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

EXECUTIVE SUMMARY

Our Business

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

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

Our Mission

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

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

Fair Value Management

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

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

Capital Management

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

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

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

Risk Management

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

Operational Risks and Internal Controls

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

Interest-Rate Risk

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

Credit Risk

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

Summary of 2005 Financial Results

GAAP Results

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

Fair Value Balance Sheets

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

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

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

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

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

CONSOLIDATED RESULTS OF OPERATIONS

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

Net Interest Income

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

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

	Year Ended December 31,								
	2005			2004			2003		
	Average Balance[1][2]	Interest Income (Expense)[1]	Average Rate[3][4]	Average Balance[1][2][5]	Interest Income (Expense)[1]	Average Rate[3][4][5]	Average Balance[1][2][5]	Interest Income (Expense)[1]	Average Rate[3][4][5]
	(dollars in millions)								
Interest-earning assets:									
Mortgage loans[6][7][8]	$ 61,248	$ 4,037	6.59%	$ 61,576	$ 4,007	6.51%	$ 63,893	$ 4,251	6.65%
Mortgage-related securities[8][9]	611,452	29,684	4.85	590,213	28,460	4.82	544,359	29,051	5.34
Total Retained portfolio	672,700	33,721	5.01	651,789	32,467	4.98	608,252	33,302	5.47
Investments[10]	53,252	1,773	3.33	81,833	2,716	3.32	94,768	3,246	3.43
Securities purchased under agreements to resell and Federal funds sold	25,344	833	3.28	29,996	420	1.40	49,085	550	1.12
Total interest-earning assets	$751,296	$ 36,327	4.83	$763,618	$ 35,603	4.66	$752,105	$ 37,098	4.93
Interest-bearing liabilities:									
Short-term debt	$192,497	$ (6,102)	(3.17)	$205,072	$ (2,908)	(1.42)	$226,850	$ (2,785)	(1.23)
Long-term debt[11]	524,270	(23,246)	(4.43)	530,816	(22,950)	(4.32)	478,028	(22,083)	(4.62)
Total debt securities	716,767	(29,348)	(4.09)	735,888	(25,858)	(3.51)	704,878	(24,868)	(3.53)
Due to Participation Certificate investors	10,399	(551)	(5.30)	12,401	(708)	(5.71)	26,234	(1,641)	(6.26)
Total interest-bearing liabilities	727,166	(29,899)	(4.11)	748,289	(26,566)	(3.55)	731,112	(26,509)	(3.63)
Income (expense) related to derivatives[12]		(1,058)	(0.15)		100	0.01		(1,091)	(0.15)
Impact of net non-interest-bearing funding	24,130	—	0.14	15,329	—	0.07	20,993	—	0.11
Total funding of interest-earning assets	$751,296	$(30,957)	(4.12)	$763,618	$(26,466)	(3.47)	$752,105	$(27,600)	(3.67)
Net interest income/yield		$ 5,370	0.71		$ 9,137	1.20		$ 9,498	1.26
Fully taxable-equivalent adjustment[13]		339	0.05		267	0.03		227	0.03
Net interest income/yield (fully taxable-equivalent basis)		$ 5,709	0.76%		$ 9,404	1.23%		$ 9,725	1.29%

