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

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

EXECUTIVE SUMMARY

Overview

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

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

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

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

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

Summary of Our 2004 Financial Results

GAAP Results

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

Net interest income was $9.1 billion in 2004, compared to $9.5 billion in 2003. Net interest yield decreased to 124 basis points in 2004 from 130 basis points in 2003 on a fully taxable-equivalent basis. The decline in 2004 net interest yield was attributable to lower yields on assets acquired in 2004 and runoff of higher-yielding assets, partially offset by a decrease in average debt funding yields, lower derivative-related expenses associated with derivatives in qualifying hedge accounting relationships and lower interest expense related to amounts due to holders of PCs and Structured Securities. Net derivative-related interest expense declined primarily because we moved a significant amount of pay-fixed swaps to no-hedge designation effective at the beginning of the second quarter of 2004 and the related interest expense on these contracts was recognized as a component of Non-interest income (loss) in periods following the move to no-hedge designation.

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

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

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

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

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

Fair Value Balance Sheet Results

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

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

Capital

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

OUR RETAINED AND TOTAL MORTGAGE PORTFOLIOS

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

Table 8 — Freddie Mac's Total Mortgage Portfolio Based on Unpaid Principal Balances[(1)(2)]

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

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

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

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

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

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

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

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

	December 31, 2004			
	PCs and Structured Securities in Retained Portfolio	PCs and Structured Securities in Cash and Investments Portfolio[4]	PCs and Structured Securities Outstanding (held by third parties)	Total PCs and Structured Securities Issued
	(dollars in millions)			
PCs and Structured Securities:				
Single-class[1]	$219,794	$ —	$454,396	$ 674,190
Multi-class[2][3]	136,904	—	390,636	527,540
Other[5]	—	—	7,238	7,238
Total PCs and Structured Securities[6][7]	$356,698	$ —	$852,270	$1,208,968

	December 31, 2003			
	PCs and Structured Securities in Retained Portfolio	PCs and Structured Securities in Cash and Investments Portfolio[4]	PCs and Structured Securities Outstanding (held by third parties)	Total PCs and Structured Securities Issued
	(dollars in millions)			
PCs and Structured Securities:				
Single-class[1]	$269,442	$15,970	$397,009	$ 682,421
Multi-class[2][3]	123,693	799	347,833	472,325
Other[5]	—	—	7,322	7,322
Total PCs and Structured Securities[6][7]	$393,135	$16,769	$752,164	$1,162,068

(1) Includes PCs that do not back Structured Securities and single-class Structured Securities backed by PCs and Ginnie Mae Certificates.
(2) Includes that portion of multi-class Structured Securities that are backed by PCs and non-agency mortgage-related securities. Also includes multi-class Structured Securities backed by Ginnie Mae Certificates.
(3) Excludes $43,419 million and $42,692 million at December 31, 2004 and 2003, respectively, of total multi-class Structured Securities where we have resecuritized other already issued Structured Securities.
(4) Represents PCs and Structured Securities held by us in connection with PC market-making and support activities, which are reflected in Investments on our consolidated balance sheets. We ceased our PC market making and support activities accomplished through our Securities Sales & Trading Group business unit and our external Money Manager program during the fourth quarter of 2004.
(5) As further discussed in "NOTE 4: FINANCIAL GUARANTEES" to the consolidated financial statements, these amounts include:
- $5,432 million and $5,044 million at December 31, 2004 and 2003, respectively, that pertain to our guarantee of the payment of principal and interest on (a) multifamily mortgage loans that are originated and held by state and municipal housing finance agencies to support tax-exempt multifamily housing revenue bonds, (b) tax-exempt multifamily housing revenue bonds that support pass-through certificates issued by third parties, and (c) Freddie Mac pass-through certificates which are backed by tax-exempt multifamily housing revenue bonds and related taxable bonds and/or loans; and
- $1,806 million and $2,278 million at December 31, 2004 and 2003, respectively, of single-family mortgage loans held by third parties for which we provided a credit guarantee.

(6) PCs and Structured Securities exclude $723,429 million and $637,491 million at December 31, 2004 and 2003, respectively, of Structured Securities backed by resecuritized PCs and other previously issued Structured Securities. These excluded Structured Securities, which do not increase our credit related exposure, consist of single-class Structured Securities backed by PCs, REMICs, and principal-only strips. The notional balances of interest-only strips of $105,703 million and $91,192 million at December 31, 2004 and 2003, respectively, are excluded because this table is based on unpaid principal balances. Also excluded are modifiable and combinable REMIC tranches and Interest and Principal classes, which collectively totaled $1,097,336 million and $988,600 million at December 31, 2004 and 2003, respectively, where the holder has the option to exchange the security tranches for other pre-defined security tranches. See "BUSINESS — Credit Guarantee Activities" for more information on Structured Securities.
(7) Includes $3,015 million and $4,729 million of Structured Securities backed by Ginnie Mae Certificates at December 31, 2004 and 2003, respectively.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

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

Fair Value Measurement

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

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

Table 11 — Assets and Liabilities Recorded at Fair Value

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Issuances and Transfers of PCs and Structured Securities

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

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

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

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

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

Table 12 — Securitization Activity Accounted for as Sales

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

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

Derivative Instruments and Hedging Activities

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

Our Retained portfolio activities and our funding of these investments with a mix of short- and long-term debt expose us to interest-rate risk and other market risks. In particular, a mortgage borrower's prepayment option makes the timing and amount of mortgage prepayments very sensitive to changes in interest rates. The borrower's option exposes us to a potential mismatch in cash inflows from the mortgage assets we purchase for investment as compared to cash outflows required to make payments on our debt. We manage this interest-rate risk through various investment and funding activities, as well as through the use of derivatives.

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

- The cash flows of a variable-rate instrument or a forecasted transaction, or a "cash flow hedge;"

- The changes in fair value of a fixed-rate instrument, or a "fair value hedge;" or

- Foreign currency fair value or cash flow, or a "foreign currency hedge."

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

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

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

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

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

Credit Losses

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

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

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

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

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

Interest Income Recognition and Impairment Recognition on Investments in Securities

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

For certain other investments in mortgage-related securities and non-mortgage-related securities classified as available-for-sale, interest income is recognized using the prospective effective interest method in accordance with EITF 99-20. Under this method, changes in the effective yield are recognized as adjustments to interest income in future periods. We specifically apply such guidance to beneficial interests (including undivided interests which are similar to beneficial interests) in securitized financial assets that:

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

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

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

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

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

Recently Issued Accounting Pronouncements

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

CONSOLIDATED RESULTS OF OPERATIONS

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

Table 13 — Summary of Consolidated Results

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

Net Interest Income

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

Analysis of Annual Results

2004 versus 2003

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

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

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

(1) Combined rate/volume changes are allocated to the individual rate and volume changes based on their relative size.
(2) The changes in Income (expense) related to derivatives are fully attributed to rate as the derivatives have no associated principal amounts recorded on the consolidated balance sheets.
(3) Yields may not sum due to rounding.

