 6, 2003 to August 22, 2003), and sought unspecified compensatory damages, costs and expenses. Among these later lawsuits was one filed by the Ohio Public Employees Retirement System and the State Teachers Retirement System of Ohio, and another by the West Virginia Investment Management Board and the Central States, Southeast and Southwest Areas Pension Fund. The latter suit also named Gregory Parseghian, Freddie Mac's former Chief Executive Officer and President, as a defendant and included allegations that he, as well as Leland Brendsel, David Glenn and Vaughn Clarke, engaged in insider trading. Two of these class action lawsuits were filed by separate participants in Freddie Mac's Thrift/401(k) Savings Plan against the company, certain individuals, and the company's Retirement Committee alleging ERISA violations. In particular, the plaintiffs claimed that the defendants breached their fiduciary duty because Freddie Mac stock was an imprudent investment for the Thrift/401(k) Savings Plan. The two Employee Retirement Income Security Act ("ERISA") lawsuits have now been consolidated as a single suit.

Many of the lawsuits described above have been voluntarily dismissed by the plaintiffs. The dismissal of those suits and the consolidation of the ERISA suits reduces the number of pending lawsuits to five.

On January 15, 2004, the plaintiffs in one of the pending lawsuits filed an amended complaint, incorporating information disclosed in Freddie Mac's restatement. The basis of the claims remains the same, although the class period alleged now ranges from July 15, 1999 to June 6, 2003.

Shareholder Derivative Lawsuits. On July 1, 2003, certain former and current members of the Board of Directors of Freddie Mac were named as defendants in a shareholder derivative action alleging breach of

fiduciary duty. The current members of the Board of Directors were subsequently dismissed as defendants from this lawsuit with the consent of the plaintiff. The remaining individual defendants in this suit are Messrs. Brendsel and Glenn, Vaughn Clarke and John Gibbons (both former Chief Financial Officers) and Gregory Parseghian. Freddie Mac is named as a nominal defendant in that action. A similar lawsuit was filed against Messrs. Brendsel, Glenn, Clarke, Gibbons and Parseghian and Freddie Mac on December 11, 2003.

Freddie Mac anticipates that additional lawsuits relating to the matters described above may be filed.

SEC Formal Investigation. On June 11, 2003, Freddie Mac announced that it had been informed by the staff of the SEC that the SEC had commenced a formal investigation. Freddie Mac received a subpoena from the SEC on June 11, 2003 requesting document production and testimony. In addition, Gregory Parseghian, PricewaterhouseCoopers LLP, Freddie Mac's current independent auditors, and a former member of the Board of Directors also received subpoenas for documents and testimony. Beginning in August 2003, the SEC subpoenaed documents and began to take witness testimony from certain present and former Freddie Mac employees and directors, as well as third parties. Freddie Mac is fully cooperating with the SEC and will continue to do so.

OFHEO Investigation. On June 7, 2003, OFHEO directed Freddie Mac and its Board of Directors to take certain actions to address the issues surrounding the restatement. OFHEO also announced that it had deployed a special investigative team to review accounting practices and controls relevant to the restatement process at Freddie Mac and to investigate employee misconduct. As part of this investigation, OFHEO submitted to Freddie Mac multiple requests for documents, and it also subpoenaed certain current Freddie Mac employees and directors, as well as former employees, requesting testimony and documents. In July 2003, OFHEO began to conduct interviews in which it took sworn testimony from certain Freddie Mac employees and directors, external third parties and former employees.

On October 23, 2003, OFHEO announced that it had entered into a consent order with David Glenn, in which Mr. Glenn agreed to cooperate fully with OFHEO's special examination and also with any supervisory and/or enforcement proceeding initiated by OFHEO, to pay a civil money penalty of $125,000, and not to participate in any manner in the conduct of the affairs of Freddie Mac or Fannie Mae without prior OFHEO approval.

On December 10, 2003, Freddie Mac announced that it had entered into a consent order and settlement generally resolving certain matters with OFHEO relating to the restatement. Under the terms of the consent order, Freddie Mac is undertaking remedial actions relating to many of the same areas as its remediation program, including governance, corporate culture, internal controls, accounting practices, disclosure and oversight. In addition, the company has paid a civil money penalty in the amount of $125 million.

Separately on the same date, OFHEO released its staff report on its investigation of matters relating to the restatement. The report included recommendations by the staff to the Director to consider increasing OFHEO's regulation of Freddie Mac's activities, for example, by setting restrictions on the growth of the company's retained portfolio, by requiring that Freddie Mac hold a capital surplus until it produces timely and certified financial statements, or by possibly implementing a mandatory disclosure regime similar to that required for companies with securities registered under the Securities Act and Exchange Act. Depending on the manner in which such recommendations are implemented, the adoption of one or more of them could have an adverse effect on Freddie Mac's financial results. As discussed below, the Director has acted upon the report's recommendation regarding a capital surplus.

On December 17, 2003, OFHEO filed administrative Notices of Charges against Messrs. Brendsel and Clarke seeking to have them pay civil money penalties, to have them make restitution to the company in the amount of the bonuses paid to them in 2000 and 2001, to prohibit Mr. Brendsel from pursuing or accepting any payments from the company that exceed the payments to which he would be entitled if he had been terminated for cause under his employment agreement, and to prohibit Mr. Clarke from pursuing or accepting any payments from the company that exceed the payments to which he would be entitled if he had been terminated for loss of confidence by the company. OFHEO also issued an administrative Notice of Charges against Freddie Mac to require the company to convert Mr. Brendsel's termination to a termination for cause under his employment contract, to convert Mr. Clarke's termination to a termination for loss of confidence, to

prohibit the company from making any payments to Mr. Brendsel that would exceed the payments to which he would be entitled if he had been terminated for cause under his employment contract, and to prohibit the company from making any payments to Mr. Clarke that would exceed the payments to which he would be entitled if he had been terminated for loss of confidence by the company. Prior to the issuance of these administrative Notices of Charges, the Board of Directors had advised OFHEO that Freddie Mac has existing contractual obligations to both former executives, which it is required to perform unless those obligations are superseded by valid authority, and that the company intends to comply fully with any valid and effective order that OFHEO may issue.

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 capital transactions, to ensure that appropriate levels of capital are maintained.

While OFHEO's framework includes stringent monitoring and imposes restrictions on share repurchases, Freddie Mac does not expect it to adversely affect its disciplined growth strategy or require the company to raise additional capital.

OFHEO's oversight of Freddie Mac's actions is intended to ensure that any growth is reasonable given market conditions and the company's capital position. OFHEO will monitor Freddie Mac's estimated capital position on a weekly basis. 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, OFHEO would require the company to submit a remedial plan or to 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 or redemption of any preferred stock. 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 resumption of timely financial reporting that complies with GAAP and certain other factors.

Management believes that this 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.

