

### ***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.

We currently outsource certain key functions to external parties, including processing functions for trade capture, market risk management analytics, asset valuation, and mortgage loan underwriting. We mitigate the risk from outsourcing by engaging in active vendor management, including establishing detailed vendor requirements, reviewing business continuity plans, monitoring quality assurance processes and engaging third party reviews of our vendors. In addition, we use a process of delegated underwriting for the single-family mortgages we purchase or securitize. In this process, we provide originators with a series of mortgage underwriting guidelines and they represent and warrant to us that the mortgages sold to us meet these guidelines. See “Credit Risks — *Mortgage Credit Risk* — Mortgage Credit Risk Management Strategies — *Underwriting Requirements and Quality Control Standards*” and “*Institutional Credit Risk* — Mortgage Seller/Service” for information about how we mitigate the risks associated with delegated underwriting.

We are making significant investments to build new financial reporting systems and to move to more effective and efficient business processing systems. During the transition period, however, we are more reliant on end-user computing systems than is desirable and are challenged to deliver integrated production systems. Certain of these end-user computing systems increase the risk of errors in some of our core operational processes and increase our reliance on monitoring controls, which is an area where we have a material weakness in our internal control over financial reporting. They may also limit our capacity for change. In the near term, we are mitigating this risk by improving our documentation and controls over these systems and placing key end-user systems under the same technology controls as our production applications. We also face challenges in the areas of system security, change management and information technology application and general controls. See “*Internal Control over Financial Reporting*” for more information concerning internal control issues related to our systems, both financial and non-financial reporting.

We are also exposed to the risk that our business processes could be adversely affected by inadequate staffing, which strains existing resources and increases the risk that an error or fraud will not be detected. This risk is of particular concern for us because of high turnover rates, critical vacancies and recent changes in our senior management. We have filled some important vacancies such as General Counsel, General Auditor, Principal Accounting Officer, and Senior Vice President, Enterprise Operational Risk. Our President and Chief Operating Officer has assumed the responsibilities of the Chief Financial Officer while we conduct a search to fill that position. Recently, high employee turnover rates have contributed to increased operational risk. While we have made progress in our efforts to build a strong management team by filling several senior positions, we need to continue to recruit additional qualified people into leadership positions across the organization in order to achieve our objectives in regard to remediation of our internal control deficiencies.

In addition to the particular risks and challenges we are facing, we face ongoing risks that are similar to those of other large financial institutions. For example, we are exposed to the risk that a catastrophic event, such as a terrorist event or natural disaster, could result in a significant business disruption and an inability to process transactions through normal business processes. To mitigate this risk, we maintain and test business continuity plans and have established backup facilities for critical business processes and systems away from, although in the same metropolitan area as, our main offices. In 2005, we began an effort to establish out-of-region capabilities for clearing and treasury services. However, it is not clear that these measures will be sufficient to respond to the full range of catastrophic events that might occur.

#### ***Internal Control over Financial Reporting***

Since the revision and restatement of our financial results for 2000 through 2002, we have had to face many challenging and complex accounting and financial reporting issues, including ongoing controls remediation and systems re-engineering and development. We fell behind in our periodic reporting for the years ended December 31, 2002, 2003, 2004 and 2005, and we have not yet returned to quarterly reporting. Improving internal control over financial reporting and mitigating the risks presented by material weaknesses and other control deficiencies in our financial reporting processes continue to be top corporate priorities. Many of the material weaknesses and other control deficiencies identified in prior years persisted throughout 2005 and continue to present challenges for us in 2006. In addition, we determined that some previously identified deficiencies were more serious than originally assessed. We also identified additional control deficiencies in 2005. While we believe we have made progress in the remediation of certain material weaknesses and other control deficiencies that have been identified, these will continue to pose significant risks to our financial reporting process until fully remediated. For example, in the course of completing our financial reporting processes for 2005, we discovered a number of internal control issues that resulted in adjustments to our interim 2005 financial results.

The material weaknesses that affected us throughout 2005 and at the end of the year included:

- Integration among our systems, business units and external service providers — Integration issues among our systems and processes related to our operational and financial accounting systems, business units and external service providers, which collectively increase the risk of error in our financial reporting due to: (a) the potential failure to correctly pass information between systems and processes; (b) incompatibility of data between systems; (c) incompatible systems; or (d) a lack of clarity in process ownership. To compensate for this weakness, we have

implemented compensating controls, including the performance of significant data validation and financial analytics, which contributed to our delayed financial reporting timeline.

- Information technology general controls as they relate to change management — Our controls over managing changes related to the introduction of program and data changes and our controls related to production data and applications need improvement. Weaknesses in these controls include lack of consistent standards and inadequate testing of changes prior to deployment.
- Information technology general controls as they relate to security administration, management and technology — Our controls over information systems security administration and management functions need to improve in the following areas: (a) development of and adherence to procedures and guidelines; (b) segregation of duties; (c) logging and monitoring user access rights; and (d) periodic review of the appropriateness of access rights. Weaknesses in these controls could allow unauthorized users to enter, delete or change data in these systems, as well as increase the possibility that entries could be duplicated or omitted inadvertently.
- Monitoring controls within financial operations and reporting functions — Monitoring controls are those controls that are designed to evaluate how other controls are working, such as the performance of financial analytics and the completion of account reconciliations. Despite the progress made in the identification, documentation, and enhancement of monitoring controls during 2005, there were several instances where these controls did not identify issues that ultimately led to accounting adjustments.
- Staffing adequacy — While we have made progress in our efforts to build a strong management team by filling several senior positions, we need to continue to recruit additional qualified people into leadership positions across the organization in order to achieve our objectives with regard to the remediation of weaknesses and deficiencies within our internal control infrastructure and our return to timely financial reporting. We have recently experienced high employee turnover rates, which strain existing resources and contribute to increased operational risk. We are also assessing our standards of performance and how we enforce those standards to create a more effective culture of accountability.
- Management risk and control self-assessment process — Our process to identify deficiencies in key financial reporting controls, prior to testing, does not provide reliable information on our risk and control environment.

In addition to these material weaknesses, a number of significant deficiencies in our internal control were apparent that, although not determined to be material at this time, still present risks of error in our financial reporting. For example, we place reliance on end-user computing solutions with both insufficient documentation and change controls. This control deficiency was considered a material weakness at December 31, 2004. We believe that our remediation efforts have reduced the severity of this deficiency, however, it continues to pose significant risk to our financial reporting processes and requires us to allocate significant resources to continue progress toward full remediation and to provide that this deficiency does not become material again.

Other significant deficiencies include areas that need improvement: the governance over our risk management processes, where we need to strengthen the resources engaged in this oversight role and our ability to aggregate risks across our organization; our new product implementation process; and the governance of and processes related to our valuation of our guarantee-related assets and liabilities. We also need to strengthen our procedures for monitoring instances where we make simplifying assumptions in the application of our accounting policies in our financial reporting, and we need to reduce our reliance on such assumptions. The excessive use of such assumptions increases the risk that differences, when compared to a stricter application of our accounting policies, could become consequential over time and result in errors that are not detected (*e.g.*, if the underlying transaction volume increases). Furthermore, we are examining the cause of certain data quality issues associated with information provided to us by seller/servicers related to mortgage loans underlying our PCs and Structured Securities and the use of that data within our operational transaction systems and financial reporting systems.

As we continue the remediation activities noted below, we may identify additional material weaknesses, significant deficiencies or other operational issues in our internal controls or conclude that significant deficiencies we have already identified should be regarded as material weaknesses, either individually or in the aggregate.

During 2005, we implemented an internal control testing and evaluation program designed to evaluate the significant components of our internal control over financial reporting and to identify whether deficiencies exist within our internal control environment. Upon discovering the need for several adjustments to our 2005 interim financial results in the course of our financial reporting processes for 2005, we began a more comprehensive review of our internal control environment. This review includes an assessment of the design and effectiveness of our internal control environment, an initiative to improve information technology general controls, and remedial actions needed to address any issues identified in the course of these reviews.

This review is expected to continue throughout 2006 and contemplates the implementation of several planned system enhancements to our accounting, financial reporting and operational infrastructure later in the year. This review will enable us to further evaluate the risk severity of our existing deficiencies and may identify new material weaknesses or other deficiencies. We believe that this process will provide consistency in evaluations and verification of the appropriateness and completeness of our remediation activities. After a control deficiency is identified, the responsible business area is required to establish a remediation plan to address it. Upon achieving milestones in our remediation plans, we will test the results. To provide for financial reporting at the end of 2006, we will conduct an assessment of the existing material weaknesses and deficiencies and remediation activities. We will regularly monitor and report on our remediation progress to senior management, our board of directors, OFHEO and our internal and external auditors.

In order to devote the resources needed to complete the review effectively and return to timely reporting as soon as possible, we have decided to delay our interim financial reporting for 2006. We have also decided to limit the number of initiatives we plan to undertake in 2006 and defer lower priority systems initiatives until we have progressed further with our internal controls. It is our objective to return to quarterly reporting with our release of full-year 2006 financial results. After we resume regular quarterly reporting, we will begin the process of registering our common stock with the SEC.

Our review of the internal control environment and our ongoing control remediation activities are intended to provide a basis for our reliance on our internal control over financial reporting. Our ability to rely on internal controls is essential to our return to timely reporting, because it will alleviate the need to perform substantive procedures to compensate for our material weaknesses and other control deficiencies.

The material weaknesses and significant deficiencies in our internal control over financial reporting adversely affect our ability to record, process, summarize and report financial data in a timely manner. Based on the continued existence of material weaknesses at December 31, 2005, our Chief Executive Officer and President and Chief Operating Officer have concluded that our internal control over financial reporting was not effective at December 31, 2005. In order to compensate for the material weaknesses and other deficiencies in our internal controls, we continue to perform extensive verification and validation procedures to provide reasonable assurance that our consolidated financial statements are prepared in accordance with GAAP. Therefore, in view of the alternative procedures we performed, we believe that these weaknesses do not prevent us from preparing and issuing our consolidated financial statements in accordance with GAAP.

Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that the information required to be disclosed by a company in its financial reports is accumulated and communicated to its senior management team as appropriate to allow timely decisions regarding required disclosure. Full evaluation of our disclosure controls and procedures has been delayed pending our completion of the design and implementation of these controls and procedures and the testing program for evaluating their effectiveness.

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

Our interest-rate risk management objective is to serve our housing mission by protecting shareholder value in all interest-rate environments. Our disciplined approach to interest-rate risk management is essential to maintaining a strong and durable capital base and uninterrupted access to debt and equity capital markets.

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

Our Retained portfolio activities expose us to interest-rate risk and other market risks arising primarily from the uncertainty as to when borrowers will pay the outstanding principal balance of mortgage loans and mortgage-related securities held in the Retained portfolio, known as prepayment risk, and the resulting potential mismatch in the timing of our receipt of cash flows on our assets versus the timing of our obligation to make payments on our liabilities. For the vast majority of our mortgage-related investments, the mortgage borrower has the option to make unscheduled payments of additional principal or to completely pay off a mortgage loan at any time before its scheduled maturity date (without having to pay a prepayment penalty) or to hold the mortgage loan to its stated maturity.

Our credit guarantee activities also expose us to interest-rate risk because changes in interest rates can cause fluctuations in the fair value of our existing credit guarantee portfolio. We generally do not hedge these changes in fair value except for interest-rate exposure related to net buy-ups and float. Float, which arises from timing differences between when the borrower pays us and when we reduce the PC balance, can lead to significant interest expense if the interest rate paid to a PC investor is higher than the reinvestment rate we earn on payments received from mortgage borrowers.

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

**Duration Risk and Convexity Risk.** Duration is a measure of a financial instrument's price sensitivity to changes in interest rates. Convexity is a measure of how much a financial instrument's duration changes as interest rates change. Our convexity risk primarily results from prepayment risk. We actively manage duration risk and convexity risk through asset selection and structuring (that is, by identifying or structuring mortgage-related securities with attractive prepayment and

other characteristics), by issuing a broad range of both callable and non-callable debt instruments and by using interest-rate derivatives. Managing the impact of duration risk and convexity risk is the principal focus of our daily market risk management activities. These risks are encompassed in our PMVS and duration gap risk measures, discussed in greater detail below. We use prepayment models to determine the estimated duration and convexity of mortgage assets for our PMVS and duration gap measures. Expected results can be affected by differences between prepayments forecasted by the models and actual prepayments.

**Yield Curve Risk.** Yield curve risk is the risk that non-parallel shifts in the yield curve (such as a flattening or steepening) will adversely affect shareholder value. Because changes in the shape, or slope, of the yield curve often arise due to changes in the market's expectation of future interest rates at different points along the yield curve, we evaluate our exposure to yield curve risk by examining potential reshaping scenarios at various points along the yield curve. Our yield curve risk under a specified yield curve scenario is reflected in our PMVS-Yield Curve, or PMVS-YC, disclosure.

**Volatility Risk.** Volatility risk is the risk that changes in the market's expectation of the magnitude of future variations in interest rates will adversely affect shareholder value. The market's expectation about the future volatility of interest rates, or implied volatility, is a key determinant of the value of an interest-rate option. Since mortgage assets generally include the borrower's option to prepay a loan without penalty, changes in implied volatility affect the value of mortgage assets. We manage volatility risk through asset selection and by maintaining a consistently high percentage of option-embedded liabilities relative to our mortgage assets. We monitor volatility risk by measuring exposure levels on a daily basis and we maintain internal limits on the amount of volatility risk exposure that is acceptable to us.

**Basis Risk.** Basis risk is the risk that interest rates in different market sectors will not move in tandem and will adversely affect shareholder value. This risk arises principally because we generally hedge mortgage-related investments with debt securities. We do not actively manage the basis risk arising from funding Retained portfolio investments with our debt securities, also referred to as mortgage-to-debt option-adjusted spread risk. See "CONSOLIDATED FAIR VALUE BALANCE SHEETS ANALYSIS — Key Components of Changes in Fair Value of Net Assets — *Changes in mortgage-to-debt OAS*" for additional information.

**Foreign-Currency Risk.** Foreign-currency risk is the risk that fluctuations in currency exchange rates (e.g., foreign currencies to the U.S. dollar) will adversely affect shareholder value. We are exposed to foreign currency risk because we have debt denominated in currencies other than the U.S. dollar, our functional currency. We mitigate foreign-currency risk by entering into swap transactions that effectively convert foreign-denominated obligations into U.S. dollar denominated obligations.

#### ***Portfolio Market Value Sensitivity and Measurement of Interest-Rate Risk***

We employ a risk management strategy that seeks to substantially match the duration characteristics of our assets and liabilities. To accomplish this, we employ an integrated strategy encompassing asset selection and structuring and asset and liability management.

The prepayment option held by mortgage borrowers drives the market value profile of our mortgage assets such that the combined market value of our mortgage assets and non-callable debt will decline if interest rates move significantly in either direction. We mitigate much of our exposure to changes in interest rates by funding a significant portion of our mortgage portfolio with callable debt. When interest rates change, our option to redeem this debt offsets a large portion of the fair value change driven by the mortgage prepayment option. Currently, approximately 60 percent of our fixed-rate mortgage assets are funded and economically hedged with callable debt. However, because the mortgage prepayment option is not fully hedged by callable debt, the combined market value of our mortgage assets and debt will be affected by changes in interest rates.