	2005 vs. 2004 Variance Due to			2004 vs. 2003 Variance Due to[5]		
	Rate[14]	Volume[14]	Total Change	Rate[14]	Volume[14]	Total Change
	(in millions)					
Interest-earning assets:						
Mortgage loans	$ 51	$ (21)	$ 30	$ (92)	$ (152)	$ (244)
Mortgage-related securities	194	1,030	1,224	(2,928)	2,337	(591)
Total Retained portfolio	245	1,009	1,254	(3,020)	2,185	(835)
Investments	9	(952)	(943)	(98)	(432)	(530)
Securities purchased under agreements to resell and Federal funds sold	487	(74)	413	116	(246)	(130)
Total interest-earning assets	$ 741	$ (17)	$ 724	$ (3,002)	$ 1,507	$(1,495)
Interest-bearing liabilities:						
Short-term debt	$(3,383)	$ 189	$(3,194)	$ (406)	$ 283	$ (123)
Long-term debt	(581)	285	(296)	1,472	(2,339)	(867)
Total debt securities	(3,964)	474	(3,490)	1,066	(2,056)	(990)
Due to Participation Certificate investors	48	109	157	133	800	933
Total interest-bearing liabilities	(3,916)	583	(3,333)	1,199	(1,256)	(57)
Income (expense) related to derivatives	(1,158)	—	(1,158)	1,191	—	1,191
Total funding of interest-earning assets	$(5,074)	$ 583	$(4,491)	$ 2,390	$ (1,256)	$ 1,134
Net interest income	$(4,333)	$ 566	$(3,767)	$ (612)	$ 251	$ (361)
Fully taxable-equivalent adjustment	76	(4)	72	38	2	40
Net interest income (fully taxable-equivalent basis)	$(4,257)	$ 562	$(3,695)	$ (574)	$ 253	$ (321)

(1) Excludes mortgage loans and mortgage-related securities traded, but not yet settled.
(2) For securities classified as available-for-sale, we calculate average balances based on their unpaid principal balance plus their associated deferred fees and costs (*e.g.*, premiums and discounts), but exclude the effects of other-than-temporary impairments on the unpaid principal balances of impaired securities. For securities in the Retained portfolio classified as trading, we calculate average balances excluding their mark-to-fair-value

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

Table 8 summarizes components of our Net interest income.

Table 8 — Net Interest Income

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

(1) Amortization relates to premiums, discounts, deferred fees and other basis adjustments to the carrying value of our financial instruments and the reclassification of previously deferred balances from AOCI for certain derivatives in cash flow hedge relationships related to individual debt issuances and mortgage purchase transactions.
(2) Includes amortization of deferred balances related to certain cash flow hedges and the accrual of periodic cash settlements of all derivatives in qualifying hedge accounting relationships. See "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — Derivatives" to our consolidated financial statements for more information.

2005 versus 2004

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

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

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

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

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

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

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

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

2004 versus 2003

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

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

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

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

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

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

Non-Interest Income (Loss)

Management and Guarantee Income

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

Table 9 — Management and Guarantee Income[1]

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

(1) Excludes amounts related to PCs we held, which are reported in Net interest income.
(2) Credit and buy-down fees are amortized over the estimated lives of the underlying securities using the retrospective effective interest method. This method of amortization results in periodic adjustments when the effective interest rate changes due to differences between actual and estimated prepayments and changes in estimated future prepayments. Catch-up adjustments are made to the unamortized balances of the deferred items to reflect the application of the updated effective yield as if it had been in effect since acquisition.
(3) Previous periods' balances have been revised to conform with the 2005 presentation.

2005 vs. 2004

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

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

2004 vs. 2003

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

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

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

Gains (Losses) on Guarantee Asset

The change in fair value of the Guarantee asset reflects:

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

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

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

Table 10 — Attribution of Change — Gains (Losses) on Guarantee Asset[1]

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

(1) Represents the change in fair value of the Guarantee asset related to PCs held by third parties that have previously been sold pursuant to SFAS 140 or PCs issued through our Guarantor Swap program, where we primarily exchange mortgage loans for PCs.
(2) Represents guarantee fees received related to PCs and Structured Securities held by third parties for which a recognized Guarantee asset exists.
(3) Represents a change in estimate resulting from enhancing our approach for determining the fair value of the Guarantee asset. See "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES" to our consolidated financial statements for further information.

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

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

Income on Guarantee Obligation

Table 11 summarizes our income on Guarantee obligation.

Table 11 — Income on Guarantee Obligation

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

(1) Related to upfront cash payments in the form of credit fees and buy-down payments that are received from counterparties to guarantee transactions that are accounted for pursuant to FIN 45 (*e.g.*, Guarantor Swaps).
(2) Related to outstanding PCs and Structured Securities (including other PCs and Structured Securities held in our Cash and investments portfolio during 2004 and 2003).