U.S. Attorney's Criminal Investigation. On June 11, 2003, Freddie Mac was informed that the U.S. Attorney's Office in Alexandria, Virginia had opened a criminal investigation involving the company. As part of its investigation, the U.S. Attorney's Office has made requests for documents and information, interviewed certain Freddie Mac employees and possibly other parties, and taken testimony before the grand jury. Freddie Mac is cooperating in all respects with this investigation.

At present, it is not possible for Freddie Mac to predict the outcome of the civil litigation, the administrative proceedings or the investigations described above or reasonably to estimate the amount of loss (or range of possible loss) that might result from adverse results or settlements of these matters, or their effect on the company's financial condition and results of operations.

NOTE 15: INCOME TAXES

Freddie Mac is exempt from state and local income taxes. *Table 15.1* presents the components of the company's "Provision for income taxes."

Table 15.1 — Provision for income taxes

	Year Ended December 31,		
	2002	2001	2000
	(dollars in millions)		
Current tax provision	$2,023	$1,584	$ 884
Deferred tax provision	2,690	(245)	620
Total provision for income taxes	$4,713	$1,339	$1,504

Freddie Mac uses the asset and liability method of accounting for income taxes pursuant to SFAS 109, "Accounting for Income Taxes." 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.

Table 15.2 summarizes Freddie Mac's deferred tax asset and liability.

Table 15.2 — Deferred tax asset/(liability)

	December 31,	
	2002	2001
	(dollars in millions)	
Deferred tax assets:		
Deferred fees related to securitizations	$ 1,308	$ 709
Basis differences related to assets held for investment	139	353
Employee compensation and benefit plans	136	97
Credit related items and reserve for loan losses	11	—
Other items, net	61	103
Cash flow hedge deferrals and unrealized (gains) losses related to available-for-sale securities	—	300
Total deferred tax asset	1,655	1,562
Deferred tax liabilities:		
Premium and discount amortization	(1,826)	(1,165)
Basis differences related to derivative instruments	(2,639)	(115)
Credit related items and reserve for loan losses	—	(102)
Cash flow hedge deferrals and unrealized (gains) losses related to available-for-sale securities	(1,260)	—
Total deferred tax (liability)	(5,725)	(1,382)
Net deferred tax (liability)/asset	$(4,070)	$ 180

Included in deferred taxes is the tax effect on the (i) net unrealized (gain) loss on available-for-sale securities and (ii) net (gain) loss related to derivatives designated in cash flow hedge relationships, which are both reported in AOCI.

A valuation allowance has not been established against Freddie Mac's deferred tax assets as of December 31, 2002 or 2001, as Freddie Mac has determined that it is more likely than not that all such tax assets will be realized in the future.

Table 15.3 reconciles the statutory federal tax rate to the effective tax rate before the cumulative effects of changes in accounting principles.

Table 15.3 — Reconciliation of Statutory to Effective Tax Rate

	Year Ended December 31,		
	2002	2001	2000
Statutory corporate rate	35.0%	35.0%	35.0%
Tax-exempt interest and dividends-received deductions	(1.2)	(3.6)	(2.9)
Tax credits	(1.1)	(2.9)	(2.0)
Provision (benefit) related to tax contingencies	(1.0)	1.4	(1.2)
Other	0.1	0.2	0.2
Effective rate	31.8%	30.1%	29.1%

Impact of tax issues. The Internal Revenue Service ("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, including those related to the REITs, 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 tax matters, if any, will have a material adverse effect on Freddie Mac's consolidated financial condition.

Tax Years 1985 to 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 Court to contest the deficiencies. In the third quarter of 1999, the IRS issued a Statutory Notice for Freddie Mac's tax years 1987 to 1990, and Freddie Mac filed a petition in the Court. Subsequently, the Court combined the 1985 to 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.

Recent 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 (i) the regular adjusted cost basis or (ii) the fair market value on January 1, 1985. On September 29, 2003, 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.

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. In addition, if the IRS

were to 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 to 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 to 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 to 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 matters in controversy, other than the same questions at issue in the 1985 to 1993 cases, involve the character of losses on dispositions of mortgage securities and certain issues relating to Freddie Mac's REIT subsidiaries.

Tax Treatment of REITs. In February 1997, Freddie Mac formed two REIT subsidiaries that issued a total of $4 billion in step-down preferred stock to investors. Under the IRS regulations in effect when the REITs were formed, the company believes that the dividend payments by the REITs to holders of the REITs' step-down preferred stock are 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 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 has challenged Freddie Mac's position that the REIT dividends are fully deductible. Given the uncertainty related to the tax treatment of the dividends, Freddie Mac has not recorded a tax benefit for a portion of the REIT dividends in its consolidated financial statements. This tax treatment is subject to change once uncertainties related to the tax treatment of such dividends are adequately clarified. The preferred stock is redeemable by the REITs under certain circumstances where the REITs obtain a legal opinion to the effect that changes in applicable tax law could adversely affect the tax treatment of the REITs or the preferred stock.

Tax Years 1998 to 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 trade transactions known as "Linked Swaps." Freddie Mac has reported and paid tax treating each pair of Linked Swaps as a single integrated transaction for federal income tax purposes. There is a risk, however, that the IRS could challenge Freddie Mac's tax treatment of 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.

In addition, two additional swaps were executed in November 2001. Although the facts and circumstances surrounding these swaps were different from the Linked Swaps, Freddie Mac also reported and paid tax treating these swaps as a single integrated transaction for federal income tax purposes. Management believes there are no significant tax exposures related to these swaps for the periods covered by the restatement.

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. Since the IRS is currently examining Freddie Mac's 2001 and 2002 tax returns, the company does not know whether the IRS will raise any issues related to these transactions as part of that 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 effect on Freddie Mac's consolidated financial condition.

NOTE 16: 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 three consecutive years of employment. It is Freddie Mac's general practice to contribute to the Pension Plan an amount up to the maximum amount deductible for federal income tax purposes each year. Pension Plan assets are held in trust and consist primarily of corporate bonds and listed stocks. In addition to the Pension Plan, Freddie Mac maintains nonqualified, unfunded defined benefit pension plans for officers of the company. The related retirement benefits for the nonqualified plans are paid from Freddie Mac's general assets.

Freddie Mac maintains a defined benefit post-retirement health care plan that 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 prior to 2002) after age 35 and who, upon separation or termination, immediately elected to commence benefits under the Pension Plan in the form of an annuity. The company's post-retirement health care plan currently is not funded and therefore has no plan assets.

The company is required to accrue the estimated cost of retiree benefits as employees render the services necessary to earn their post-retirement benefits. Freddie Mac's pension and post-retirement health care costs and the funded status of these plans for 2002, 2001 and 2000 presented in the following tables were calculated using assumptions as of September 30, 2002, 2001 and 2000, respectively. *Table 16.1* summarizes the components of consolidated net periodic benefit costs related to Freddie Mac's defined benefit pension plans and post-retirement health care plan. Net periodic benefit costs are included in the line "Salaries and employee benefits" on the company's consolidated statements of income.