To further reduce our exposure to changes in interest rates, we hedge a significant portion of the remaining prepayment risk with option-based derivatives. These derivatives primarily consist of call swaptions, which tend to increase in value as interest rates decline, and put swaptions, which tend to increase in value as interest rates increase. With the addition of these option-based derivatives, the market value of stockholders' equity becomes relatively stable over a wide range of interest rates because a greater portion of our prepayment risk has been hedged. The market value of stockholders' equity is further stabilized by our ongoing portfolio rebalancing primarily involving interest-rate swaps. Generally, receive-fixed swaps increase in value as interest rates decline and pay-fixed swaps increase in value as interest rates increase. Although some unhedged exposure to changes in interest rates remains, these exposures are generally well understood, subject to established limits, monitored and controlled through our disciplined risk management process.

We measure our exposure to key interest-rate risks every day against both internal management limits and limits set by our board of directors. Throughout 2005, our interest-rate risk remained low and well below management and board limits.

**PMVS and Duration Gap.** Our primary interest-rate risk measures are PMVS and duration gap. PMVS is measured in two ways, one measuring the estimated sensitivity of our portfolio market value (as defined below) to parallel moves in interest rates (PMVS-L) and the other to nonparallel movements (PMVS-YC). PMVS-L and PMVS-YC are based on the assumption of instantaneous yield curve shifts; therefore neither measure includes the effect on fair value of any rebalancing actions that we would typically take to reduce our risk exposure.

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

While PMVS and duration gap estimate the exposure of the fair value of net assets attributable to common stockholders (measured as fair value of total net assets less the fair value of preferred stock) to changes in interest rates, they do not capture the potential impact of certain other market risks, such as changes in volatility, basis, prepayment model, mortgage-to-debt option-adjusted spreads and foreign-currency risk. The impact of these other market risks can be significant. See “*Sources of Interest-Rate Risk and Other Market Risks*” and “CONSOLIDATED FAIR VALUE BALANCE SHEETS ANALYSIS — Key Components of Changes in Fair Value of Net Assets — *Changes in mortgage-to-debt OAS*” for further information.

- PMVS-L shows the estimated loss in pre-tax portfolio market value, expressed as a percentage of our after-tax fair value of net assets attributable to common stockholders, from an immediate adverse 50 basis point parallel shift in the level of LIBOR rates (that is, when the yield at each point on the LIBOR yield curve increases or decreases by 50 basis points). We believe the use of an immediate 50 basis point shift in the LIBOR yield curve is a conservative estimate of interest-rate risk.
- PMVS-YC shows the estimated loss in pre-tax portfolio market value, expressed as a percentage of our after-tax fair value of net assets attributable to common stockholders, from an immediate adverse 25 basis point change in the slope (up and down) of the LIBOR yield curve. The 25 basis point change in slope for the PMVS-YC measure is obtained by shifting the two-year and ten-year LIBOR rates by an equal amount (12.5 basis points), but in opposite directions. LIBOR rate shifts between the two-year and ten-year points are interpolated.
- Duration gap estimates the net sensitivity of the fair value of our financial instruments to movements in interest rates. Duration gap is presented in units expressed as months. A duration gap of zero implies that the change in value of assets from an instantaneous rate move will be accompanied by an equal and offsetting move in the value of debt and derivatives thus leaving the net fair value of equity unchanged. However, because duration does not capture convexity exposure (the amount by which duration itself changes as rates move), actual changes in fair value from interest-rate changes may differ from those implied by duration gap alone. For that reason, we believe duration gap is most useful when used in conjunction with PMVS.

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

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

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

*PMVS Results.* Table 33 provides estimated point-in-time PMVS-L and PMVS-YC results at December 31, 2005 and 2004. Table 33 also provides year-end PMVS-L estimates assuming an immediate 100 basis point shift in the LIBOR yield curve. Because we do not hedge all prepayment option risk, the duration of our mortgage assets changes more rapidly as changes in interest rates increase. Accordingly, as shown in Table 33, the PMVS-L results based on a 100 basis point shift

in the LIBOR curve are disproportionately higher than the PMVS-L results based on a 50 basis point shift in the LIBOR curve.

**Table 33 — Portfolio Market Value Sensitivity Assuming Shifts of the LIBOR Yield Curve**

	Portfolio Market Value Sensitivity			Potential Pre-Tax Loss in Portfolio Market Value (in millions)		
	PMVS-YC	PMVS-L		PMVS-YC	PMVS-L	
	25 bp	50 bp	100 bp	25 bp	50 bp	100 bp
At:						
December 31, 2005	—%	1%	3%	\$ 26	\$236	\$ 798
December 31, 2004	—%	3%	8%	\$ 25	\$725	\$2,083

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

Table 34 shows that the low PMVS-L risk levels for the periods presented would generally have been higher if we had not used derivatives to manage our interest-rate risk exposure.

**Table 34 — Derivative Impact on PMVS**

	Before Derivatives	After Derivatives	Effect of Derivatives
<b>At December 31, 2005</b>			
PMVS-L (50bp)	2%	1%	(1)%
PMVS-YC (25bp)	—%	—%	—%
<b>At December 31, 2004</b>			
PMVS-L (50bp)	7%	3%	(4)%
PMVS-YC (25bp)	1%	—%	(1)%

*Duration Gap Results.* Our estimated average duration gap for the months of December 2005 and 2004 was zero months and negative one month, respectively.

The disclosure in our Monthly Volume Summary reports, which are available on our website at [www.FreddieMac.com](http://www.FreddieMac.com), reflects the average of the daily PMVS-L, PMVS-YC and Duration Gap estimates for a given reporting period (a month, quarter or year).

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

**Use of Derivatives.** We use derivatives primarily to:

- hedge forecasted issuances of debt and synthetically create callable and non-callable funding;
- regularly adjust or rebalance our funding mix in order to more closely match changes in the interest-rate characteristics of our mortgage assets; and
- hedge foreign-currency exposure (discussed above in “*Sources of Interest-Rate Risk and Other Market Risks — Foreign-Currency Risk.*”)

*Hedge Forecasted Debt Issuances and Create Synthetic Funding.* We typically commit to purchase mortgage investments on an opportunistic basis for a future settlement, typically ranging from two weeks to three months after the date of the commitment. To facilitate larger and more predictable debt issuances that contribute to lower funding costs, we use interest-rate derivatives to economically hedge the interest-rate risk exposure from the time we commit to purchase a mortgage to the time the related debt is issued. We also use derivatives to synthetically create the substantive economic equivalent of various debt funding structures. For example, the combination of a series of short-term debt issuances over a defined longer-term period and a pay-fixed swap with the same maturity as the last issuance is the substantive economic equivalent of a long-term fixed-rate debt instrument of comparable maturity. Similarly, the combination of non-callable debt and a swaption, or option to enter into a receive-fixed swap, with the same maturity as the non-callable debt, is the substantive economic equivalent of callable debt. These derivatives strategies increase our funding flexibility and allow us to better match asset and liability cash flows, often reducing the overall funding costs.

*Adjust Funding Mix.* We generally use interest-rate swaps to mitigate contractual funding mismatches between our assets and liabilities. We also 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. As market conditions dictate, we take rebalancing actions to keep our interest-rate risk exposure within management-set limits. In a declining interest-rate environment, we typically enter into receive-fixed swaps or purchase Treasury-based derivatives to shorten the duration of our funding to offset the declining duration of our mortgage assets. In a rising interest-rate environment, we typically enter into pay-fixed swaps or sell Treasury-based derivatives in order to lengthen the duration of our funding to offset the increasing duration of our mortgage assets.

**Types of Derivatives.** The derivatives we use are common in the financial markets. We principally use the following types of derivatives:

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

In addition to swaps, futures and options, our derivative positions include the following:

*Forward Purchase and Sale Commitments.* We routinely enter into forward purchase and sale commitments for mortgage loans and mortgage-related securities. Most of these commitments are derivatives subject to the requirements of SFAS 133.

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

*Prepayment Management Agreement.* Beginning in 2002, we required that certain mortgage pools delivered to us between 2001 and 2003, which we considered to pose an elevated risk of prepayment, be covered by a prepayment management agreement to partially compensate us for the adverse financial impacts caused by disproportionately higher mortgage prepayments. We also offered an incentive through an adjusted guarantee fee level on certain mortgage deliveries when the prepayment experience of the mortgage pools was within defined ranges. Effective December 31, 2005, we agreed to an early termination of this prepayment management agreement.

*Credit Derivatives.* See "Credit Risks — Mortgage Credit Risk — Mortgage Credit Risk Management Strategies" for more information.

#### **Derivative-Related Risks**

Our use of derivatives exposes us to derivative market liquidity risk and counterparty credit risk.

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

We limit our duration and convexity exposure to each counterparty. At December 31, 2005, the largest single uncollateralized exposure of our 25 approved OTC counterparties listed in "Table 35 — Derivative Counterparty Credit Exposure" was related to a AAA-rated counterparty, constituting \$93 million, or 49 percent, of the total uncollateralized exposure of our OTC interest-rate swaps, option-based derivatives and foreign-currency swaps.

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

We actively manage our exposure to counterparty credit risk using several tools, including:

- review of external rating analyses;
- strict standards for approving new derivative counterparties;
- ongoing monitoring of our positions with each counterparty by type of derivative;

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

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

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

*Master Netting and Collateral Agreements.* We use master netting and collateral agreements to reduce our credit risk exposure to our active OTC derivative counterparties for interest-rate swaps, option-based derivatives and foreign-currency swaps. See “NOTE 17: CONCENTRATION OF CREDIT AND OTHER RISKS” to our consolidated financial statements for additional information.

Table 35 summarizes our exposure to counterparty credit risk in our derivatives, which represents the net positive fair value of derivative contracts and related accrued interest after netting by counterparty as applicable (*i.e.*, net amounts due to us under derivative contracts). This table is useful in understanding the credit risk related to our derivative portfolio.

**Table 35 — Derivative Counterparty Credit Exposure**

December 31, 2005						
Rating <sup>(1)</sup>	Number of Counterparties <sup>(2)</sup>	Notional Amount	Total Exposure at Fair Value <sup>(3)</sup>	Exposure, Net of Collateral <sup>(4)</sup>	Weighted Average Contractual Maturity (in years)	Collateral Posting Threshold
(dollars in millions)						
AAA	2	\$ 3,102	\$ 93	\$ 93	2.7	Mutually agreed upon
AA	7	148,135	619	16	4.3	\$10 million or less
AA-	8	156,058	2,499	73	5.8	\$10 million or less
A+	5	227,842	5,297	2	5.8	\$1 million or less
A	2	24,879	364	5	4.0	\$1 million or less
A-	1	210	3	1	6.0	\$1 million or less
Subtotal <sup>(5)</sup>	25	560,226	8,875	190	5.3	
Other derivatives <sup>(6)</sup>		98,033	—	—		
Commitments		21,961	35	35		
Credit derivative		2,414	—	—		
Swap guarantee derivatives		738	—	—		
Total derivatives		<u>\$683,372</u>	<u>\$8,910</u>	<u>\$225</u>		
December 31, 2004						
Rating <sup>(1)</sup>	Number of Counterparties <sup>(2)</sup>	Notional Amount	Total Exposure at Fair Value <sup>(3)</sup>	Exposure, Net of Collateral <sup>(4)</sup>	Weighted Average Contractual Maturity (in years)	Collateral Posting Threshold
(dollars in millions)						
AAA	2	\$ 3,041	\$ 498	\$498	2.5	Mutually agreed upon
AA+	1	597	399	32	23.9	\$10 million or less
AA	5	110,692	3,096	25	4.4	\$10 million or less
AA-	7	135,041	5,199	36	5.2	\$10 million or less
A+	6	153,867	6,505	—	5.1	\$1 million or less
A	3	56,530	1,478	8	5.1	\$1 million or less
A-	1	210	11	2	7.0	\$1 million or less
Subtotal <sup>(5)</sup>	25	459,978	17,186	601	5.0	
Other derivatives <sup>(6)</sup>		138,822	—	—		
Prepayment management agreement		113,692	—	—		
Commitments		32,952	40	40		
Credit derivatives		10,926	—	—		
Swap guarantee derivatives		408	—	—		
Total derivatives		<u>\$756,778</u>	<u>\$17,226</u>	<u>\$641</u>		

(1) We use the lower of S&P and Moody's ratings to manage collateral requirements. In this table, the rating of the legal entity is stated in terms of the S&P equivalent.

(2) Based on legal entities. Affiliated legal entities are reported separately.

(3) For each counterparty, this amount includes derivatives with a net positive fair value (recorded as Derivative assets, at fair value) including the related accrued interest receivable/payable (net) (recorded in Accounts and other receivables, net and Accrued interest payable).

(4) Total Exposure at Fair Value less collateral held as determined at the counterparty level.

(5) Consists of OTC derivative agreements for interest-rate swaps, option-based derivatives, excluding written options, foreign-currency swaps and purchased interest-rate caps. Written options do not present counterparty credit exposure, because we receive a one-time up-front premium in exchange for giving the holder the right to execute a contract under specified terms, which generally puts us in a liability position.

(6) Consists primarily of exchange-traded contracts.

Over time, our exposure to individual counterparties for OTC interest-rate swaps, option-based derivatives and foreign-currency swaps varies depending on changes in fair values which are affected by changes in period-end interest rates, the implied volatility of interest rates, foreign-currency exchange rates and the amount of derivatives held. Our uncollateralized exposure to counterparties for these derivatives, after applying netting agreements and collateral, decreased to \$190 million at December 31, 2005 from \$601 million at December 31, 2004. This decrease was due to a significant decrease in uncollateralized exposure to AAA-rated counterparties, which typically are not required to post collateral given their low risk profile.

At December 31, 2005, the uncollateralized exposure to non-AAA-rated counterparties was due to uncollateralized exposure below the applicable counterparty posting threshold as well as market movements during the time period between when a derivative was marked to fair value and the date we received the related collateral.

As indicated in Table 35, approximately 98 percent of our counterparty credit exposure for OTC interest-rate swaps, option-based derivatives and foreign-currency swaps was collateralized at December 31, 2005. In the event that all of our

counterparties for these derivatives were to have defaulted simultaneously on December 31, 2005, our maximum loss for accounting purposes would have been approximately \$190 million. Our economic loss, as measured by our potential additional uncollateralized exposure, may be higher than the uncollateralized exposure of our derivatives if we were not able to replace the defaulted derivatives in a timely fashion. We monitor the risk that our uncollateralized exposure to each of our OTC counterparties for interest-rate swaps, option-based derivatives and foreign-currency swaps will increase under certain adverse market conditions by performing daily market stress tests. These tests evaluate the potential additional uncollateralized exposure we would have to each of these derivative counterparties assuming changes in the level and implied volatility of interest rates and changes in foreign-currency exchange rates over a brief time period.

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

*OTC Forward Purchase and Sale Commitments Treated as Derivatives.* Since the typical maturity for our OTC commitments is less than one year, we do not require master netting and collateral agreements for the counterparties of these commitments. However, we monitor the credit fundamentals of our OTC commitments counterparties on an ongoing basis to ensure that they continue to meet our internal risk-management standards. As indicated in Table 35, the exposure to OTC commitments counterparties of \$35 million and \$40 million at December 31, 2005 and 2004, respectively, was uncollateralized.

