

CONSOLIDATED FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

REPORT OF INDEPENDENT AUDITORS

To the Board of Directors and Stockholders of Freddie Mac:

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income, of cash flows, and of stockholders' equity present fairly, in all material respects, the financial position of Freddie Mac, a stockholder-owned government-sponsored enterprise (the "company"), and its subsidiaries at December 31, 2005 and 2004, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2005, in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

We have also audited in accordance with auditing standards generally accepted in the United States of America the supplemental consolidated fair value balance sheets of the company as of December 31, 2005 and 2004. As described in "NOTE 16: FAIR VALUE DISCLOSURES," the supplemental consolidated fair value balance sheets have been prepared by management to present relevant financial information that is not provided by the historical-cost consolidated balance sheets and is not intended to be a presentation in conformity with generally accepted accounting principles. In addition, the supplemental consolidated fair value balance sheets do not purport to present the net realizable, liquidation, or market value of the company as a whole. Furthermore, amounts ultimately realized by the company from the disposal of assets or amounts required to settle obligations may vary significantly from the fair values presented. In our opinion, the supplemental consolidated fair value balance sheets referred to above present fairly, in all material respects, the information set forth therein as described in "NOTE 16: FAIR VALUE DISCLOSURES."

As discussed in "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES," the company changed its method of accounting for interest expense related to callable debt instruments as of January 1, 2005, and its method for determining gains and losses on sales of certain guaranteed securities as of October 1, 2005.

PricewaterhouseCoopers LLP

McLean, Virginia
June 28, 2006

FREDDIE MAC
CONSOLIDATED STATEMENTS OF INCOME

	Year Ended December 31,		
	2005	2004	2003
	(dollars in millions, except share-related amounts)		
<i>Interest income</i>			
Mortgage loans	\$ 4,037	\$ 4,007	\$ 4,251
Mortgage-related securities in the Retained portfolio	29,684	28,460	29,051
Cash and investments	2,606	3,136	3,796
Total interest income	<u>36,327</u>	<u>35,603</u>	<u>37,098</u>
<i>Interest expense</i>			
Short-term debt	(6,102)	(2,908)	(2,785)
Long-term debt	(23,246)	(22,950)	(22,083)
Total interest expense on debt securities	(29,348)	(25,858)	(24,868)
Due to Participation Certificate investors	(551)	(708)	(1,641)
Total interest expense	(29,899)	(26,566)	(26,509)
Income (expense) related to derivatives	(1,058)	100	(1,091)
Net interest income	<u>5,370</u>	<u>9,137</u>	<u>9,498</u>
<i>Non-interest income (loss)</i>			
Management and guarantee income (includes interest on Guarantee asset of \$371, \$257 and \$244)	1,450	1,382	1,653
Gains (losses) on Guarantee asset	(1,064)	(1,135)	(1,461)
Income on Guarantee obligation	920	732	925
Derivative gains (losses)	(1,357)	(4,475)	39
Hedge accounting gains (losses)	22	743	644
Gains (losses) on investment activity	(127)	(348)	(1,114)
Gains (losses) on debt retirement	206	(327)	(1,775)
Resecuritization fees	125	159	352
Other income	24	230	493
Non-interest income (loss)	<u>199</u>	<u>(3,039)</u>	<u>(244)</u>
<i>Non-interest expense</i>			
Salaries and employee benefits	(805)	(758)	(624)
Professional services	(386)	(588)	(311)
Occupancy expense	(58)	(60)	(52)
Other administrative expenses	(286)	(144)	(194)
Total administrative expenses	(1,535)	(1,550)	(1,181)
Provision for credit losses	(251)	(143)	5
REO operations income (expense)	(40)	3	(7)
Housing tax credit partnerships	(320)	(281)	(200)
Minority interests in earnings of consolidated subsidiaries	(96)	(129)	(157)
Other expenses	(771)	(271)	(696)
Non-interest expense	<u>(3,013)</u>	<u>(2,371)</u>	<u>(2,236)</u>
Income before income tax expense and cumulative effect of change in accounting principle	2,556	3,727	7,018
Income tax expense	(367)	(790)	(2,202)
Net income before cumulative effect of change in accounting principle	2,189	2,937	4,816
Cumulative effect of change in accounting principle, net of taxes of \$32	(59)	—	—
Net income	<u>\$ 2,130</u>	<u>\$ 2,937</u>	<u>\$ 4,816</u>
Preferred stock dividends	(223)	(210)	(216)
Net income available to common stockholders	<u>\$ 1,907</u>	<u>\$ 2,727</u>	<u>\$ 4,600</u>
<i>Basic earnings per common share:</i>			
Earnings before cumulative effect of change in accounting principle	\$ 2.84	\$ 3.96	\$ 6.69
Cumulative effect of change in accounting principle, net of taxes	\$ (0.09)	\$ —	\$ —
Basic earnings per common share	\$ 2.76	\$ 3.96	\$ 6.69
<i>Diluted earnings per common share:</i>			
Earnings before cumulative effect of change in accounting principle	\$ 2.83	\$ 3.94	\$ 6.68
Cumulative effect of change in accounting principle, net of taxes	\$ (0.08)	\$ —	\$ —
Diluted earnings per common share	\$ 2.75	\$ 3.94	\$ 6.68
<i>Weighted average common shares outstanding (in thousands)</i>			
Basic	691,582	689,282	687,094
Diluted	693,511	691,521	688,675
Dividends per common share	\$ 1.52	\$ 1.20	\$ 1.04

The accompanying notes are an integral part of these financial statements.

**FREDDIE MAC
CONSOLIDATED BALANCE SHEETS**

	December 31,	
	2005	2004
	(in millions, except share-related amounts)	
Assets		
<i>Retained portfolio</i>		
Mortgage loans:		
Held-for-investment, at amortized cost	\$ 60,009	\$ 58,852
Reserve for losses on mortgage loans held-for-investment	(119)	(114)
Held-for-sale, at lower-of-cost-or-market	1,538	2,582
Mortgage loans, net of reserve	61,428	61,320
Mortgage-related securities:		
Available-for-sale, at fair value (includes \$168 and \$194, respectively, pledged as collateral that may be repledged)	638,465	590,461
Trading, at fair value	8,894	11,842
Participation Certificate residuals, at fair value	597	845
Total mortgage-related securities	647,956	603,148
<i>Retained portfolio</i>	709,384	664,468
<i>Cash and investments</i>		
Cash and cash equivalents		
	10,468	35,253
Investments:		
Non-mortgage-related securities:		
Available-for-sale, at fair value	42,165	29,830
Securities purchased under agreements to resell and Federal funds sold	15,159	32,197
<i>Cash and investments</i>	67,792	97,280
Accounts and other receivables, net	6,373	7,286
Derivative assets, at fair value	7,097	15,257
Guarantee asset, at fair value	5,083	4,516
Real estate owned, net	629	741
Other assets	9,864	5,736
<i>Total assets</i>	\$806,222	\$795,284
Liabilities and stockholders' equity		
<i>Debt securities, net</i>		
Senior debt:		
Due within one year	\$288,532	\$282,303
Due after one year	454,627	443,772
Subordinated debt, due after one year	5,633	5,622
<i>Total debt securities, net</i>	748,792	731,697
Due to Participation Certificate investors	10,607	13,654
Accrued interest payable	7,611	7,329
Guarantee obligation	5,541	4,065
Derivative liabilities, at fair value	590	226
Reserve for guarantee losses on Participation Certificates	295	150
Other liabilities	4,646	5,238
<i>Total liabilities</i>	778,082	762,359
Commitments and contingencies (Notes 1, 3, 4, 13 and 14)		
<i>Minority interests in consolidated subsidiaries</i>	949	1,509
<i>Stockholders' equity</i>		
Preferred stock, at redemption value	4,609	4,609
Common stock, \$0.21 par value, 726,000,000 shares authorized, 725,882,280 shares issued and 692,717,422 shares and 690,606,185 shares outstanding, respectively	152	152
Additional paid-in capital	924	873
Retained earnings	31,559	30,728
Accumulated other comprehensive income (loss) (AOCI), net of taxes, related to:		
Available-for-sale securities	(2,485)	4,339
Cash flow hedge relationships	(6,287)	(7,924)
Minimum pension liability	(1)	(8)
Total accumulated other comprehensive income (loss), net of taxes	(8,773)	(3,593)
Treasury stock, at cost, 33,164,858 shares and 35,276,095 shares, respectively	(1,280)	(1,353)
<i>Total stockholders' equity</i>	27,191	31,416
<i>Total liabilities and stockholders' equity</i>	\$806,222	\$795,284

The accompanying notes are an integral part of these financial statements.

FREDDIE MAC
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

Year Ended December 31,

	2005		2004		2003	
	Shares	Amount	Shares	Amount	Shares	Amount
	(in millions)					
<i>Preferred stock, at redemption value</i>						
Balance, beginning of year	92	\$ 4,609	92	\$ 4,609	92	\$ 4,609
<i>Preferred stock, end of year</i>	92	4,609	92	4,609	92	4,609
<i>Common stock, par value</i>						
Balance, beginning of year	726	152	726	152	726	152
<i>Common stock, end of year</i>	726	152	726	152	726	152
<i>Additional paid-in capital</i>						
Balance, beginning of year		873		814		744
Stock-based compensation, before tax effect of \$24, \$20 and \$23, respectively		67		56		64
Income tax benefit from employee stock option exercises		6		20		16
Common stock issuances		(13)		(17)		(10)
REIT preferred stock purchase		(9)		—		—
<i>Additional paid-in capital, end of year</i>		924		873		814
<i>Retained earnings</i>						
Balance, beginning of year		30,728		28,837		24,955
Net income		2,130		2,937		4,816
Preferred stock dividends declared		(223)		(210)		(216)
Common stock dividends declared		(1,076)		(836)		(718)
<i>Retained earnings, end of year</i>		31,559		30,728		28,837
<i>AOCI, net of taxes</i>						
Balance, beginning of year		(3,593)		(1,498)		2,340
Changes in unrealized gains (losses) related to available-for-sale securities, net of reclassification adjustments		(6,824)		(2,010)		(5,868)
Changes in unrealized gains (losses) related to cash flow hedge relationships, net of reclassification adjustments		1,637		(87)		2,040
Change in minimum pension liability		7		2		(10)
<i>AOCI, net of taxes, end of year</i>		(8,773)		(3,593)		(1,498)
<i>Treasury stock, at cost</i>						
Balance, beginning of year	35	(1,353)	37	(1,427)	39	(1,470)
Common stock issuances	(2)	73	(2)	74	(2)	43
<i>Treasury stock, end of year</i>	33	(1,280)	35	(1,353)	37	(1,427)
<i>Total stockholders' equity</i>		\$27,191		\$31,416		\$31,487
<i>Comprehensive income (loss)</i>						
Net income		\$ 2,130		\$ 2,937		\$ 4,816
Changes in AOCI, net of taxes, net of reclassification adjustments		(5,180)		(2,095)		(3,838)
<i>Total comprehensive income (loss)</i>		\$ (3,050)		\$ 842		\$ 978

The accompanying notes are an integral part of these financial statements.