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

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

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

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

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

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

Net interest yield on a fully taxable-equivalent basis decreased by 6 basis points to 124 basis points in 2004 from 130 basis points in 2003, as the decline in yields on interest-earning assets exceeded the benefit of lower debt funding costs. The yield on interest-earning assets declined due to the Retained portfolio's acquisition of relatively lower-yielding assets and the liquidation of higher-coupon securities, partially offset by an improvement in the yield on the Cash and investments portfolio as short-term interest rates increased during 2004. The yield on interest-bearing liabilities declined due to the maturity and repurchase of higher cost long-term debt and the issuance of new long-term debt at lower rates, coupled with lower costs associated with the amounts of interest expense Due to Participation Certificate investors. This decline was partially offset by higher short-term debt yields as average short-term rates were higher in 2004 as compared to 2003. Income (expense) related to derivatives improved during 2004, as we moved a significant amount of our pay-fixed swaps to no hedge designation and the related net interest expense was reported as Derivative gains (losses) effective at the beginning of the second quarter of 2004 (as described above). The impact of this movement was slightly offset by the movement of a significant amount of our receive-fixed swaps to no hedge designation in the fourth quarter of 2004 and the recording of the related Net interest income in Derivative gains (losses) in periods subsequent to the move.

2003 versus 2002

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

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

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

(1) Combined rate/volume changes are allocated to the individual rate and volume changes based on their relative size.
(2) The changes in Income (expense) related to derivatives are fully attributed to rate as the derivatives have no associated principal amounts recorded on the consolidated balance sheets.
(3) Yields may not sum due to rounding.

Net interest income on a fully taxable-equivalent basis decreased by $52 million to $9,725 million in 2003 from $9,777 million in 2002. During 2003, interest income on mortgage-related securities declined by $988 million, or 3 percent. The interest income generated by the 14 percent growth in the average unpaid principal balance of the Retained portfolio was more than offset by the accelerated amortization of net premiums on Retained portfolio securities, lower yields on assets acquired due to the low interest-rate environment during 2003, and the continued liquidation of higher-yielding assets. Net interest income and net interest yield were reduced as the yield on interest-earning assets declined at a faster rate than the cost of debt funding during 2003. During the first quarter of 2003, we refined the assumptions and calculations for the amortization of certain deferred fees recorded as basis adjustments on assets in our Retained portfolio. The effect on Net interest income of refining these assumptions, which was treated as a change in estimate under GAAP, was the recognition of $31 million of additional amortization income during the first quarter of 2003. These refined assumptions also affected Management and guarantee fee income as discussed in "Management and Guarantee Income" below. Interest income related to Cash and investments declined by $351 million, or 8 percent, during 2003 as the negative impact of declining interest rates during the first half of the year was only partially offset by the 19 percent increase in the average balances of Cash and investments.

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

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

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

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

Analysis of Quarterly Results

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

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

	1Q 2004	2Q 2004	3Q 2004	4Q 2004	Full year 2004
	(dollars in millions)				
Contractual amounts of net interest income	$3,146	$2,897	$3,008	$2,695	$11,746
Deferred item amortization expense, net[1]					
Asset-related amortization expense, net	(592)	(62)	(446)	(308)	(1,408)
Debt-related amortization expense, net	(298)	(322)	(366)	(315)	(1,301)
Amortization expense, net	(890)	(384)	(812)	(623)	(2,709)
Income (expense) related to derivatives					
Amortization of deferred balances in AOCI, net[2]	(367)	(482)	(481)	(484)	(1,814)
Accrual of periodic settlements of derivatives[3]					
Pay-fixed swaps	(427)	—	—	—	(427)
Receive-fixed swaps	527	494	525	422	1,968
Foreign-currency swaps	138	101	82	55	376
Other	(1)	(1)	(1)	—	(3)
Accrual of periodic settlements of derivatives	237	594	606	477	1,914
Total income (expense) related to derivatives	(130)	112	125	(7)	100
Net interest income	2,126	2,625	2,321	2,065	9,137
Fully taxable-equivalent adjustment	63	63	67	74	267
Net interest income (fully taxable-equivalent basis)	$2,189	$2,688	$2,388	$2,139	$ 9,404
Net interest yield (fully taxable-equivalent basis)	1.15%	1.44%	1.24%	1.13%	1.24%

	1Q 2003	2Q 2003	3Q 2003	4Q 2003	Full year 2003
	(dollars in millions)				
Contractual amounts of net interest income	$3,056	$3,088	$3,353	$3,493	$12,990
Deferred item amortization expense, net[1]					
Asset-related amortization expense, net	(238)	(540)	(280)	(364)	(1,422)
Debt-related amortization expense, net	(257)	(241)	(216)	(265)	(979)
Amortization expense, net	(495)	(781)	(496)	(629)	(2,401)
Income (expense) related to derivatives					
Amortization of deferred balances in AOCI, net[2]	(446)	(363)	(341)	(332)	(1,482)
Accrual of periodic settlements of derivatives[3][4]	306	241	(74)	(82)	391
Total income (expense) related to derivatives	(140)	(122)	(415)	(414)	(1,091)
Net interest income	2,421	2,185	2,442	2,450	9,498
Fully taxable-equivalent adjustment	41	64	60	62	227
Net interest income (fully taxable-equivalent basis)	$2,462	$2,249	$2,502	$2,512	$ 9,725
Net interest yield (fully taxable-equivalent basis)	1.40%	1.26%	1.27%	1.26%	1.30%

(1) Amortization relates to premiums, discounts, deferred fees and other basis adjustments. Basis adjustments are modifications to the carrying value of our financial instruments.
(2) Represents changes in fair values of derivatives in cash flow hedge relationships that were previously deferred in AOCI and have been reclassified to earnings as the associated hedged forecasted issuances of debt and forecasted mortgage purchase transactions affect earnings.
(3) Reflects the accrual of periodic cash settlements in accordance with the contractual terms of all derivatives in qualifying hedge accounting relationships.
(4) Data for 2003 not available at the level of detail provided for 2004.

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

Investment asset mix. The purchase, sale and liquidation of assets within the Retained portfolio and the Cash and investments portfolio, which we collectively refer to as our portfolios, has a significant impact on our overall net interest yield. As the composition of the portfolios changes between higher or lower yielding assets, the overall asset yield on these portfolios fluctuates. Generally, during periods of relatively low interest rates, as experienced in 2003 and 2004, the yield on portfolio assets will decline as higher-yielding assets liquidate and new assets are acquired at lower rates. The composition of the Retained portfolio and the Cash and investments portfolio is discussed later in the "CONSOLIDATED BALANCE SHEETS ANALYSIS."