## **Credit Risks**

Our credit guarantee portfolio is subject primarily to two types of credit risk — mortgage credit risk and institutional credit risk. Mortgage credit risk is the risk that a borrower will fail to make timely payments on a mortgage or security we own or guarantee. Institutional credit risk is the risk that a counterparty that has entered into a business contract or arrangement with us will fail to meet its obligations. See “Table 46 — Total Mortgage Portfolio and Total Guaranteed PCs and Structured Securities Issued Based on Unpaid Principal Balances” for more information on the composition of our Total mortgage portfolio.

### ***Mortgage Credit Risk***

**Mortgage Credit Risk Management Strategies.** Mortgage credit risk is primarily influenced by the credit profile of the borrower on the mortgage, the features of the mortgage itself, the type of property securing the mortgage and by the general economy, especially the movement of house prices. To manage our mortgage credit risk, we focus on three key areas: underwriting requirements and quality control standards; portfolio diversification; and portfolio management activities, including loss mitigation, and the use of credit enhancements and credit risk transfers. While we have historically focused on obtaining credit enhancements at the time of mortgage purchase, we are continuing to expand our capabilities in this area to allow more active and ongoing credit portfolio rebalancing and risk transfers.

**Underwriting Requirements and Quality Control Standards.** All mortgages that we purchase or guarantee have an inherent risk of default. We seek to manage the underlying risk in a given mortgage we securitize or purchase for our Retained portfolio by adequately pricing for the risk we assume using our underwriting and quality control processes. We use a process of delegated underwriting for the single-family mortgages we purchase or securitize. In this process, we provide originators with a series of mortgage underwriting guidelines and they represent and warrant to us that the mortgages sold to us meet these guidelines. We subsequently review a sample of these loans and, if we determine that any loan is not in compliance with our underwriting standards, we may require the seller/servicer to repurchase that mortgage or make us whole in the event of a default. We provide originators with written standards and/or automated underwriting software tools, such as Loan Prospector® and other quantitative credit risk management tools that are designed to evaluate single-family mortgages and monitor the related mortgage credit risk for loans we may purchase. Loan Prospector® generates a credit risk classification by evaluating information on significant indicators of mortgage default risk, such as loan-to-value ratios, credit scores and other mortgage and borrower characteristics. These statistically-based risk assessment tools increase our ability to distinguish among single-family loans based on their expected risk, return and importance to our mission. We may allow seller/servicers to underwrite mortgages for sale to us using other automated underwriting systems and agreed-upon underwriting standards that differ from our normal standards.

The percentage of our single-family mortgage purchase volume evaluated using Loan Prospector® prior to purchase has declined over the last three years. As part of our post-purchase quality control review process, we use Loan Prospector® to evaluate the credit quality of virtually all single-family mortgages that were not evaluated by Loan Prospector® prior to purchase. Loan Prospector® risk classifications influence both the price we charge to guarantee loans and the loans we review in quality control.

We have been expanding the share of mortgages we purchase that were underwritten and originated using alternative automated underwriting systems, which could increase our credit risk. We regularly monitor the performance of mortgages purchased using these systems and if they underperform mortgages originated using Loan Prospector we may seek additional compensation for guaranteeing such mortgages in the future.

For multifamily mortgage loans, unless the mortgage loans have significant credit enhancements, we use an intensive pre-purchase underwriting process for the mortgages we purchase. Our underwriting process includes assessments of the local market, the borrower, the property manager, the property's historical and projected financial performance and the property's physical condition, which may include a physical inspection of the property. In addition to our own inspections, we rely on third-party appraisals and environmental and engineering reports.

**Credit Enhancements.** Our charter requires that single-family mortgages with loan-to-value ratios above 80 percent at the time of purchase must be covered by one or more of the following: (a) primary mortgage insurance; (b) a seller's agreement to repurchase or replace any mortgage in default (for such period and under such circumstances as we may require); or (c) retention by the seller of at least a ten percent participation interest in the mortgages. In addition, for some mortgage loans, we elect to share the default risk by transferring a portion of that risk to various third parties through a variety of other credit enhancements. In many cases, the lender's or third party's risk is limited to a specific level of losses at the time the credit enhancement becomes effective. At December 31, 2005 and 2004, credit-enhanced single-family mortgages and mortgage-related securities represented approximately 17 percent and 19 percent of the \$1,395 billion and \$1,267 billion, respectively, unpaid principal balance of the Total mortgage portfolio, excluding non-Freddie Mac mortgage-related securities and that portion of issued Structured Securities that is backed by Ginnie Mae Certificates. We exclude non-Freddie Mac mortgage-related securities because they expose us primarily to institutional credit risk. We exclude that portion of Structured Securities backed by Ginnie Mae Certificates because the incremental credit risk to which we are exposed is considered de minimis. See "CONSOLIDATED BALANCE SHEETS ANALYSIS — Table 17 — Characteristics of Mortgage Loans and Mortgage-Related Securities in the Retained Portfolio" for additional information about our non-Freddie Mac mortgage-related securities. Our ability and desire to expand the portion of our Total mortgage portfolio with credit enhancements will depend on our evaluation of the credit quality of new business purchase opportunities, the risk profile of our portfolio and the future availability of effective credit enhancements at prices that permit an attractive return. While the use of credit enhancements reduces our exposure to mortgage credit risk, it increases our exposure to institutional credit risk.

Primary mortgage insurance is the most prevalent type of credit enhancement protecting our Total mortgage portfolio and is typically provided on a loan-level basis for certain single-family mortgages. Primary mortgage insurance transfers varying portions of the credit risk associated with a mortgage to a third-party insurer. The amount of insurance we obtain on any mortgage depends on our requirements, which depend on our assessment of risk. We may from time to time agree with the insurer to reduce the amount of coverage that is in excess of our charter's minimum requirement and may also furnish certain services to the insurer in exchange for fees paid by the insurer. As is the case with credit enhancement agreements generally, these agreements often improve the overall value of purchased mortgages and thus may allow us to offer lower guarantee fees to sellers.

After primary mortgage insurance, the most prevalent type of credit enhancement that we use is pool insurance. With pool insurance, a mortgage insurer provides insurance on a pool of loans up to a stated aggregate loss limit. In addition to a pool-level loss coverage limit, some pool insurance contracts may have limits on coverage at the loan level. For pool insurance contracts that expire before the completion of the contractual term of the mortgage loan, we seek to ensure that the contracts cover the period of time during which we believe the mortgage loans are most likely to default.

Other forms of credit enhancements on single-family mortgage loans include indemnification agreements (under which we may require a lender to reimburse us for credit losses realized on mortgages), government guarantees, collateral (including cash or high-quality marketable securities) pledged by a lender and subordinated security structures.

For multifamily mortgages, we occasionally use credit enhancements to mitigate risk. The types of credit enhancements used for multifamily mortgage loans include recourse, third-party guarantees or letters of credit, cash escrows, subordinated participations in mortgage loans or structured pools, and cross-default and cross-collateralization provisions. Cross-default and cross-collateralization provisions typically work in tandem. With a cross-default provision, if the loan on a property goes into default, we have the right to declare specified other mortgage loans of the same borrower or certain of its affiliates to be in default and to foreclose those other mortgages. In cases where the borrower agrees to cross-collateralization, we have the additional right to apply excess proceeds from the foreclosure of one mortgage to amounts owed to us by the same borrower or its specified affiliates relating to other multifamily mortgage loans we own. For information about our maximum coverage in regards to these credit enhancements, see "NOTE 4: FINANCIAL GUARANTEES" to our consolidated financial statements. We also receive similar credit enhancements for multifamily PC Guarantor Swaps; for tax-exempt multifamily

housing revenue bonds that support pass-through certificates issued by third parties for which we provide our guarantee of the payment of principal and interest; for Freddie Mac pass-through certificates that are backed by tax-exempt multifamily housing revenue bonds and related taxable bonds and/or loans; and for multifamily mortgage loans that are originated and held by the state and municipal agencies to support tax-exempt multifamily housing revenue bonds for which we provide our guarantee of the payment of principal and interest.

**Portfolio Diversification.** A key characteristic of our credit risk portfolio is diversification along a number of critical risk dimensions. We continually monitor a variety of mortgage loan characteristics such as product mix, loan-to-value ratios and geographic concentration, which may affect the default experience on our overall mortgage portfolio. As part of our risk management practices, we have adopted a set of limits on our purchases and holdings of certain types of loans that are deemed to have higher risks, including interest-only loans, Option ARMs, loans with high loan-to-value ratios, and mortgages originated with limited or no underwriting documentation.

Table 36 provides the distribution of our Total mortgage portfolio.

**Table 36 — Total Mortgage Portfolio Distribution<sup>(1)(2)</sup>**

	December 31,	
	2005	2004
(dollars in millions)		
<b>Balances related to:</b>		
Guaranteed PCs and Structured Securities:		
Single-family .....	\$1,294,521	\$1,173,847
Multifamily .....	14,503	15,546
Structured Securities backed by non-Freddie Mac mortgage-related securities .....	26,500	19,575
Mortgage loans in the Retained Portfolio:		
Single-Family .....	20,396	23,389
Multifamily .....	41,085	37,971
Total Unpaid Principal Balance .....	<u>\$1,397,005</u>	<u>\$1,270,328</u>
<b>Product Distribution</b>		
<i>Single-family</i>		
30-year fixed .....	59%	56%
15-year fixed .....	23	28
ARMS/Variable-rate .....	8	8
Option ARMS <sup>(3)</sup> .....	1	—
Interest only <sup>(4)</sup> .....	2	—
Balloon/Resets .....	2	3
Other <sup>(5)</sup> .....	1	1
<i>Total single-family</i> .....	<u>96</u>	<u>96</u>
<i>Multifamily</i> .....	<u>4</u>	<u>4</u>
<b>Total</b> .....	<u>100%</u>	<u>100%</u>

(1) Based on unpaid principal balances.

(2) Excludes non-Freddie Mac mortgage-related securities other than those that underlie Structured Securities.

(3) Represents loans that may expose the borrower to future increases in the loan obligation in excess of increases that result solely from contractual interest-rate adjustments. Includes mortgage loans we purchased that underlie the guaranteed portion of whole-loan REMICs and that portion of alternative collateral deals that are backed by negative amortization loans.

(4) Represents loans where the borrower pays only interest for a period of time before the loan begins to amortize.

(5) Represents alternative collateral deals that include Structured Securities backed by non-agency securities, which were backed by FHA/VA and subprime mortgage loans primarily, and Structured Securities backed by Ginnie Mae securities.

Product mix affects the credit risk profile of our Total mortgage portfolio. In general, 15-year fixed-rate mortgages exhibit the lowest default rate among the types of mortgage loans we securitize and purchase, due to the accelerated rate of principal amortization on these mortgages and the credit profiles of borrowers who seek and qualify for them. The next lowest rate of default is associated with 30-year fixed-rate mortgages. Balloon/reset mortgages and ARMs typically default at a higher rate than fixed-rate mortgages, although default rates for different types of ARMs may vary. While ARMs are typically originated with interest rates that are initially lower than those available for fixed-rate mortgages, their interest rates also change over time based on changes in an index or reference interest rate. As a result, the borrower's payments may rise or fall, within limits, as interest rates change. As payment amounts increase, the risk of default also increases. In the low interest rate environment experienced during 2005, 2004 and 2003, this trend was reversed with ARMs exhibiting lower default rates than fixed-rate mortgages.

During 2005 and 2004, there was a rapid proliferation of alternative product types designed to address a variety of borrower needs, including issues of affordability and lack of income documentation. While each of these products has been on the market for some time, their prevalence increased in 2005 and 2004. We expect each of these products to default more often than traditional products and we consider this when determining our guarantee fee. Our purchases of interest-only and Option ARM mortgage products increased in 2005, representing approximately 11 percent of our Total mortgage portfolio purchases as compared to 2 percent in 2004, and we expect this trend to continue in 2006. Despite this recent

increase in purchases, these products represent a small percentage of the unpaid principal balance of our Total mortgage portfolio. At December 31, 2005 and 2004, interest-only and option ARMs collectively represented approximately 3 percent and less than 1 percent, respectively, of the unpaid principal balance of the Total mortgage portfolio. We will continue to monitor the growth of these products in our portfolio and, if appropriate, may seek credit enhancements to further manage the incremental risk.

We also hold securities issued by third parties where the underlying collateral may include interest-only and Option ARM mortgage products. We generally mitigate credit risk inherent in these securities through a guarantee from the third party issuer or the underlying structure of the security. For additional information about the credit quality and credit risk management of non-Freddie Mac securities we hold see “*Institutional Credit Risk — Non-Freddie Mac Mortgage-Related Securities*” and “MD&A — CONSOLIDATED BALANCE SHEETS ANALYSIS — Retained Portfolio.”

The subprime segment of the mortgage market primarily serves borrowers with lower quality credit payment histories. Our participation in this market helps reduce barriers to homeownership for these borrowers by increasing the availability of mortgage credit and reducing the costs of homeownership. We participate in the subprime market segment primarily in two ways. First, our Retained portfolio makes investments in non-Freddie Mac mortgage-related securities that were originated in this market segment. Substantially all of these securities were rated “AAA” by one or more rating agencies at the time of purchase. Second, we guarantee securities backed by subprime mortgages, which comprise a portion of the “alternative collateral deals” we purchase. These securities have previously been credit enhanced and at the time of our purchase most were “shadow rated” at least “BBB” (based on the S&P rating scale) by at least one nationally recognized credit rating agency which assessed the credit risks of the securities without regard to the benefits of our guarantee. At December 31, 2005 and 2004, we guaranteed \$2.3 billion and \$4.5 billion of securities backed by subprime mortgages which constituted less than one percent of our Total mortgage portfolio, respectively. In addition to the non-Freddie Mac mortgage-related securities discussed above, we make investments through our Retained portfolio in some of the Structured Securities we issue with underlying collateral that is subprime.

The distribution of the single-family loans underlying our Total mortgage portfolio by original and estimated current loan-to-value ratio, credit scores, loan purpose, property type and occupancy type is shown in Table 37.