Table 16.1 — Net Periodic Benefit Cost Detail

	Pension Benefits			Post-Retirement Benefits		
	Year Ended December 31,			Year Ended December 31,		
	2002	2001	2000	2002	2001	2000
	(dollars in millions)					
Service cost of current period	$ 12	$ 12	$ 10	$ 4	$2	$3
Interest cost on projected benefit obligation	14	12	10	3	2	1
Expected return on plan assets	(13)	(13)	(12)	—	—	—
Recognized net actuarial (gain) loss	—	(1)	(1)	1	—	—
Recognized prior service cost	—	—	—	(1)	—	—
Net periodic benefit costs	$ 13	$ 10	$ 7	$ 7	$4	$4

Table 16.2 summarizes the changes in the projected benefit obligation and the fair value of plan assets for the defined benefit pension plans, and the change in the accumulated benefit obligation for the post-retirement health care plan. The Amendment referred to below for Pension Benefits for 2002 relates to the increase in the maximum annual defined benefit limit as defined by IRC Section 415(b) and the maximum compensation limit as defined by IRC Section 401(a)(17). The Amendment referred to for Post-Retirement Benefits for 2002 includes changes in eligibility and Medicare coordination. The Amendment referred to for Pension Benefits for 2001 relates to the company's change in the death benefit effective January 1, 2001 to provide pre-retirement death benefits for all participants.

Table 16.2 — Projected Benefit Obligations and Fair Value of Plan Assets

	Pension Benefits		Post-Retirement Benefits	
	December 31,		December 31,	
	2002	2001	2002	2001
	(dollars in millions)			
PROJECTED BENEFIT OBLIGATION:				
Beginning balance	$179	$162	$28	$22
Amendment	1	1	(8)	—
Service cost of current period	12	12	4	2
Interest cost on benefit obligation	14	12	3	2
Net actuarial loss (gain)	27	(5)	27	2
Benefits paid	(3)	(3)	—	—
Ending balance	$230	$179	$54	$28
THE FAIR VALUE OF PLAN ASSETS:				
Beginning balance	$139	$152		
Actual loss return on plan assets	(13)	(20)		
Employer contributions	37	10		
Benefits paid	(3)	(3)		
Ending balance	$160	$139		

Table 16.3 sets forth the funded status of the defined benefit pension plans and post-retirement health care plan, the assumptions used to calculate the funded status and amounts recognized in the Consolidated Balance Sheets.

Table 16.3 — Funded Status of Plans and by Assumptions

	Pension Benefits		Post-Retirement Benefits	
	December 31,		December 31,	
	2002	2001	2002	2001
	(dollars in millions)			
Benefit obligation in excess of plan assets	$ 70	$ 40	$ 54	$ 28
Unrecognized net actuarial (loss) gain	(57)	(4)	(23)	3
Unrecognized prior service cost	(2)	(1)	7	—
Initial unrecognized net asset being recognized over 17 years	(1)	(1)	—	—
Net liability included in Other liabilities	$ 10	$ 34	$ 38	$ 31
Prepaid benefit cost	$ (2)	$ —		
Accrued benefit liability	12	34		
Net amount recognized	$ 10	$ 34		
MAJOR ASSUMPTIONS:				
Assumed discount rate	7.00%	7.50%	7.00%	7.50%
Rate of increase in compensation levels	4.50	4.50	—	—
Consumer price index	2.50	3.50	—	—
Expected long-term rate of return on plan assets	9.00	9.00	—	—

The assumed health care cost trend rate used in measuring the accumulated post-retirement benefit obligation is 15.0 percent in 2003, gradually declining to 5.0 percent in 2007 and remaining at that level thereafter.

Table 16.4 sets forth the effect on the accumulated post-retirement benefit obligation and the sum of the service cost and interest cost components of the net periodic post-retirement benefit costs that would result from a 1 percent increase or decrease in the assumed health care cost trend rate.

Table 16.4 — Selected Data Regarding the Post-Retirement Plan

	One-Percent Increase	One-Percent Decrease
Effect on the accumulated post-retirement benefit obligation for health care benefits	22%	(17)%
Effect on the net periodic post-retirement benefit cost components	25%	(19)%

Defined Contribution Plans

Freddie Mac also offers a tax-qualified defined contribution pension plan (the "Savings Plan") to all eligible employees. Employees were permitted to contribute from 1 percent to 15 percent of their annual salaries to the Savings Plan, up to $14,500 in 2002, 2001 and 2000 ($11,000 pre-tax and $3,500 after tax in 2002 and $10,500 pre-tax and $4,000 after tax in 2001 and 2000). Freddie Mac matches employees' contributions up to 6 percent of their salaries per pay period; the percentage matched depends upon the length of service. In addition, Freddie Mac is authorized to make discretionary contributions to the Savings Plan on behalf of each eligible employee, based on salary level. Employees become vested in Freddie Mac's discretionary contributions after 5 years. Freddie Mac made contributions to the Savings Plan totaling $21.4 million, $21.1 million, and $16.0 million for 2002, 2001 and 2000, respectively.

See "NOTE 14 — LEGAL CONTINGENCIES" for information regarding two class action lawsuits filed by separate participants in Freddie Mac's Thrift/401(k) Savings Plan.

Executive Deferred Compensation Plan

The 2002 Executive Deferred Compensation Plan is an unfunded, non-qualified plan that allows certain key employees to elect to defer their annual salary and cash bonus, and certain key management employees to defer the settlement of restricted stock units received from Freddie Mac, for any number of years specified by the employee, but under no circumstances may the period elected exceed their 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, including interest accruals. 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 reasonably equal installments over five, ten or 15 years. Distributions are paid from Freddie Mac's general assets.

NOTE 17: FAIR VALUE DISCLOSURES

The FVBS in *Table 17.1* 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, 2002 and 2001. The FVBS includes all items recorded in the consolidated balance sheets prepared in accordance with GAAP, as well as all off-balance-sheet financial instruments that are not recorded in the GAAP consolidated balance sheets. The valuation of financial instruments on the FVBS is in accordance with GAAP fair value guidelines prescribed by SFAS 107, "Disclosures about Fair Value of Financial Instruments" ("SFAS 107").

For information regarding the impact of the restatement and other corrections on Freddie Mac's FVBS net assets at December 31, 2001, *see* "NOTE 1: RESTATEMENT."

Table 17.1 — Consolidated Fair Value Balance Sheets[1]

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

(1) The consolidated fair value balance sheets do not purport to present the net realizable, liquidation or market value of the company as a whole.
(2) Carrying amount is derived from the company's GAAP consolidated balance sheets.
(3) Includes mortgage-related securities held in connection with PC market-making and support activities.
(4) Fair values at December 31, 2002 and 2001 include estimated income taxes on the difference between fair value balance sheets and the GAAP balance sheets.