FREDDIE MAC
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year Ended December 31,		
	2005	2004	2003
	(in millions)		
Cash flows from operating activities			
Net income	\$ 2,130	\$ 2,937	\$ 4,816
Adjustments to reconcile net income to net cash provided by operating activities:			
Cumulative effect of change in accounting principle, net	59	—	—
Hedge accounting gains	(22)	(743)	(644)
Unrealized losses (gains) on derivatives not in hedge accounting relationships, net	1,014	2,758	(1,079)
Asset related amortization — premiums, discounts and hedging basis adjustments	791	1,302	968
Debt related amortization — premiums and discounts on certain debt securities and hedging basis adjustments	9,129	5,748	5,027
Net discounts paid on retirements of debt	(5,207)	(3,085)	(3,326)
(Gains) losses on debt retirement	(206)	327	1,775
Provision for credit losses	260	143	(5)
Housing tax credit partnership losses	320	281	200
Losses on investment activity	343	738	2,625
(Decrease) increase in deferred income taxes	(1,452)	(346)	737
Purchases of held-for-sale mortgages	(26,763)	(31,698)	(82,074)
Sales of held-for-sale mortgages	23,662	30,965	84,329
Repayments of held-for-sale mortgages	118	162	390
Net proceeds of trading securities	2,598	38,672	8,935
Change in accounts and other receivables, net	661	1,870	3,902
Change in amounts due to Participation Certificate investors, net	(3,077)	529	(22,369)
Change in accrued interest payable	282	(235)	275
Change in income taxes payable	607	773	(1,074)
Change in Guarantee asset	(567)	(830)	(1,362)
Change in Guarantee obligation	1,413	1,173	1,606
Change in Participation Certificate residuals, at fair value	112	(170)	(389)
Other, net	(66)	37	7
<i>Net cash provided by operating activities</i>	<u>6,139</u>	<u>51,308</u>	<u>3,270</u>
Cash flows from investing activities			
Purchases of available-for-sale securities	(414,063)	(276,573)	(446,036)
Proceeds from sales of available-for-sale securities	94,961	85,583	143,513
Proceeds from maturities of available-for-sale securities	249,857	176,432	240,041
Purchases of held-for-investment mortgages	(12,980)	(12,525)	(15,567)
Repayments of held-for-investment mortgages	12,051	11,511	15,283
Proceeds from sales of REO	1,380	1,552	1,327
Net decrease (increase) in securities purchased under agreements to resell and Federal funds sold	17,038	(11,615)	2,461
Repurchase of REIT preferred stock	(142)	—	—
Derivative premiums and terminations, net	932	(193)	3,333
Investments in housing tax credit partnerships	(127)	(69)	(32)
<i>Net cash used for investing activities</i>	<u>(51,093)</u>	<u>(25,897)</u>	<u>(55,677)</u>
Cash flows from financing activities			
Proceeds from issuance of short-term debt	857,361	826,020	900,073
Repayments of short-term debt	(862,176)	(841,638)	(881,860)
Proceeds from issuance of long-term debt	153,504	187,779	258,267
Repayments of long-term debt	(125,959)	(183,541)	(210,121)
Repayments of minority interest in consolidated subsidiaries	(436)	(405)	(376)
Proceeds from issuance of common stock	60	57	33
Payment of cash dividends on preferred stock and common stock	(1,299)	(1,046)	(934)
Repayments of housing tax credit partnerships notes payable	(940)	(498)	(349)
Increase (decrease) in cash overdraft	54	(28)	24
<i>Net cash provided by (used for) financing activities</i>	<u>20,169</u>	<u>(13,300)</u>	<u>64,757</u>
Net (decrease) increase in cash and cash equivalents	(24,785)	12,111	12,350
Cash and cash equivalents at beginning of year	35,253	23,142	10,792
<i>Cash and cash equivalents at end of year</i>	<u>\$ 10,468</u>	<u>\$ 35,253</u>	<u>\$ 23,142</u>
Supplemental cash flow information			
Cash (received) paid for:			
Interest	\$ 26,797	\$ 23,902	\$ 25,918
Derivative interest carry, net	(590)	325	578
Income taxes	1,212	363	2,538
Loans in acceleration held in the retained portfolio	1,372	1,716	2,003
Non-cash investing and financing activities:			
Securitized and retained available-for-sale securities of held-for-sale mortgages	175	272	1,681
Transfers from mortgage loans to REO	1,312	1,546	1,570
Investments in housing tax credit partnerships financed by notes payable	1,095	1,184	702
Transfers from held-for-sale mortgages to held-for-investment mortgages	291	198	179

The accompanying notes are an integral part of these financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

We are a stockholder-owned, government-sponsored enterprise, or GSE, established by Congress in 1970 to provide a continuous flow of funds for residential mortgages. Our obligations are ours alone and are not insured or guaranteed by the U.S., or any other agency or instrumentality of the U.S. We play a fundamental role in the American housing finance system, linking the domestic mortgage market and the global capital markets. Our participation in the secondary mortgage market includes providing our credit guarantee for residential mortgages originated by mortgage lenders and investing in mortgage loans and mortgage-related securities that we hold in our Retained portfolio. Through our credit guarantee activities, we securitize mortgage loans by issuing Mortgage Participation Certificates, or PCs, to third-party investors. We also resecuritize mortgage-related securities that are issued by us or the Government National Mortgage Association, or Ginnie Mae, as well as non-agency entities. Resecuritized mortgage-related securities are referred to as Structured Securities. We also guarantee multifamily mortgage loans that support housing revenue bonds issued by third parties and we guarantee other mortgage loans held by third parties. Securitized mortgage-related assets that back PCs and Structured Securities that are held by third parties are not reflected as our assets. In return for providing our guarantee on issued PCs and Structured Securities, we may earn a management and guarantee fee that is paid to us over the life of the related PCs and Structured Securities. Our obligation to guarantee the payment of principal and interest on issued PCs and Structured Securities usually results in the recognition of a Guarantee asset and Guarantee obligation.

Our financial reporting and accounting policies conform to U.S. generally accepted accounting principles, or GAAP. Certain amounts in prior periods have been reclassified to conform to the current presentation.

Estimates

The preparation of financial statements requires us to make estimates and assumptions that affect (a) the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and (b) the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Our estimates and judgments include the following: the estimation of fair value for financial instruments (See “NOTE 16: FAIR VALUE DISCLOSURES” for a discussion of our fair value estimates); determining the expected future cash flows (including the timing and amounts of prepayments) of mortgage-related assets in the Retained portfolio for the purpose of amortizing deferred amounts and assessing when securities are other-than-temporarily impaired; assessing the reserves for credit losses on mortgage loans and guarantee losses on PCs; assessing our legal and tax contingencies; estimating the expected timing and amounts of future issuances of non-callable debt; and determining other matters that affect the reported amounts and disclosure of contingencies in the financial statements.

Net income for 2005 was reduced by approximately \$206 million (after tax), or \$0.30 per diluted common share, related to the implementation of enhancements to our approach for certain valuations, the estimation of reserves for uncollectible interest and models used to estimate prepayment behavior of mortgage assets that were recorded as changes in accounting estimates.

Effective January 1, 2005, we implemented several enhancements to the valuation approach that we use to estimate the fair value of our guarantee-related assets and liabilities. With respect to our guarantee-related assets, these enhancements include the use of third-party quotes on assets that have similar characteristics. We have also worked with third parties to create and value hypothetical credit structures based on the collateral underlying our PCs, and used those values in determining the fair values of our guarantee-related liabilities. The change in valuation approach for our guarantee-related assets and liabilities primarily affected our Guarantee asset and Participation Certificate residuals, which are both carried at fair value, and reduced Net income by approximately \$68 million (after-tax). This valuation change also affected the amortization of deferred credit fees resulting in a \$17 million reduction in Net income. Additional information about the valuation methods used for our guarantee-related assets and liabilities is discussed in “NOTE 2: TRANSFERS OF SECURITIZED INTERESTS IN MORTGAGE-RELATED ASSETS.”

We also changed our estimate of reserves for uncollectible interest on single-family mortgage loans we hold that are greater than 90 days delinquent. Our new estimation approach establishes reserves for all accrued but uncollected interest on all single-family loans that are greater than 90 days delinquent. Prior to this change, we accrued interest on all single-family loans and established reserves for all accrued interest we deemed uncollectible using internal statistically based models. This change resulted in a \$77 million (after-tax) reduction in Net income for 2005.

Also, effective January 1, 2005, we implemented refinements to our prepayment model that is used to evaluate prepayment behavior for assets in our Retained portfolio. As a result, prepayment speeds used in our amortization model

generally increased, reflecting better estimates of the effects of recent market conditions on expected prepayments. This change resulted in a \$44 million (after-tax) reduction in Net income for 2005.

Net income for 2004 was decreased by approximately \$56 million (after tax), or \$0.08 per diluted common share, as the result of a change in estimate related to enhancements to certain assumptions and calculations in the amortization process for deferred fees recorded as basis adjustments on assets in our Retained portfolio.

Net income for 2003 was increased by approximately \$92 million (after tax), or \$0.13 per diluted common share, as a result of changes in accounting estimates related to: (a) the amortization of certain deferred fees recorded as basis adjustments on assets in our Retained portfolio, which increased net income by \$20 million, and (b) improvements to our approach for estimating the expected weighted-average lives of mortgages with related deferred fees, including credit fees and buy-down fees, which increased net income by \$72 million.

Table 1.1 shows the pre-tax impact of the changes in estimates on our consolidated statement of income:

Table 1.1 — Summary of Change in Estimates (Pre-Tax)

	Year ended December 31,		
	2005	2004	2003
	(in millions)		
Interest income	\$(166)	\$(86)	\$ 31
<i>Non-interest income (loss)</i>			
Management and guarantee income	(17)	—	110
Gains (losses) on Guarantee asset	(27)	—	—
Gains (losses) on investment activity	(78)	—	—
Other income	(27)	—	—
Total non-interest income (loss)	<u>(149)</u>	<u>—</u>	<u>110</u>
Total pre-tax impact of changes in estimates	<u>\$(315)</u>	<u>\$(86)</u>	<u>\$141</u>

Changes in Accounting Principles

Effective January 1, 2005, we changed our method of accounting for interest expense related to callable debt instruments to recognize interest expense using an effective interest method over the contractual life of the debt. For periods prior to 2005, we amortized premiums, discounts, deferred issuance costs and other basis adjustments in interest expense using an effective interest method over the estimated life of the debt. We implemented this change in accounting method to facilitate improved financial reporting, particularly to promote the comparability of our financial reporting with that of our primary competitor. The change in accounting method also reduces the operational complexity associated with determining the estimated life of callable debt. The cumulative effect of this change was a \$59 million (after-tax) reduction in net income for 2005.

Table 1.2 summarizes the pro forma net income and related basic and diluted earnings per common share, had the amortization of premiums, discounts, deferred issuance costs and other basis adjustments related to callable debt based on the contractual maturity been in effect for the years ended December 31, 2004 and 2003.

Table 1.2 — Pro Forma Information — Change in Accounting for Interest Expense Related to Callable Debt

	Year Ended December 31,	
	2004	2003
	(in millions, except share-related amounts)	
As reported:		
Net income	\$2,937	\$4,816
Basic earnings per common share	\$ 3.96	\$ 6.69
Diluted earnings per common share	\$ 3.94	\$ 6.68
Pro forma:		
Net income	\$2,910	\$4,746
Basic earnings per common share	\$ 3.92	\$ 6.59
Diluted earnings per common share	\$ 3.90	\$ 6.58

Beginning October 1, 2005, we changed our method for determining gains and losses upon the re-sale of PCs and Structured Securities related to deferred items recognized in connection with our guarantee of those securities. This change in accounting principle was facilitated by system changes that now allow us to apply and track these deferred items relative to the specific portions of the purchased PCs and Structured Securities, thus improving our financial reporting. Due to the unavailability of certain historical data, we did not have the ability to calculate the cumulative effect of the change nor were we able to determine the pro forma effects of applying the new method retroactively. See “NOTE 2: TRANSFERS OF SECURITIZED INTERESTS IN MORTGAGE-RELATED ASSETS” for additional information.

Consolidation and Equity Method of Accounting

The consolidated financial statements include our accounts and those of our subsidiaries. All material intercompany transactions have been eliminated in consolidation. For each entity with which we are involved, we determine whether the entity should be considered our subsidiary and included in our consolidated financial statements. We consolidate (a) all Variable Interest Entities, or VIEs, in which we are the primary beneficiary and (b) entities that are not VIEs in which we hold more than 50 percent of the voting rights and have the ability to exercise control over the entity.

For each entity in which we are involved, we determine if the entity is a VIE. A VIE is an entity (a) that has a total equity investment at risk that is not sufficient to finance its activities without additional subordinated financial support from other entities or (b) where the group of equity holders does not have the ability to make significant decisions about the entity's activities, or the obligation to absorb the entity's expected losses or the right to receive the entity's expected residual returns, or both. We consolidate entities that are VIEs when we are the primary beneficiary. We are considered the primary beneficiary and must consolidate a VIE when we absorb a majority of expected losses or expected residual returns, or both. In addition to the VIEs that are consolidated, we have significant variable interest in certain other VIEs that are not consolidated because we are not the primary beneficiary. See "NOTE 3: VARIABLE INTEREST ENTITIES" for more information.

We consolidate entities that are not VIEs when we hold more than 50 percent of the voting rights and have the ability to exercise control over the entity. Accordingly, we consolidate our two majority-owned Real Estate Investment Trusts, or REITs, Home Ownership Funding Corporation and Home Ownership Funding Corporation II. The equity and net earnings attributable to the minority shareholder interests in our consolidated subsidiaries are reported separately in the consolidated balance sheets as Minority interests in consolidated subsidiaries and in the consolidated statements of income as Minority interests in earnings of consolidated subsidiaries.

We use the equity method of accounting for VIEs when we are not the primary beneficiary and for entities that are not VIEs over which we have the ability to exercise significant influence, but not control. Under the equity method of accounting, we report our recorded investment as part of Other assets on the consolidated balance sheets and recognize our share of the entity's net income or losses in the consolidated statements of income, with an offset to the recorded investment on the consolidated balance sheets. Losses are recognized up to the amount of investment recorded.