**Table 37 — Characteristics of Single-Family Total Mortgage Portfolio<sup>(1)</sup>**

<u>Original Loan-to-Value, or LTV, Ratio Range<sup>(2)</sup></u>	<u>Purchases During the Year Ended December 31,</u>			<u>Ending Balance December 31,</u>		
	<u>2005</u>	<u>2004</u>	<u>2003</u>	<u>2005</u>	<u>2004</u>	<u>2003</u>
Less than 60% . . . . .	21%	23%	29%	25%	26%	26%
Above 60% to 70% . . . . .	16	16	19	17	17	17
Above 70% to 80% . . . . .	50	46	40	44	42	41
Above 80% to 90% . . . . .	7	8	7	8	9	9
Above 90% to 95% . . . . .	4	6	4	5	5	6
Above 95% . . . . .	2	1	1	1	1	1
Total . . . . .	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>
Weighted average original loan-to-value ratio . . . . .	71%	71%	68%	70%	70%	70%
<u>Estimated Current LTV Ratio Range<sup>(3)</sup></u>						
Less than 60% . . . . .				57%	53%	44%
Above 60% to 70% . . . . .				17	19	20
Above 70% to 80% . . . . .				18	18	23
Above 80% to 90% . . . . .				6	7	9
Above 90% to 95% . . . . .				1	2	3
Above 95% . . . . .				1	1	1
Total . . . . .				<u>100%</u>	<u>100%</u>	<u>100%</u>
Weighted average estimated current LTV ratio . . . . .				55%	57%	61%
<u>Credit Score<sup>(4)</sup></u>						
740 and above . . . . .	44%	41%	49%	45%	44%	44%
700 to 739 . . . . .	23	24	23	23	23	23
660 to 699 . . . . .	19	20	17	18	18	17
620 to 659 . . . . .	10	11	8	9	9	9
Less than 620 . . . . .	4	4	3	4	4	4
Not Available . . . . .	—	—	—	1	2	3
Total . . . . .	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>
Weighted average credit score . . . . .	722	719	729	725	723	723
<u>Loan Purpose</u>						
Purchase . . . . .	44%	40%	19%	32%	28%	25%
Cash-out refinance . . . . .	35	27	26	29	27	26
Other refinance . . . . .	21	33	55	39	45	49
Total . . . . .	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>
<u>Property Type</u>						
1 unit . . . . .	97%	97%	98%	97%	97%	97%
2-4 units . . . . .	3	3	2	3	3	3
Total . . . . .	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>
<u>Occupancy Type</u>						
Primary residence . . . . .	91%	92%	95%	93%	94%	94%
Second/vacation home . . . . .	5	4	3	4	3	3
Investment . . . . .	4	4	2	3	3	3
Total . . . . .	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>

(1) Purchases and ending balances are based on the unpaid principal balance of the single-family mortgage portfolio (excluding non-Freddie Mac mortgage-related securities, alternative collateral deals that are not backed by prime mortgage loans and that portion of Structured Securities that is backed by Ginnie Mae Certificates). Such purchases totaled \$396 billion, \$360 billion and \$701 billion at December 31, 2005, 2004 and 2003, respectively. Such ending balances totaled \$1,333 billion, \$1,203 billion and \$1,151 billion at December 31, 2005, 2004 and 2003, respectively.

(2) Our charter requires that mortgage loans purchased with loan-to-value ratios above 80 percent be covered by mortgage insurance or other credit enhancements.

(3) Current market values are estimated by adjusting the value of the property at origination based on changes in the market value of house prices since origination. Estimated current LTV excludes alternative collateral deals and Option ARMs. Estimated current LTV ratio range is not applicable to purchases made during the year.

(4) Credit score data are as of mortgage loan origination.

*Loan-to-Value Ratios.* Our principal safeguard against credit losses for mortgage loans in our single-family, non-credit-enhanced portfolio is provided by the borrowers' equity in the underlying properties. Mortgage loans with higher loan-to-value ratios (and therefore lower levels of borrower equity) at the time of purchase are also protected by credit enhancements, since our charter requires that loans with loan-to-value ratios above 80 percent at the time of purchase be covered by mortgage insurance or certain other credit protections.

The likelihood of single-family mortgage default depends not only on the initial credit quality of the loan, but also on events that occur after origination. Accordingly, we monitor changes in house prices across the country and the impact of these house price changes on the underlying loan-to-value ratio of mortgages in our portfolio. House prices have risen significantly over the last 10 years, and have grown very dramatically over the last four years. This house price appreciation

has increased the values of properties underlying the mortgages in our portfolio. We monitor regional geographic markets for changes in these trends, particularly with respect to new loans originated in regional markets that have had significant house price appreciation, and may seek to reinsure a portion of this risk should we determine that the possibility of such changes warrants action. Historical experience has shown that defaults are less likely to occur on mortgages with lower estimated current loan-to-value ratios. Furthermore, in the event of a default, increases in house prices generally reduce the total amount of loss, thereby mitigating credit losses.

**Credit Score.** Credit scores are a useful measure for assessing the credit quality of a borrower. Credit scores are numbers reported by credit repositories, based on statistical models, that summarize an individual's credit record and predict the likelihood that a borrower will repay future obligations as expected. FICO® scores, developed by Fair, Isaac and Co., Inc., are the most commonly used credit scores today. FICO scores are ranked on a scale of approximately 300 to 850 points. Statistically, consumers with higher credit scores are more likely to repay their debts as expected than those with lower scores. The weighted average credit score for the Total mortgage portfolio (based on the credit score at origination) remained high at 725 at December 31, 2005 and 723 at both December 31, 2004 and 2003, indicating borrowers with strong credit quality.

**Loan Purpose.** Mortgage loan purpose indicates how the borrower intends to use the funds from a mortgage loan. The three general categories are: purchase, cash-out refinance, or other refinance. In a purchase transaction, funds are used to acquire a property. In a cash-out refinance transaction, in addition to paying off an existing first mortgage lien, the borrower obtains additional funds that may be used for other purposes, including paying off subordinate mortgage liens and providing unrestricted cash proceeds to the borrower. In other refinance transactions, the funds are used to pay off an existing first mortgage lien and may be used in limited amounts for certain specified purposes; such refinances are generally referred to as "no cash-out" or "rate and term" refinances. Other refinance transactions also include refinance mortgages for which the delivery data provided was not sufficient for us to determine whether the mortgage was a cash-out or a no cash-out refinance transaction. Given similar loan characteristics (e.g., loan-to-value ratios), purchase transactions have the lowest likelihood of default followed by no-cash out refinances and then cash out refinances. As a practical matter, however, no-cash out refinances tend to have lower loan-to-value ratios and borrowers with higher credit scores than purchase transactions and as such, have better overall performance than purchase transactions.

**Property Type.** Single-family mortgage loans are defined as mortgages secured by housing with up to four living units. Mortgages on one-unit properties tend to have lower credit risk than mortgages on multiple-unit properties.

**Occupancy Type.** Borrowers may purchase a home as a primary residence, second/vacation home or investment property that is typically a rental property. Mortgage loans on properties occupied by the borrower as a primary or secondary residence tend to have a lower credit risk than mortgages on investment properties.

**Geographic Concentration.** Since our business involves purchasing mortgages from every geographic region in the U.S., we maintain a geographically diverse mortgage portfolio. This diversification generally mitigates credit risks arising from changing local economic conditions. See "NOTE 17: CONCENTRATION OF CREDIT AND OTHER RISKS" to our consolidated financial statements for more information concerning the distribution of our Total mortgage portfolio by geographic region. Our Total mortgage portfolio's geographic distribution was relatively stable from 2003 to 2005, and remains broadly diversified across these regions.

**Loss Mitigation Activities.** Within our Total mortgage portfolio, we expect and price for some mortgage loans to become non-performing due to changes in general economic conditions, changes in the financial status of individual borrowers or other factors. Table 38 summarizes our non-performing assets. The increase in our non-performing assets from 2001 through 2003 was primarily driven by higher delinquencies associated with our alternative collateral deals. While these delinquencies result in higher levels of non-performing assets, we have limited loss exposure due to the credit enhancements associated with these securities. The increase in our troubled debt restructurings from 2004 to 2005 was primarily related to multifamily loans impacted by Hurricane Katrina. At December 31, 2005, troubled debt restructurings as shown in Table 38 included multifamily loans affected by Hurricane Katrina with unpaid principal balances totaling approximately \$210 million.

**Table 38 — Non-Performing Assets**

	December 31,				
	2005	2004	2003	2002	2001
	(in millions)				
Troubled debt restructurings <sup>(1)</sup> .....	\$2,605	\$2,297	\$ 2,370	\$2,164	\$1,617
Serious delinquencies <sup>(2)</sup> .....	6,438	6,318	7,470	6,830	5,070
Non-accrual loans <sup>(3)</sup> .....	1	27	21	47	44
Subtotal <sup>(4)</sup> .....	9,044	8,642	9,861	9,041	6,731
REO, net <sup>(5)</sup> .....	629	741	795	594	447
Total .....	<u>\$9,673</u>	<u>\$9,383</u>	<u>\$10,656</u>	<u>\$9,635</u>	<u>\$7,178</u>

- (1) Includes previously delinquent loans whose terms have been modified. Some of these loans may be performing as a result of the modified terms. Troubled debt restructurings are considered part of our impaired loan population. Figures presented are based on unpaid principal balances of mortgage loans. See "NOTE 6: LOAN LOSS RESERVES" to the consolidated financial statements for additional information on impaired loans.
- (2) Includes single-family loans 90 days or more delinquent. For multifamily loans, the population includes all loans 60 days or more delinquent, but less than 90 days delinquent. Also included within this population are multifamily loans greater than 90 days past due but where principal and interest are being paid to us under the terms of a credit enhancement agreement. Also includes seriously delinquent loans in alternative collateral deals, which totaled \$1,449 million, \$2,234 million, \$2,793 million, \$2,290 million and \$1,052 million at December 31, 2005, 2004, 2003, 2002 and 2001, respectively. For more information about delinquency rates, see "NOTE 6: LOAN LOSS RESERVES — Table 6.3 — Delinquency Performance" to the consolidated financial statements.
- (3) Non-accrual mortgage loans are loans for which interest income is recognized only on a cash basis and only includes multifamily loans that are 90 days or more delinquent. No single-family mortgage loans are classified as non-accrual.
- (4) For the year ended December 31, 2005, \$481 million was included in net interest income and management and guarantee income related to these mortgage loans (excluding interest income related to alternative collateral deals). The amount of forgone net interest income and additional management and guarantee income that we would have recorded had these loans been current is \$140 million for the year ended December 31, 2005.
- (5) For more information about REO balances, see "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES" and "NOTE 7: REAL ESTATE OWNED" to the consolidated financial statements.

Loss mitigation activities are a key component of our strategy for managing and resolving troubled assets and lowering credit losses. Our loss mitigation strategy emphasizes early intervention in delinquent mortgages and alternatives to foreclosure. Other single-family loss mitigation activities include providing our single-family servicers with default management tools designed to help them manage non-performing loans more effectively. Foreclosure alternatives are intended to reduce the number of delinquent mortgages that proceed to foreclosure and, ultimately, mitigate our total credit losses by eliminating a portion of the costs related to foreclosed properties. Repayment plans, the most common type of foreclosure alternative, mitigate our credit losses because they assist borrowers in returning to compliance with the original terms of their mortgages. Loan modifications, the second most common type of foreclosure alternative, involve changing the terms of a mortgage and therefore are a more favorable alternative to the borrower during a declining interest-rate environment. Forbearance agreements, the third most common type of foreclosure alternative, provide a temporary suspension of the foreclosure process to allow additional time for the borrower to return to compliance with the original terms of the borrower's mortgage or to implement another foreclosure alternative. The total number of loans with foreclosure alternatives was approximately 60,000, 48,300 and 46,900 for the years ended December 31, 2005, 2004 and 2003, respectively. The increase in foreclosure alternatives in 2005 was primarily driven by forbearance agreements related to single-family loans affected by Hurricane Katrina.

We require multifamily servicers to closely manage mortgage loans they have sold us in order to mitigate potential losses. Generally, on an annual basis, for loans over \$1 million, servicers must submit an assessment of the mortgaged property to us based on the servicer's analysis of financial and other information about the property and, except for certain higher performing loans, an inspection of the property. We evaluate these assessments internally and may direct the servicer to take specific actions to reduce the likelihood of delinquency or default. If a loan defaults despite this intervention, we may offer a foreclosure alternative to the borrower. For example, we may modify the terms of a multifamily mortgage loan, which gives the borrower an opportunity to bring the loan current and allows the borrower to retain ownership of the property. Since multifamily seller/servicers are an important part of our loss mitigation process, we rate their performance regularly and conduct on-site reviews of their servicing operations to confirm compliance with our standards.

**Other Credit Risk Management Activities.** We purchase a broad range of mortgage products with differing degrees of default risk. To compensate us for unusual levels of risk in some mortgage products we may charge incremental fees above a base guarantee fee calculated based on credit risk factors such as the mortgage product type, loan purpose, loan-to-value ratio, and other loan or borrower attributes. In addition, we occasionally use financial incentives and credit derivatives, as described below, in situations where we believe they will benefit our credit risk management strategy. These arrangements are intended to reduce our credit-related expenses and to help us manage purchase quality, thereby improving our overall returns.

In some cases, we provide financial incentives in the form of lump sum payments to selected seller/servicers if they deliver a specified volume or percentage of mortgage loans meeting specified credit risk standards over a defined period of

time. These financial incentives may also take the form of a fee payable to us by the seller if the mortgages delivered to us do not meet certain credit standards.

We have also entered into risk-sharing agreements. Under these agreements, default losses on specific mortgage loans delivered by sellers are compared to default losses on reference pools of mortgage loans with similar characteristics. Based upon the results of that comparison, we remit or receive payments based upon the default performance of the specified mortgage loans. These agreements are accounted for as credit derivatives rather than financial guarantees, in part, because we may make payments to the seller/servicer under these agreements (depending upon actual default experience over the lives of the mortgages). The total notional amount of mortgage loans subject to these agreements was approximately \$2.4 billion and \$10.9 billion at December 31, 2005 and 2004, respectively. These risk-sharing agreements are derivatives classified as no hedge designation, with changes in fair value recorded as Derivative gains (losses) on the consolidated statements of income. The fair value of these risk-sharing agreements is recorded in Derivative assets, at fair value and Derivative liabilities, at fair value on the consolidated balance sheets, with net amounts of \$(1) million and \$(2) million at December 31, 2005 and 2004, respectively.

Although these arrangements are part of our overall credit risk management strategy, we have not treated them as credit enhancements for purposes of describing our Total mortgage portfolio characteristics because the financial incentive and credit derivative agreements may result in us making payments to the seller/servicer.

**Credit Performance.** Credit losses are a useful indicator of credit risk management activities; however, they must ultimately be considered relative to the revenue received for assuming the underlying credit risk. Several key statistics associated with potential and actual credit losses are detailed in the tables below.

*Delinquencies.* Table 39 presents delinquency information for the single-family loans underlying our Total mortgage portfolio.

**Table 39 — Single-Family — Delinquency Rates — By Region**<sup>(1)(2)(3)</sup>

	December 31,		
	2005	2004	2003
Northeast .....	0.22%	0.24%	0.28%
Southeast .....	0.38	0.31	0.32
North central .....	0.30	0.27	0.27
Southwest .....	0.64	0.26	0.28
West .....	0.11	0.15	0.19
Total non-credit-enhanced — all regions .....	0.30	0.24	0.27
Total credit-enhanced — all regions .....	2.46	2.75	2.96
Total credit-enhanced and non-credit-enhanced — all regions .....	0.69%	0.73%	0.86%

(1) Based on mortgage loans in the Retained portfolio and Total Guaranteed PCs and Structured Securities Issued, excluding that portion of Structured Securities that is backed by Ginnie Mae Certificates.

(2) Based on the number of mortgages 90 days or more delinquent or in foreclosure. Excludes delinquencies in alternative collateral deals.

(3) Region Designation: West (AK, AZ, CA, GU, HI, ID, MT, NV, OR, UT, WA); Northeast (CT, DE, DC, MA, ME, MD, NH, NJ, NY, PA, RI, VT, VA, WV); North central (IL, IN, IA, MI, MN, ND, OH, SD, WI); Southeast (AL, FL, GA, KY, MS, NC, PR, SC, TN, VI); Southwest (AR, CO, KS, LA, MO, NE, NM, OK, TX, WY). Beginning in 2005, Puerto Rico and Virgin Islands were reclassified from Northeast to Southeast.

While overall single-family delinquencies have declined over the past three years as a result of generally strong economic conditions and continued house price appreciation in the United States, non-credit enhanced delinquencies increased in 2005, with some regional variation, primarily due to Hurricane Katrina. See “Table 6.3 — Delinquency Performance” in “NOTE 6: LOAN LOSS RESERVES” to the consolidated financial statements for detailed delinquency performance information.