Limitations

The FVBS does not capture all elements of value that are implicit in Freddie Mac's operations as a going concern since the FVBS only captures the values of the current investment and securitization portfolios. For example, the FVBS does not capture the value of new investment and securitization business that would likely

replace prepayments as they occur. In addition, the FVBS also does not capture the value associated with future growth opportunities in Freddie Mac's investment and securitization portfolios. Thus, the fair value of net assets attributable to stockholders presented in the FVBS 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 Freddie Mac's fixed assets and deferred taxes), as well as certain financial instruments that are not covered by the SFAS 107 disclosure requirements (such as pension liabilities) at their GAAP carrying amounts in the FVBS. Management believes these items do not have a significant impact on Freddie Mac's overall financial prospects or fair value results.

Valuation Methods and Assumptions

The following methods and assumptions were used to estimate the fair value of assets and liabilities at December 31, 2002 and 2001.

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 LOCOM 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 FVBS purposes.

Freddie Mac determines the fair value of mortgage loans based on comparisons to actively traded mortgage-related securities with similar characteristics, with an adjustment for yield, credit and liquidity differences. Specifically, for value estimation purposes, 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 an adjustment for yield, credit and liquidity differences. To accomplish this, the fair value of the single-family whole loans includes an adjustment representing 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 implied guarantee fee 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.

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. (Freddie Mac had no mortgage-related securities classified as held-to-maturity in 2002 and 2001.) Mortgage-related securities largely consist of PCs and Structured Securities issued by Freddie Mac, Fannie Mae and Ginnie Mae. They also include other mortgage-related securities such as home equity, commercial mortgage-backed, and manufactured housing securities.

The fair value of securities with readily available third-party market prices is based on market prices obtained from brokers and dealers or reliable third-party pricing service providers. For other securities, an OAS approach is used to estimate fair value. This OAS approach uses a model developed from market data and management judgment to estimate the OAS risk premium an investor would require as compensation for a given product's prepayment uncertainty and interest-rate volatility. Once an OAS has been determined, fair value is calculated by using the OAS as an input to Freddie Mac's interest-rate and prepayment models in order to determine the estimated net present value of projected cash flows. Other securities that are not priced using the OAS approach are priced using other modeling techniques or by using other securities as proxies.

For FVBS purposes, "mortgage-related securities" also includes the expected market value of financial guarantee contracts that Freddie Mac purchased to obtain additional credit protection on certain manufactured housing asset-backed securities. These financial guarantee contracts, which had a fair value of approximately $148 million and zero as of December 31, 2002 and December 31, 2001, respectively, are excluded from the fair values used for GAAP consolidated balance sheet purposes. The fair value of these contracts 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.

Mortgage-related securities also include Participation Certificate 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. *See* "NOTE 2: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES" for more information about accounting policies related to PC residuals.

Cash and cash equivalents

"Cash and cash equivalents" largely consist of highly liquid investment securities with an original maturity of three months or less and securities 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 assumed to be a reasonable approximation of fair value.

Investments

"Investments" principally consists of mortgage-related and non-mortgage-related securities classified as either available-for-sale or trading, which are reported at fair value on Freddie Mac's consolidated balance sheets. "Investments" also includes PC residuals related to Freddie Mac PCs reported in the Investments line item.

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 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 assumed to be a reasonable approximation of fair value.

Guarantee assets for Participation Certificates

Under GAAP, in certain cases Freddie Mac records the fair value of management and guarantee fees on PCs as guarantee assets in its consolidated balance sheets. In other cases, management and guarantee fees are recognized on an accrual basis. *See* "NOTE 2: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES" for more information about accounting policies related to management and guarantee fees.

For FVBS purposes, guarantee assets reflect the fair value of guarantees on all outstanding PCs held by third parties, including those accounted for at fair value under GAAP and those accounted for using the accrual basis under GAAP. For FVBS purposes, guarantee fee assets are valued using the same method as

that used for GAAP fair value purposes. For information concerning the company's valuation methodologies *See* "NOTE 2: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES," and "NOTE 3: SECURITIZATION OF MORTGAGE-RELATED ASSETS."

Derivative assets

"Derivative assets, at fair value" largely consists of interest-rate swaps, option-based derivatives, futures, and forward commitments to purchase or sell securities, which are already reflected at fair value on the GAAP consolidated balance sheets. The fair values of interest-rate swaps are determined by using LIBOR-based yield curves to calculate the expected cash flows for both the fixed-rate and floating-rate components of the swap contracts. Option-based derivatives, which principally represent 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 sources. Forward commitments to purchase or sell securities are valued using the methods described for mortgage-related securities valuation, above.

The fair value of derivative assets includes an estimate of 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 significantly affected by expected credit losses because management obtains collateral from most counterparties typically within two 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 low-income housing tax credit ("LIHTC") limited partnerships that are eligible for federal tax credits, real estate owned (*e.g.*, properties acquired primarily through foreclosure), fixed assets (such as property, plant and equipment), and other miscellaneous assets.

The receivables are financial instruments under SFAS 107 and are required to be measured at fair value. Because these receivables are short-term in nature, management believes the carrying amount on the GAAP balance sheets is a reasonable approximation of their fair value. For the LIHTC partnerships, fair value of expected tax benefits is estimated using expected cash flows discounted at a market-based yield.

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 deferred taxes. The net deferred tax asset includes GAAP-based deferred taxes, adjusted for estimated income taxes on the difference between the FVBS and the GAAP balance sheets, using the statutory federal tax rate of 35 percent. This adjustment represents the undiscounted, incremental tax asset related to the excess of GAAP-based stockholders' equity over FVBS net assets. 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 FVBS 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 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 sales of Treasury securities used for risk management purposes.

Short-term debt is valued using third-party market prices, where available, or using an OAS approach as described below. For long-term non-callable and callable debt with readily available third-party market prices, fair value is based on bid-side market prices obtained from brokers and dealers and reliable third-party pricing service providers. For all other long-term non-callable and callable debt, an OAS approach is used to estimate fair value. This OAS approach involves using a model based on market observations, with adjustments based on management judgment, to estimate the risk premium an investor would require as compensation to accept liquidity, credit and interest-rate volatility risk. Once an OAS has been determined, fair value is calculated by

using the OAS as an input to Freddie Mac's models to determine the estimated fair value of expected cash flows.

Guarantee obligation for Participation Certificates

Under GAAP, in certain cases Freddie Mac records the fair value of estimated guarantee-related credit losses on PCs as guarantee obligations in its consolidated balance sheets. In other cases, guarantee-related credit losses are recognized as incurred. *See* "NOTE 2: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES" for more information about accounting policies related to guarantee-related credit losses.

For FVBS purposes, guarantee obligations reflect the fair value of estimated guarantee-related credit losses on all outstanding PCs held by third parties. For FVBS purposes, guarantee obligations are valued using the same method as that used for GAAP fair value purposes. For information concerning the company's valuation methodologies *See* "NOTE 2: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES," and "NOTE 3: SECURITIZATION OF 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 balance sheets represents GAAP loan loss reserves for off-balance sheet PCs that are not already accounted for under SFAS 140. This line item has no basis in the FVBS, because the estimated fair value of all expected default losses is included in the guarantee obligation reported on the FVBS, 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.