We regularly invest as a limited partner in qualified low-income housing tax credit, or LIHTC, partnerships that are eligible for federal tax credits. Most of these are VIEs. We are the primary beneficiary and consolidate certain of these partnerships as described further in "NOTE 3: VARIABLE INTEREST ENTITIES." Our recorded investment in those partnerships that are not consolidated is accounted for under the equity method and is reported as part of Other assets on the consolidated balance sheets. Our share of partnership income or loss is reported in the consolidated statements of income as Non-interest expense — Housing tax credit partnerships. Our obligations to make delayed equity contributions that are unconditional and legally binding are recorded at their present value in Other liabilities on the consolidated balance sheets. To the extent our cost basis in qualified LIHTC partnerships differs from the book basis reflected at the partnership level, the difference is amortized over the life of the tax credits and included in our share of earnings (losses) from housing tax credit partnerships. We periodically review these investments for impairment and adjust them to fair value when a decline in market value below the recorded investment is deemed to be other than temporary. Impairment losses are included in our consolidated statements of income as part of Non-interest expense — Housing tax credit partnerships.

Cash and Cash Equivalents and Statements of Cash Flows

Highly liquid investment securities that have an original maturity of three months or less and are used for cash management purposes are accounted for as cash equivalents. Cash collateral we obtained from counterparties to derivative contracts where we are in a net unrealized gain position is recorded as Cash and cash equivalents. The vast majority of the cash and cash equivalents balance is interest-bearing in nature.

In the consolidated statements of cash flows, cash flows related to the acquisition and termination of derivatives other than forward commitments are generally classified in investing activities, without regard to whether the derivatives are designated as a hedge of another item. Cash flows from commitments accounted for as derivatives that result in the acquisition or sale of mortgage securities or mortgage loans are classified in either: (a) operating activities for trading securities or mortgage loans classified as held-for-sale, or (b) investing activities for available-for-sale securities or mortgage loans classified as held-for-investment. Cash flows related to mortgage loans classified as held-for-sale are classified in operating activities until the loans have been securitized and retained as available-for-sale PCs, at which time the cash flows are classified as investing activities. Cash flows related to guarantee fees, including buy-up and buy-down payments, are classified as operating activities, along with the cash flows related to the collection and distribution of payments on the mortgage loans underlying PCs. Buy-up and buy-down payments are discussed further below in "Swap-Based Issuances of PCs and Structured Securities." There were less than \$1 million, \$428 million and \$322 million of non-cash net transfers to

the available-for-sale classification from the trading classification related to securitization transactions during 2005, 2004 and 2003, respectively.

Transfers of PCs and Structured Securities that Qualify as Sales

Upon completion of a transfer of a financial asset that qualifies as a sale under SFAS No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities" ("SFAS 140"), we de-recognize all assets sold and recognize all assets obtained and liabilities incurred. In this regard, we recognize the fair value of our obligation to guarantee the payment of principal and interest of PCs and Structured Securities transferred in sale transactions. The portion of such obligation that relates to our non-contingent obligation to stand ready to perform under our guarantee is recognized as a Guarantee obligation, while the portion of the obligation that relates to estimated incurred losses on securitized assets is recognized for consolidated balance sheet purposes as Reserve for guarantee losses on Participation Certificates. The resulting gain (loss) on sale of transferred PCs and Structured Securities is reflected in our consolidated statements of income as a component of Gains (losses) on investment activity.

In recording a sales transaction, we also continue to carry on our consolidated balance sheets any retained interests in securitized financial assets. Such retained interests include our right to receive management and guarantee fees on PCs or Structured Securities, which is classified on our consolidated balance sheets as a Guarantee asset. The carrying amount of all such retained interests is determined by allocating the previous carrying amount of the transferred assets between assets sold and the retained interests based upon their relative fair values at the date of transfer. Other retained interests include PCs or Structured Securities that are not transferred to third parties upon the completion of a securitization or securitization transaction.

Swap-Based Issuances of PCs and Structured Securities

In addition to issuing PCs and Structured Securities through cash-based sales transactions, we issue such securities through various swap-based exchanges. In the case of PC-based swaps, we issue such securities to third parties through Guarantor and MultiLender Swap transactions. Guarantor Swaps represent transactions in which financial institutions transfer mortgage loans to us in exchange for PCs we issue that are backed by such mortgage loans. MultiLender Swaps are similar to Guarantor Swaps, except that formed pools include loans that are contributed by more than one other party or by us. In Guarantor and MultiLender Swaps, as in sales transactions, in return for providing our guarantee, we earn a guarantee fee that is paid to us over the life of an issued PC. It is also common for buy-up or buy-down payments to be exchanged between our counterparties and us upon the issuance of a PC. Buy-Ups are upfront payments made by us that increase the guarantee fee we will receive over the life of the PC. Buy-Downs are upfront payments that are made to us that decrease (*i.e.*, partially prepay) the guarantee fee we will receive over the life of the PC. We also may receive upfront, cash-based payments as additional compensation for our guarantee of mortgage loans, referred to as Credit Fees, and as additional consideration received on such exchanges, we may receive various types of seller-provided credit enhancements related to the underlying mortgage loans. We also issue and transfer Structured Securities to third parties in exchange for PCs and non-Freddie Mac mortgage-related securities.

We recognize the fair value of our contractual right to receive guarantee fees as a Guarantee asset at the inception of an executed guarantee. Additionally, we recognize a Guarantee obligation at the greater of (a) fair value or (b) the contingent liability amount required by SFAS No. 5, "Accounting For Contingencies," or SFAS 5, to be recognized at inception of an executed guarantee. Similar to transfers of PCs and Structured Securities that qualify as sales, that portion of our estimated guarantee liability that relates to our non-contingent obligation to stand ready to perform under a PC guarantee is recognized as Guarantee obligation, while that portion of such estimated guarantee liability that relates to our contingent obligation to make payments under our guarantee is recognized for consolidated balance sheet purposes as Reserve for guarantee losses on Participation Certificates. Further, credit enhancements received in connection with Guarantor Swaps and other similar exchange transactions of PCs are measured at fair value and recognized as follows: (a) pool insurance is recognized as an Other asset; (b) recourse and/or indemnifications that are provided by counterparties to Guarantor Swap transactions are recognized as Other assets; and (c) primary mortgage insurance is recognized at inception as a component of the recognized Guarantee obligation.

Because Guarantee asset, Guarantee obligation and credit enhancement-related assets that are recognized at the inception of an executed Guarantor Swap are valued independently of each other, net differences between such recognized assets and liabilities may exist at inception. Net positive differences between such amounts are deferred on our consolidated balance sheet as a component of Guarantee obligation and are hereinafter referred to as "Deferred Guarantee Income". Net negative differences between Guarantee asset, Guarantee obligation and credit enhancement-related assets that are recognized at the inception of executed financial guarantees are expensed immediately to earnings as a component of Non-interest expense — Other expenses. Additionally, cash payments that are made or received in connection with Buy-Ups

and Buy-Downs are recognized as adjustments of recognized Deferred Guarantee Income. Likewise, Credit Fees that we receive at inception are also recognized as adjustments of recognized Deferred Guarantee Income.

With regard to PCs that we issue through our MultiLender Swap Program, we account for a portion of such transactions in the same manner as transfers described above that are accounted for as sales. The remaining portion of such PC issuances are accounted for in a manner consistent with the accounting for PCs issued through the Guarantor Swap program.

Concerning Structured Securities that we issue to third parties in exchange for PCs and non-Freddie Mac mortgage-related securities, we do not recognize any incremental Guarantee asset or Guarantee obligation on such transactions. Rather, we defer and amortize into income on a straight-line basis that portion of the transaction fee that we receive on such transactions that relates to the estimated fair value of our future administrative responsibilities for issued Structured Securities. In cases where we retain portions of Structured Securities issued in such transactions, a portion of the received transaction fee is deferred as a carrying value adjustment of retained Structured Securities. The balance of transaction fees received, which relates to compensation earned in connection with structuring-related services rendered by us to third parties, is recognized immediately in earnings as Non-interest income — Resecuritization fees.

Purchases of PCs or Structured Securities

The purchase of a PC or Structured Security prompts the extinguishment of the corresponding, recognized Guarantee obligation. Likewise, and where applicable, the purchase of such securities also prompts the extinguishment of the related unamortized balance of Deferred Guarantee Income.

We de-recognize an extinguished Guarantee obligation against earnings as a component of Gains (losses) on investment activity. Correspondingly, the recognized Guarantee asset is reclassified on our consolidated balance sheets as a component of Participation Certificate residuals, at fair value, or PC Residuals.

The unamortized balance of Deferred Guarantee Income is extinguished as a basis adjustment to the recognized value of purchased PCs. Like purchase discounts, such basis adjustments are subsequently amortized into earnings as Interest income pursuant to the requirements of SFAS No. 91, “Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases,” or SFAS 91, using the effective interest method.

Subsequent Measurement of Recognized Guarantee-Related Assets and Liabilities

Deferred Guarantee Income

Deferred Guarantee Income is amortized into earnings at a rate that is commensurate with the observed decline in the unpaid principal balance of securitized mortgage loans. Periodic amortization of recognized Deferred Guarantee Income is reflected in earnings as a component of Income on Guarantee obligation.

Recognized Guarantee Asset

We generally account for a Guarantee asset like a debt instrument classified as trading under SFAS 115. As such, all changes in the fair value of recognized Guarantee asset are reflected in earnings as a component of Gains (losses) on Guarantee asset. All guarantee-related compensation that is received over the life of the loan in cash is reflected in earnings as a component of Management and guarantee income.

Recognized Guarantee Obligation

We subsequently amortize the recognized Guarantee obligation into earnings in proportion to the rate of the unpaid principal balance decline of securitized mortgage loans. Periodic amortization of a recognized Guarantee obligation is reflected in earnings as a component of Income on Guarantee obligation. The subsequent measurement of our contingent obligation to make guarantee payments is further discussed below in “Reserves for Losses on Mortgage Loans Held-for-Investment and Losses on PCs”.

Recognized Credit Enhancements

Credit enhancements that are separately recognized as Other assets are amortized into earnings as Non-interest expense. Such assets are amortized over related contract terms at the greater of results calculated by amortizing recognized credit enhancements (a) in proportion to the rate of unpaid principal balance decline of covered mortgage loans or (b) on a straight-line basis over a credit enhancement’s contract term, whichever is shorter. Recurring insurance premiums are recorded at the amount paid and amortized over their contractual life and, if provided quarterly, then the amortization period is three months.

PC Residuals

PC residuals relate to certain PCs or Structured Securities held by us as investments and represent the fair value of the expected future cash flows associated with the guarantee contracts (including cash flows related to Management and guarantee fees and our Guarantee obligation) that are inherent within such securities.

We recognize a PC residual in connection with PCs or Structured Securities held by us that (a) were previously transferred to third parties as part of transactions that were accounted for either as sales or in a manner described above for Guarantor Swap transactions (such that a Guarantee asset and Guarantee obligation was previously established for held PCs or Structured Securities), (b) were formed from mortgage loans purchased through our Cash Window (“Cash Window Purchases”) and that were never transferred to third parties, (c) were purchased by us from third parties in contemplation of the related issuance of such PCs through the Guarantor Swap program or (d) relate to Buy-Ups paid in connection with purchased PCs that had not previously been included as part of a transfer that was accounted for as a sale or as part of a guarantee transaction that was accounted for like Guarantor Swaps as described above.

Like a recognized Guarantee asset, a PC residual is accounted for like a debt security and is classified as either available-for-sale or trading under SFAS 115. PC residuals relating to PCs or Structured Securities that were transferred to third parties and for which a Guarantee asset and Guarantee obligation was recognized are accounted for like debt securities that are classified as trading. PC residuals relating to PCs held in portfolio that were formed from Cash Window Purchases and that were never transferred to third parties are generally accounted for like debt securities that are classified as available-for-sale.

All changes in the fair value of PC residuals that are designated as trading are reflected in earnings as a component of Gains (losses) on investment activity. All changes in the fair value of PC residuals that are accounted for as available-for-sale are reflected as a component of Accumulated other comprehensive income (loss), net of taxes, or AOCI, a component of Stockholders’ equity. All cash received over the life of the underlying loans with respect to the Guarantee asset component of the PC residuals is reflected in earnings as a component of Net interest income.

Due to Participation Certificate Investors

Timing differences between our receipt of scheduled and unscheduled principal and interest payments from seller/servicers on mortgages underlying PCs and the subsequent pass through of those payments on PCs owned by third-party investors result in the liability Due to Participation Certificate investors. In those cases, the PC balance is not reduced for payments of principal received from seller/servicers in a given month until the first day of the next month and we do not release the cash received (principal and interest) to the PC investor until the fifteenth day of that next month. We generally invest the principal and interest amounts we receive in short-term investments from the time the cash is received until the time we pay the PC investor. Interest income resulting from investment of principal and interest payments from seller/servicers is reported in interest income.