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

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

Derivative Overview

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

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

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

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

(1) The fair values of derivatives (netted by counterparty) are presented as Derivative assets, at fair value, and Derivative liabilities, at fair value, on our consolidated balance sheets.
(2) Derivatives that meet specific criteria may be accounted for as cash flow hedges. Changes in the fair value of the effective portion of these open derivatives contracts are recorded in AOCI, net of taxes. Net deferred gains and losses on closed cash flow hedges (*i.e.*, where the derivative is either terminated or redesignated) are also included in AOCI, net of taxes, until the related forecasted transaction is determined to be probable of not occurring or affects earnings.
(3) For most derivatives not qualifying as an accounting hedge, fair value gains and losses are reported as Derivative gains (losses) on our consolidated statements of income. For forward purchase and sale commitments of securities classified as trading (with notional balances of approximately $— billion, $— billion and $78 billion at December 31, 2005, 2004 and 2003, respectively), fair value gains and losses are reported as Gains (losses) on investment activity on our consolidated statements of income and therefore, those fair value gains and losses are not included above.
(4) Hedge accounting gains (losses) arise when the fair value change of a derivative does not exactly offset the fair value change of the hedged item attributable to the hedged risk. For further information, see "Hedge Accounting Gains (Losses)" below and "NOTE 12: DERIVATIVES" to our consolidated financial statements.
(5) For all derivatives in qualifying hedge accounting relationships, the accrual of periodic cash settlements is recorded in Net interest income on our consolidated statements of income and therefore, those amounts are not included above. For derivatives not in qualifying hedge accounting relationships, the accrual of periodic cash settlements is recorded in Derivative gains (losses) on our consolidated statements of income.
(6) Derivative gains (losses) in each period include gains or losses reclassified from AOCI, net of taxes, as a result of the termination of cash flow hedge designations because we determined that the related forecasted transaction is probable of not occurring.

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

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

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

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

Derivative Gains (Losses)

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

Table 13 — Derivatives Not in Hedge Accounting Relationships

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

(1) Other consists of basis swaps, certain option-based contracts, futures, foreign-currency swaps, interest-rate caps, commitments, derivatives held as part of our external Money Manager program (in 2003) and other derivatives not accounted for in hedge accounting relationships, including credit derivatives, swap guarantee derivatives and a prepayment management agreement.
(2) Derivative gains (losses) in each period include gains or losses reclassified from AOCI, net of taxes, as a result of the termination of cash flow hedge designations because we determined that the related forecasted transactions are probable of not occurring.
(3) Composed of receive-fixed swaps of $0.4 billion and $0.1 billion and pay-fixed swaps of $(0.8) billion and $(1.8) billion for the years ended December 31, 2005 and 2004, respectively.

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

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

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

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

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

Hedge Accounting Gains (Losses)

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

Gains (Losses) on Investment Activity

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

Table 14 — Gains (Losses) on Investment Activity

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

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

Gains (losses) on trading securities

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

Gains (losses) on PC residuals, at fair value

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

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

Gains (losses) on sale of mortgage loans

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

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

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

Total security impairments

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

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

Lower-of-cost-or-market adjustments

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

Gains (Losses) on Debt Retirement

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

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

Resecuritization Fees

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

Table 15 — Total Resecuritization Fees and Activity

	Year Ended December 31,		
	2005	2004	2003
		(in millions)	
Resecuritization fees[1]:			
Multi-class	$ 119	$ 149	$ 338
Single-class	6	10	14
Total resecuritization fees	$ 125	$ 159	$ 352

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

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

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

Other Income

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

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

Non-Interest Expense

Table 16 summarizes the components of Non-interest expenses.