Our multifamily delinquency rate remained very low at zero percent, 0.06 percent and 0.05 percent at the end of 2005, 2004 and 2003, respectively. Hurricane Katrina has not affected our reported multifamily delinquency rate because the contractual terms of certain affected mortgage loans, with unpaid principal balances totaling \$210 million at December 31, 2005, were modified. Multifamily delinquencies may include mortgage loans where the borrowers are not paying as agreed, but principal and interest are being paid to us under the terms of a credit enhancement agreement.

**Table 40 — Single-Family Mortgages By Year of Origination — Percentage of Mortgage Portfolio and Non-Credit-Enhanced Delinquency Rates**

Year of Origination	December 31,					
	2005		2004		2003	
	Percent of Single-Family Balance <sup>(1)</sup>	Non-Credit-Enhanced Delinquency Rate <sup>(2)</sup>	Percent of Single-Family Balance <sup>(1)</sup>	Non-Credit-Enhanced Delinquency Rate <sup>(2)</sup>	Percent of Single-Family Balance <sup>(1)</sup>	Non-Credit-Enhanced Delinquency Rate <sup>(2)</sup>
Pre-1998 .....	3%	0.75%	4%	0.67%	7%	0.69%
1998 .....	2	0.56	3	0.49	4	0.45
1999 .....	1	0.89	2	0.78	3	0.73
2000 .....	—	2.09	1	1.94	1	1.78
2001 .....	4	0.75	6	0.59	10	0.48
2002 .....	11	0.38	16	0.26	24	0.18
2003 .....	34	0.17	44	0.06	51	0.01
2004 .....	21	0.21	24	0.03	—	—
2005 .....	24	0.08	—	—	—	—
At December 31 .....	<u>100%</u>	<u>0.30%</u>	<u>100%</u>	<u>0.24%</u>	<u>100%</u>	<u>0.27%</u>

(1) Based on unpaid principal balances of the single-family mortgage portfolio (excluding non-Freddie Mac mortgage-related securities, alternative collateral deals and that portion of Structured Securities that is backed by Ginnie Mae Certificates).

(2) Based on mortgages 90 days or more delinquent or in foreclosure.

Our single-family portfolio was affected by heavy refinance volumes in recent years. At December 31, 2005, 79 percent of our single-family mortgage portfolio consisted of mortgage loans originated in 2005, 2004 or 2003. Mortgage loans originated in 2002 and earlier, which represent approximately 21 percent of our single-family mortgage portfolio, have delinquency rates that are generally higher than the overall portfolio delinquency rate due to the natural aging of the loans and, in some instances, the weaker credit quality of these loans. For example, mortgage loans originated in 2000 were generally for purchase transactions, which typically involve more risk because they tend to have relatively higher loan-to-value ratios and borrowers with lower credit scores, resulting in weaker credit quality, than loans originated in refinancing transactions. As a result, we have experienced higher than average early defaults and delinquency rates on these mortgage loans originated in 2000, but they represent less than one percent of the single-family Total mortgage portfolio.

*Credit Loss Performance.* Table 41 provides detail on our credit loss performance, including REO activity, charge-offs and credit losses. The decrease in REO operations income of \$43 million in 2005 compared to 2004 was primarily attributable to a reduction in recoveries.

**Table 41 — Credit Loss Performance**

	Year Ended December 31,		
	2005	2004	2003
	(dollars in millions)		
<b>REO</b>			
REO balances:			
Single-family .....	\$ 611	\$ 740	\$ 758
Multifamily .....	18	1	37
Total .....	<u>\$ 629</u>	<u>\$ 741</u>	<u>\$ 795</u>
REO activity (number of properties): <sup>(1)</sup>			
Beginning property inventory, at January 1 .....	9,604	9,170	7,222
Properties acquired .....	15,861	18,489	17,750
Properties disposed .....	(17,395)	(18,055)	(15,802)
Ending property inventory, at December 31 .....	<u>8,070</u>	<u>9,604</u>	<u>9,170</u>
Average holding period (in days) <sup>(2)</sup> .....	186	177	174
REO operations income (expense):			
Single-family .....	\$ (40)	\$ (1)	\$ (4)
Multifamily .....	—	4	(3)
Total .....	<u>\$ (40)</u>	<u>\$ 3</u>	<u>\$ (7)</u>
<b>CHARGE-OFFS</b>			
<b>Single-family:</b>			
Foreclosure alternatives, gross .....	\$ (44)	\$ (47)	\$ (40)
Recoveries <sup>(3)</sup> .....	23	21	17
Foreclosure alternatives, net .....	(21)	(26)	(23)
REO acquisitions, gross .....	(242)	(253)	(176)
Recoveries <sup>(3)</sup> .....	162	139	127
REO acquisitions, net .....	(80)	(114)	(49)
Single-family totals:			
Charge-offs, gross .....	(286)	(300)	(216)
Recoveries <sup>(3)</sup> .....	185	160	144
<b>Single-family charge-offs, net</b> .....	<u>(101)</u>	<u>(140)</u>	<u>(72)</u>
<b>Multifamily:</b>			
Charge-offs, gross .....	(8)	—	(8)
Recoveries <sup>(3)</sup> .....	—	—	1
<b>Multifamily charge-offs, net</b> .....	<u>(8)</u>	<u>—</u>	<u>(7)</u>
<b>Total Charge-offs:</b>			
Charge-offs, gross .....	(294)	(300)	(224)
<b>Recoveries:</b>			
Related to primary mortgage insurance .....	119	85	94
Not related to primary mortgage insurance .....	66	75	51
<b>Total recoveries<sup>(3)</sup></b> .....	<u>185</u>	<u>160</u>	<u>145</u>
<b>Charge-offs, net</b> .....	<u>\$ (109)</u>	<u>\$ (140)</u>	<u>\$ (79)</u>
<b>CREDIT GAINS (LOSSES)<sup>(4)</sup></b>			
Single-family .....	\$ (141)	\$ (141)	\$ (76)
Multifamily .....	(8)	4	(10)
<b>Total</b> .....	<u>\$ (149)</u>	<u>\$ (137)</u>	<u>\$ (86)</u>
In basis points: <sup>(5)</sup>			
Single-family .....	(1.1)	(1.1)	(0.7)
Multifamily .....	—	—	(0.1)
<b>Total</b> .....	<u>(1.1)</u>	<u>(1.1)</u>	<u>(0.8)</u>

(1) Includes single-family and multifamily REO properties.

(2) Represents weighted average holding period for single-family and multifamily properties based on number of REO properties disposed.

(3) Includes recoveries of charge-offs primarily resulting from foreclosure alternatives and REO acquisitions on loans where a share of default risk has been assumed by mortgage insurers, servicers, or other third parties through credit enhancements. Recoveries of charge-offs through credit enhancements are limited in some instances to amounts less than the full amount of the loss.

(4) Equal to REO operations income (expense) plus Charge-offs, net.

(5) Calculated as credit gains (losses) divided by the average Total mortgage portfolio, excluding non-Freddie Mac mortgage-related securities and that portion of Structured Securities that is backed by Ginnie Mae Certificates.

Table 42 and Table 43 provide detail by region for two credit performance statistics, REO activity and charge-offs. Regional REO acquisition and charge-off trends generally follow a pattern that is similar to, but lags, that of regional delinquency trends.

**Table 42 — REO Activity By Region<sup>(1)</sup>**

	Year Ended December 31,		
	2005	2004	2003
	(number of properties)		
<b>REO Inventory</b>			
Beginning property inventory, at January 1 .....	9,604	9,170	7,222
Properties acquired by region:			
Northeast .....	1,306	1,500	1,600
Southeast .....	4,504	5,499	5,378
North central .....	5,790	5,787	4,643
Southwest .....	3,412	3,926	3,503
West .....	849	1,777	2,626
Total properties acquired .....	15,861	18,489	17,750
Properties disposed by region:			
Northeast .....	(1,384)	(1,562)	(1,674)
Southeast .....	(5,221)	(5,596)	(4,476)
North central .....	(5,715)	(5,111)	(3,908)
Southwest .....	(3,820)	(3,605)	(3,018)
West .....	(1,255)	(2,181)	(2,726)
Total properties disposed .....	(17,395)	(18,055)	(15,802)
Ending property inventory, at December 31 .....	8,070	9,604	9,170

(1) See "Table 39 — Single-Family — Delinquency Rates-By Region" for a description of these regions.

**Table 43 — Single-Family Charge-offs and Recoveries By Region<sup>(1) (2)</sup>**

	Year Ended December 31,								
	2005			2004			2003		
	Charge-offs, gross	Recoveries	Charge-offs, net	Charge-offs, gross	Recoveries	Charge-offs, net	Charge-offs, gross	Recoveries	Charge-offs, net
	(in millions)								
Northeast .....	\$ 21	\$ (10)	\$ 11	\$ 24	\$ (10)	\$ 14	\$ 21	\$ (10)	\$ 11
Southeast .....	76	(54)	22	84	(49)	35	62	(44)	18
North central .....	102	(66)	36	92	(49)	43	54	(35)	19
Southwest .....	68	(44)	24	66	(35)	31	43	(32)	11
West .....	19	(11)	8	34	(17)	17	36	(23)	13
Total .....	<u>\$286</u>	<u>\$(185)</u>	<u>\$101</u>	<u>\$300</u>	<u>\$(160)</u>	<u>\$140</u>	<u>\$216</u>	<u>\$(144)</u>	<u>\$72</u>

(1) See "Table 39 — Single-Family — Delinquency Rates-By Region" for a description of these regions.

(2) Includes recoveries of charge-offs primarily resulting from foreclosure alternatives and REO acquisitions on loans where a share of default risk has been assumed by mortgage insurers, servicers, or other third parties through credit enhancements. Recoveries of charge-offs through credit enhancements are limited in some instances to amounts less than the full amount of the loss.

Table 44 summarizes our loan loss reserves activity.

**Table 44 — Loan Loss Reserves Activity**

	Year Ended December 31,				
	2005	2004	2003	2002	2001
	(dollars in millions)				
<b>Total loan loss reserves<sup>(1)</sup>:</b>					
Beginning balance	\$ 264	\$ 299	\$ 265	\$ 224	\$ 229
Provision for credit losses	251	143	(5)	122	33
Charge-offs, gross	(294)	(300)	(224)	(171)	(129)
Recoveries <sup>(2)</sup>	185	160	145	99	101
Charge-offs, net	(109)	(140)	(79)	(72)	(28)
Adjustment for change in accounting <sup>(3)</sup>	—	—	110	—	—
Transfers-out during the period <sup>(4)</sup>	(11)	(20)	(11)	(9)	(10)
Other transfers, net, during the period <sup>(5)</sup>	19	(18)	19	—	—
Ending balance	<u>\$ 414</u>	<u>\$ 264</u>	<u>\$ 299</u>	<u>\$ 265</u>	<u>\$ 224</u>
Charge-offs, net to Total mortgage portfolio <sup>(6)</sup>	0.8bp	1.1bp	0.7bp	0.7bp	0.3bp
Coverage ratio (reserves to charge-offs, net)	3.8	1.9	3.8	3.7	8.0

- (1) Includes Reserves for loans held-for-investment in the Retained portfolio and Reserves for guarantee losses on Participation Certificates. See “NOTE 6: LOAN LOSS RESERVES” to the consolidated financial statements for more details.
- (2) Includes recoveries of charge-offs primarily resulting from foreclosure alternatives and REO acquisitions on loans where a share of default risk has been assumed by mortgage insurers, servicers or third parties through credit enhancements. Recoveries of charge-offs through credit enhancements are limited in some instances to amounts less than the full amount of the loss.
- (3) On January 1, 2003, \$110 million of recognized Guarantee obligation attributable to estimated incurred losses on outstanding PCs or Structured Securities was reclassified to Reserve for guarantee losses on Participation Certificates.
- (4) Represents the reclassification of the reserve amount attributable to uncollectible interest on outstanding PCs and Structured Securities, which is included as an offset to the related receivable balance within Accounts and other receivables, net on the consolidated balance sheets.
- (5) Represents the portion 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 upon initial recognition of a Guarantee obligation. In addition, the amount includes an increase (reduction) of loan loss reserves of \$9 million and \$(31) million in 2005 and 2004, respectively, related to prior period adjustments for which the related income was recorded in Other income.
- (6) Calculated using the average Total mortgage portfolio, excluding non-Freddie Mac mortgage-related securities and that portion of Structured Securities that is backed by Ginnie Mae Certificates.

We maintain two loan loss reserves — Reserve for losses on mortgage loans held-for-investment and Reserve for guarantee losses on Participation Certificates — at levels we deem adequate to absorb probable incurred losses on mortgage loans held-for-investment in the Retained portfolio and certain mortgages underlying PCs held by third parties. In certain circumstances, incurred losses related to PCs we hold in the Retained portfolio are captured as part of mark-to-market adjustments that are recognized in connection with PC residuals, which represent the portion of the fair value of the PCs related to the Guarantee asset and Guarantee obligation. See “CRITICAL ACCOUNTING POLICIES AND ESTIMATES — Credit Losses” and “NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES” to the consolidated financial statements for further information.

As shown in “Table 44 — Loan Loss Reserves Activity,” total loan loss reserves increased in 2005. The increase in loan loss reserves in 2005 is primarily related to our estimate of our incurred losses as a result of Hurricane Katrina. The 2005 provision also includes additions 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 experiencing higher default rates based on their year of origination.

*Credit Risk Sensitivity.* Our credit risk sensitivity analysis assesses the assumed increase in the present value of expected single-family mortgage portfolio losses over ten years as the result of an estimated immediate five percent decline in house prices nationwide, followed by a return to more normal growth in house prices based on historical experience. We use an internally developed Monte Carlo simulation-based model to generate our credit risk sensitivity analyses. The Monte Carlo model uses a simulation program to generate numerous potential interest-rate paths that, in conjunction with a prepayment model, are used to estimate mortgage cash flows along each path. In the credit rate sensitivity analysis, we adjust the house-price assumption used in the base case to estimate the level and sensitivity of potential credit costs resulting from a sudden decline in house prices.

The credit risk sensitivity results at December 31, 2005 and 2004 are shown in Table 45. Credit risk sensitivity results at the end of each quarter in 2005 and the fourth quarter of 2004 are presented in “RISK MANAGEMENT AND DISCLOSURE COMMITMENTS.”

**Table 45 — Credit Risk Sensitivity — Estimated Increase in Net Present Value, or NPV, of Credit Losses<sup>(1)</sup>**

	Before Receipt of Credit Enhancements <sup>(2)</sup>		After Receipt of Credit Enhancements <sup>(3)</sup>	
	NPV	NPV Ratio <sup>(4)</sup>	NPV	NPV Ratio <sup>(4)</sup>
	(dollars in millions, except ratios)			
At:				
December 31, 2005 .....	\$873	6.5bps	\$564	4.2bps
December 31, 2004 .....	\$794	6.5bps	\$463	3.8bps

(1) Based on single-family Total mortgage portfolio, excluding non-Freddie Mac mortgage-related securities and that portion of Structured Securities that is backed by Ginnie Mae Certificates.

(2) Assumes that none of the credit enhancements currently covering our single-family mortgages has any mitigating impact on our credit losses.

(3) Assumes we collect amounts due from credit enhancement providers after giving effect to certain assumptions about counterparty default rates.

(4) Calculated as the ratio of net present value of increase in credit losses to the single-family Total mortgage portfolio, excluding non-Freddie Mac mortgage-related securities and that portion of Structured Securities that is backed by Ginnie Mae Certificates.