For unscheduled principal prepayments, these timing differences result in an expense accrual upon prepayment of the underlying mortgage. This is because the related PCs continue to bear interest due to the PC investor at the PC coupon rate from the date of prepayment until the date the PC security balance is reduced, while generally no interest is received from the mortgage on that prepayment amount during that period. The expense recognized upon prepayment is reported in Interest expense — Due to Participation Certificate investors. We report PC coupon interest amounts relating to our investment in PCs consistent with the accounting practices generally applied by third party investors in PCs. Accordingly, the PC coupon interest on prepayments of a mortgage pending remittance on PCs held by us is reported as both Interest Income — Mortgage-related securities in the Retained portfolio and Interest expense — Due to Participation Certificate investors. Scheduled and unscheduled principal payments received by us that relate to our investment in PCs are reported as a reduction to our investment in PCs on the consolidated balance sheets.

Mortgage Loans

Mortgage loans that we may sell are classified as held-for-sale. If we decide to retain a loan, the loan is transferred to the held-for-investment portfolio. Loans transferred to the held-for-investment portfolio are transferred at lower of cost or market. Lower-of-cost-or-market valuation adjustments relating to these loans are treated as basis adjustments and are subsequently amortized into interest income over the period held. We recognize interest on mortgage loans on an accrual basis, except when we believe the collection of principal or interest is doubtful.

Held-for-sale mortgages are reported at lower-of-cost-or-market, on a portfolio basis, with losses reported in Gains (losses) on investment activity. Premiums and discounts on loans classified as held-for-sale are not amortized during the period that such loans are classified as held-for-sale. For a description of how we determine the fair value of our held-for-sale mortgage loans, see “NOTE 16: FAIR VALUE DISCLOSURES.”

Mortgage loans that we have the ability and intent to hold for the foreseeable future or to maturity are classified as held-for-investment. These mortgage loans are reported at their outstanding principal balances, net of deferred fees (including premiums and discounts). These deferred items are amortized into interest income over the estimated lives of the mortgages using the effective interest method. We use actual prepayment experience and estimates of future prepayments to

determine the constant yield needed to apply the effective interest method. For purposes of estimating future prepayments, the mortgages are aggregated by similar characteristics such as origination date, coupon and maturity.

Reserves for Losses on Mortgage Loans Held-for-Investment and Losses on PCs

We maintain a Reserve for losses on mortgage loans held-for-investment to provide for credit losses inherent in that portfolio. We also maintain a Reserve for guarantee losses on Participation Certificates or Structured Securities held by third parties. The Reserve for losses on mortgage loans held-for-investment and Reserve for guarantee losses on Participation Certificates are collectively referred to as “loan loss reserves.” Increases in loan loss reserves are reflected in earnings as a component of the Provision for credit losses. Decreases in loan loss reserves are reflected through either (a) charging-off such balances (net of recoveries) when realized losses are recorded or (b) a reduction in the Provision for credit losses.

Loan loss reserves are also recorded upon the sale of PCs and Structured Securities for which losses were incurred on the underlying mortgage loans while we held such securities. We recognize incurred losses as a component of Gains (losses) on investment activity through, where applicable: (a) the subsequent measurement of corresponding PC residuals that are classified as trading; (b) the recognition of impairment-related losses on such securities (*i.e.*, to the extent that such securities do not have recognized PC residual balances associated with them that are classified as trading); or (c) as a component of gain (loss) on sale of such securities. Upon the sale of such PCs or Structured Securities, incurred losses are classified on the consolidated balance sheets as Reserve for guarantee losses on Participation Certificates.

Single-family loan portfolio — We estimate credit losses on homogeneous pools of single-family loans using statistically-based models that evaluate a variety of factors. The homogeneous pools of single-family mortgage loans are determined based on common underlying characteristics, including year of origination, loan-to-value ratio and geographic region. In determining the loan loss reserves for impaired single-family loans at the balance sheet date, we determine the point within the range of probable losses that represents the best estimate of losses. The factors used to estimate losses include the year of loan origination, geographic location, actual and estimated amounts for loss severity trends for similar loans, default experience, proceeds from credit enhancements, pre-foreclosure real estate taxes and insurance, and estimated costs should the underlying property ultimately be foreclosed upon and sold.

We frequently validate and update the models and factors to capture changes in actual loss experience, as well as changes in underwriting practices and in our loss mitigation strategies. We also consider macroeconomic and other factors including regional housing trends, applicable home price indices, unemployment and employment dislocation trends, consumer credit statistics, recent changes in credit underwriting practices, the extent of third party insurance, and other measurable factors that influence the quality of the portfolio at the balance sheet date. Favorable trends in these macroeconomic and other factors produce a reserve requirement toward the lower end of the range, while adverse trends in these factors produce a reserve requirement toward the higher end of the range. We then adjust the level of loan loss reserves to the level required based on our best assessment of these factors.

Multifamily loan portfolio — We estimate credit losses on the multifamily loan portfolio based on all available evidence, including adequacy of third-party credit enhancements, evaluation of the repayment prospects, and fair value of collateral underlying the individual loans. The review of the repayment prospects and value of collateral underlying individual loans is based on property-specific and market-level risk characteristics including apartment vacancy rates, apartment rental rates, and property sales information. Loans individually evaluated for impairment include loans that become 60 days past due for principal and interest, certain loans with observable collateral deficiencies and loans whose contractual terms were modified due to credit concerns. When loan loss reserves for individual loans are established, consideration is given to all available evidence, such as present value of discounted expected future cash flows, fair value of collateral, and credit enhancements.

Non-performing Loans

Non-performing loans consist of (a) loans that were previously delinquent whose terms have been modified and, therefore, are now considered part of our impaired loan population (“troubled debt restructurings”), (b) serious delinquencies and (c) nonaccrual loans. Serious delinquencies are those single-family loans that are 90 days or more past due or in foreclosure, and multifamily loans that are more than 60 days but less than 90 days past due. This category also includes multifamily loans that are 90 days or more past due but where principal and interest are being paid to us under the terms of a credit enhancement agreement. Non-performing loans generally accrue interest in accordance with their contractual terms unless they are in nonaccrual status. Nonaccrual loans are loans where interest income is recognized on a cash basis, and only include multifamily loans 90 days or more past due. For nonaccrual loans, any existing accruals are reversed against interest income unless they are both well secured and in the process of collection. For single-family loans greater than 90 days delinquent, interest income is accrued; however, we establish reserves for all accrued but uncollected interest on all single-family loans we hold that are greater than 90 days delinquent. Prior to 2005, we established a reserve for

all single-family accrued interest we deemed uncollectible using internal statistically based models, which estimated accrued but uncollectible interest. We report this reserve as a reduction to the accrued loan interest balance in Accounts and other receivables, net.

Impaired loans include single-family loans, both performing and non-performing, that are troubled debt restructurings. Multifamily impaired loans are defined as performing and non-performing troubled debt restructurings, loans 60 days or more past due (except for certain credit-enhanced loans) and certain mortgage loans with real estate collateral values less than the outstanding unpaid principal balances. See “Table 6.2 — Impaired Loans” in “NOTE 6: LOAN LOSS RESERVES” for further discussion.

We have the option to purchase mortgage loans out of PC pools under certain circumstances, such as to resolve an existing or impending delinquency or default. Our general practice is to purchase the mortgage loans out of pools after the loans are 120 days delinquent. These loans are recorded on our consolidated balance sheets at fair value.

Charge-Offs

The loan loss reserves are reduced for charge-offs when a loss is specifically identified and is virtually certain of occurring. For both single-family and multifamily mortgages where the original terms of the mortgage loan agreement are modified for economic or legal reasons related to the borrower’s financial difficulties, losses are recorded at the time of modification and the loans are subsequently accounted for as troubled debt restructurings. For mortgages that are foreclosed upon and thus transferred to Real estate owned, net, or REO, or are involved in a pre-foreclosure sale, losses at the time of transfer or pre-foreclosure sale are charged-off against Reserve for losses on mortgage loans held-for-investment. For transfers to REO, losses arise when the carrying basis of the loan (including accrued interest) exceeds the fair value of the foreclosed property (after deduction for estimated selling costs and consideration of third-party insurance or other credit enhancements). REO gains arise and are recognized immediately in earnings when the fair market value of the acquired asset (after deduction for estimated disposition costs) exceeds the carrying value of the mortgage (including accrued interest). REO gains and losses subsequent to foreclosure are included in REO operations income (expense).

Investments in Securities

Investments in securities consist primarily of mortgage-related securities. We classify securities as “available-for-sale” or “trading.” We currently do not classify any securities as “held-to-maturity” although we may elect to do so in the future. Securities classified as available-for-sale and trading are reported at fair value with changes in fair value included in AOCI and Gains (losses) on investment activity, respectively. See “NOTE 16: FAIR VALUE DISCLOSURES” for more information on how we determine the fair value of securities.

We record forward purchases and sales of securities that are specifically exempt from the requirements of “Accounting for Derivative Instruments and Hedging Activities,” or SFAS 133, on a trade date basis. Securities underlying forward purchases and sales contracts that are not exempt from the requirements of SFAS 133 are recorded on the contractual settlement date with a corresponding commitment recorded on the trade date.

We often retain Structured Securities created through resecuritizations of mortgage-related securities held by us. The new Structured Securities we acquire in these transactions are classified as available-for-sale or trading based upon the predominant classification of the mortgage-related security collateral we contributed.

For most of our investments in securities, interest income is recognized using the retrospective effective interest method. Deferred items, including premiums, discounts and other basis adjustments, are amortized into interest income over the estimated lives of the securities. We use actual prepayment experience and estimates of future prepayments to determine the constant yield needed to apply the effective interest method. We recalculate the constant effective yield based on changes in estimated prepayments as a result of changes in interest rates and other factors. When the constant effective yield changes, an adjustment to interest income is made for the amount of amortization that would have been recorded if the new effective yield had been applied since the mortgage assets were acquired.

For certain securities investments, interest income is recognized using the prospective effective interest method. We specifically apply this accounting to beneficial interests in securitized financial assets that (a) 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 strips) or (b) are not of high credit quality at the acquisition date. We recognize as interest income (over the life of these securities) the excess of all estimated cash flows attributable to these interests over their principal amount using the effective yield method. We update our estimates of expected cash flows periodically and recognize changes in calculated effective yield on a prospective basis.

We periodically review securities for potential impairment. We consider a number of factors, including whether the fair value of a security is less than its amortized cost, 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 also recognize impairment when qualitative factors indicate that

we may not recover the unrealized loss. When evaluating these factors, we consider our intent and ability to hold the investment until a point in time at which recovery of the unrealized loss can be reasonably expected to occur. Impairment losses on manufactured housing securities exclude the effects of separate financial guarantee contracts that are not embedded in the securities since the benefits of such contracts are not recognized until claims become probable of recovery under the contracts. When a security is deemed to be impaired, the cost basis of the security is written down to fair value, with the loss recorded to Gains (losses) on investment activity. Based on the new cost basis, the adjusted deferred amounts related to the impaired security are amortized over the security's remaining life in a prospective manner consistent with the amount and timing of the future estimated cash flows. The security cost basis is not changed for subsequent recoveries in fair value. For certain securities meeting the criteria of (a) and (b) in the preceding paragraph, other-than-temporary impairment is defined as occurring whenever there is an adverse change in estimated cash flows coupled with a decline in fair value below the amortized cost basis.

Gains and losses on the sale of securities are included in Gains (losses) on investment activity, including those gains (losses) reclassified into earnings from AOCI. We use the specific identification method for determining the cost of a security in computing the gain or loss.

Repurchase and Resale Agreements

We enter into repurchase and resale agreements primarily as an investor or to finance our security positions. Such transactions are accounted for as purchases and sales when the transferor relinquishes control over transferred securities and as secured financings when the transferor does not relinquish control. Our policy is to take possession of securities purchased under agreements to resell and reverse dollar roll transactions.

Debt Securities Issued

Debt securities that we issue are classified as either Due within one year or Due after one year based on their remaining contractual maturity. The classification of interest expense on debt securities as either short-term or long-term is based on the original contractual maturity of the debt security. Deferred items, including premiums, discounts, issuance costs and hedging-related basis adjustments, are amortized and reported through interest expense using the effective interest method over the contractual life of the related indebtedness. The balance of deferred items remaining when debt is extinguished prior to its contractual maturity is reflected in earnings in the period of extinguishment as a component of Gains (losses) on debt retirement. Prior to 2005, for callable debt, deferred items were amortized over the period during which the related indebtedness was expected to be outstanding and changes in the expected life were reflected prospectively as an adjustment to the effective yield on the debt. Amortization of hedging-related basis adjustments is initiated upon the termination of the related hedge relationship. Amortization of premiums, discounts and issuance costs begins at the time of debt issuance. Premiums, discounts and hedging-related basis adjustments are reported as a component of Debt securities, net. Issuance costs are reported as a component of Other assets. Debt securities denominated in a foreign currency are translated into U.S. dollars using foreign exchange spot rates at the balance sheet dates and any translation gains or losses are reported in Non-interest income (loss) — Other income.