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

Purchase premiums and discounts are amortized over the estimated life of the purchased assets as adjustments to interest income based on the effective interest method in accordance with SFAS 91. This method of amortization results in periodic adjustments to interest income, which are applied retrospectively to the date of purchase of the underlying mortgage-related security, when the effective interest-rate changes due to differences between actual and previously estimated prepayments and changes in estimated future prepayments.

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

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

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

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

As discussed in the analysis of Net interest income results for full year 2004, we moved a significant amount of our pay-fixed swaps that were previously in hedge accounting relationships to no hedge designation effective at the beginning of the second quarter of 2004, and we also moved a significant amount of our receive-fixed swaps to no hedge designation in the fourth quarter of 2004. For periods following these moves, the interest income or expense associated with these swaps is included in Derivative gains (losses).

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

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

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

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

4Q04 vs. 3Q04

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

3Q04 vs. 2Q04

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

2Q04 vs. 1Q04

Net interest income and net interest yield, both of which are presented on a fully taxable-equivalent basis, increased $499 million and 29 basis points, respectively, during the second quarter of 2004 compared to the first quarter of 2004. The increase in Net interest income resulted from lower amortization expense related to net premiums and other security-related basis adjustments and the impact of moving a significant amount of our pay-fixed swaps to no hedge designation, effective at the beginning of the second quarter. The reduction in amortization expense related to net premiums and other security-related basis adjustments resulted from an increase in long-term market interest rates from the first quarter of 2004. The increase in net interest yield was driven by the reduction in amortization expense and the movement of the pay-fixed swaps as described above.

1Q04 vs. 4Q03

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

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

4Q03 vs. 3Q03

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

3Q03 vs. 2Q03

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

2Q03 vs. 1Q03

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

1Q03 vs. 4Q02

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

Non-Interest Income (Loss)

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

Table 17 — Non-Interest Income (Loss)

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

Management and Guarantee Income

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

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

Table 18 — Management and Guarantee Income

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

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

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

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

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

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

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

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

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

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

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

Table 19 — Quarterly Management and Guarantee Income

	1Q 2004		2Q 2004		3Q 2004		4Q 2004	
	Amount	Rate	Amount	Rate	Amount	Rate	Amount	Rate
	(dollars in millions, rate in basis points)							
Contractual management and guarantee fees	$320	16.7	$322	16.6	$324	16.3	$337	16.3
Amortization of deferred fees(1)	64	3.4	(71)	(3.7)	56	2.8	30	1.4
Total management and guarantee income	$384	20.1	$251	12.9	$380	19.1	$367	17.7

	1Q 2003		2Q 2003		3Q 2003		4Q 2003	
	Amount	Rate	Amount	Rate	Amount	Rate	Amount	Rate
	(dollars in millions, rate in basis points)							
Contractual management and guarantee fees	$314	17.3	$311	17.4	$295	17.3	$309	17.1
Amortization of deferred fees(1)(2)	248	13.7	168	9.5	(55)	(3.2)	63	3.5
Total management and guarantee income(2)	$562	31.0	$479	26.9	$240	14.1	$372	20.6

(1) In accordance with SFAS 91, deferred items are amortized over the estimated lives of the underlying securities using the retrospective effective interest method. This method of amortization results in periodic adjustments when the effective interest rate changes due to differences between actual and estimated prepayments and changes in estimated future prepayments. Catch-up adjustments are made to the unamortized balances of the deferred items to reflect the application of the updated effective yield as if it had been in effect since acquisition.

(2) We reclassified amounts from certain expenses related to uncollectible interest on PCs held by third parties from Management and guarantee income to (Provision) benefit for credit losses to conform with the 2004 presentation. This resulted in increases of $4 million, $3 million, $5 million and $3 million for 1Q 2003, 2Q 2003, 3Q 2003 and 4Q 2003, respectively, in Management and guarantee income.

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

4Q04 vs. 3Q04

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

3Q04 vs. 2Q04

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

2Q04 vs. 1Q04

Management and guarantee income decreased by $133 million, or 35 percent, to $251 million in the second quarter of 2004 from $384 million in the first quarter of 2004. This decline was driven by an approximate 85 basis points increase in the 30-year mortgage rate during the quarter and associated slower estimated prepayment speeds used in our amortization models. This estimated decline in prepayment speeds caused slower amortization and resulted in net amortization expense for the second quarter of 2004.

1Q04 vs. 4Q03

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

4Q03 vs. 3Q03

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

3Q03 vs. 2Q03

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

2Q03 vs. 1Q03

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

Gains (Losses) on Guarantee Asset

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

The change in fair value of the guarantee asset reflects:

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

Factors Affecting the Fair Value of the Guarantee Asset. With the passage of time, actual expected cash flows are received and are no longer included in the valuation of the guarantee asset. Cash flows received, which are recorded as Management and guarantee income, represent a reduction of our investment in the guarantee asset. As depicted in "Table 20 — Attribution of Gains (Losses) on Guarantee Asset for Participation Certificates, at Fair Value," cash flows received on the guarantee asset are allocated between interest income (imputed income on the asset based on the discount rate used in the calculation of the fair value of the guarantee asset) and return of investment (the portion of actual cash flows that represents a reduction of the guarantee asset receivable). The realization of cash flows results in a corresponding reduction in the valuation of the guarantee asset.

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

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

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

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

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

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

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

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

	1Q 2004	2Q 2004	3Q 2004	4Q 2004	Full Year 2004
	(dollars in millions)				
Return of investment in guarantee asset	$ (199)	$ (200)	$ (207)	$ (223)	$ (829)
Changes in fair value of future cash flows	(444)	771	(639)	6	(306)
Gains (losses) on "Guarantee asset for Participation Certificates at fair value"	$ (643)	$ 571	$ (846)	$ (217)	$(1,135)
Guarantee asset for Participation Certificates, at fair value, at period end	$3,583	$4,724	$4,184	$4,516	$ 4,516

	1Q 2003	2Q 2003	3Q 2003	4Q 2003	Full Year 2003
	(dollars in millions)				
Return of investment in guarantee asset	$ (153)	$ (154)	$ (160)	$ (180)	$ (647)
Changes in fair value of future cash flows	(415)	(938)	418	121	(814)
Gains (losses) on "Guarantee asset for Participation Certificates, at fair value"	$ (568)	$(1,092)	$ 258	$ (59)	$(1,461)
Guarantee asset for Participation Certificates, at fair value, at period end	$2,424	$ 2,076	$3,030	$3,686	$ 3,686