Minority interests in consolidated subsidiaries

"Minority interest in consolidated subsidiaries" represents interests that third parties hold in Freddie Mac's two majority-owned REIT subsidiaries that issued certain preferred stock to outside investors. In accordance with GAAP, Freddie Mac consolidates the REITs. The fair value of the third party minority interests in these REITs is 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 FVBS 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.

NOTE: 18: CONCENTRATION OF CREDIT RISK

Mortgage Portfolio

Table 18.1 summarizes the total mortgage portfolio by geographical concentration. Excluded from the total mortgage portfolio at December 31, 2002 and 2001 are $170,660 million and $139,523 million, respectively, of non-Freddie Mac mortgage securities held in the retained portfolio and securities issued by Freddie Mac that are backed by Ginnie Mae Certificates. *See* "NOTE 5: RETAINED PORTFOLIO AND CASH AND INVESTMENTS PORTFOLIO" for more information about the securities Freddie Mac holds.

Table 18.1 — Concentration of Credit Risk

	December 31,			
	2002		2001	
	Amount	Percentage	Amount	Percentage
	(dollars in millions)			
By Region[1]				
West	$ 294,681	26%	$ 263,921	26%
Northeast	264,843	23	238,605	24
North central	244,509	21	207,313	21
Southeast	200,476	18	176,846	17
Southwest	141,440	12	124,516	12
	$1,145,949	100%	$1,011,201	100%
By State				
California	$ 183,174	16%	$ 161,370	16%
Florida	67,753	6	58,312	6
Illinois	60,076	5	51,405	5
Texas	55,596	5	48,033	5
All Others	779,350	68	692,081	68
	$1,145,949	100%	$1,011,201	100%

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

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 2002 and 2001, the four most significant of these arrangements accounted for almost 61 percent and 55 percent, respectively, of Freddie Mac's volume; the largest of which is with Wells Fargo Home Mortgage, Inc. In 2002, Wells Fargo Home Mortgage, Inc. alone accounted for approximately 32 percent of the company's mortgage volume while ABN Amro Mortgage Group, Inc. alone accounted for approximately 16 percent of the company's mortgage 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 ensure 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 on a regular basis. Additional reviews are completed when market conditions or events affecting an individual counterparty occur.

Derivative Counterparties. Freddie Mac's standards for entering into derivative agreements include rigorous internal credit and legal reviews. All of these counterparties are major financial institutions and are experienced market-makers in the over-the-counter ("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. 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 loss can be netted with the gain 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 current exposure. Freddie Mac's collateral agreements require most counterparties to post collateral for the amount of the company's net exposure to them, taking into consideration posting thresholds. 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 their valuations. As described further below, this time lag in posting collateral can affect Freddie Mac's net uncollateralized exposure to derivative counterparties. All of Freddie Mac's collateral is held by a third-party custodian.

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 or 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.

Table 18.2 summarizes Freddie Mac's exposure to counterparty credit risk in its derivatives. This table is useful in understanding Freddie Mac's credit risk related to its OTC derivative portfolio.

Table 18.2 — Derivative Counterparty Credit Exposure

	December 31, 2002					
Rating[1]	**Number of Counterparties**[2]	**Notional**	**Total Exposure at Fair Value**[3]	**Exposure, Net of Collateral**[4]	**Weighted Avg. Contractual Maturity (in years)**	**Collateral Posting Threshold**[5]
			(dollars in millions)			
AAA	2	$ 2,438	$ 386	$ 386	4.4	Mutually agreed upon
AA+	1	609	299	13	25.5	$10 million or less
AA	3	97,229	1,161	104	4.3	$10 million or less
AA−	9	205,769	3,764	307	4.9	$10 million or less
A+	8	214,833	2,922	183	4.6	$1 million or less
A	2	83,776	1,559	48	3.7	$1 million or less
A−	2	1,655	21	3	1.8	$1 million or less
Subtotal	27	606,309	$10,112	$1,044	4.5	
Other derivatives[6]		245,552				
Prepayment management agreement		117,219				
Commitments		191,563				
Credit derivatives		17,301				
Total derivatives		$1,177,944				

	December 31, 2001					
Rating[1]	**Number of Counterparties**[2]	**Notional**	**Total Exposure at Fair Value**[3]	**Exposure, Net of Collateral**[4]	**Weighted Avg. Contractual Maturity (in years)**	**Collateral Posting Threshold**[5]
			(dollars in millions)			
AAA	2	$ 27,858	$ —	$—	4.7	Mutually agreed upon
AA+	1	616	83	—	26.2	$10 million or less
AA	5	203,155	331	12	5.3	$10 million or less
AA−	10	259,012	632	52	4.6	$10 million or less
A+	2	76,445	61	—	5.6	$1 million or less
A	2	91,807	678	—	4.8	$1 million or less
BBB+	1	88	2	1	7.5	Full posting required
Subtotal	23	658,981	$1,787	$65	5.0	
Other derivatives[6]		379,225				
Commitments		121,588				
Credit derivatives		10,984				
Total derivatives		$1,170,778				

(1) Freddie Mac uses the lower of Standard and Poor's ("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" and "Derivative liabilities, 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) Consists primarily of exchange-traded contracts. Exchange-traded derivatives do not measurably increase Freddie Mac's 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.

Freddie Mac's uncollateralized exposure to OTC derivative counterparties, after applying netting agreements and collateral, was $1,044 million and $65 million as of December 31, 2002 and 2001, respectively. In the extremely unlikely event that all of Freddie Mac's OTC derivative counterparties were to have defaulted simultaneously on December 31, 2002, the maximum loss to Freddie Mac would have been $1,044 million.

NOTE 19: VARIABLE INTEREST ENTITIES

The company is a party to numerous entities that may be considered to be VIEs under FIN 46. *See* Consolidation of Variable Interest Entities in "NOTE 2: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES" for discussion of FIN 46. These VIEs include low-income multifamily housing tax credit partnerships, certain Structured Securities — T-Series trusts, certain mortgage and asset-backed investment entities and multifamily credit enhanced-bond trusts. The disclosure below discusses where it is reasonably possible that Freddie Mac will consolidate or disclose information about its VIEs when FIN 46 becomes effective. Further, the disclosures below are based on qualitative determinations of whether it is reasonably possible that Freddie Mac has at least a significant variable interest in a VIE. As Freddie Mac continues to evaluate the impact of applying FIN 46, additional VIEs may be identified or certain entities identified here may be excluded from future disclosure.

Low Income Housing Tax Credit Partnerships

Freddie Mac invests as a limited partner in partnerships (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 1988 and 2002. Freddie Mac does not guarantee any obligations of these partnerships, and Freddie Mac's exposure is limited to the amount of its investments.