### ***Institutional Credit Risk***

Our primary institutional credit risk exposure, other than counterparty credit risk exposure relating to derivatives, arises from agreements with the following entities: mortgage loan insurers; mortgage seller/servicers; issuers, guarantors or third party providers of credit enhancements on non-Freddie Mac mortgage-related securities held in our Retained portfolio; mortgage investors and originators; and issuers, guarantors and insurers of investments held in our Cash and investments portfolio. See “Interest-Rate Risk and Other Market Risks — *Derivative-Related Risks* — Derivative Counterparty Credit Risk” for information concerning counterparty credit risk exposure relating to derivatives.

**Mortgage Loan Insurers.** We bear institutional credit risk relating to the potential insolvency or non-performance of mortgage insurers that insure mortgages we purchase or guarantee. We manage this risk by establishing eligibility standards for mortgage insurers and by regularly monitoring our exposure to individual mortgage insurers. We also monitor the mortgage insurers’ credit ratings, as provided by nationally recognized credit rating agencies and we periodically review the methods used by the credit rating agencies. We also perform periodic on-site reviews of mortgage insurers to confirm compliance with our eligibility requirements and to evaluate their management and control practices. In addition, state insurance authorities regulate mortgage insurers. Substantially all mortgage insurers providing primary mortgage insurance and pool insurance coverage on single-family mortgages we purchased during 2005 were rated “AA” or better by S&P. At December 31, 2005, there were seven mortgage insurers (the largest being Mortgage Guarantee Insurance Corporation) that each provided more than seven percent of our Total mortgage insurance coverage (including primary mortgage insurance and pool insurance) and together accounted for approximately 99 percent of our overall coverage.

**Mortgage Seller/Servicers.** We are exposed to institutional credit risk arising from the insolvency of or non-performance by our mortgage seller/servicers, including performance of their repurchase obligations arising from the representations and warranties made to us for loans they underwrote and sold to us. The servicing fee charged by mortgage servicers varies by mortgage product. We generally require our single-family servicers to retain a minimum percentage fee for mortgages serviced on our behalf, typically 0.25 percent of the unpaid principal balance of the mortgage loans. However, on an exception basis, we allow a lower or no minimum servicing amount. The credit risk associated with servicing fees relates to whether we could transfer the servicing to an alternate servicer without a loss in the event the current servicer is unable to fulfill its responsibilities.

In order to manage the credit risk associated with our mortgage seller/servicers, we require them to meet minimum financial capacity standards, insurance and other eligibility requirements. We institute remedial actions against seller/servicers that fail to comply with our standards. These actions may include transferring mortgage servicing to other qualified servicers or terminating our relationship with the seller/servicer. We conduct periodic operational reviews of our single-family mortgage seller/servicers to help us better understand their control environment and its impact on the quality of loans sold to us. We use this information to determine the terms of business we conduct with a particular seller/servicer.

We manage the credit risk associated with our multifamily seller/servicers by establishing eligibility requirements for participation in our multifamily programs. These seller/servicers must also meet our standards for originating and servicing multifamily loans. We conduct regular quality control reviews of our multifamily mortgage seller/servicers to determine whether they remain in compliance with our standards.

**Non-Freddie Mac Mortgage-Related Securities.** Investments for our Retained portfolio expose us to institutional credit risk on non-Freddie Mac mortgage-related securities to the extent that servicers, issuers, guarantors, or third parties

providing credit enhancements become insolvent or do not perform. See “Table 17 — Characteristics of Mortgage Loans and Mortgage-Related Securities in the Retained Portfolio” for more information concerning our Retained portfolio.

Our non-Freddie Mac mortgage-related securities portfolio consists of both agency and non-agency mortgage securities. Agency mortgage-related securities, which are securities issued or guaranteed by Fannie Mae or Ginnie Mae, present minimal institutional credit risk due to the high credit quality of Fannie Mae and Ginnie Mae. Agency mortgage-related securities are generally not separately rated by credit rating agencies, but are viewed as having a level of credit quality at least equivalent to non-agency mortgage securities rated AAA (based on the S&P rating scale or an equivalent rating from other nationally recognized credit rating agencies). At December 31, 2005, we held approximately \$45 billion of agency securities, representing approximately 3 percent of our Total mortgage portfolio.

Non-agency mortgage-related securities expose us to institutional credit risk if the nature of the credit enhancement relies on a third party to cover potential losses. However, most of our non-agency mortgage-related securities rely primarily on subordinated tranches to provide credit loss protection and therefore expose us to limited counterparty risk. In those instances where we desire further protection, we may choose to mitigate our exposure with bond insurance or by purchasing additional subordination. Bond insurance exposes us to the risks related to the bond insurer’s ability to satisfy claims. At December 31, 2005, substantially all of the bond insurers providing coverage for non-agency mortgage-related securities held by us were rated AAA or equivalent by at least one nationally recognized credit rating agency. At December 31, 2005, we held approximately \$243 billion of non-agency mortgage-related securities. Of this amount, 97.8 percent were rated AAA or equivalent.

We manage institutional credit risk on non-Freddie Mac mortgage-related securities by only purchasing securities that meet our investment guidelines and performing ongoing analysis to evaluate the creditworthiness of the issuers and servicers of these securities and the bond insurers that guarantee them. To assess the creditworthiness of these entities, we may perform additional analysis, including on-site visits, verification of loan documentation, review of underwriting or servicing processes and similar due diligence measures. In addition, we regularly evaluate our investments to determine if any impairment in fair value requires an impairment loss recognition in earnings, warrants divestiture or requires a combination of both.

**Mortgage Investors and Originators.** We are exposed to pre-settlement risk through the purchase, sale and financing of mortgage loans and mortgage-related securities with mortgage investors and originators. The probability of such a default is generally remote over the short time horizon between the trade and settlement date. We manage this risk by evaluating the creditworthiness of our counterparties and monitoring and managing our exposures. In some instances, we may require these counterparties to post collateral.

**Cash and Investments Portfolio.** Institutional credit risk also arises from the potential insolvency or non-performance of issuers or guarantors of investments held in our Cash and investments portfolio. Instruments in this portfolio are investment grade at the time of purchase and primarily short-term in nature, thereby substantially mitigating institutional credit risk in this portfolio. We regularly evaluate these investments to determine if any impairment in fair value requires an impairment loss recognition in earnings, warrants divestiture or requires a combination of both.

## OFF-BALANCE SHEET ARRANGEMENTS

### Off-Balance Sheet Transactions

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

### Guarantee of PCs and Structured Securities

As discussed in "BUSINESS — Credit Guarantee Activities," we participate in the secondary mortgage market in part by issuing PCs and Structured Securities to third party investors. We guarantee the payment of principal and interest on issued PCs or Structured Securities. In these transactions, mortgage-related assets that back PCs and Structured Securities held by third parties are not reflected as our assets, unless we retained an interest in PCs that back Structured Securities that were issued as part of a sale transaction.

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

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

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

In addition to the issuance and transfer of PCs to third parties, we also sell PCs from our Retained portfolio in resecuritized form. More specifically, we issue single- and multi-class Structured Securities that are backed by securities held in our Retained portfolio and subsequently transfer such Structured Securities to third parties in exchange for cash, or for PCs and other mortgage-related securities delivered to us by third party dealers who sell such Structured Securities to mortgage security investors. We generally earn resecuritization fees in connection with the creation of Structured Securities and can earn an ongoing management and guarantee fee for certain issued Structured Securities. Our principal exposure on Structured Securities relates only to that portion of resecuritized assets that is represented by non-Freddie Mac mortgage-related securities. Our outstanding PCs and Structured Securities also include securities issued by third parties that we guarantee. See "NOTE 4: FINANCIAL GUARANTEES" for more information about these guarantees. For information about our purchase and securitization activity, see "PORTFOLIO BALANCES AND ACTIVITIES."

The accounting policies and fair value estimation methodologies we apply to our credit guarantee activities significantly affect the volatility of our reported earnings through the initial recognition of the fair value of the Guarantee asset and Guarantee obligation in connection with sales of PCs and Structured Securities, the recognition of subsequent gains or losses from the change in fair value of the Guarantee asset and PC residuals generated from such sales and the repurchase and sale of PCs into and out of our Retained portfolio. See "CONSOLIDATED RESULTS OF OPERATIONS — Non-Interest Income (Loss)" for an analysis of management and guarantee income and other affected consolidated statements of income captions related to our credit guarantee activities. See "CONSOLIDATED BALANCE SHEETS ANALYSIS" for discussion of our Guarantee asset and Guarantee obligation. The accounting for our securitization transactions (including gains and losses on transfers of PCs and Structured Securities that are accounted for as sales and periodic cash flows on transfers of securitized interests and corresponding retained interests) and the significant assumptions used to determine the gains or losses from such transfers that are accounted for as sales are discussed in "NOTE 2: TRANSFERS OF SECURITIZED INTERESTS IN MORTGAGE-RELATED ASSETS" to the consolidated financial statements.

## Other

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

We are a party to numerous entities that are considered to be variable interest entities in accordance with FASB Interpretation No. 46 (Revised December 2003), “Consolidation of Variable Interest Entities”, or FIN 46(R). These variable interest entities include low-income multifamily housing tax credit partnerships, certain Structured Securities trusts (T-Series transactions or alternative collateral deals), and certain asset-backed investment entities. See “NOTE 3: VARIABLE INTEREST ENTITIES” to the consolidated financial statements for additional information related to our significant variable interests in these VIEs.

As part of our credit guarantee business, we routinely enter into forward purchase and sale commitments for mortgage loans and mortgage-related securities. A portion of these commitments are accounted for as derivatives, with their fair value reported as either Derivative assets, at fair value or Derivative liabilities, at fair value on the consolidated balance sheets. See “RISK MANAGEMENT — Interest-Rate Risk and Other Market Risks” for further information. Certain non-derivative commitments are related to commitments arising from mortgage swap transactions and commitments to purchase certain multifamily mortgage loans that will be classified as held-for-investment. These non-derivative commitments totaled \$178.8 billion and \$182.9 billion at December 31, 2005 and 2004, respectively. Such commitments were not accounted for as derivatives and were not recorded on our consolidated balance sheets.

## CRITICAL ACCOUNTING POLICIES AND ESTIMATES

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

### Fair Value Measurement

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

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

amounts into income and extinguishment when we purchase the related PCs and Structured Securities into the Retained portfolio.

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

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

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

We periodically evaluate our methodologies and may change them to improve our fair value estimates, to accommodate market developments or to compensate for changes in data availability or other operational constraints.

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

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

The fair values for approximately 99 percent of our mortgage-related securities are based on prices obtained from third parties or are determined using models with significant market inputs. The fair values for the remainder of our mortgage-related securities are obtained from internal models with few or no market inputs. The fair values for our non-mortgage-related securities are based on prices obtained from third parties, unless their interest rates frequently reset, in which case the carrying value is presumed to be a reasonable approximation of fair value. As few of the derivative contracts we use are listed on exchanges, the majority of our derivative positions are valued using internally developed models that use market inputs. Approximately 68 percent of the gross fair value of our derivatives portfolio relates to interest-rate and foreign-currency swaps that do not have embedded options. These derivatives are valued using a discounted cash flow model that projects future cash flows and discounts them at the spot rate related to each cash flow. The remaining 32 percent of our derivatives portfolio is valued based on prices obtained from third parties or using models with significant market inputs. The fair values for all of our debt securities are based on prices obtained from third parties or are determined using models with significant market inputs.

Some of our financial instruments are not traded in active markets. Examples include the Guarantee asset, Guarantee obligation and PC residuals. In 2005, our approach for valuing these items incorporated more third-party market-based information in their valuations. Our valuation methodologies and the recent improvements are discussed in "NOTE 2: TRANSFERS OF SECURITIZED INTERESTS IN MORTGAGE-RELATED ASSETS" to our consolidated financial statements.

As described above, the estimation of fair value requires judgment and we may have reasonably chosen different methodologies or assumptions in the current period. The use of different pricing methodologies and assumptions could have produced materially different estimates of fair value in the periods currently presented. However, we believe the fair values we estimated are reasonable based on internal reviews of significant pricing models and methodologies as well as

verification of financial instrument pricing with third-party broker/dealers or pricing services. Furthermore, our estimates of fair value are likely to change in future periods to reflect changes in market factors such as interest rates and related volatility, credit performance, expectations about prepayment behavior and other factors. Our estimates of fair value for individual instruments may change by material amounts, depending on market developments. See “RISK MANAGEMENT — Interest-Rate Risk and Other Market Risks” for discussion of market risks and our interest-rate sensitivity measures, PMVS and duration gap.

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

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

We evaluate whether transfers of PCs or Structured Securities qualify as sales based upon the requirements of SFAS No. 140, “Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities” and, prior to April 1, 2001, SFAS No. 125, “Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,” which we collectively refer to as SFAS 125/140. In this regard, we account for a transfer as a sale to the extent we conclude that (i) assets that underlie the transferred PCs or Structured Securities are legally beyond our reach and the reach of our creditors even in the event that we were to become financially insolvent, (ii) a third-party buyer can freely pledge or exchange the PCs or Structured Securities that were transferred to it and (iii) we did not maintain effective control over transferred PCs or Structured Securities through either (a) an arrangement that both entitles and obligates us to repurchase or redeem transferred PCs or Structured Securities before their maturity or (b) the ability to unilaterally cause the holder of a transferred PC or Structured Security to return specific assets (*i.e.*, other than through a clean up call).

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

If we determine that a transfer of PCs or Structured Securities does not qualify as a sale, we account for such transfer as a secured borrowing or as a financial guarantee transaction pursuant to the provisions of FASB Interpretation No. 45, “Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others”, or FIN 45. Many of the transfers of PCs and Structured Securities that are made to third parties do not qualify as sales or secured borrowings, but are accounted for as financial guarantee transactions pursuant to the provisions of FIN 45. For such transactions, at the inception of an executed guarantee, we recognize a Guarantee obligation that is initially measured to be the greater of (a) fair value or (b) the contingent liability amount required to be recognized at inception of the guarantee by SFAS No. 5, “Accounting For Contingencies,” or SFAS 5. We also recognize the fair value of any consideration received on such transactions. Positive differences between the fair value of consideration expected and received, and Guarantee obligations incurred, are deferred as a component of recognized Guarantee obligations, while negative differences between such amounts are recognized immediately in earnings as a component of Other expense.

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

### **Derivative Instruments and Hedging Activities**

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

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

- the cash flows of a variable-rate instrument or a forecasted transaction, or a “cash flow hedge;”
- the changes in fair value of a fixed-rate instrument, or a “fair value hedge;” or
- foreign-currency fair value or cash flow, or a “foreign-currency hedge.”

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

The determination of whether a derivative qualifies for hedge accounting requires judgment about the application of SFAS 133. SFAS 133 requires contemporaneous documentation of our hedge relationships, including identification of the hedged item, the hedging instrument, the nature of the hedged risk and the method used to assess the effectiveness of the hedge relationship. Throughout 2005, we have used a comparison of the critical terms of the hedging instrument to those of the hedged item to assess the effectiveness of hedges. If our documentation and assessments are not adequate, the derivative does not qualify for hedge accounting.

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

For a more detailed description of our use of derivatives and summaries of derivative positions, see “CONSOLIDATED RESULTS OF OPERATIONS — Derivative Overview” and “NOTE 12: DERIVATIVES” to the consolidated financial statements.