Table 16 — Non-Interest Expense

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

Administrative Expenses

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

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

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

Provision for Credit Losses

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

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

Housing Tax Credit Partnerships

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

Other Expenses

Reserve for legal settlements

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

Realized losses on certain guarantees

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

Amortization of credit enhancements

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

Other expenses

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

Income Tax Expense

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

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

CONSOLIDATED BALANCE SHEETS ANALYSIS

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

Retained Portfolio

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

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

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

(1) Variable-rate mortgages include mortgages with a current contractual coupon that is scheduled to change prior to contractual maturity, ARMs, and mortgage-related securities backed by ARMs with 1-, 3-, 5-, 7- and 10-year initial fixed-rate periods. Mortgage loans also include mortgages with balloon/reset provisions.
(2) Amounts for 2004 have been revised to conform with the 2005 presentation.
(3) We guarantee the payment of principal and interest on our Guaranteed PCs and Structured Securities and are subject to the credit risk associated with the underlying mortgage loan collateral.
(4) Agency mortgage-related securities are generally not separately rated by credit rating agencies, but are viewed as having a level of credit quality at least equivalent to non-agency mortgage securities rated AAA or equivalent.
(5) Credit rating of most non-agency mortgage-related securities is designated by at least two nationally recognized credit rating agencies.
(6) Consists of obligations of states and political subdivisions. Approximately 66 percent and 72 percent were AAA rated at December 31, 2005 and 2004, respectively.
(7) At December 31, 2005 and 2004, 51 percent and 43 percent, respectively, of mortgage-related securities backed by manufactured housing were rated BBB− or above. For the same dates, 75 percent and 96 percent, respectively, of these securities were supported by third-party credit enhancements (*e.g.*, bond insurance) and other credit enhancements (*e.g.*, deal structure through subordination). Approximately 33 percent were AAA rated at December 31, 2005 and 2004.
(8) Approximately 98 percent and 97 percent were AAA rated at December 31, 2005 and 2004, respectively.

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

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

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

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

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

Issuers Greater than 10 Percent of Stockholders' Equity

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

Cash and Investments

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

Table 19 — Cash and Investments

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

(1) Credit ratings for most securities are designated by at least two nationally recognized credit rating agencies.
(2) Consists primarily of securities that can be prepaid prior to their contractual maturity without penalty.

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

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

Table 20 — Fair Value of Securities in the Cash and Investments Portfolio[1]

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

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

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

Derivative Assets and Liabilities, at Fair Value

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

Table 21 — Total Derivative Portfolio

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

(1) Notional or contractual amounts are used to calculate the periodic amounts to be received and paid and generally do not represent actual amounts to be exchanged or directly reflect our exposure to institutional credit risk. Notional or contractual amounts are not recorded as assets or liabilities on our consolidated balance sheets.
(2) The fair value by derivative type presented on this table is shown prior to netting by counterparty. The fair value of derivatives presented on the consolidated balance sheets, however, is netted by counterparty, and is reported in the Derivative assets, at fair value and Derivative liabilities, at fair value captions. The fair values for futures are directly derived from quoted market prices. Fair values of other derivatives are derived primarily from valuation models using market data inputs.
(3) Primarily represents written options, including guarantees of stated final maturity of issued Structured Securities and written call options on PCs we issued (see "NOTE 4: FINANCIAL GUARANTEES" to our consolidated financial statements for more information).
(4) Includes Treasury futures notional amounts of $— million and $2,001 million at December 31, 2005 and 2004, respectively.

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

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

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

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

Table 22 summarizes the changes in derivative fair values.

Table 22 — Changes in Derivative Fair Values

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

(1) Includes fair value changes for over-the-counter, or OTC, interest-rate swaps, option-based derivatives, foreign-currency swaps and interest-rate caps.
(2) Consists primarily of cash premiums paid or received on options and the initial value of interest-rate swaps after we have exercised related swaptions.

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

Table 23 — Derivative Fair Values and Maturities

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

(1) Fair value is categorized based on the years from December 31, 2005 until the contractual maturity of the derivative.
(2) Represents interest-rate swap agreements scheduled to begin on a future date.

Guarantee Asset

Table 24 summarizes the changes in our Guarantee asset balance.

Table 24 — Changes in Guarantee Asset

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

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

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

Total Debt Securities, Net

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

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

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

(1) Includes securities sold under agreements to repurchase and Federal funds purchased and swap collateral obligations.
(2) Primarily represents unamortized discounts on zero-coupon debt securities. Also, includes accrued interest payable on swap collateral obligations.
(3) Primarily represents the mark-to-market of foreign-currency debt that is in hedge accounting relationships. Balance will fluctuate due to a number of factors, primarily the U.S. dollar to Euro exchange rate.