Contemporaneous transfers of cash between us and a creditor in connection with the issuance of a new debt obligation and satisfaction of an existing debt obligation are accounted for as extinguishments, with recognition of any gains or losses in earnings if the debt instruments have substantially different terms. If the debt instruments do not have substantially different terms, the transaction is accounted for as an exchange rather than an extinguishment.

Derivatives

Generally, derivatives are financial instruments with little or no initial net investment in comparison to their notional amount and whose value is based upon an underlying asset, index, reference rate or other variable. They may be privately negotiated contractual agreements that can be customized to meet specific needs, including certain commitments to purchase and sell mortgage loans, mortgage-related securities or debt securities, or they may be standardized contracts executed through organized exchanges. All derivatives are reported at their fair value on the consolidated balance sheets. The fair value of derivatives is generally reported net by counterparty, provided that a legally enforceable master netting agreement exists. Derivatives in a net unrealized gain position are reported as Derivative assets, at fair value. Similarly, derivatives in a net unrealized loss position are reported as Derivative liabilities, at fair value.

Currently, the majority of our derivatives are not designated in hedge accounting relationships. For those derivatives not designated as an accounting hedge, fair value gains and losses are reported as Derivative gains (losses) in the consolidated statements of income. For purchase and sale commitments of securities classified as trading, fair value gains and losses are reported as Gains (losses) on investment activity in the consolidated statements of income.

Subject to certain qualifying conditions, we may designate a derivative as either a hedge of the cash flows of a variable-rate instrument or forecasted transaction, referred to as a cash flow hedge; a hedge of the fair value of a fixed-rate

instrument, referred to as a fair value hedge; or a foreign-currency fair value or cash flow hedge, referred to as a foreign-currency hedge. In order to be designated as an accounting hedge, the derivative must be expected to be highly effective in offsetting the changes in cash flows or fair value of the hedged item resulting from the hedged risk. In addition, the documentation of the hedging designation must include identification of the hedged item, the hedging instrument, the risk exposure and corresponding risk management objective, how effectiveness will be assessed and how ineffectiveness will be measured.

For a derivative qualifying as a cash flow hedge, we report changes in the fair value of these instruments in AOCI to the extent the hedge is effective. The remaining ineffective portion is reported as Hedge accounting gains (losses). In general, we recognize the associated amounts reported in AOCI as Net interest income during the period or periods in which the hedged item affects earnings. Amounts reported in AOCI related to changes in the fair value of commitments to purchase or sell securities that are designated as cash flow hedges are recognized as basis adjustments to the assets held which are amortized in earnings as interest income using the effective interest method and, for assets sold, as Gains (losses) on investment activity.

If the hedged item in a cash flow hedge is the forecasted issuance of debt and the occurrence of the forecasted transaction becomes probable of not occurring, the amount in AOCI is reclassified to earnings immediately. If we expect at any time that continued reporting of a net loss in AOCI would lead to recognizing a net loss on the combination of a hedging instrument and the hedged transaction (and related asset acquired or liability incurred) in one or more future periods, the loss is reclassified immediately into earnings for the amount that is not expected to be recovered.

For a derivative qualifying as a fair value hedge, we report changes in the fair value of the derivative as Hedge accounting gains (losses) along with the changes in the fair value of the hedged item attributable to the risk being hedged. Any difference between these two amounts results in ineffectiveness recognized in the income statement. When the hedge is terminated or redesignated, the fair value adjustment to the carrying amount of the hedged asset or liability is amortized to earnings as a component of the hedged item's interest income or expense over the remaining life of the hedged item using the effective interest method. If a derivative no longer qualifies as a cash flow or fair value hedge, we discontinue hedge accounting prospectively. We continue to carry the derivative on the consolidated balance sheets at fair value and record further fair value gains and losses as Derivative gains (losses) in our consolidated statements of income until the derivative is terminated or redesignated.

The periodic interest cash flows related to derivative contracts currently accrued, which are derived primarily from interest-rate swap contracts, are classified as Income (expense) related to derivatives for derivatives in hedge relationships and as Derivative gains (losses) for derivatives not in hedge accounting relationships.

Real Estate Owned

REO is carried at the lower of cost or market, net of estimated disposition costs. Amounts we expect to be received from third-party insurance or other credit enhancements are reported when the claim is filed and are recorded as a component of Accounts and other receivables, net in the consolidated balance sheets. Material development and improvement costs relating to REO are capitalized. Operating expenses on the properties, net of any rental or other income, are included in REO operations income (expense). Estimated declines in REO fair value that result from ongoing valuation of the properties are provided for and charged to REO operations income (expense) when identified. The resulting valuation allowance is treated as a lower of cost or market adjustment to the basis of the properties. Any gains and losses on REO dispositions are included in REO operations income (expense).

Income Taxes

We use the asset and liability method of accounting for income taxes pursuant to SFAS No. 109, "Accounting for Income Taxes." Under this method, deferred tax assets and liabilities are recognized based upon the expected future tax consequences of existing temporary differences between the financial reporting and the tax reporting basis of assets and liabilities using enacted statutory tax rates. To the extent tax laws change, deferred tax assets and liabilities are adjusted, when necessary, in the period that the tax change is enacted. Valuation allowances are recorded to reduce deferred tax assets when it is more likely than not that a tax benefit will not be realized. For all periods presented, no such valuation allowance was deemed necessary by our management. Reserves are recorded for income tax contingencies and contingent interest where the potential for loss is probable and reasonably estimable in accordance with SFAS 5.

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

Stock-Based Compensation

We record compensation expense equal to the estimated fair value of the stock-based compensation on the grant date, which is generally the effective date of the grant, amortized on a straight-line basis over the vesting period. The vesting period is generally three to five years for options, restricted stock and restricted stock units and three months for the Employee Stock Purchase Plan, or ESPP. The recorded compensation expense is offset by an adjustment to Additional paid-in capital in our consolidated balance sheets.

The fair value of options to purchase shares of our common stock, including options issued pursuant to the ESPP, is estimated using a Black-Scholes option pricing model, taking into account the exercise price and an estimate of the expected life of the option, the market value of the underlying stock, expected volatility, expected dividend yield, and the risk-free interest rate for the expected life of the option. The fair value of restricted stock and restricted stock unit awards is based on the fair value of our common stock on the grant date.

Incremental compensation expense related to modification of awards is based on a comparison of the fair value of the modified award with the fair value of the original award before modification (measured using the shorter of the remaining or revised term). We generally expect to settle our stock-based compensation awards in shares. In limited cases an award may be cash-settled upon a contingent event such as involuntary termination. These awards are accounted for as an equity award until the contingency becomes probable of occurring, then the award is reclassified from equity to liability. Such liabilities are initially measured at intrinsic value with changes in intrinsic value recognized as an adjustment to Salaries and employee benefits.

In December 2004, the FASB issued SFAS No. 123 (revised 2004), "Share-Based Payment," or SFAS 123(R). SFAS 123(R) requires companies to measure and record compensation expense for share-based payments based on the instruments' fair value reduced by expected forfeitures. The adoption of the revision to this statement did not have a material impact on our financial position or results of operations.

Earnings Per Common Share

Basic earnings per common share is computed as net income available to common stockholders divided by the weighted average common shares outstanding for the period. Diluted earnings per common share is determined using the weighted average number of common shares during the period, adjusted for the dilutive effect of common stock equivalents. Dilutive common stock equivalents reflect the assumed net issuance of additional common shares pursuant to certain of our stock-based compensation plans that could potentially dilute earnings per common share.

Comprehensive Income

Comprehensive income is the change in equity, on a net of tax basis, resulting from transactions and other events and circumstances from non-owner sources during a period. It includes all changes in equity during a period, except those resulting from investments by stockholders. We define comprehensive income as consisting of net income plus changes in the unrealized gains and losses on available-for-sale securities, the effective portion of derivatives accounted for as cash flow hedge relationships, and changes in the minimum pension liability.

Reportable Segments

We have one business segment for financial reporting purposes under SFAS No. 131, "Disclosures About Segments of an Enterprise and Related Information," or SFAS 131, for all periods presented in the consolidated financial statements.

Recently Issued Accounting Standards, Not Yet Adopted

Accounting for Certain Hybrid Instruments — In February 2006, the FASB issued SFAS No. 155, "Accounting for Certain Hybrid Financial Instruments," or SFAS 155. This statement amends SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," or SFAS 133, and SFAS No. 140. The objective of this statement is to simplify the accounting for certain hybrid financial instruments, permitting fair value measurement for any hybrid financial instrument with an embedded derivative that otherwise would require bifurcation. In addition, this statement establishes a requirement to evaluate interests in securitized financial assets to identify instruments that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation. SFAS 155 is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. Since SFAS 155 is to be adopted prospectively, it will not result in a cumulative effect of a change in accounting principle. We are presently assessing which instruments will be affected and how other potential accounting standards may interact with SFAS 155. With respect to mortgage-related security purchases beginning in 2007, this standard could require us to account for these securities, or a portion of these securities, by recognizing changes in fair values in current earnings.

Determining Variability in Applying FASB Interpretation No. 46(R) — In April 2006, the FASB issued FASB Staff Position No. FSP FIN 46(R)-6, "Determining the Variability to Be Considered in Applying FASB Interpretation

No. 46(R),” or FSP FIN 46(R)-6. FSP FIN 46(R)-6 addresses how a reporting enterprise should determine the variability to be considered in applying FASB Interpretation No. 46 (revised December 2003) “Consolidation of Variable Interest Entities,” or FIN 46(R). It requires the variability to be considered to be based on the design of the entity. This statement is effective for us beginning July 1, 2006. We do not expect the adoption of FSP FIN 46(R)-6 to be material to our financial condition or results of operations.

NOTE 2: TRANSFERS OF SECURITIZED INTERESTS IN MORTGAGE-RELATED ASSETS

Securitization Transactions Executed By Us

As discussed in “NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES,” we issue two types of mortgage-related securities: PCs and Structured Securities.

Table 2.1 below presents the unpaid principal balances of issued PCs and Structured Securities as of December 31, 2005 and 2004.

Table 2.1 — Guaranteed PCs and Structured Securities Issued Based on Unpaid Principal Balances⁽¹⁾⁽²⁾

	December 31,	
	2005	2004
	(in millions)	
Guaranteed PCs and Structured Securities Issued:		
Held by third parties	\$ 974,200	\$ 852,270
Held in the Retained portfolio	361,324	356,698
Total Guaranteed PCs and Structured Securities issued ⁽³⁾⁽⁴⁾	<u>\$1,335,524</u>	<u>\$1,208,968</u>

- (1) Excludes mortgage loans and mortgage-related securities traded, but not yet settled.
- (2) Due to timing differences in our receipt of principal and interest payments from mortgage servicers and subsequent pass-through of payments to PC investors, the unpaid principal balances of the underlying mortgage loans do not equal the unpaid principal balances of issued PCs and Structured Securities. See “NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — Due to Participation Certificate Investors” for more information.
- (3) As further discussed in “NOTE 4: FINANCIAL GUARANTEES,” we guarantee certain mortgage-related securities issued by third parties.
- (4) Guaranteed PCs and Structured Securities exclude \$961,776 million and \$723,429 million at December 31, 2005 and 2004, respectively, of Structured Securities backed by resecuritized PCs and other previously issued Structured Securities. These excluded Structured Securities do not increase our credit-related exposure and consist of single-class and multiclass Structured Securities backed by PCs, REMICs and principal-only strips. The notional balance of interest-only strips of \$132,883 million and \$105,703 million at December 31, 2005 and 2004, respectively, is excluded because this table is based on unpaid principal balances. Also excluded are modifiable and combinable REMIC tranches and interest and principal classes where the holder has the option to exchange the security tranches for other pre-defined security tranches. These tranches and classes collectively totaled \$1,495,501 million and \$1,097,336 million at December 31, 2005 and 2004, respectively.

At December 31, 2005 and 2004, approximately 92 percent and 87 percent, respectively, of issued PCs and Structured Securities (excluding securities we issued that are backed by Ginnie Mae Certificates or non-agency mortgage-related securities and other securities issued by third-parties that we guaranteed) had a corresponding Guarantee asset, Guarantee obligation or PC residual recognized on our consolidated balance sheets. The percentage of these PCs and Structured Securities that had a corresponding Guarantee asset, Guarantee obligation or PC residual due to the adoption of FIN 45 accounting on January 1, 2003 was 50 percent and 40 percent, at December 31, 2005 and 2004, respectively. At December 31, 2005 and 2004, 93 percent and 89 percent, respectively, of PCs and Structured Securities held by third parties had a related Guarantee asset and Guarantee obligation established.

Gains and Losses on Transfers of PCs and Structured Securities that are Accounted for as Sales

We recognized net pre-tax gains of approximately \$364 million, \$356 million and \$711 million for the years ended December 31, 2005, 2004 and 2003, respectively, on transfers of PCs and Structured Securities that were accounted for as sales under SFAS 125/140.