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

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

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

Income on Guarantee Obligation

With the adoption of FIN 45 on January 1, 2003, we changed the way we account for Income on "Guarantee obligation for Participation Certificates." Beginning in 2003, we began recording guarantee obligations for PCs issued through our Guarantor Program and for certain Structured Securities that we issue to third parties in exchange for non-agency mortgage-backed securities, as well as for that portion of PCs issued through MultiLender Program transactions that are not accounted for as sales under SFAS 125/140. Previously, we recorded a guarantee obligation only upon the transfer of PCs or Structured Securities that qualified for sale accounting pursuant to SFAS 125/140. (We continue to record guarantee obligations for *these sales.) Consequently, the size of our guarantee obligation subject to this accounting was larger in 2004 and 2003 as compared with 2002. Compensation for this obligation is received in the form of upfront fees (credit and buy-down fees) and contractual guarantee fees received over time. Credit and buy-down fees received prior to 2003 were included in Other liabilities on our consolidated balance sheets and amortized into income as a component of Management and guarantee fee income. In 2003, we began amortizing these items and the initial recorded value of our guarantee obligation into Income on "Guarantee obligation for Participation Certificates" based on actual payment experience on the underlying mortgage loans, which we refer to as the Declining Unpaid Principal Balance Method. Prior to 2003, we marked our guarantee obligation to fair value at the end of each period.*

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

Table 22 — Income on Guarantee Obligation for 2004 and 2003

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

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

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

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

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

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

Table 23 summarizes the attribution of changes in the fair value of the guarantee obligation for 2002. The guarantee obligation for 2002 was established at its initial fair value, which is determined by estimating the amount and timing of cash flows related to the guarantee obligation. Factors in determining the fair value of the guarantee obligation include expectations about house price appreciation, interest rates, default rates, loan prepayment rates and other economic factors that influence expected credit losses and expected income earned on mortgage principal and interest payments held in our cash and investments portfolio pending remittance to PC investors. See "Table 37 — Changes in Guarantee Obligation for Participation Certificates" in "CONSOLIDATED BALANCE SHEETS ANALYSIS — Guarantee Obligation for Participation Certificates" for additional information about the guarantee obligation.

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

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

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

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

	1Q 2004	2Q 2004	3Q 2004	4Q 2004	Year Ended December 31, 2004
			(dollars in millions)		
Amortization income related to:					
Credit and buy-down fees received	$ 23	$ 37	$ 28	$ 40	$ 128
Initial fair value of contractual guarantee fees	128	194	129	153	604
Income on "Guarantee obligation for Participation Certificates"	$ 151	$ 231	$ 157	$ 193	$ 732
Guarantee obligation for Participation Certificates	$3,241	$3,557	$3,727	$4,065	$4,065
Liquidation rate for Outstanding PCs and Structured Securities(1)	30%	36%	22%	25%	29%

	1Q 2003	2Q 2003	3Q 2003	4Q 2003	Year Ended December 31, 2003
			(dollars in millions)		
Amortization income related to:					
Credit and buy-down fees received	$ —	$ 10	$ 25	$ 22	$ 57
Initial fair value of contractual guarantee fees	235	255	276	102	868
Income on "Guarantee obligation for Participation Certificates"	$ 235	$ 265	$ 301	$ 124	$ 925
Guarantee obligation for Participation Certificates	$1,655	$1,956	$2,385	$2,904	$2,904
Liquidation rate for Outstanding PCs and Structured Securities(1)	65%	81%	80%	31%	63%

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

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

Derivative Gains (Losses)

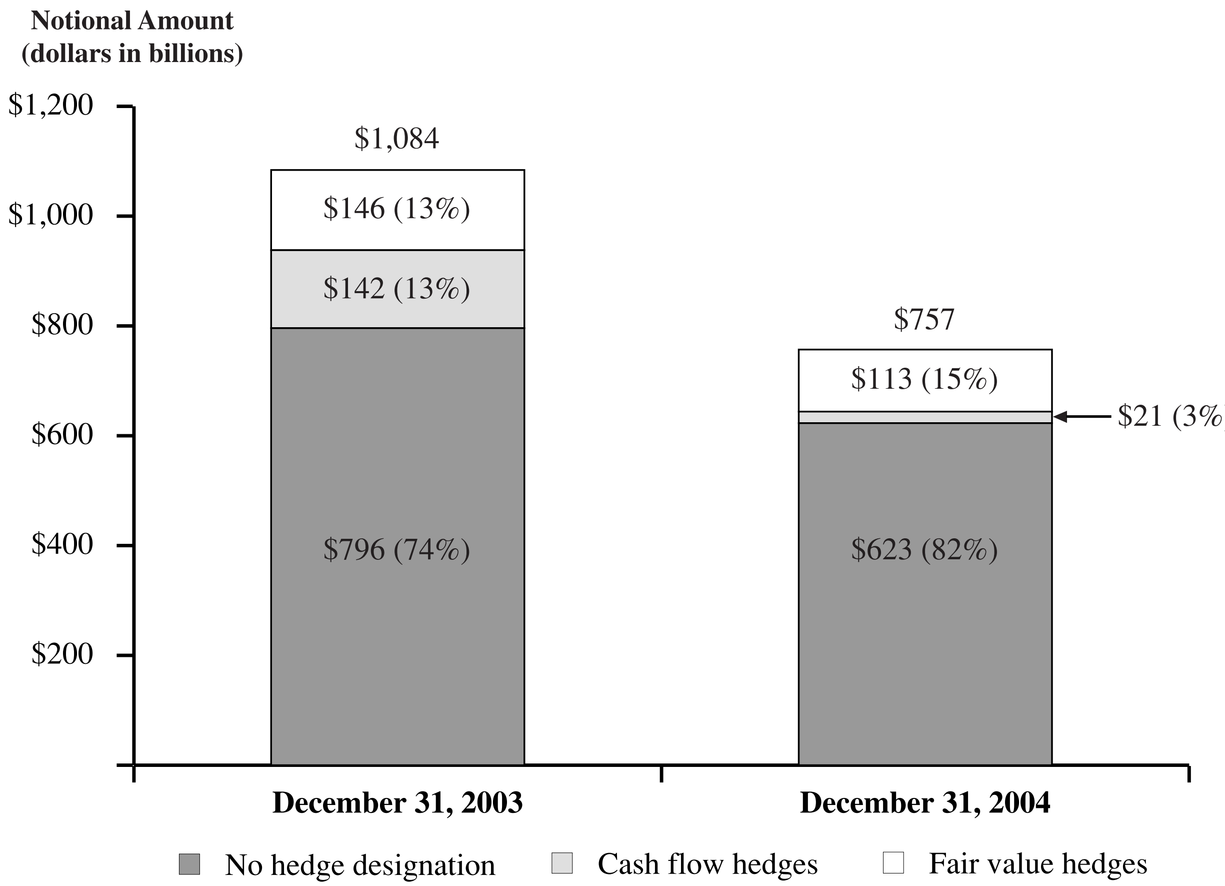
Derivative gains (losses) represents the change in fair value of derivatives not accounted for in hedge accounting relationships because the derivatives did not qualify for, or we did not elect to pursue, hedge accounting, resulting in fair value changes being recorded to earnings. Derivative gains (losses)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