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

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

Table 26 — Senior Debt, Due Within One Year

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

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

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

(1) Represents par value, net of associated discounts or premiums. Swap collateral obligations include the related accrued interest payable.
(2) Represents the weighted average effective rate at the end of the period, which includes the amortization of discounts or premiums and issuance costs, but excludes the amortization of foreign-currency-related and hedging-related basis adjustments.
(3) Includes unamortized discounts or premiums and issuance costs. Issuance costs are reported in the Other assets caption on our consolidated balance sheets.
(4) Represents the approximate weighted average effective rate during the period, which includes the amortization of discounts or premiums and issuance costs, but excludes the amortization of foreign-currency-related and hedging-related basis adjustments.

Guarantee Obligation

Table 27 summarizes the changes in the Guarantee obligation balance.

Table 27 — Changes in the Guarantee Obligation

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

(1) Represents portions of the Guarantee obligation recognized upon the sale of PCs or Structured Securities that correspond to incurred credit losses reclassified to Reserve for guarantee losses on Participation Certificates at initial recognition of a Guarantee obligation.
(2) Includes the fair value of the Guarantee obligation that was recognized in connection with transfers of PCs and Structured Securities that qualified as sales, as well as the fair value of the Guarantee obligation recognized that related to PCs and Structured Securities issued in Guarantor Swaps and other similar transactions subject to FIN 45. The amount is presented net of reductions attributable to purchases of PCs and Structured Securities.
(3) Represents the excess of recognized consideration received on guarantee transactions that are accounted for pursuant to the requirements of FIN 45 over the recognized fair value of the corresponding Guarantee obligation. Consideration received includes the contractual right to receive guarantee fees, various credit enhancements for which we are the named beneficiary and upfront cash payments that relate to credit and buy-down fees.
(4) Relates to upfront cash payments in the form of credit fees and buy-down payments that are received from counterparties to guarantee transactions that are accounted for pursuant to FIN 45 (*e.g.*, Guarantor Swaps).

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

Total Stockholders' Equity

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

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

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

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

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

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

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

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

CONSOLIDATED FAIR VALUE BALANCE SHEETS ANALYSIS

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

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

Key Components of Changes in Fair Value of Net Assets

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

Core spread income

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

Changes in mortgage-to-debt OAS

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

Return on risk positions

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

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

Core guarantee fees, net

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

Change in the fair value of the guarantee portfolio

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

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

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

Fee income

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

Discussion of Fair Value Results

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

LIQUIDITY AND CAPITAL RESOURCES

Liquidity

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

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

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

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

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

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

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

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

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

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

Debt Securities

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

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

Table 29 — Debt Security Issuances by Product, at Par Value[1]

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

(1) Excludes securities sold under agreements to repurchase and Federal funds purchased, swap collateral obligations and securities sold, not yet purchased.
(2) Includes $— million and $717 million of Medium-term Notes issued for the years ended December 31, 2005 and 2004, respectively, which were accounted for as debt exchanges.
(3) Includes $3,396 million and $— million of Reference Notes® securities issued for the years ended December 31, 2005 and 2004, respectively, which were accounted for as debt exchanges.

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

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

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

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

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

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

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

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

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

Table 30 — Debt Security Repurchases, Calls and Exchanges

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

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

Table 31 — Freddie Mac Credit Ratings

	Rating Agency		
	Standard & Poor's	Moody's	Fitch
Senior long-term debt(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 Reference Notes® securities and €Reference Notes® securities.
(2) Includes Reference Bills® securities and discount notes.

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

Equity Securities

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

Cash and Investments Portfolio

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

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

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

Contractual Obligations

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

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

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

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

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

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

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

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

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

Capital Resources

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

Capital Transactions

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

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

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

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

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

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

Capital Adequacy

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

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

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

RISK MANAGEMENT

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

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

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

Operational Risks

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

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

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