As of December 31, 2002, the company had unconsolidated investments in 156 housing tax credit partnerships in which it is reasonably possible that Freddie Mac has at least a significant variable interest. The size of these partnerships at December 31, 2002, as measured in total assets, was approximately $5.4 billion, of which it is reasonably possible that Freddie Mac will consolidate approximately $800 million when FIN 46 becomes effective. These partnerships are accounted for using the equity method, as described in "NOTE 2: 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, 2002, Freddie Mac's maximum exposure to loss on unconsolidated housing tax credit partnerships, in which it is reasonably possible that Freddie Mac has at least a significant variable interest, was approximately $1.8 billion.

Structured Securities — T-Series Trusts

In T-Series transactions, 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. The trust issues various senior and subordinated interests. Freddie Mac guarantees and purchases certain senior interests issued by the trust. The subordinated interests not guaranteed and purchased by Freddie Mac are either held by the seller or other party or sold in the capital markets. Simultaneous with the guarantee and purchase of certain senior interests issued by the trust, Freddie Mac issues Structured Securities which Freddie Mac guarantees. These Structured Securities represent an interest in the senior interests issued by the trust.

At December 31, 2002, the company had investments or guarantees related to 44 T-Series trusts in which it is reasonably possible that Freddie Mac is the primary beneficiary or has a significant variable interest. The size of these trusts at December 31, 2002, as measured in total assets, was approximately $22.4 billion. Some of these T-Series trusts may be qualifying special-purposes entities (QSPEs) as defined by SFAS 140, which are exempted from the scope of FIN 46. Freddie Mac is currently evaluating these entities to identify any T-Series trusts that are QSPEs.

Freddie Mac's maximum exposure to loss consists primarily of any outstanding guarantees. As of December 31, 2002, Freddie Mac's maximum exposure to loss on T-Series transactions, in which it is reasonably possible that Freddie Mac is the primary beneficiary or has a significant variable interest, was approximately $21.7 billion.

Mortgage and Asset-backed Investment Trusts

Freddie Mac invests in a variety of mortgage and asset backed investment trusts. Included among these are Manufactured Housing Contract Senior/Subordinate Pass-Through Certificates. These represent interests in trusts consisting of a pool of manufactured housing installment sale contracts, installment loan agreements or mortgage loans secured by first liens on real estate. The trusts act as vehicles to allow loan originators to reduce their balance sheet exposure to whole loans, convert assets into cash, and provide new funding opportunities. The issuers, who may either be the originators of the loans or the underwriters of the deal, create the trusts. The issuers 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 of the underlying pool, and cash flow deficiencies due to timing from the scheduled and unscheduled payment of principal and interest from the underlying pool.

Freddie Mac invests in these securities to meet affordable housing goals and to achieve profitable investment returns. In addition, Freddie Mac has investments in similar trusts containing multifamily mortgage loans and FHA loans.

At December 31, 2002, the company had investments in 22 trusts related to manufactured housing loans, multifamily mortgages and FHA loans in which it is reasonably possible that Freddie Mac has at least a significant variable interest. The size of these mortgage and asset-backed trusts at December 31, 2002, as measured in total assets, was approximately $5.8 billion, primarily related to the manufactured housing trusts.

As an investor, Freddie Mac's maximum exposure to loss consists primarily of the book value of its investment. As of December 31, 2002, Freddie Mac's maximum exposure to loss on mortgage and asset-backed trusts in which it is reasonably possible that Freddie Mac has at least a significant variable interest was approximately $1.3 billion, primarily related to manufactured housing trusts. The majority of this exposure is covered by secondary guarantees from third parties.

Multifamily Credit-Enhanced Bond Trusts

Freddie Mac assists investors in tax-exempt multifamily housing revenue bonds to refinance their investments in those bonds through a two-trust securitization structure. These bonds are secured by mortgage loans on low- and moderate-income multifamily housing projects.

The structure of the securitization begins with the establishment of an "aggregation trust" by the investor, into which the investor deposits a pool of bonds. Freddie Mac issues a standby credit enhancement agreement, under which it promises to pay to the trustee any amounts due and payable on the bonds which are not paid. The aggregation trust trustee then issues trust receipts to the investor, which represent the beneficial ownership in the bonds as credit enhanced by Freddie Mac. The investor then deposits those trust receipts into a second "securitization trust." The securitization trust issues both senior certificates and subordinate certificates, representing the beneficial ownership in the trust receipts. The senior certificates are sold to qualified institutional buyers, the proceeds of which are paid to the investor. Freddie Mac also provides a liquidity facility to the securitization trust to fund the purchase of any senior certificates that may be "put" back to the trust. Any such certificates that are repurchased by the trust are pledged to Freddie Mac as security for its advance under the liquidity facility. The subordinate certificates are owned by the investor, but are pledged to Freddie Mac as security for any funds drawn under either the credit enhancement agreement or the liquidity facility. In consideration of Freddie Mac's issuance of the credit enhancement agreement and the liquidity facility, the investor pays a monthly fee to Freddie Mac.

This refinancing structure provides liquidity to the market for tax-exempt multifamily housing bonds, since the investors are provided with funds that can be used to finance additional multifamily housing projects. In addition, Freddie Mac receives credit toward its affordable housing goals.

As of December 31, 2002, the company had issued credit enhancement agreements related to six multifamily housing bond securitizations, with respect to which it is reasonably possible that Freddie Mac has a significant variable interest in the aggregation trusts. The size of these aggregation trusts at December 31, 2002, as measured in total assets, was approximately $1.5 billion. This amount represents Freddie Mac's maximum exposure to loss on the aggregation trusts and consists primarily of outstanding guarantees. It is reasonably possible that Freddie Mac will be the primary beneficiary and consolidate these multifamily credit-enhanced bond trusts when FIN 46 becomes effective.

NOTE 20: MINORITY INTERESTS

The equity and net earnings attributable to the minority shareholder 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 billion of perpetual, step-down preferred stock issued to outside investors. The dividend rate on the step-down preferred stock is 13.3% from initial issuance through 2006 (the "initial term"). Beginning in 2007, the dividend rate will step-down to 1.0%. Dividends on this preferred stock accrue in arrears. The amortized balance of the two step-down preferred stock issuances as recorded within "Minority interests in consolidated subsidiaries" on the consolidated balance sheets totaled $2.3 billion and $2.6 billion at December 31, 2002 and 2001, respectively. The preferred stock is redeemable by the REITs under certain circumstances where the REITs obtain a legal opinion to the effect that changes in applicable tax law could adversely affect the tax treatment of the REITs or the preferred stock.

CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

The following discussion, together with additional information in our Proxy Statement for our March 31, 2004 annual meeting of stockholders, is presented in accordance with Item 304 of SEC Regulation S-K. Among other things, this item requires a company that has changed its independent public accountant to disclose certain information pertaining to those events if they occurred within the company's two most recent fiscal years or any subsequent interim period. Since Freddie Mac changed its independent accountant in March 2002, which was within its two most recent fiscal years, Item 304 disclosures are provided below and in our Proxy Statement for our March 31, 2004 annual meeting of stockholders.