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

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

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

Table 25 — Derivatives by Hedge Accounting Designation



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

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

Effective as of the beginning of the second quarter of 2004, we determined that substantially all pay-fixed interest-rate swaps and other derivatives that previously had been in cash flow hedge accounting relationships no longer met the hedge accounting requirements of SFAS 133. Consequently, we discontinued hedge accounting treatment for these relationships for financial reporting purposes at that time resulting in pay-fixed swaps with a notional balance of approximately $108 billion being moved from the cash flow hedge designation to no hedge designation. We also voluntarily discontinued hedge accounting treatment for a significant amount of our receive-fixed interest-rate swaps effective November 1, 2004, resulting in receive-fixed interest-rate swaps with a notional balance of approximately $50 billion being moved from a fair value hedge designation to no hedge designation. We believe that the voluntary discontinuance of hedge accounting treatment for receive-fixed swaps will assist us in addressing the period-to-period volatility of the value of our no hedge designation derivatives, and will help us reduce the operational complexity and related control remediation efforts that would otherwise be needed to ensure ongoing compliance with the requirements for obtaining and maintaining hedge accounting treatment. We may consider implementing new hedge accounting strategies in the future.

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

Table 26 — Notional Amounts of Receive- and Pay-Fixed Swaps(1)

	March 31, 2004		June 30, 2004		September 30, 2004		December 31, 2004	
Description	Notional	% of Total	Notional	% of Total	Notional	% of Total	Notional	% of Total
				(dollars in billions)				
Receive-fixed swaps:								
Fair value hedge	$113.0	99%	$ 97.6	99%	$127.2	98%	$58.0	69%
No hedge designation(2)	0.8	1	0.7	1	2.7	2	25.6	31
Total	$113.8	100%	$ 98.3	100%	$129.9	100%	$83.6	100%
Pay-fixed swaps:								
Cash flow hedge	$107.8	78%	$ —	—%	$ —	—%	$ —	—%
No hedge designation(2)	29.7	22	156.1	100	150.1	100	95.0	100
Total	$137.5	100%	$156.1	100%	$150.1	100%	$95.0	100%

	March 31, 2003		June 30, 2003		September 30, 2003		December 31, 2003	
Description	Notional	% of Total	Notional	% of Total	Notional	% of Total	Notional	% of Total
				(dollars in billions)				
Receive-fixed swaps:								
Fair value hedge	$ 89.1	63%	$ 92.2	79%	$ 81.5	72%	$ 93.5	87%
No hedge designation(2)	52.6	37	24.0	21	31.5	28	13.8	13
Total	$141.7	100%	$116.2	100%	$113.0	100%	$107.3	100%
Pay-fixed swaps:								
Cash flow hedge	$ 90.0	76%	$ 98.1	62%	$149.8	72%	$132.0	74%
No hedge designation(2)	28.9	24	60.5	38	57.8	28	47.1	26
Total	$118.9	100%	$158.6	100%	$207.6	100%	$179.1	100%

(1) Excludes swaps held as part of our external Money Manager program. As previously disclosed in our Information Statement Supplement dated October 4, 2004, we ceased our PC market-making and support activities accomplished through our external Money Manager program during the fourth quarter of 2004.
(2) For more information concerning all of our derivatives that are classified as no hedge designation, see "Table 27 — Derivatives Not in Hedge Accounting Relationships."

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

Table 27 — Derivatives Not in Hedge Accounting Relationships

	1Q 2004		2Q 2004		3Q 2004		4Q 2004		Year Ended December 31, 2004
	Notional	Derivative Gains (Losses)	Notional	Derivative Gains (Losses)	Notional	Derivative Gains (Losses)	Notional	Derivative Gains (Losses)	Derivative Gains (Losses)
					(dollars in billions)				
Call swaptions	$223.5	$2.7	$226.4	$(5.0)	$207.1	$ 3.1	$189.9	$(0.4)	$ 0.4
Put swaptions	128.7	(1.2)	88.7	1.0	70.8	(1.1)	25.2	(0.1)	(1.4)
Receive-fixed swaps	0.8	(0.1)	0.7	(0.1)	2.7	—	25.6	(0.2)	(0.4)
Pay-fixed swaps	29.7	(1.2)	156.1	5.7	150.1	(5.0)	95.0	(0.4)	(0.9)
Other(1)	442.6	0.1	379.8	(0.6)	436.3	—	286.8	—	(0.5)
Subtotal	825.3	0.3	851.7	1.0	867.0	(3.0)	622.5	(1.1)	(2.8)
Accrual of periodic settlements:									
Receive-fixed swaps		—		—		—		0.1	0.1
Pay-fixed swaps		(0.2)		(0.6)		(0.6)		(0.4)	(1.8)
Subtotal		(0.2)		(0.6)		(0.6)		(0.3)	(1.7)
Total	$825.3	$0.1	$851.7	$ 0.4	$867.0	$(3.6)	$622.5	$(1.4)	$(4.5)

	1Q 2003		2Q 2003		3Q 2003		4Q 2003		Year Ended December 31, 2003
	Notional	Derivative Gains (Losses)	Notional	Derivative Gains (Losses)	Notional	Derivative Gains (Losses)	Notional	Derivative Gains (Losses)	Derivative Gains (Losses)
					(dollars in billions)				
Call swaptions	$153.4	$0.3	$167.8	$3.1	$173.8	$(3.1)	$216.9	$(0.9)	$(0.6)
Put swaptions	134.5	(0.3)	155.6	(0.3)	146.3	0.3	123.1	—	(0.3)
Receive-fixed swaps(2)	52.6	0.2	24.0	0.6	31.5	(0.5)	13.8	(0.5)	(0.2)
Pay-fixed swaps	28.9	0.2	60.5	(0.4)	57.8	2.1	47.1	0.9	2.8
Other(1)(2)(3)	553.6	0.6	572.7	0.7	487.7	(1.5)	395.4	(0.5)	(0.7)
Subtotal	923.0	1.0	980.6	3.7	897.1	(2.7)	796.3	(1.0)	1.0
Accrual of periodic settlements		(0.1)		(0.2)		(0.4)		(0.3)	(1.0)
Total	$923.0	$0.9	$980.6	$3.5	$897.1	$(3.1)	$796.3	$(1.3)	$ —

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

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

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

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

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

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

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

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

During 2002, derivative gains (losses) were largest in the third quarter when the gains totaled $6.3 billion. This third quarter gain in 2002 was driven by a $4.8 billion gain on call swaptions, net of losses on put swaptions and a $1.3 billion gain on receive-fixed swaps, net of losses on pay-fixed swaps. The decrease in interest rates in the third quarter of 2002 increased the fair value of the interest-rate swaps underlying the call swaptions, which combined with the increase in the implied volatility of interest rates, resulted in a significant increase in the value of the call swaptions. While increases in implied volatility also have a favorable effect on the value of put swaptions, the decrease in fair value of the underlying pay-fixed interest-rate swaps due to the decrease in interest rates resulted in a net decrease in the fair value of these swaptions during 2002.