In connection with the derivation of such gains (losses) upon sale prior to October 1, 2005, we had consistently applied a methodology for determining the order in which to record extinguishments of unamortized deferred guarantee income, buy-down fees and credit fees as adjustments to the carrying value of the repurchased securities. Beginning October 1, 2005, we changed our method for determining gains (losses) upon the re-sale of PCs and Structured Securities related to unamortized deferred guarantee income, buy-down fees and credit fees. Our methodology is now to apply a specific identification method of associating the extinguished deferred guarantee income, buy-down fees and credit fees to the specific portions of purchased PCs and Structured Securities and to relieve those carrying value adjustments through the gains (losses) when the specific portion of the PC or Structured Security is re-sold. This change in accounting principle was facilitated by system changes that now allow us to apply and track the extinguished carrying value adjustments to the specific portions of the purchased PCs and Structured Securities.

Valuation of Recognized Guarantee Asset, Guarantee Obligation and PC Residuals

Recognized Guarantee asset

Effective January 1, 2005, we enhanced our approach for estimating the fair value of the Guarantee asset to make greater use of third-party market data. For approximately 70 percent of the Guarantee asset, the new valuation approach involves obtaining dealer quotes on proxy securities with collateral similar to aggregated characteristics of our portfolio, effectively equating the Guarantee asset with current, or “spot,” market values for excess servicing interest-only, or IO, securities, which trade at a discount to trust IO security prices. We consider excess servicing securities to be comparable to the Guarantee asset, in that they represent an IO-like income stream, have less liquidity than trust IO securities and do not have matching principal-only securities. The remaining 30 percent of the Guarantee asset, which relates to underlying loan products for which comparable market prices are not readily available, is valued using an expected cash flow approach with market input assumptions extracted from the dealer quotes provided on the more liquid products, reduced by an estimated liquidity discount.

For periods prior to January 1, 2005, we calculated the Guarantee asset fair value using an expected cash flow approach. Specifically, Monte Carlo projections were used to forecast Guarantee asset-related future cash flows. The forecasted cash flows were then discounted using factors that were derived from modeled forward interest rates for each scenario path, to which we then applied a trailing average option-adjusted spread of up to 24 months that was based on trust IO security prices.

Recognized Guarantee obligation

Effective January 1, 2005, we enhanced our approach for estimating the fair value of the Guarantee obligation to make greater use of third-party market data. We concluded that the structured credit market has evolved to the point where we can now look to that market for fair value discovery. We have divided our Guarantee obligation portfolio into three primary components: performing loans, non-performing loans and manufactured housing. For each component, we have developed a specific valuation approach for capturing its unique characteristics.

For performing loans, our enhanced approach uses the capital markets to obtain estimated subordination levels based on rating agency models and dealer price quotes on proxy securities with collateral characteristics matched to our portfolio to value the expected credit losses and the risk premium for unexpected losses related to our guarantee portfolio (which is predominantly prime mortgages) to reduce our reliance on internal models. We segmented the portfolio into distinct loan cohorts to differentiate between product types, coupon rate, seasoning, and interests retained by us versus those held by third parties. We use our models to adjust the dealer quotes as appropriate, including an adjustment to remove the price effects of interest rate risks not relevant to the credit loss estimation from the quoted dealer prices.

Since typical structured securitizations of single-family collateral only include performing loans, we developed a separate method for estimating the fair value of the Guarantee obligation for non-performing loans. For loans that are extremely delinquent and have been purchased out of pools, we obtained dealer indications that reflect their non-performing status. To value delinquent loans remaining in PCs, we start with the market driven performing loan and non-performing whole loan values and use empirically observed delinquency transition rates to interpolate the appropriate values in each phase of delinquency (*i.e.*, 30 days, 60 days, 90 days).

We evaluated market sources to determine the appropriate credit costs associated with the Guarantee obligation for the manufactured housing portfolio, which we estimated for purposes of our valuation approach to be approximately two percent of our total guarantee portfolio, but approximately 20 percent of the fair value of the Guarantee obligation, and determined that there is limited price discovery in the market. As a result, we used our judgment to develop an alternative approach for estimating the incremental credit costs associated with the manufactured housing portfolio. Specifically, we calculated the ratio of realized credit losses for performing loans and manufactured housing loans to determine a loss history ratio. We then applied the loss history ratio to market implied performing loan Guarantee obligation fair value estimates to calculate the implied credit costs for the manufactured housing portfolio. This approach grounds the Guarantee obligation related to manufactured housing in performing loan market prices, while adjusting for the loss history reflected in empirical data. We undertook a similar process for estimating the fair value of seriously delinquent manufactured housing loans. We then benchmarked our performing loan Guarantee obligation fair value estimate by obtaining a range of price indications that corroborated the reasonableness of our estimate through discussions with leading market participants, including third-party dealers and mortgage insurance companies. The changes to the credit components of the Guarantee obligation necessitated a change to the approach used to estimate the costs associated with administering the collection and distribution of payments on the mortgage loans underlying a PC. Finally, we use our models to estimate the present value of net cash flows related to security program cycles. This estimate is included in the Guarantee obligation valuation.

For periods prior to January 1, 2005, the Guarantee obligation fair value was calculated using internal models to estimate future cash flows using a Monte Carlo simulation. The components of estimated cash flows associated with the Guarantee obligation included estimates of expected future credit losses using statistically based models that were benchmarked periodically to the non-conforming loan, or jumbo, securitization market. For all periods our estimates included costs to administer the collection and distribution of payments on the mortgage loans underlying a PC and considered net cash flows due to security program cycles.

Recognized PC residuals

The fair value of recognized PC residuals is determined in a manner that is consistent with the approach described above for the recognized Guarantee asset and Guarantee obligation.

Key assumptions used in the valuation of the Guarantee asset

Table 2.2 summarizes the key assumptions associated with the fair value measurements of the recognized Guarantee asset. The assumptions included in this table for 2004 and 2003 relate to those used in our internal models to measure the fair value of the Guarantee asset for single-family loans at the time of securitization and the subsequent fair value measurements, which occurred throughout each year. For 2005, the fair values at the time of securitization and the subsequent fair value measurements were estimated using third party information. The assumptions included in this table for 2005 are those implied by our fair value estimates, with the Internal Rates of Return, or IRRs, adjusted where necessary to align our internal models with estimated fair values determined using third party information. Prepayment rates are presented as implied by our internal models and have not been similarly adjusted.

Table 2.2 — Key Assumptions Utilized in Fair Value Measurements of the Guarantee Asset

Valuation Assumptions for the Guarantee Asset	2005		2004		2003	
	Range ⁽³⁾	Mean ⁽⁴⁾	Range ⁽³⁾	Mean ⁽⁴⁾	Range ⁽³⁾	Mean ⁽⁴⁾
Internal rates of return ⁽¹⁾	1.8% - 13.8%	8.7%	(1.4)% - 13.6%	6.7%	4.5% - 15.1%	9.4%
Prepayment rates ⁽²⁾	7.6% - 59.8%	17.2%	6.9% - 58.6%	19.1%	8.0% - 62.9%	23.3%

- (1) The IRRs reported above represent a duration-weighted average of the discount rates used to value the recognized Guarantee asset. In 2004 and 2003, such rates were derived by determining a single rate that equated (a) the simple average of future cash flows of the Guarantee asset for each Loan Group with that of (b) the calculated fair value of the Guarantee asset for each Loan Group. In 2005, the IRRs represent a duration-weighted average of the discount rates as adjusted to align with our estimated fair values. Negative IRRs can occur when sufficiently large negative option-adjusted spreads are applied to LIBOR. When we calibrate our modeled discounted cash flows to the traded price of an IO security, a negative option-adjusted spread can result when the traded price exceeds the implied market value of the modeled discounted cash flows. A negative option-adjusted spread is necessary to calibrate the implied market value of the modeled discounted cash flows to the traded price.
- (2) Average Prepayment rates are simulated on a monthly frequency, although rates reported above represent an unpaid principal balance weighted average of annualized values of such Prepayment rates.
- (3) The lowest value in each presented range represents the first percentile IRRs and prepayment rates throughout 2005, 2004 and 2003. Likewise, the highest value in each range represents the 99th percentile IRRs and prepayment rates throughout 2005, 2004 and 2003.
- (4) Reported values represent the weighted average value of all IRRs and prepayment rates throughout the 2005, 2004 and 2003 periods.

Weighted average lives of the Guarantee asset during 2005, 2004 and 2003 ranged between 1.6 and 8.9 years, 1.2 and 8.7 years, and 1.0 and 8.5 years, respectively, while the average derived weighted average lives of the Guarantee asset for the same periods were 5.1, 5.3 and 4.8 years, respectively. Such derived weighted average lives are reflective of prepayment speed assumptions cited in Table 2.2 above.

At December 31, 2005, the fair value of the recognized Guarantee asset was based upon a valuation approach that incorporates market-based information. In order to report the hypothetical sensitivity of the carrying value of the Guarantee asset to changes in key assumptions, we used internal models to approximate their reported carrying values. We then measured the hypothetical impact of changes in key assumptions using our models to estimate the potential view of fair value the market might have in response to those changes. In our models, the assumed Internal Rates of Return were adjusted to calibrate our model results with the reported carrying value. The sensitivity analysis in Table 2.3 illustrates hypothetical adverse changes in the fair value of the Guarantee asset for changes in key assumptions at December 31, 2005.

Table 2.3 — Sensitivity Analysis of the Guarantee Asset

	December 31, 2005 GA ⁽¹⁾
	(dollars in millions)
Fair value	\$4,938
Weighted average IRR assumptions:	9.2%
Impact on fair value of 100 bps upward change	\$ (184)
Impact on fair value of 200 bps upward change	\$ (354)
Weighted average prepayment rate assumptions:	15.5%
Impact on fair value of 10% upward change	\$ (212)
Impact on fair value of 20% upward change	\$ (404)

- (1) At December 31, 2005, our Guarantee asset totaled \$5,083 million on our consolidated balance sheet and of that amount, approximately \$145 million (or approximately 3 percent), relates to PCs backed by multifamily mortgage loans. The sensitivity analysis presented in Table 2.3 relates solely to the Guarantee asset associated with PCs backed by single-family mortgage loans.

Valuation of Other Retained Interests

Other retained interests include securities that were issued by us as part of a securitization transaction for which sale accounting was applied. The majority of these securities is classified as available-for-sale. The fair value of Other retained interests is generally based on independent price quotations obtained from third-party pricing services or dealer marks.

In order to report the hypothetical sensitivity of the carrying value of Other retained interests, we used internal models calibrated to the fair values. The sensitivity analysis in Table 2.4 illustrates hypothetical adverse changes in the fair value of Other retained interests for changes in key assumptions based on these models.

Table 2.4 — Sensitivity Analysis of Other Retained Interests

	<u>December 31, 2005</u> (dollars in millions)
Fair value	\$124,939
Weighted average IRR assumptions:	5.4%
Impact on fair value of 100 bps upward change	\$ (4,470)
Impact on fair value of 200 bps upward change	\$ (8,656)
Weighted average prepayment rate assumptions:	11.3%
Impact on fair value of 10% upward change	\$ (85)
Impact on fair value of 20% upward change	\$ (164)

Cash Flows on Transfers of Securitized Interests and Corresponding Retained Interests

Table 2.5 below summarizes cash flows on retained interests.

Table 2.5 — Details of Cash Flows

	<u>Year Ended December 31,</u>		
	<u>2005</u>	<u>2004</u>	<u>2003</u>
	(in millions)		
Cash flows from:			
Transfers of Freddie Mac securities that were accounted for as sales	\$86,326	\$152,662	\$347,874
Cash flows received on the Guarantee asset ⁽¹⁾	\$ 1,270	\$ 1,086	\$ 891
Other Retained Interests principal and interest ⁽²⁾	\$25,611	\$ 28,439	\$ 35,975
Purchases of delinquent or foreclosed loans ⁽³⁾	\$(4,373)	\$ (4,931)	\$ (5,822)

(1) Represents contractual guarantee-related cash flows received by us in connection with the recognized Guarantee asset.

(2) Excludes cash flows related to retained interests held in the portfolio of our Securities Sales and Trading Group, or SS&TG, business unit which ceased operations in the fourth quarter of 2004. Such cash flows were not material.

(3) Represents delinquent mortgage loans purchased out of securitized pools that back issued PCs or Structured Securities.

NOTE 3: VARIABLE INTEREST ENTITIES

We are a party to numerous entities that are considered to be variable interest entities, or VIEs. These VIEs include low-income housing tax credit partnerships, certain Structured Securities transactions and a mortgage reinsurance company. In addition, we buy the highly-rated senior securities in certain mortgage securitization trusts that are VIEs. Highly-rated senior securities issued by these securitization trusts are not designed to absorb a significant portion of the variability created by the assets/collateral in the trusts. Our investments in these securities do not represent a significant variable interest in the securitization trusts. Further, we invest in securitization entities that are qualifying special purpose entities which are not subject to consolidation because of our inability to unilaterally liquidate or change the qualifying special purpose entity. See “NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — Consolidation and Equity Method of Accounting” for further information regarding the consolidation practices of our VIEs.