### **Credit Losses**

We maintain a Reserve for losses on mortgage loans held-for-investment to provide for credit losses incurred related to those mortgage loans. At December 31, 2005 and 2004, the Reserve for losses on mortgage loans held-for-investment was \$119 million and \$114 million, respectively. We also maintain a Reserve for guarantee losses on Participation Certificates to provide for losses incurred on mortgages underlying PCs or Structured Securities held by third parties. At December 31, 2005 and 2004, the Reserve for guarantee losses on Participation Certificates was \$295 million and \$150 million, respectively. The Reserve for losses on mortgage loans held-for-investment and the Reserve for guarantee losses on Participation Certificates are collectively referred to as the loan loss reserves. Increases in loan loss reserves are reflected in earnings as a component of the Provision for credit losses. Loan loss reserves decrease when charge-offs of such balances (net of recoveries) occur or when we record realized losses.

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

impact on the loan loss reserves and the provision for credit losses. Key estimates and assumptions that could have an impact on loan loss reserves include:

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

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

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

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

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

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

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

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

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

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

**Accounting Changes and Recently Issued Accounting Pronouncements**

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

## PORTFOLIO BALANCES AND ACTIVITIES

### Total Mortgage Portfolio

Our Total mortgage portfolio includes the unpaid principal balances of mortgages and mortgage-related securities held in our Retained portfolio and the unpaid principal balances of guaranteed PCs and Structured Securities held by third parties. Guaranteed PCs and Structured Securities held by third parties are considered outstanding and are not included on our consolidated balance sheets.

Table 46 provides information about our Total mortgage portfolio at December 31, 2005 and 2004.

**Table 46 — Total Mortgage Portfolio and Total Guaranteed PCs and Structured Securities Issued Based on Unpaid Principal Balances<sup>(1)</sup>**

	December 31,			
	2005		2004	
	Amounts (dollars in millions)	% of Total Mortgage Portfolio	Amounts (dollars in millions)	% of Total Mortgage Portfolio
Outstanding Guaranteed PCs and Structured Securities <sup>(2)</sup> .....	\$ 974,200	58%	\$ 852,270	56%
Retained portfolio:				
PCs and Structured Securities .....	361,324	21	356,698	24
Non-Freddie Mac mortgage-related securities .....	287,212	17	234,878	16
Mortgage loans .....	61,481	4	61,360	4
Total Retained portfolio <sup>(3)</sup> .....	<u>710,017</u>	<u>42</u>	<u>652,936</u>	<u>44</u>
Total mortgage portfolio .....	<u>\$1,684,217</u>	<u>100%</u>	<u>\$1,505,206</u>	<u>100%</u>

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

(2) Represents Guaranteed PCs and Structured Securities held by third parties.

(3) The Retained portfolio presented in this table differs from the Retained portfolio presented in our consolidated balance sheets because the amounts presented in our consolidated balance sheets include valuation adjustments and deferred balances. See “Table 17 — Characteristics of Mortgage Loans and Mortgage-Related Securities in the Retained Portfolio” for a reconciliation of the Retained portfolio amounts shown in this table to the amounts shown under such caption on our consolidated balance sheets.

See “Table 49 — Guaranteed PCs and Structured Securities Issued and Outstanding” for more information concerning outstanding guaranteed PCs and Structured Securities. Also see “Table 17 — Characteristics of Mortgage Loans and Mortgage-Related Securities in the Retained Portfolio” for more information concerning the non-Freddie Mac mortgage-related securities in our Retained portfolio.

Table 47 presents the distribution of unsecuritized whole mortgage loans held in our Retained portfolio.

**Table 47 — Mortgage Loans Held in the Retained Portfolio<sup>(1)</sup>**

	December 31,	
	2005	2004
	(in millions)	
<b>Single-family:</b>		
Conventional		
Fixed-rate .....	\$18,532	\$21,409
Variable-rate .....	903	990
Total conventional .....	<u>19,435</u>	<u>22,399</u>
FHA/VA — Fixed-rate .....	255	344
Rural Housing Service, or RHS, and other federally guaranteed loans .....	706	646
Total single-family .....	<u>20,396</u>	<u>23,389</u>
<b>Multifamily:</b>		
Conventional		
Fixed-rate .....	36,961	34,127
Variable-rate .....	4,121	3,841
Total conventional .....	<u>41,082</u>	<u>37,968</u>
RHS .....	3	3
Total multifamily .....	<u>41,085</u>	<u>37,971</u>
<b>Total mortgages</b> .....	<u>\$61,481</u>	<u>\$61,360</u>

(1) Based on unpaid principal balances. Excludes mortgage loans traded, but not yet settled.

Table 48 summarizes purchases into our Total mortgage portfolio.

**Table 48 — Total Mortgage Portfolio Purchase Detail<sup>(1)</sup>**

	Year Ended December 31,			
	2005		2004	
	Amounts	% of Purchase Amounts	Amounts	% of Purchase Amounts
	(dollars in millions)			
<b>New business purchases<sup>(2)</sup></b>				
Single-family mortgage purchases				
Conventional:				
30-year fixed-rate <sup>(3)(4)</sup>	\$272,702	67%	\$220,867	59%
15-year fixed-rate <sup>(4)</sup>	40,963	10	72,754	19
ARMs/Variable-Rate <sup>(4)(5)</sup>	35,677	9	50,187	14
Interest Only <sup>(6)</sup>	26,516	7	818	—
Option ARMs <sup>(7)</sup>	3,918	1	—	—
Balloon/Resets <sup>(8)</sup>	1,720	—	9,658	3
FHA/VA <sup>(9)</sup>	—	—	319	—
RHS and other federally guaranteed loans	177	—	209	—
<b>Total single-family</b>	<b>381,673</b>	<b>94</b>	<b>354,812</b>	<b>95</b>
Multifamily:				
Conventional	11,172	3	12,712	3
<b>Total multifamily</b>	<b>11,172</b>	<b>3</b>	<b>12,712</b>	<b>3</b>
<b>Total mortgage purchases</b>	<b>392,845</b>	<b>97</b>	<b>367,524</b>	<b>98</b>
<b>Non-Freddie Mac mortgage-related securities purchased for Structured Securities:</b>				
Alternative collateral deals backed by:				
Option ARMs	14,331	3	5,653	2
Ginnie Mae Certificates	37	—	85	—
Other <sup>(10)(11)</sup>	—	—	1,552	—
<b>Total Non-Freddie Mac mortgage-related securities purchased for Structured Securities</b>	<b>14,368</b>	<b>3</b>	<b>7,290</b>	<b>2</b>
<b>Total single-family and multifamily mortgage purchases and total non-Freddie Mac mortgage-related securities purchased for Structured Securities</b>	<b>\$407,213</b>	<b>100%</b>	<b>\$374,814</b>	<b>100%</b>
<b>Non-Freddie Mac Mortgage-Related Securities Purchased into the Retained Portfolio:</b>				
Agency Securities:				
Fannie Mae:				
Single-Family:				
Fixed-Rate	\$ 2,854		\$ 756	
Variable-Rate	3,368		3,282	
<b>Total Fannie Mae</b>	<b>6,222</b>		<b>4,038</b>	
Ginnie Mae:				
Single-Family:				
Fixed-Rate	64		—	
<b>Total Ginnie Mae</b>	<b>64</b>		<b>—</b>	
<b>Total agency mortgage-related securities</b>	<b>6,286</b>		<b>4,038</b>	
Non-Agency Securities:				
Single-family and other mortgage-related securities				
Single-family:				
Fixed-Rate	2,478		1,294	
Variable-Rate	148,276		101,620	
<b>Total single-family and other mortgage-related securities</b>	<b>150,754</b>		<b>102,914</b>	
CMBS:				
Fixed-Rate	11,291		8,841	
Variable-Rate	3,549		2,037	
<b>Total CMBS</b>	<b>14,840</b>		<b>10,878</b>	
Mortgage Revenue Bonds:				
Single-family:				
Fixed-Rate	2,374		1,499	
Variable-Rate	27		—	
Multifamily:				
Fixed-Rate	418		414	
Variable-Rate	21		31	
<b>Total mortgage revenue bonds</b>	<b>2,840</b>		<b>1,944</b>	
<b>Total non-agency mortgage-related securities</b>	<b>168,434</b>		<b>115,736</b>	
<b>Total non-Freddie Mac mortgage-related securities purchased into the Retained portfolio</b>	<b>174,720</b>		<b>119,774</b>	
<b>Total new business purchases</b>	<b>\$581,933</b>		<b>\$494,588</b>	
Mortgage purchases with credit enhancements		17%		19%
Mortgage liquidations <sup>(12)</sup>	\$384,674		\$401,029	
Mortgage liquidations rate		26%		28%
Freddie Mac securities repurchased into the Retained portfolio:				
Single-family:				
Fixed-Rate	\$106,682		\$ 72,147	
Variable-Rate	29,805		23,942	
Multifamily:				
Variable-Rate	—		146	
<b>Total Freddie Mac securities repurchased into the Retained portfolio</b>	<b>\$136,487</b>		<b>\$ 96,235</b>	

- (1) Based on unpaid principal balances. Excludes mortgage loans and mortgage-related securities traded but not yet settled.
- (2) 2004 data includes certain mortgage-related securities that have been transferred from the Investments caption to the Retained portfolio caption on the consolidated balance sheets.
- (3) Includes 20 year fixed-rate mortgages.
- (4) Subsequent to the issuance of our Information Statement dated June 14, 2005, we reclassified select captions to agree with current period classifications.
- (5) Includes ARMs with 1-, 3-, 5-, 7- and 10-year initial fixed-rate periods.
- (6) Represents loans where the borrower pays interest only for a period of time before the borrower begins making principal payments.

- (7) Includes mortgage loans we purchased that underlie whole-loan REMICs. Excludes \$83 million of mortgage loan purchases that collateralize the unguaranteed portion of whole-loan REMICs.
- (8) Mortgages whose terms require lump sum principal payments on contractually determined future dates unless the borrower qualifies for and elects an extension of the maturity date at an adjusted interest rate.
- (9) Excludes FHA/VA loans that may be collateral for alternative collateral deals.
- (10) Includes Structured Securities backed by non-agency securities, which were backed by a mixture of prime, FHA/VA and subprime mortgage loans.
- (11) 2004 data represents \$1,462 million of fixed-rate and \$90 million of variable-rate non-Freddie Mac single-family mortgage-related securities.
- (12) Excludes the effect of sales of non-Freddie Mac mortgage-related securities.

### Guaranteed PCs and Structured Securities

Guaranteed PCs and Structured Securities Issued represent the unpaid principal balances of the mortgage-related securities we issue or otherwise guarantee. Table 49 presents the distribution of underlying mortgage assets for total PCs and Structured Securities issued and outstanding.

**Table 49 — Guaranteed PCs and Structured Securities Issued and Outstanding**

	December 31,			
	2005		2004	
	Total Issued PCs and Structured Securities <sup>(1)</sup>	Outstanding PCs and Structured Securities <sup>(2)</sup>	Total Issued PCs and Structured Securities <sup>(1)</sup>	Outstanding PCs and Structured Securities <sup>(2)</sup>
	(in millions)			
PCs and Structured Securities				
Single-family:				
Conventional:				
30-year fixed-rate <sup>(3)</sup>	\$ 810,897	\$614,112	\$ 689,945	\$509,923
15-year fixed-rate	321,176	220,225	347,135	224,627
ARMs/Variable-rate	131,294	88,898	102,273	59,234
Option ARMs <sup>(4)</sup>	3,830	414	—	—
Balloons/Resets	26,321	24,973	32,966	31,075
FHA/VA <sup>(5)</sup>	849	823	1,350	1,340
RHS and other federally guaranteed loans	154	154	178	178
<i>Total single-family</i>	<u>1,294,521</u>	<u>949,599</u>	<u>1,173,847</u>	<u>826,377</u>
Multifamily:				
Conventional:				
Fixed-rate	10,149	9,902	10,787	10,526
Variable-rate	4,354	4,210	4,759	4,614
<i>Total multifamily</i>	<u>14,503</u>	<u>14,112</u>	<u>15,546</u>	<u>15,140</u>
Structured Securities backed by Non-Freddie Mac mortgage-related securities:				
Ginnie Mae Certificates <sup>(6)</sup>	2,021	1,900	3,015	2,628
Other <sup>(7)</sup>	24,479	8,589	16,560	8,125
<i>Total Structured Securities</i>	<u>26,500</u>	<u>10,489</u>	<u>19,575</u>	<u>10,753</u>
<b>Total</b>	<u><u>\$1,335,524</u></u>	<u><u>\$974,200</u></u>	<u><u>\$1,208,968</u></u>	<u><u>\$852,270</u></u>

- (1) Based on unpaid principal balances. Excludes mortgage loans and mortgage-related securities traded, but not yet settled.
- (2) Represents PCs and Structured Securities held by third parties.
- (3) Includes 20-year fixed-rate mortgages.
- (4) Excludes \$82 million of Structured Securities issued by non-consolidated, special-purpose entities established by us that are not guaranteed by us.
- (5) Excludes FHA and VA loans that may be collateral for alternative collateral deals.
- (6) Ginnie Mae Certificates which underlie the Structured Securities are backed by FHA/VA loans.
- (7) Alternative collateral deals include Structured Securities backed by non-agency securities, which are backed by a mixture of prime, FHA/VA and subprime mortgage loans. Outstanding alternative collateral deals include \$1,520 million and \$1,587 million of fixed-rate, \$3,472 million and \$1,165 million of ARMs/variable-rate, \$3,566 million and \$5,286 million of FHA/VA, \$12 million and \$17 million of the Rural Housing Service and other federally guaranteed loans and \$19 million and \$70 million of second mortgages, which are mortgage loans that are subordinate to a superior mortgage lien on the property, at December 31, 2005 and 2004, respectively.

Table 50 provides further detail regarding both issued and outstanding Guaranteed PCs and Structured Securities.

**Table 50 — Single-Class and Multi-Class PCs and Other Structured Securities Based on Unpaid Principal Balances<sup>(1)</sup>**

<u>December 31, 2005</u>	<u>PCs and Structured Securities in Retained Portfolio</u>	<u>PCs and Structured Securities Outstanding (held by third parties) (in millions)</u>	<u>Total Guaranteed PCs and Structured Securities Issued</u>
PCs and Structured Securities:			
Single-class <sup>(2)</sup> .....	\$202,970	\$529,901	\$ 732,871
Multi-class <sup>(3)(4)(5)</sup> .....	158,354	437,668	596,022
Other <sup>(6)</sup> .....	—	6,631	6,631
Total PCs and Structured Securities <sup>(7)</sup> .....	<u>\$361,324</u>	<u>\$974,200</u>	<u>\$1,335,524</u>
<u>December 31, 2004</u>			
PCs and Structured Securities: <sup>(8)</sup>			
Single-class <sup>(2)</sup> .....	\$219,154	\$454,973	\$ 674,127
Multi-class <sup>(3)(5)</sup> .....	137,544	390,516	528,060
Other <sup>(6)</sup> .....	—	6,781	6,781
Total PCs and Structured Securities <sup>(7)</sup> .....	<u>\$356,698</u>	<u>\$852,270</u>	<u>\$1,208,968</u>

(1) Excludes Freddie Mac mortgage-related securities traded, but not yet settled.

(2) Includes PCs not backing Structured Securities and single-class Structured Securities backed by PCs and Ginnie Mae Certificates.