Hedge Accounting Gains (Losses)

For those derivatives that are accounted for in a hedge accounting relationship, hedge accounting ineffectiveness generally arises when the fair value change of a derivative financial instrument does not exactly offset the fair value change of the hedged item. Our hedge accounting relationships primarily consist of derivatives linked to either existing debt in a fair value hedge accounting relationship or the variability of interest payments on the forecasted issuances of debt securities in a cash flow hedge accounting relationship.

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

Gains (Losses) on Investment Activity

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

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

Table 28 — Gains (Losses) on Investment Activity

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

(1) We reclassified $524 million for full year 2003 from Gains (losses) on sale of mortgage loans and available-for-sale securities to Gains (losses) on trading securities to conform with the 2004 presentation.
(2) Includes impairments on securities classified as available-for-sale and trading. Impairments relating to securities within the scope of Emerging Issues Task Force Issue 99-20, "Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets," are calculated and recorded for both available-for-sale and trading securities.

Gains (Losses) on Trading Securities were ($1,071) million, ($1,606) million and $921 million in 2004, 2003 and 2002, respectively. Gains (losses) on securities we hold that are classified for accounting purposes as trading represent changes in the fair value of our trading positions, which include trading securities held, certain forward commitments to purchase or sell trading securities, and Treasury and agency debt security "short sale" transactions (also referred to as "securities sold, not yet purchased") executed for asset/liability management purposes. Historically, our trading positions arose primarily in connection with our Securities

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

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

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

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

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

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

Security Impairments were ($126) million, ($736) million and ($650) million in 2004, 2003 and 2002, respectively. We record impairment losses on our investment portfolio when we have concluded that a decrease in the fair value of a security is other than temporary. Impairment losses recognized in 2004, 2003 and 2002 were primarily related to certain investments in mortgage-related interest-only securities and manufactured housing securities.

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

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

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

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

Gains (Losses) on Debt Retirement

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

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

Resecuritization Fees

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

Resecuritization fees totaled $159 million, $352 million and $276 million in 2004, 2003 and 2002, respectively. A steep yield curve generally increases the value of structured cash flows, which results in greater value differences between PCs and Structured Securities as well as a corresponding increase in the volume of new Structured Securities being issued. As the yield curve flattened during 2004 and investor demand for Structured Securities decreased, we experienced a 28 percent decline in the volume of Structured Securitization activities based on unpaid principal balances compared to 2003. In addition, we decreased our average fees to perform resecuritizations during 2004 in response to competitive pressures and to support the price of our PCs, which represent most of the collateral that we resecuritize. Investors' demand for Structured Securities remained high during 2003 and 2002 largely due to the comparatively steep yield curve during those periods.

Other Income

Other income primarily consists of fees associated with servicing and technology-related programs, including Loan Prospector®, various fees related to multifamily loans (including application and other fees) and various other fees received from mortgage originators and servicers. In 2004 and 2003, other income also includes the correction of certain prior year accounting errors.

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

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

Non-Interest Expense

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

Table 29 — Non-Interest Expense

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

Administrative Expenses

Salaries and employee benefits, Professional services, Occupancy expense and certain other administrative expenses are collectively referred to as administrative expenses. Administrative expenses are generally incurred to conduct daily operations and support functions. Also, other administrative expenses include *amortization expense related to previously capitalized software development costs, net of reductions for current period capitalized software development costs.*

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

Table 30 — Administrative Expenses

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

(1) We reclassified certain expenses from Other administrative expenses to Professional services for 2003 and 2002 to conform with the 2004 presentation.
(2) Other charitable contributions are included in Other administrative expenses for 2004, 2003 and 2002. See "Table 31 — Other Expenses" for the special charitable contributions made in 2002.

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

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

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

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

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

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

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

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

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

Housing Tax Credit Partnerships

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

Our share of losses generated from our investment in Housing tax credit partnerships totaled ($281) million, ($200) million and ($160) million in 2004, 2003 and 2002, respectively. The year-over-year increases in this expense primarily reflect our increased investment in such partnerships. The related tax benefits, which are reported as a reduction in Income tax expense, totaled $378 million, $302 million and $220 million in 2004, 2003 and 2002, respectively.

Minority Interest in Earnings of Consolidated Subsidiaries

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

Minority interest in earnings of consolidated subsidiaries totaled ($129) million, ($157) million and ($184) million in 2004, 2003 and 2002, respectively. The majority of this amount for each of 2004, 2003 and 2002 relates to dividends on the preferred stock issued by our two majority-owned real estate investment trust, or REIT, subsidiaries. These dividends are recorded using an effective interest method and, therefore, will continue to decline over time as our recorded investment in the REITs decreases.

Other Expenses

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

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

Table 31 — Other Expenses

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

(1) Special charitable contributions represents a cash contribution to the Freddie Mac Foundation and corporate giving programs announced in the fourth quarter of 2002. The contribution to the Freddie Mac Foundation is expected to provide operating funds for the Foundation for six to eight years from the contribution date.

(2) We reclassified certain expenses from Other administrative expenses as included in Administrative expenses (see "Table 30 — Administrative Expenses" for additional information) to Other for 2003 and 2002 to conform with the 2004 presentation.

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

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

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

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

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

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

Income Tax Expense

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

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

CONSOLIDATED BALANCE SHEETS ANALYSIS

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

Table 32 — Summary Consolidated Balance Sheets

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

Our total assets remained relatively flat as of December 31, 2004 compared to December 31, 2003, declining by $8.2 billion, or 1 percent. This decrease was primarily driven by an $11.8 billion reduction in our Cash and investments portfolio. During the same period, total liabilities, plus minority interests in consolidated subsidiaries, decreased by $8.1 billion, which was driven by decreases in total debt securities. These and other changes in our consolidated balance sheets are discussed below.

Retained Portfolio

The Retained portfolio includes mortgage loans and mortgage-related securities that we acquire for investment purposes and primarily consists of PCs and Structured Securities and other agency and non-agency mortgage-related securities.