On March 6, 2002, we announced that our Board of Directors had appointed PwC to serve as our independent public accountants for the year ending December 31, 2002, replacing Arthur Andersen LLP. The Board's appointment of PwC was made upon the recommendation of the Audit Committee after our solicitation of proposals to audit our financial statements for the year ending December 31, 2002.

The audit reports of Arthur Andersen on our consolidated financial statements for the fiscal years ended December 31, 2001 and 2000 did not contain any adverse opinion or disclaimer of opinion, nor were they qualified or modified as to uncertainty, audit scope or accounting principles.

During the years ended December 31, 2001 and 2000 and through March 6, 2002, the date of PwC's appointment, we had no disagreements with Arthur Andersen on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure, which disagreements if not resolved to Arthur Andersen's satisfaction would have caused them to make reference to the subject matter of the disagreement in connection with their reports. As discussed elsewhere (*see* "EXPLANATORY NOTE" and "FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA — NOTE 1: RESTATEMENT"), subsequent to PwC's appointment, we undertook a restatement of our consolidated financial statements for the years 2000, 2001 and 2002 which resulted in significant changes in our accounting principles and practices and our financial statement disclosure.

None of the reportable events described under Item 304(a)(1)(v) of Regulation S-K occurred within our two fiscal years ended December 31, 2001 and the interim period through the date of PwC's appointment.

During our two fiscal years ended December 31, 2001 and the interim period through PwC's appointment, we did not consult with PwC regarding any of the matters or events set forth in Item 304(a)(2)(i) and (ii) of Regulation S-K.

DIRECTORS AND EXECUTIVE OFFICERS

Directors

Information on Directors of Freddie Mac is set forth under "Proposal 1: Election of Directors — Nominees for Election" of our Proxy Statement for our March 31, 2004 annual meeting and is incorporated herein by reference.

Executive Officers

As of January 31, 2004, the executive officers of Freddie Mac are as follows:

Name	Age	Year of Affiliation	Position
Richard F. Syron	60	2003	Chairman and Chief Executive Officer
Paul T. Peterson	54	1989	Executive Vice President and Chief Operating Officer
Martin F. Baumann	56	2003	Executive Vice President and Chief Financial Officer
David A. Andrukonis	46	1980	Senior Vice President and Chief Enterprise Risk Officer
Margaret A. Colon	45	1983	Senior Vice President and Chief Administrative Officer
Adrian B. Corbiere	59	1999	Senior Vice President of Multifamily
R. Mitchell Delk	50	1991	Senior Vice President of Government Relations and Public Policy
Nazir G. Dossani	61	1993	Senior Vice President of Investments and Capital Markets
Melvin M. Kann*	63	1993	Senior Vice President and General Auditor
William I. Ledman	55	1994	Senior Vice President of Information Systems and Services
Michael C. May	45	1983	Senior Vice President of Mortgage Sourcing, Operations and Funding
Dwight P. Robinson	50	1998	Senior Vice President of Corporate Relations
Jerry Weiss	45	2003	Senior Vice President and Chief Compliance Officer
John F. Woods	39	2002	Senior Vice President and Principal Accounting Officer

* Mr. Kann announced his retirement from Freddie Mac effective April 1, 2004.

The following is a brief biographical description of each executive officer of Freddie Mac.

Richard F. Syron was appointed Chairman and Chief Executive Officer in December 2003. Prior to joining Freddie Mac, 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.

Paul T. Peterson was appointed Executive Vice President and Chief Operating Officer in June 2003. Previously, he served as Executive Vice President of Single-Family Business from December 1999 through June 2003. Mr. Peterson also served as Senior Vice President — Servicer Division from 1995 to 1999. Prior to that, he served as Senior Vice President of Corporate Finance from January 1992 to January 1995, as Vice President of Corporate Finance from March 1990 to January 1992 and as Director of Portfolio Management from April 1989 to March 1990.

Martin F. Baumann was appointed Executive Vice President of Finance in April 2003 and Chief Financial Officer in June 2003. Prior to joining Freddie Mac, Mr. Baumann worked at PwC since 1969, where he was a partner from 1980. At PwC, 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 PwC's U.S. and World Financial Services Executive Committees.

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 Freddie Mac since joining the company 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 Freddie Mac, 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 Freddie Mac in 1983, Ms. Colon was a senior auditor with Deloitte Haskins and Sells.

Adrian B. Corbiere was appointed Senior Vice President of Multifamily in August 1999. Before joining Freddie Mac, Mr. Corbiere served as Managing Director, Real Estate Investments at Allstate Insurance Company from 1996 to 1999. Prior to that, Mr. Corbiere held various positions from 1986 to 1996 at New England Financial, a subsidiary of Metropolitan Life Insurance Company, including Senior Vice President, Private Lending and Senior Vice President of the Commercial Mortgage Department.

R. Mitchell Delk was appointed Senior Vice President of Government Relations and Public Policy in October 2003. Mr. Delk was previously Senior Vice President of Government Relations from March 1999 through October 2003 and Vice President of Government Relations from 1991 to 1999. Before joining Freddie Mac, he served as Counselor to the Chairman and as Director of Legislative Affairs at the SEC from 1989 to 1991. Prior to that, Mr. Delk spent four years as an investment banker at The First Boston Corporation and seven years on Capitol Hill as a counselor to the Senate Banking Committee and several members of Congress.

Nazir G. Dossani was named to the position of Senior Vice President of Investments and Capital Markets in October 2003. Prior to that, he was Senior Vice President of Investments from December 1998. Mr. Dossani joined Freddie Mac in February 1993 as Vice President of Asset and Liability Management. Prior to joining Freddie Mac, he served as Vice President of Pricing and Portfolio Analysis at Fannie Mae.

Melvin M. Kann was appointed Senior Vice President and General Auditor in August 1993. Prior to joining Freddie Mac, Mr. Kann served as Senior Vice President of Bank United of Texas, FSB from 1991 to 1993 and as Senior Vice President of Southeast Banking Corporation in Miami, Florida from 1983 to 1991.

William I. Ledman was appointed Senior Vice President of Information Systems and Services in January 1995. He had been Vice President of Computer and Network Operations since he joined Freddie Mac in February 1994. Prior to joining Freddie Mac, Mr. Ledman held a variety of information systems-related positions with GEICO, a property-casualty insurance company, between 1974 and 1994, the most recent being Vice President of Systems and Data Processing.

Michael C. May was appointed Senior Vice President of Mortgage Sourcing, Operations & Funding in October 2003. Prior to that, Mr. May served as Senior Vice President and Chief Operating Officer of Single Family Operations from July 2002 to October 2003. He served as Senior Vice President of Project Enterprise Execution from June 2000 to June 2002, Senior Vice President of Customer Services and Control from August 1998 to June 2002. Prior to that, since joining Freddie Mac in 1983, Mr. May served in various positions, including Vice President of Loan Prospector, Vice President of Structured Finance, and Vice President of Freddie Mac's Securities Sales & Trading Group. Prior to joining Freddie Mac in 1983, he worked at the Student Loan Marketing Association where he served as an internal auditor.