Low-Income Housing Tax Credit Partnerships

We invest as a limited partner in low-income housing tax credit partnerships formed for the purpose of providing funding for affordable multifamily rental properties. These low-income housing tax credit partnerships invest directly in limited partnerships that develop or rehabilitate multifamily rental properties. Completed properties are rented to qualified low-income tenants, allowing the properties to be eligible for federal tax credits. A general partner operates the partnership, identifying investments and obtaining debt financing as needed to finance partnership activities. Although these partnerships generate operating losses, we realize a return on our investment through reductions in income tax expense that result from tax credits and the deductibility of the operating losses. The partnership agreements are typically structured to meet a required 15-year period of occupancy by qualified low-income tenants. These investments were made between 1989 and 2005. At December 31, 2005 and 2004, we did not guarantee any obligations of these partnerships and our exposure was limited to the amount of our investments. At December 31, 2005 and 2004, we were the primary beneficiary of investments in six and five low-income housing tax credit partnerships, respectively, and we consolidated these investments. The investors in the obligations of the consolidated low-income housing tax credit partnerships have recourse only to the assets of those VIEs and do not have recourse to us.

Asset-Backed Investment Trusts

We invest in a variety of mortgage and non-mortgage-related, asset-backed investment trusts. These investments represent interests in trusts consisting of a pool of receivables or other financial assets, typically credit card receivables, auto loans or student loans. These trusts act as vehicles to allow originators to securitize assets. Securities are structured from the underlying pool of assets to provide for varying degrees of risk. Primary risks include potential loss from the credit risk and interest-rate risk of the underlying pool. The originators of the financial assets or the underwriters of the deal create the trusts and typically own the residual interest in the trust assets. At December 31, 2005 and 2004, we were not the primary beneficiary of any asset-backed investment trusts.

Structured Securities — T-Series Transactions

In T-Series transactions (or alternative collateral deals), a seller or sellers of mortgage loans transfers mortgage loans to a trust specifically for the purpose of issuing securities collateralized by the mortgage loans. These T-Series trusts issue various senior interests, subordinated interests or both. We guarantee and purchase certain of the senior interests. Simultaneous with this guarantee and purchase, we issue and guarantee Structured Securities. These Structured Securities represent an interest in the senior interests of the T-Series transactions. The subordinated interests are generally either held by the seller or other party or sold in the capital markets. At December 31, 2005 and 2004, we were not the primary beneficiary of any T-Series transactions.

Consolidated VIEs

Table 3.1 represents the carrying amounts and classification of consolidated assets that are collateral for the consolidated VIEs.

Table 3.1 — Assets of Consolidated VIEs

<u>Consolidated Balance Sheets Line Item</u>	<u>December 31,</u>	
	<u>2005</u>	<u>2004</u>
	<u>(in millions)</u>	
Cash and cash equivalents	\$ 45	\$ 51
Accounts and other receivables, net	167	170
Total assets of consolidated VIEs	<u>\$212</u>	<u>\$221</u>

VIEs Not Consolidated

Low-Income Housing Tax Credit Partnerships

At December 31, 2005 and 2004, we had unconsolidated investments in 168 and 149 low-income housing tax credit partnerships, respectively, in which we had a significant variable interest. The size of these partnerships at December 31, 2005 and 2004, as measured in total assets, was \$8.1 billion and \$6.7 billion, respectively. These partnerships are accounted for using the equity method, as described in “NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES.” As a limited partner, our maximum exposure to loss equals the undiscounted book value of our equity investment. At December 31, 2005 and 2004, our maximum exposure to loss on unconsolidated low-income housing tax credit partnerships, in which we had a significant variable interest, was \$3.7 billion and \$3.1 billion, respectively.

Asset-Backed Investment Trusts

At December 31, 2005, we no longer had a significant variable interest in any trusts related to non-mortgage-related, asset-backed securities. At December 31, 2004, we had investments in three trusts related to non-mortgage-related, asset-backed securities in which we had a significant variable interest. These investments had been made between 2000 and 2004 and were typically senior interests rated A1 and P1 by Standard & Poor’s, or S&P, and Moody’s, respectively. These ratings are the short-term equivalent of between A and AAA in typical long-term rating scales. These trusts had total assets at December 31, 2004 of \$12.8 billion. As an investor, our maximum exposure to loss consisted of the book value of our investment. At December 31, 2004, our maximum exposure to loss on non-mortgage-related, asset-backed investment trusts, in which we had a significant variable interest, was approximately \$3.4 billion.

Structured Securities — T-Series Transactions

At both December 31, 2005 and 2004, we had investments or guarantees related to two T-Series transactions in which we had a significant variable interest. Our involvement in these two T-Series transactions began in 1996 and 2002, respectively. The size of these two transactions at December 31, 2005 and 2004, as measured in total assets, was \$105 million and \$170 million, respectively. At December 31, 2005 and 2004, our maximum exposure to loss on these

T-Series transactions, in which we had a significant variable interest, was \$88 million and \$147 million, respectively, consisting of the book value of our investments plus incremental guarantees of the senior interests that are held by third parties.

NOTE 4: FINANCIAL GUARANTEES

Principal and Interest Guarantees of PCs and Structured Securities

We guarantee the payment of principal and interest on the PCs and Structured Securities we issue that are held by third parties. At December 31, 2005 and 2004, the maximum potential amount of future payments under these guarantees is approximately the amount of the total unpaid principal balance of our PCs and Structured Securities held by third parties which was \$974 billion and \$852 billion, respectively. However, the actual amount of future payments under these guarantees will be determined by the performance of the mortgage loans that underlie these PCs and Structured Securities.

During 2005 and 2004, we guaranteed \$397.9 billion and \$365.1 billion, respectively, of PCs and Structured Securities to third parties. Upon completion of the transfer of PCs or Structured Securities to third parties, we recognize the initial fair value of our obligation to make guarantee payments. The accounting methods for our guarantees of PCs and Structured Securities are further discussed in “NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES.” At December 31, 2005 and 2004, we had a recognized Guarantee obligation on the consolidated balance sheets of \$5.5 billion and \$4.1 billion, respectively, which included \$1.8 billion and \$1.4 billion, respectively, of Deferred Guarantee Income. In addition, we have a Reserve for guarantee losses on Participation Certificates that totals \$295 million and \$150 million at December 31, 2005 and 2004, respectively, for incurred credit losses that were recognized in conjunction with PCs and Structured Securities held by third parties. The balance of PCs and Structured Securities held by third parties also includes securities issued by third parties that we guarantee totaling \$6.6 billion and \$6.8 billion at December 31, 2005 and 2004, respectively. Details of these guarantees are as follows:

- *Multifamily:* We guarantee multifamily housing revenue bonds totaling \$5.8 billion and \$5.0 billion at December 31, 2005 and 2004, respectively, via two principal forms. First, we provide a guarantee of the payment of principal and interest on tax-exempt multifamily housing revenue bonds that support pass-through certificates issued by third parties. These housing revenue bonds are collateralized by mortgage loans on low- and moderate-income multifamily housing projects. Second, we provide a guarantee of principal and interest on multifamily mortgage loans that are originated and held by state and municipal housing finance agencies to support tax-exempt multifamily housing revenue bonds.
- *Single-family:* We guarantee single-family mortgage loans held by third parties totaling \$0.8 billion and \$1.8 billion at December 31, 2005 and 2004, respectively.

As part of the guarantee arrangements pertaining to multifamily housing revenue bonds, we also provide a commitment to advance funds, commonly referred to as “liquidity guarantees,” totaling \$5.7 billion and \$5.1 billion at December 31, 2005 and 2004, respectively, to enable the repurchase by others of tendered tax-exempt pass-through certificates and housing revenue bonds that are unable to be remarketed. Any repurchased securities would be pledged to us to secure such funding until such time as the securities could be remarketed. We have not made any payments to date under these liquidity guarantees.

Generally, the contractual terms of our guarantees on PCs and Structured Securities are 15 to 30 years. However, the actual term of each guarantee may be significantly less than the contractual term due to the prepayment characteristics of the mortgage-related assets that back PCs and Structured Securities. We do not expect the maximum potential interest payments we would be required to make associated with these guarantees to significantly exceed 120 days of interest at the certificate rate, given that we generally begin a process to purchase the defaulted mortgages when they have been delinquent for 120 consecutive days.

At December 31, 2005 and 2004, in connection with PCs or Structured Securities backed by single-family mortgage loans, we had maximum coverage totaling \$27.5 billion and \$27.2 billion, respectively, in primary mortgage insurance, \$3.6 billion and \$3.5 billion, respectively, in pool insurance and other credit enhancements and \$5.6 billion and \$4.1 billion, respectively, in recourse to lenders. In addition, at December 31, 2005 and 2004, \$1.9 billion and \$2.6 billion, respectively, of outstanding Structured Securities related to Ginnie Mae Certificates, which are backed by the full faith and credit of the U.S. government. With respect to PCs and Structured Securities backed by multifamily mortgage loans, we had maximum combined credit enhancements totaling \$7.3 billion and \$9.1 billion at December 31, 2005 and 2004, respectively. At December 31, 2005 and 2004, our recorded balance of credit enhancements on our consolidated balance sheets was \$420 million and \$295 million, respectively.

Guarantees of Stated Final Maturity of Issued Structured Securities

We commonly issue Structured Securities with stated final maturities that are shorter than the stated maturity of the underlying mortgage loans. If the assets that back such Structured Securities have not fully matured as of the stated final maturity date of such securities, we may sponsor an auction of the underlying assets. To the extent that auction proceeds are insufficient to cover unpaid principal amounts due to investors in such Structured Securities, we are obligated to fund such principal. Such guarantees of stated final maturity are accounted for as derivative instruments.

At December 31, 2005 and 2004, the maximum potential amount of payments we could be required to make under guarantees of stated final maturity of issued Structured Securities was \$11.7 billion and \$9.0 billion, respectively, which represents the outstanding unpaid principal balance of the underlying mortgage loans. At December 31, 2005 and 2004, the total fair value of recognized liabilities concerning such guarantees was \$2 million and \$1 million, respectively.

Indemnifications

In connection with various business transactions, we provide indemnification to counterparties for breaches of standard representations and warranties in contracts entered into in the normal course of business. It is difficult to estimate our maximum exposure under these indemnification arrangements since in many cases there are no stated or notional amounts included in the indemnification clauses. However, no claim for indemnification pursuant to these provisions has been made. At December 31, 2005, our assessment is that the risk of such claim for indemnification is remote. Such representations and warranties pertain to hold harmless clauses, adverse changes in tax laws and potential claims from third parties related to items such as actual or alleged infringement of intellectual property. We have not recorded any liabilities related to these indemnifications in our consolidated balance sheets at December 31, 2005 and 2004 because we do not expect material amounts to be paid under these agreements.

Other Guarantees

We have guaranteed the performance of interest-rate swap contracts in two circumstances. First, as part of a securitization transaction, we transferred certain swaps and related assets to a third party. We guaranteed that interest income generated from the assets would be sufficient to cover the required payments under the interest-rate swap contracts. Second, we guaranteed that a borrower would perform under an interest-rate swap contract linked to a customer's variable-rate mortgage. The maximum remaining terms of any of these guarantees at both December 31, 2005 and 2004 was 29 years; however, the actual terms may be significantly less than the contractual terms because the mortgage loans underlying the swaps are prepayable. The maximum potential amount of future undiscounted payments under the guarantees was \$717 million and \$591 million at December 31, 2005 and 2004, respectively. At December 31, 2005 and 2004, the total fair value of recognized liabilities concerning such guarantees was \$2 million and \$1 million, respectively.

During 2005, we issued written call options with a notional amount of \$25 million with respect to PCs issued by us. The maximum amount of future payments under these call options is unlimited. The fair value of these options recorded on our consolidated balance sheet at December 31, 2005 was not material. We did not issue written options on our PCs in 2004.

We provide guarantees to reimburse servicers for premiums paid to acquire servicing in situations where we require the original seller to repurchase the loan and the original seller is unable to perform under its separate servicing agreement to reimburse the servicer for those servicing premiums. Our servicing-related premium guarantees are payable according to a vesting schedule for up to five years from the date of purchase of servicing rights. The maximum potential amount of future payments under these servicing-related premium guarantees was \$54 million and \$113 million at December 31, 2005 and 2004, respectively. We have not established a liability on our consolidated balance sheets at December 31, 2005 and 2004 because we do not expect material amounts to be paid under these arrangements.

NOTE 5: RETAINED PORTFOLIO AND CASH AND INVESTMENTS PORTFOLIO

Table 5.1 summarizes amortized cost, estimated fair values and corresponding gross unrealized gains and gross unrealized losses by major security type for available-for-sale securities.