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

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

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

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

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

The non-agency mortgage-related securities portion of the Retained portfolio grew from December 31, 2003 to December 31, 2004 in both unpaid principal balance and as a percentage of the total Retained portfolio. This growth is a result of the strong supply of non-agency mortgage-related securities, particularly floating rate products, combined with the fact that investment opportunities in agency fixed-rate products have not been as attractive to us because strong demand from other investors, and lower mortgage loan originations, have generally resulted in unattractive mortgage-to-debt option-adjusted spreads.

Cash and Investments

Cash and investments include investments we acquire to manage recurring cash flows, provide a source of liquidity, temporarily deploy capital until the capital can be redeployed into Retained portfolio investments or credit guarantee business opportunities and manage interest-rate risk exposure.

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

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

Table 34 — Cash and Investments

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

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

As noted in Table 34, the balance of our total Cash and investments declined $11.8 billion during 2004. Our Investments balance decreased $35.5 billion during 2004 due in large part to ceasing of the PC market-making and support activities of our Securities Sales & Trading Group business unit and the discontinuation of our external Money Manager program. In contrast, our balances of Cash and cash equivalents and Securities purchased under agreements to resell and Federal funds sold increased by a combined $23.7 billion during 2004 because of the investment of a portion of the proceeds realized from liquidating the securities held by our Securities Sales & Trading Group.

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

Derivative Assets and Liabilities, at Fair Value

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

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

Table 35 — Total Derivative Portfolio

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

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

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

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

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

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

Guarantee Asset for Participation Certificates

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

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

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

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

(1) As of January 1, 2003, the fair value of those credit enhancements previously recognized as a component of guarantee assets were reclassified to Other assets.
(2) Subsequent to the issuance of our Information Statement dated September 24, 2004, we reclassified $7 million from Gains (losses) on "Guarantee asset for Participation Certificates, at fair value" to Additions, net of repurchases.
(3) Individual guarantee assets are marked to fair value based on the related PCs or Structured Securities. Consequently, the fair value of some guarantee assets increases, while the fair value of other guarantee assets decreases.

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

Total Debt Securities, Net

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

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

Guarantee Obligation for Participation Certificates

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

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

Table 37 — Changes in Guarantee Obligation for Participation Certificates

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

(1) Represents the reclassification of the incurred losses included in the "Guarantee obligation for Participation Certificates" at January 1, 2003 in conjunction with the implementation of FIN 45.
(2) Represents portions of guarantee obligations recognized upon the sale of PCs or Structured Securities that correspond to incurred credit losses reclassified to Reserve for guarantee losses on Participation Certificates at initial recognition of a guarantee obligation.
(3) Includes the fair value of guarantee obligations that were recognized in connection with transfers of PCs and Structured Securities that qualified as sales, as well as the fair value of guarantee obligations recognized that related to PCs and Structured Securities issued in Guarantor swaps and other similar transactions subject to FIN 45. The amount is presented net of reductions attributable to purchases of PCs and Structured Securities.
(4) Includes amortization of deferred revenue recognized for our guarantee obligation.

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

Total Stockholders' Equity

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

Table 38 summarizes the components of Total stockholders' equity.

Table 38 — Total Stockholders' Equity

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

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

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

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

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

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

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

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

AVERAGE CONSOLIDATED BALANCE SHEETS AND RATE/VOLUME ANALYSIS

Table 40 reflects an analysis of net interest income and presents average balances and related yields earned on assets and rates paid on liabilities. Average balance sheet information is presented because we believe end-of-period balances may not always be representative of activity throughout the periods presented. We also believe that the rate/volume analysis may be helpful in understanding how changes in business volumes and yields influenced our financial results, particularly net interest income on earning assets. For most components of the average balances, a daily weighted average balance is calculated for the period. When daily weighted average balance information is not available, a simple monthly average balance is calculated. In addition, Net interest income/yield (fully taxable-equivalent basis) is presented on this table. Taxable equivalent adjustments to interest income involve the conversion of tax-exempt sources of interest income to the equivalent amounts of interest income that would be necessary to derive the same net return if the investments had been subject to income taxes using our statutory tax rate (35 percent).

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

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

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

(1) Excludes mortgage loans and mortgage-related securities traded, but not yet settled.
(2) For securities classified as available-for-sale, we calculate average balances based on their unpaid principal balance plus their associated deferred fees and costs (*e.g.*, premiums and discounts), but exclude the effects of other-than-temporary impairments. For securities in the Retained portfolio classified as trading, we calculate average balances excluding their mark-to-fair-value adjustments. For securities in the Cash and investments portfolio classified as trading, we calculate average balances based on their fair values.
(3) May not sum due to rounding.
(4) Average rates for securities classified as available-for-sale are on the historical cost basis, which is not affected by the change in fair value that is reflected in the AOCI component of Stockholders' equity.
(5) Non-accrual loans are included in average balances.
(6) Rates calculated on a fully taxable-equivalent basis were 4.86%, 5.37% and 6.43% for the years ended December 31, 2004, 2003 and 2002, respectively, based upon related income of $28,688 million, $29,246 million and $30,253 million, respectively.
(7) Investments consist of Cash and cash equivalents and the Total mortgage-related and non-mortgage-related securities subtotal of Investments as reported on the consolidated balance sheets.
(8) Includes current portion of long-term debt.
(9) Includes amortization of deferred balances related to certain cash flow hedges and the accrual of periodic cash settlements in accordance with the contractual terms of all derivatives in qualifying hedge accounting relationships. See "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES" to our consolidated financial statements for more information.
(10) Represents the adjustment necessary to calculate the tax-exempt income and yield on a tax equivalent basis. We analyze Net interest income, and the related Net interest yield, on a taxable-equivalent basis. Analysis on a taxable-equivalent basis allows the comparison of ratios related to tax-exempt or tax-advantaged securities to those of fully taxable securities with higher yields.
(11) Combined rate/volume changes are allocated to the individual rate and volume change based on their relative size.

CONSOLIDATED FAIR VALUE BALANCE SHEETS

The consolidated fair value balance sheets in Table 41 present our estimates of the fair value of our recorded assets and liabilities and off-balance sheet financial instruments at December 31, 2004 and 2003.

Table 41 — Consolidated Fair Value Balance Sheets(1)

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

(1) The consolidated fair value balance sheets do not purport to present our net realizable, liquidation or market value as a whole. Furthermore, amounts we ultimately realize from disposition of assets or settlement of liabilities may vary significantly from the fair values presented.
(2) Carrying amounts equal the amounts reported on our GAAP consolidated balance sheets.
(3) The fair value of Mortgage-related securities reported in this table exceeds the carrying value because the fair value includes PC residuals related to Participation Certificates held in the Retained portfolio that are not recognized under GAAP because such PCs were issued prior to the implementation of FIN 45.
(4) Fair values include estimated income taxes on the difference between the consolidated fair value pre-tax net assets and the consolidated GAAP pre-tax net assets.