(3) Includes that portion of multi-class Structured Securities that are backed by PCs and non-agency mortgage-related securities. Also includes multi-class Structured Securities backed by Ginnie Mae Certificates.

(4) Excludes \$82 million of Structured Securities issued by non-consolidated, special-purpose entities established by us that are not guaranteed by us.

(5) Principal-only strips backed by Freddie Mac mortgage-related Securities held in the Retained portfolio are classified as multi-class for the purpose of this table.

(6) See "NOTE 4: FINANCIAL GUARANTEES," for a discussion of our guarantees of principal and interest related to these securities.

(7) PCs and Structured Securities Issued exclude \$961,777 million and \$723,429 million at December 31, 2005 and 2004, respectively, of Structured Securities backed by resecutitized PCs and other previously issued Structured Securities. These excluded Structured Securities, which do not increase our credit related exposure, consist of single-class Structured Securities backed by PCs, REMICs, and principal-only strips. The notional balances of interest-only strips (including excess interest-only strips) totaled \$132,883 million and \$105,703 million at December 31, 2005 and 2004, respectively, and are excluded because this table is based on unpaid principal balances. Also excluded are modifiable and combinable REMIC tranches and interest and principal classes, which collectively totaled \$1,495,501 million and \$1,097,336 million at December 31, 2005 and 2004, respectively, where the holder has the option to exchange the security tranches for other pre-defined security tranches.

(8) Subsequent to our Information Statement dated June 14, 2005, we reclassified PCs and Structured Securities in the Retained portfolio from Single-class to Multi-class and Total Guaranteed PCs and Structured Securities Issued from Single-class and Other to Multi-class to conform to the current period classifications.

Table 51 provides settlement detail for the mortgage-related securities that we issued during the past two years.

**Table 51 — Security Settlement Detail for Total Guaranteed PCs and Structured Securities Issued<sup>(1)</sup>**

	Year Ended December 31,	
	2005	2004
(in millions)		
Total Guaranteed PCs and Structured Securities Issuance Detail:		
Single-family:		
Conventional: <sup>(2)</sup>		
30-year fixed-rate	\$272,910	\$220,137
15-year fixed-rate	41,037	72,358
ARMs/Variable-Rate	35,666	50,226
Interest Only	26,487	818
Option ARMs	3,918	—
Balloon/Resets	1,817	9,737
FHA/VA	—	319
RHS and other federally guaranteed loans	10	48
<i>Total single-family</i>	<u>381,845</u>	<u>353,643</u>
Multifamily:		
Conventional	1,654	4,175
<i>Total multifamily</i>	<u>1,654</u>	<u>4,175</u>
Non-Freddie Mac mortgage-related securities purchased for Structured Securities:		
Alternative collateral deals backed by:		
Option ARMs	14,331	5,653
Ginnie Mae Certificates	37	85
Other	—	1,552
<i>Total Non-Freddie Mac mortgage-related securities purchased for Structured Securities</i>	<u>14,368</u>	<u>7,290</u>
Total Guaranteed PCs and Structured Securities Issued	<u>\$397,867</u>	<u>\$365,108</u>

(1) Based on unpaid principal balances. Excludes Freddie Mac mortgage-related securities traded, but not yet settled.

(2) The single-family product detail in this table does not agree to similar detail in “Table 48 — Total Mortgage Portfolio Purchase Detail” due to timing differences associated with mortgage loan purchases into the Retained portfolio and sales from the Retained portfolio. Specifically, we report mortgage loans in Table 48 when we purchase them into the Retained portfolio whereas we report mortgage loans in Table 51 when we sell them from the Retained portfolio to create PCs and Structured Securities.

Our new business purchases consist of mortgage loans and non-Freddie Mac mortgage-related securities that are purchased for our Retained portfolio and serve as collateral for our issued PCs and Structured Securities. We generate a significant portion of our mortgage purchase volume through several key mortgage lenders that have entered into unique business arrangements with us. See “BUSINESS — Credit Guarantee Activities” for information about these relationships and consequent risks. During 2005 and 2004, we increased purchases of adjustable-rate (*i.e.*, ARMs/Variable-Rate and Option ARMs) and interest-only mortgage products and non-Freddie Mac mortgage-related securities because these products generally offered more attractive option-adjusted spreads than fixed-rate products.

## QUARTERLY SELECTED FINANCIAL DATA

In our opinion, financial data for each quarter and full-year 2005 and 2004 reflects all adjustments, consisting of normal recurring adjustments, necessary for fair presentation of the results of operations for such periods. See “NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — Estimates” and “— Changes in Accounting Principles” for more information concerning some of these adjustments.

	2005				
	1Q	2Q	3Q	4Q	Full-Year
	(in millions, except share-related amounts)				
Net interest income	\$1,501	\$1,269	\$1,363	\$1,237	\$ 5,370
Non-interest income (loss)	(292)	(278)	423	346	199
Non-interest expense	(940)	(583)	(729)	(761)	(3,013)
Income tax benefit (expense)	16	(68)	(177)	(138)	(367)
Net income before cumulative effect of change in accounting principle	285	340	880	684	2,189
Cumulative effect of change in accounting principle, net of taxes	(59)	—	—	—	(59)
Net income	<u>\$ 226</u>	<u>\$ 340</u>	<u>\$ 880</u>	<u>\$ 684</u>	<u>\$ 2,130</u>
Earnings per common share before cumulative effect of change in accounting principle:					
Basic <sup>(1)</sup>	\$ 0.34	\$ 0.41	\$ 1.19	\$ 0.90	\$ 2.84
Diluted <sup>(1)</sup>	\$ 0.33	\$ 0.41	\$ 1.19	\$ 0.90	\$ 2.83
Earnings per common share after cumulative effect of change in accounting principle:					
Basic <sup>(1)</sup>	\$ 0.25	\$ 0.41	\$ 1.19	\$ 0.90	\$ 2.76
Diluted <sup>(1)</sup>	\$ 0.25	\$ 0.41	\$ 1.19	\$ 0.90	\$ 2.75

  

	2004				
	1Q	2Q	3Q	4Q	Full-Year
	(in millions, except share-related amounts)				
Net interest income	\$2,126	\$2,625	\$ 2,321	\$2,065	\$ 9,137
Non-interest income (loss)	(26)	1,532	(3,691)	(854)	(3,039)
Non-interest expense	(503)	(548)	(603)	(717)	(2,371)
Income tax (expense) benefit	(285)	(855)	467	(117)	(790)
Net income (loss)	<u>\$1,312</u>	<u>\$2,754</u>	<u>\$(1,506)</u>	<u>\$ 377</u>	<u>\$ 2,937</u>
Earnings (loss) per common share:					
Basic <sup>(1)</sup>	\$ 1.83	\$ 3.92	\$ (2.26)	\$ 0.47	\$ 3.96
Diluted <sup>(1)</sup>	\$ 1.82	\$ 3.91	\$ (2.26)	\$ 0.47	\$ 3.94

(1) Earnings (loss) per share is computed independently for each of the quarters presented. Due to the use of weighted-average common shares outstanding when calculating earnings (loss) per share, the sum of the four quarters may not equal the full-year amount. Earnings (loss) per share amounts may not recalculate using the amounts in this table due to rounding.

## RISK MANAGEMENT AND DISCLOSURE COMMITMENTS

In October 2000, we announced our voluntary adoption of a series of commitments designed to enhance market discipline, liquidity and capital. In September 2005, we entered into a written agreement with OFHEO that updated these commitments and set forth a process for implementing them. The letters between the company and OFHEO dated September 1, 2005 constituting the written agreement are available on the Investor Relations page of our website at [www.freddiemac.com/investors/reports.html#commit](http://www.freddiemac.com/investors/reports.html#commit). As noted in these letters, disclosures may be affected by situations where current financial statements are not available. Our commitments at December 31, 2005 follow:

Description	Status
<p>1. <i>Periodic Issuance of Subordinated Debt:</i></p> <ul style="list-style-type: none"> <li>• We will issue Freddie SUBS<sup>®</sup> for public secondary market trading that are rated by no less than two nationally recognized statistical rating organizations.</li> <li>• Freddie SUBS<sup>®</sup> will be issued in an amount such that the sum of Total capital (core capital plus general allowance for losses) and the outstanding balance of “Qualifying subordinated debt” will equal or exceed the sum of 0.45 percent of outstanding PCs and Structured Securities we guaranteed and 4 percent of total on-balance sheet assets. Each quarter we will submit to OFHEO calculations of the quantity of qualifying Freddie SUBS<sup>®</sup> and Total capital as part of our quarterly capital report.</li> <li>• Every six months, beginning January 1, 2006, we will submit to OFHEO a subordinated debt management plan that includes any issuance plans for the six months following the date of the plan.</li> </ul>	<ul style="list-style-type: none"> <li>• We did not issue any Freddie SUBS<sup>®</sup> during 2005, 2004 or 2003. We issued approximately \$1.25 billion of Freddie SUBS<sup>®</sup> in June 2006. Our ability to issue additional subordinated debt may be limited until we return to regular financial reporting. During 2001 and 2002, we completed a total of four offerings of Freddie SUBS<sup>®</sup> that provided approximately \$5.5 billion in net proceeds.</li> <li>• At December 31, 2005, we had \$5.5 billion in qualifying Freddie SUBS<sup>®</sup> outstanding and Total capital, for the purpose of this calculation, in the amount of \$36.4 billion, resulting in a surplus of \$5.2 billion.</li> <li>• We have submitted our semi-annual subordinated debt management plan to OFHEO.</li> <li>• We expect to issue additional subordinated debt in a principal amount in excess of \$1 billion from time to time during the remainder of 2006, subject to market conditions and other factors.</li> </ul>
<p>2. <i>Liquidity Management and Contingency Planning:</i></p> <ul style="list-style-type: none"> <li>• We will maintain a contingency plan providing for at least three months’ liquidity without relying upon the issuance of unsecured debt. We will also periodically test the contingency plan in consultation with OFHEO.</li> </ul>	<ul style="list-style-type: none"> <li>• We have in place a liquidity contingency plan, upon which we report to OFHEO on a monthly basis. During the second quarter of 2006, we also began our periodic testing.</li> </ul>
<p>3. <i>Interest-Rate Risk Disclosures:</i></p> <ul style="list-style-type: none"> <li>• We will provide public disclosure of our duration gap, PMVS-L and PMVS-YC interest-rate risk sensitivity results on a monthly basis. See “RISK MANAGEMENT — Interest-Rate Risk and Other Market Risks — <i>Portfolio Market Value Sensitivity and Measurement of Interest-Rate Risk</i>” for a description of these metrics.</li> </ul>	<ul style="list-style-type: none"> <li>• For the twelve months ended December 31, 2005, our duration gap averaged zero months, PMVS-L averaged one percent and PMVS-YC averaged zero percent. Our 2005 monthly average duration gap, PMVS results and related disclosures are provided in our Monthly Volume Summary which is available on our website, <a href="http://www.FreddieMac.com/investors/volsum">www.FreddieMac.com/investors/volsum</a>.</li> </ul>

Description	Status																																							
<p>4. <i>Credit Risk Disclosures:</i></p> <ul style="list-style-type: none"> <li>We will make quarterly assessments of the impact on expected credit losses from an immediate 5 percent decline in single-family home prices for the entire U.S. We will disclose the impact in present value terms and measure our losses both before and after receipt of private mortgage insurance claims and other credit enhancements.</li> </ul>	<ul style="list-style-type: none"> <li>Our quarterly credit risk sensitivity estimates are as follows:</li> </ul> <table border="1" style="margin-left: auto; margin-right: auto;"> <thead> <tr> <th rowspan="2"></th> <th colspan="2" style="text-align: center;">Before Receipt of Credit Enhancements<sup>(1)</sup></th> <th colspan="2" style="text-align: center;">After Receipt of Credit Enhancements<sup>(2)</sup></th> </tr> <tr> <th style="text-align: center;">Net Present Value, or NPV<sup>(3)</sup> (dollars in millions)</th> <th style="text-align: center;">NPV Ratio<sup>(4)</sup></th> <th style="text-align: center;">Net Present Value, or NPV<sup>(3)</sup> (dollars in millions)</th> <th style="text-align: center;">NPV Ratio<sup>(4)</sup></th> </tr> </thead> <tbody> <tr> <td>As of:</td> <td></td> <td></td> <td></td> <td></td> </tr> <tr> <td>12/31/05</td> <td style="text-align: right;">\$873</td> <td style="text-align: right;">6.5 bps</td> <td style="text-align: right;">\$564</td> <td style="text-align: right;">4.2 bps</td> </tr> <tr> <td>09/30/05</td> <td style="text-align: right;">844</td> <td style="text-align: right;">6.6</td> <td style="text-align: right;">516</td> <td style="text-align: right;">4.0</td> </tr> <tr> <td>06/30/05</td> <td style="text-align: right;">787</td> <td style="text-align: right;">6.3</td> <td style="text-align: right;">471</td> <td style="text-align: right;">3.7</td> </tr> <tr> <td>03/31/05<sup>(5)</sup></td> <td style="text-align: right;">814</td> <td style="text-align: right;">6.6</td> <td style="text-align: right;">505</td> <td style="text-align: right;">4.1</td> </tr> <tr> <td>12/31/04</td> <td style="text-align: right;">794</td> <td style="text-align: right;">6.5</td> <td style="text-align: right;">463</td> <td style="text-align: right;">3.8</td> </tr> </tbody> </table> <p>(1) Assumes that none of the credit enhancements currently covering our mortgage loans has any mitigating impact on our credit losses.</p> <p>(2) Assumes we collect amounts due from credit enhancement providers after giving effect to certain assumptions about counterparty default rates.</p> <p>(3) Based on single-family Total mortgage portfolio, excluding Structured Securities backed by Ginnie Mae Certificates.</p> <p>(4) Calculated as the ratio of net present value of increase in credit losses to the single-family Total mortgage portfolio, defined above.</p> <p>(5) Beginning with period ended March 31, 2005, results included in this table are based on the model enhancements implemented on January 1, 2005. Results from March 31, 2005 using the previous model were \$756 million or 6.2 bps before receipt of credit enhancements and \$447 million or 3.6 bps after receipt of credit enhancements.</p>		Before Receipt of Credit Enhancements <sup>(1)</sup>		After Receipt of Credit Enhancements <sup>(2)</sup>		Net Present Value, or NPV <sup>(3)</sup> (dollars in millions)	NPV Ratio <sup>(4)</sup>	Net Present Value, or NPV <sup>(3)</sup> (dollars in millions)	NPV Ratio <sup>(4)</sup>	As of:					12/31/05	\$873	6.5 bps	\$564	4.2 bps	09/30/05	844	6.6	516	4.0	06/30/05	787	6.3	471	3.7	03/31/05 <sup>(5)</sup>	814	6.6	505	4.1	12/31/04	794	6.5	463	3.8
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<p>5. <i>Public Disclosure of Risk Rating:</i></p> <ul style="list-style-type: none"> <li>We will seek to obtain a rating, that will be continuously monitored by at least one nationally recognized statistical rating organization, assessing “risk-to-the-government” or independent financial strength.</li> </ul>	<ul style="list-style-type: none"> <li>At June 1, 2006, our “risk-to-the-government” rating from Standard &amp; Poor’s, or S&amp;P, was “AA–” and Moody’s Bank Financial Strength Rating for us was “A–”.</li> </ul>																																							