Dwight P. Robinson was appointed Senior Vice President of Corporate Relations in September 1999. Mr. Robinson previously served as Vice President of Industry Relations. Prior to that, Mr. Robinson served as Deputy Secretary of HUD and as President of Ginnie Mae.

Jerry Weiss was appointed Senior Vice President and Chief Compliance Officer in October 2003. Prior to joining Freddie Mac, Mr. Weiss worked for more than 10 years at Merrill Lynch Investment Managers, most recently as First Vice President and Global Head of Compliance. Prior to that, Mr. Weiss was in 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. Prior to that, Mr. Woods served as Senior Vice President of Control and Accounting in Funding & Investments from April 2002 to October 2003. Prior to joining Freddie Mac, Mr. Woods was a consulting partner at Arthur Andersen.

EXECUTIVE COMPENSATION

Information on Freddie Mac's Executive Compensation is set forth under the section entitled "Executive Compensation" of our Proxy Statement for our March 31, 2004 annual meeting of stockholders and is incorporated herein by reference.

SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

Security Ownership of Management

Information on the beneficial ownership of Freddie Mac common stock by each Freddie Mac director, certain executive officers and by all directors and executive officers as a group is set forth under the section entitled "Corporate Governance Stock Ownership" of our Proxy Statement for our March 31, 2004 annual meeting of stockholders and is incorporated herein by reference.

Security Ownership of Certain Beneficial Owners

Information on the beneficial ownership of Freddie Mac common stock by certain beneficial owners is set forth under the section entitled "Corporate Governance Stock Ownership" of our Proxy Statement for our March 31, 2004 annual meeting of stockholders and is incorporated herein by reference.

CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

Information on certain relationships and related transactions is set forth under the section entitled "Proposal 1: Election of Directors — Transactions with Institutions Related to Directors" of our Proxy Statement for our March 31, 2004 annual meeting of stockholders and is incorporated herein by reference.

INDEMNIFICATION AND OTHER REIMBURSEMENTS OF DIRECTORS, OFFICERS AND EMPLOYEES

Information concerning indemnification and reimbursement arrangements is set forth under the section entitled "Proposal 1: Election of Directors — Indemnification and Other Reimbursements of Directors, Officers and Employees" of our Proxy Statement for our March 31, 2004 annual meeting of stockholders and is incorporated herein by reference.

PRINCIPAL ACCOUNTANT FEES AND SERVICES

Information on principal accountant fees and services is set forth under the section entitled "Proposal 2: Ratification of Independent Auditors" of our Proxy Statement for our March 31, 2004 annual meeting of stockholders and is incorporated herein by reference.

CERTIFICATION*

I, Richard F. Syron, certify that:

1. I have reviewed this Information Statement of Freddie Mac;

2. Based on my knowledge, this Information Statement does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this Information Statement; and

3. Based on my knowledge, the financial statements, and other financial information included in this Information Statement, fairly present in all material respects the financial condition, results of operations and cash flows of Freddie Mac as of, and for, the periods presented in this Information Statement.

Date: February 27, 2004

/s/ Richard F. Syron

Richard F. Syron
Chairman and Chief Executive Officer

CERTIFICATION*

I, Martin F. Baumann, certify that:

1. I have reviewed this Information Statement of Freddie Mac;

2. Based on my knowledge, this Information Statement does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this Information Statement; and

3. Based on my knowledge, the financial statements, and other financial information included in this Information Statement, fairly present in all material respects the financial condition, results of operations and cash flows of Freddie Mac as of, and for, the periods presented in this Information Statement.

Date: February 27, 2004

/s/ Martin F. Baumann

Martin F. Baumann
Executive Vice President and Chief Financial Officer

* These certifications do not address disclosure controls and procedures and internal controls over financial reporting as of December 31, 2002. This is because the required evaluation and assessment of these controls and procedures was not adequately performed as of that date.

RATIO OF EARNINGS TO FIXED CHARGES

	Year		
	2002	2001	2000
	(dollars in millions)		
Income before cumulative effect of change in accounting principles, net of taxes	$10,090	$ 3,115	$ 3,666
Add:			
Income tax expense	4,713	1,339	1,504
Minority interest in earnings of consolidated subsidiaries	184	208	231
Interest expense	26,564	27,549	25,483
Earnings, as adjusted	$41,551	$32,211	$30,884
Fixed charges[1]			
Interest expense	$26,564	$27,549	$25,483
Total Fixed charges	$26,564	$27,549	$25,483
Earnings to fixed charges[2]	1.56	1.17	1.21

(1) Fixed charges exclude capitalized interest and the estimated interest factor of rental expenses related to operating leases as these costs are insignificant to the computation of the ratio of earnings to fixed charges.
(2) Ratio of earnings to fixed charges is computed by dividing "Earnings, as adjusted" by "Fixed charges."

RATIO OF EARNINGS TO COMBINED FIXED CHARGES AND PREFERRED STOCK DIVIDENDS

	Year		
	2002	2001	2000
	(dollars in millions)		
Income before cumulative effect of change in accounting principles, net of taxes	$10,090	$ 3,115	$ 3,666
Add:			
Income tax expense	4,713	1,339	1,504
Minority interest in earnings of consolidated subsidiaries	184	208	231
Interest expense	26,564	27,549	25,483
Earnings, as adjusted	$41,551	$32,211	$30,884
Fixed charges[1]			
Interest expense	$26,564	$27,549	$25,483
Preferred stock dividends[2]	343	310	252
Total Fixed charges including preferred stock dividends	$26,907	$27,859	$25,735
Earnings to combined fixed charges and preferred stock dividends[3]	1.54	1.16	1.20

(1) Fixed charges exclude capitalized interest and the estimated interest factor of rental expenses related to operating leases as these costs are insignificant to the computation of the ratio of earnings to combined fixed charges and preferred stock dividends.
(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 "Fixed charges including preferred stock dividends."

ADDITIONAL FINANCIAL INFORMATION

For more information about Freddie Mac stock or to obtain a copy of the latest Information Statement (prepared in lieu of a Form 10-K), contact:

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On the Internet: http://www.freddiemac.com

ANNUAL MEETING

The annual meeting of Freddie Mac's shareholders will be held:

March 31, 2004
9:00 a.m. Eastern Time
Hilton McLean Tysons Corner,
7920 Jones Branch Dr., McLean, VA

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 2002 and 2003 were paid on:

March 29, 2002
June 28, 2002
September 30, 2002
December 31, 2002

March 31, 2003
June 30, 2003
September 30, 2003
December 31, 2003

Subject to approval by Freddie Mac's Board of Directors, dividends on the company's common stock and non-cumulative preferred stock in 2004 are expected to be paid on:

March 31, 2004
June 30, 2004
September 30, 2004
December 31, 2004

CORPORATE HEADQUARTERS

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