The fair value information on the consolidated fair value balance sheets includes the estimated fair values of all items recorded in the consolidated balance sheets prepared in accordance with GAAP, as well as all off-balance sheet financial instruments that represent our assets or liabilities that are not recorded in the GAAP consolidated balance sheets. These off-balance sheet items predominantly consist of the unrecognized guarantee assets and obligations associated with a portion of our PCs issued through our Guarantor Program as well as commitments to purchase multifamily and single-family mortgage loans that will be classified as held-for-investment in the GAAP consolidated financial statements and insurance contracts on manufactured housing investments. See "CRITICAL ACCOUNTING POLICIES AND ESTIMATES" and "OFF-BALANCE SHEET ARRANGEMENTS" as well as "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES" and "NOTE 16: FAIR VALUE DISCLOSURES" to the consolidated financial statements for more information on fair values.

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

Key Components of Changes in Fair Value of Net Assets

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

Core spread income

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

Return on risk positions

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

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

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

Core guarantee fees, net

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

Change in fair value of guarantee portfolio

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

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

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

Fee income

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

Discussion of Fair Value Results

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

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

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

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

VOLUME STATISTICS

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

Table 42 — Volume Statistics[1]

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

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

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

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

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

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

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

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

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

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

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

Table 43 — Characteristics of Purchases into the Single-Family Mortgage Portfolio(1)

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

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

Single-family mortgage loans purchased with loan-to-value ratios above 80 percent accounted for 15 percent, 12 percent and 16 percent for the years ended December 31, 2004, 2003 and 2002, respectively. In addition, the weighted average loan-to-value ratio of the mortgage loans purchased decreased from 70 percent for the year ended December 31, 2002 to 68 percent for the year ended December 31, 2003 and increased to 71 percent for the year ended December 31, 2004. The lower loan-to-value ratios in 2002 and 2003 as compared to 2004 are primarily the result of house-price appreciation combined with the surge in refinance activity in these years as a result of the reduction in interest rates.

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

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

LIQUIDITY AND CAPITAL RESOURCES

Liquidity

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

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

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

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

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

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

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

Total Capitalization

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

Table 44 — Total Capitalization

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

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

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

Debt Securities

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

Table 45 — Debt Security Issuances by Product(1)

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

(1) Excludes securities sold under agreements to repurchase and Federal funds purchased, swap collateral obligations, and securities sold, not yet purchased.
(2) Amounts for 2003 have been revised to present additional detail and to conform with the 2004 presentation.

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

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

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

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

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

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

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

Financing Calendars. Annually, we publish financing calendars for the upcoming year, which are intended to provide clarity and transparency with regard to the timing of new debt issues and reopening of prior issues, the anticipated size of individual offerings and settlement dates. All Reference Notes® securities, €Reference Notes® securities and Reference Bills® securities issued during 2004 and the first five months of 2005 were issued in accordance with our previously announced financing calendars.

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

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

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

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

Table 46 — Freddie Mac Credit Ratings

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

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

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

Equity Securities

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

Cash and Investments Portfolio

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

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

- temporarily deploy capital until the capital can be redeployed into Retained portfolio investments or credit guarantee business opportunities;
- maintain capital reserves to meet mortgage funding needs;
- provide diverse sources of liquidity; and
- help manage the interest-rate risk inherent in mortgage-related assets.

The non-mortgage-related securities in the Cash and investments portfolio consist principally of asset-backed securities and other marketable assets that can be readily converted to cash. During 2004, we adjusted the investment strategy for the Cash and investments portfolio and, as a result, this portfolio did not hold corporate debt securities or preferred stock at December 31, 2004. The non-mortgage investments in this portfolio may expose us to institutional credit risk and the risk that the investments will decline in value due to market-driven events such as credit downgrades or changes in interest rates and other market conditions. See "RISK MANAGEMENT — Credit Risks — *Institutional Credit Risk*" for more information.

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

Contractual Obligations

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

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

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

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

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

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

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

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

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

Capital Resources

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

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

Table 48 — Summary of Core Capital

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

Capital Transactions

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

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

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

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

All repurchases of our common stock have been made as part of the stock repurchase plan approved by our Board of Directors on September 5, 1997. This plan allows repurchases of common stock not to exceed five percent of shares outstanding as of September 5, 1997, which was approximately 34 million shares. At December 31, 2004, approximately 13 million common shares remained available for repurchase under this plan. During 2003, 2004 and the first five months of 2005, we did not repurchase any common shares. We repurchased approximately 9.1 million shares of common stock during 2002 for approximately $555 million. In addition, we may not be able to issue or redeem preferred stock or subordinated debt until we resume timely financial reporting and therefore, changes in Core capital will generally be limited to net income and dividends. See "BUSINESS — Regulatory and Governmental Matters — OFHEO" for a discussion of the framework established by OFHEO for monitoring our capital. In addition, we periodically reissue treasury stock to employees and non-employee directors as part of our stock-based compensation plans. See "NOTE 11: STOCK-BASED COMPENSATION" to the consolidated financial statements for a description of these plans.

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

Capital Adequacy

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

The GSE Act establishes our capital standards, and OFHEO has issued regulations that set our minimum, critical and risk-based capital requirements. We operate with the intention to hold capital that exceeds all regulatory requirements.

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

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

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

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

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

Table 49 — Regulatory Capital Requirements

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

(1) OFHEO is the authoritative source of the capital calculations that underlie our capital classifications. For 2004, we amended the minimum and critical capital requirements, core capital and surplus amounts previously reported to OFHEO to incorporate adjustments reflected in our consolidated financial statements. The 2004 minimum and critical capital requirements, core capital and surplus amounts are estimates and have been revised to reflect changes related to a closing agreement entered into with the IRS concerning our REIT subsidiaries. See "NOTE 14: INCOME TAXES" to the consolidated financial statements for further information.
(2) Core capital consists of the par value of outstanding common stock (common stock issued less common stock held in treasury), par value of outstanding perpetual noncumulative preferred stock, additional paid in capital and retained earnings, as determined in accordance with GAAP.
(3) Risk-based and Total capital amounts are those calculated by OFHEO prior to the issuance of our 2004 and 2003 financial results. OFHEO determined not to recalculate the risk-based capital amounts given that the minimum capital requirement remained the determining requirement for our classification as adequately capitalized.
(4) Total capital includes Core capital and general reserves for mortgage and foreclosure losses.

OFF-BALANCE SHEET ARRANGEMENTS

Off-Balance Sheet Transactions

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

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

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

Guaranty of PCs and Structured Securities

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

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

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

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

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

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

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

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

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

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

Other

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

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

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

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

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