Table 5.1 — Available-For-Sale Securities

<u>December 31, 2005</u>	<u>Amortized Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized Losses</u>	<u>Fair Value</u>
		(in millions)		
Retained portfolio				
Mortgage-related securities issued by:				
Freddie Mac	\$354,573	\$1,848	\$(4,974)	\$351,447
Fannie Mae	43,784	389	(867)	43,306
Ginnie Mae	1,085	33	(3)	1,115
Other	231,693	692	(1,029)	231,356
Obligations of states and political subdivisions	11,022	272	(53)	11,241
Total mortgage-related securities	<u>642,157</u>	<u>3,234</u>	<u>(6,926)</u>	<u>638,465</u>
Cash and investments portfolio				
Non-mortgage-related securities:				
Asset-backed securities	30,712	22	(156)	30,578
Obligations of states and political subdivisions	5,835	—	(12)	5,823
Commercial paper	5,764	—	—	5,764
Total non-mortgage-related securities	<u>42,311</u>	<u>22</u>	<u>(168)</u>	<u>42,165</u>
Total available-for-sale securities	<u>\$684,468</u>	<u>\$3,256</u>	<u>\$(7,094)</u>	<u>\$680,630</u>
<u>December 31, 2004</u>				
Retained portfolio				
Mortgage-related securities issued by:				
Freddie Mac	\$348,034	\$5,506	\$(1,438)	\$352,102
Fannie Mae	58,922	950	(353)	59,519
Ginnie Mae	1,677	86	(1)	1,762
Other	166,738	1,700	(380)	168,058
Obligations of states and political subdivisions	8,751	301	(32)	9,020
Total mortgage-related securities	<u>584,122</u>	<u>8,543</u>	<u>(2,204)</u>	<u>590,461</u>
Cash and investments portfolio				
Non-mortgage-related securities:				
Asset-backed securities	21,668	120	(55)	21,733
Obligations of states and political subdivisions	8,098	—	(1)	8,097
Total non-mortgage-related securities	<u>29,766</u>	<u>120</u>	<u>(56)</u>	<u>29,830</u>
Total available-for-sale securities	<u>\$613,888</u>	<u>\$8,663</u>	<u>\$(2,260)</u>	<u>\$620,291</u>

Table 5.2 shows the fair value of available-for-sale securities in a gross unrealized loss position at December 31, 2005, and how long they have been in that position.

Table 5.2 — Available-For-Sale Securities in a Gross Unrealized Loss Position

<u>December 31, 2005</u>	<u>Less than 12 months</u>		<u>12 months or Greater</u>		<u>Total</u>	
	<u>Fair Value</u>	<u>Gross Unrealized Losses</u>	<u>Fair Value</u>	<u>Gross Unrealized Losses</u>	<u>Fair Value</u>	<u>Gross Unrealized Losses</u>
			(in millions)			
Retained portfolio						
Mortgage-related securities issued by:						
Freddie Mac	\$158,235	\$(1,975)	\$ 93,056	\$(2,999)	\$251,291	\$(4,974)
Fannie Mae	12,084	(182)	19,918	(685)	32,002	(867)
Ginnie Mae	111	(3)	25	—	136	(3)
Other	55,213	(627)	13,859	(402)	69,072	(1,029)
Obligations of states and political subdivisions	2,186	(32)	860	(21)	3,046	(53)
Total mortgage-related securities	<u>227,829</u>	<u>(2,819)</u>	<u>127,718</u>	<u>(4,107)</u>	<u>355,547</u>	<u>(6,926)</u>
Cash and investments portfolio						
Non-mortgage related securities:						
Asset-backed securities	11,715	(78)	5,485	(78)	17,200	(156)
Obligations of states and political subdivisions	1,207	(12)	—	—	1,207	(12)
Total non-mortgage-related securities	<u>12,922</u>	<u>(90)</u>	<u>5,485</u>	<u>(78)</u>	<u>18,407</u>	<u>(168)</u>
Total available-for-sale securities in a gross unrealized loss position	<u>\$240,751</u>	<u>\$(2,909)</u>	<u>\$133,203</u>	<u>\$(4,185)</u>	<u>\$373,954</u>	<u>\$(7,094)</u>

At December 31, 2005, gross unrealized losses on available-for-sale securities were \$(7,094) million, or approximately 2 percent of the fair value of such securities in an unrealized loss position, as noted in Table 5.1 and Table 5.2. The gross unrealized losses relate to approximately 85,000 individual lots representing approximately 16,000 separate securities. We

routinely purchase multiple lots of individual securities at different times and at different costs. We determine gross unrealized gains and gross unrealized losses by specifically identifying investment positions at the lot level; therefore, some of the lots we hold for a single security may be in an unrealized gain position while other lots for that security are in an unrealized loss position, depending upon the amortized cost of the specific lot.

We have the ability and intent to hold the available-for-sale securities in an unrealized loss position for a period of time sufficient to recover all unrealized losses. Based on our ability and intent to hold the available-for-sale securities and our consideration of other factors described below, we have concluded that the impairment of these securities is temporary.

- **Freddie Mac securities.** The unrealized losses on our securities are primarily a result of movements in interest rates. Since we guarantee the payment of principal and interest on these securities, we review the estimated credit exposure of the mortgages underlying these securities in evaluating potential impairment. The extent and duration of the decline in fair value relative to the amortized cost have met our criteria that are used to indicate that the impairment of these securities is temporary.
- **Fannie Mae securities and Obligations of states and political subdivisions.** The unrealized losses on Fannie Mae securities and Obligations of states and political subdivisions are primarily a result of movements in interest rates. The extent and duration of the decline in fair value relative to the amortized cost have met our criteria that are used to indicate that the impairment of these securities is temporary and no other facts or circumstances existed to suggest that the decline was not temporary. The issuer guarantees related to these securities have led us to conclude that any credit risk is minimal.
- **Other securities in the Retained portfolio and Asset-backed securities in the Cash and Investment portfolio.** The unrealized losses on mortgage-related securities included in Other and Asset-backed securities are principally a result of movements in interest rates. The extent and duration of the decline in fair value relative to the amortized cost have met our criteria that are used to indicate that the impairment of these securities is temporary. The vast majority of these securities are investment grade (*i.e.*, rated BBB– or better on a S&P equivalent scale).

Table 5.3 below illustrates the gross realized gains and gross realized losses received from the sale of available-for-sale securities.

Table 5.3 — Gross Realized Gains and Gross Realized Losses on Available-For-Sale Securities

	Year Ended December 31,		
	2005	2004	2003
	(in millions)		
Gross realized gains	\$ 891	\$ 787	\$ 1,903
Gross realized (losses)	(345)	(203)	(1,077)
Net realized gains	<u>\$ 546</u>	<u>\$ 584</u>	<u>\$ 826</u>

Table 5.4 summarizes, by major security type, the remaining contractual maturities and weighted average yield of available-for-sale securities at December 31, 2005.

Table 5.4 — Maturities and Weighted Average Yield of Available-For-Sale Securities

December 31, 2005	Amortized Cost	Fair Value	Weighted Average Yield ⁽¹⁾
	(dollars in millions)		
Retained portfolio			
Total mortgage-related securities ⁽²⁾			
Due 1 year or less	\$ 22	\$ 22	5.80%
Due after 1 through 5 years	3,565	3,609	5.35
Due after 5 through 10 years	13,078	13,227	5.73
Due after 10 years	625,492	621,607	4.94
Total	<u>\$642,157</u>	<u>\$638,465</u>	4.96
Cash and investments portfolio			
Non-mortgage-related securities:			
Asset-backed securities ⁽²⁾			
Due 1 year or less	\$ 3	\$ 3	4.29
Due after 1 through 5 years	21,466	21,369	4.12
Due after 5 through 10 years	7,132	7,095	4.16
Due after 10 years	2,111	2,111	4.42
Total	<u>30,712</u>	<u>30,578</u>	4.15
Obligations of states and political subdivisions			
Due 1 year or less	95	95	3.13
Due after 1 through 5 years	1,163	1,153	3.07
Due after 5 through 10 years	82	82	3.40
Due after 10 years	4,495	4,493	3.71
Total	<u>5,835</u>	<u>5,823</u>	3.57
Commercial paper			
Due 1 year or less	5,764	5,764	3.67
Due after 1 through 5 years	—	—	—
Due after 5 through 10 years	—	—	—
Due after 10 years	—	—	—
Total	<u>5,764</u>	<u>5,764</u>	3.67
Total non-mortgage-related securities			
Due 1 year or less	5,862	5,862	3.66
Due after 1 through 5 years	22,629	22,522	4.07
Due after 5 through 10 years	7,214	7,177	4.16
Due after 10 years	6,606	6,604	3.94
Total	<u>\$ 42,311</u>	<u>\$ 42,165</u>	4.01
Total available-for-sale securities for Retained portfolio and Cash and investments portfolio			
Due 1 year or less	\$ 5,884	\$ 5,884	3.67
Due after 1 through 5 years	26,194	26,131	4.24
Due after 5 through 10 years	20,292	20,404	5.17
Due after 10 years	632,098	628,211	4.93
Total	<u>\$684,468</u>	<u>\$680,630</u>	4.90

(1) The weighted average yield is calculated based on a yield for each individual security held at the balance sheet date. The numerator for the individual security yield consists of the sum of (a) the year-end interest coupon rate multiplied by the year-end unpaid principal balance and (b) the annualized amortization income or expense calculated for December 2005 (excluding any adjustments recorded for changes in the effective rate). The denominator for the individual security yield consists of the year-end amortized cost of the security excluding effects of other-than-temporary impairments on the unpaid principal balances of impaired securities.

(2) Information provided for mortgage-related securities and asset-backed securities is based on contractual maturities, which may not represent their expected lives. Obligations underlying these securities may be prepaid at any time without penalty.

Table 5.5 presents the changes in AOCI, net of taxes, related to available-for-sale securities. The Net unrealized holding (losses), net of tax, represents the net fair value adjustments recorded on available-for-sale securities throughout the year, after the effects of our statutory tax rate of 35 percent. The Net reclassification adjustment for net realized (gains), net of tax, represents the amount of those fair value adjustments, after the effects of our statutory tax rate of 35 percent, that have been recognized in earnings due to a sale of an available-for-sale security or the recognition of an impairment loss. See “NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES” for further information regarding the component of AOCI related to available-for-sale securities.

Table 5.5 — AOCI, Net of Taxes, Related to Available-For-Sale Securities

	Year Ended December 31,		
	2005	2004	2003
	(in millions)		
Beginning balance	\$ 4,339	\$ 6,349	\$12,217
Net unrealized holding (losses), net of tax ⁽¹⁾	(6,707)	(1,709)	(5,770)
Net reclassification adjustment for net realized (gains), net of tax ⁽²⁾⁽³⁾	(117)	(301)	(98)
Ending balance	<u>\$ (2,485)</u>	<u>\$ 4,339</u>	<u>\$ 6,349</u>

(1) Net of tax (benefit) of \$(3,611) million, \$(920) million and \$(3,107) million for the years ended December 31, 2005, 2004 and 2003, respectively.

(2) Net of tax (expense) of \$(63) million, \$(162) million and \$(53) million for the years ended December 31, 2005, 2004 and 2003, respectively.

(3) Includes the reversal of previously recorded unrealized losses that have been recognized as impairment losses on available-for-sale securities of \$234 million, \$72 million and \$438 million, net of taxes, for the years ended December 31, 2005, 2004 and 2003, respectively.

Table 5.6 summarizes the estimated fair values by major security type for trading securities held in our Retained portfolio.

Table 5.6 — Trading Securities in the Retained Portfolio

	December 31,	
	2005	2004
	(in millions)	
Retained portfolio		
Mortgage-related securities issued by:		
Freddie Mac	\$8,156	\$11,398
Fannie Mae	534	385
Ginnie Mae	204	59
Total trading securities in the Retained portfolio	<u>\$8,894</u>	<u>\$11,842</u>

The net unrealized holding losses on trading securities we still hold that have been recognized in earnings for the years ended December 31, 2005, 2004 and 2003 were \$(261) million, \$(240) million and \$(402) million, respectively.

Collateral Pledged

Collateral Pledged to Freddie Mac

Our counterparties are required to pledge collateral for reverse repurchase transactions and most interest-rate swap agreements, after giving consideration to collateral posting thresholds generally related to a counterparty’s credit rating. Even though it is our practice not to repledge assets held as collateral, based on master agreements a portion of the collateral may be repledged. At December 31, 2005, we did not have collateral in the form of securities pledged to and held by us under secured lending transactions and interest-rate swap agreements. At December 31, 2004, the fair value amount of collateral pledged to and held by us, in the form of securities, was \$466 million, of which approximately \$3 million was available for repledging.

Collateral Pledged by Freddie Mac

We are also required to pledge collateral for margin requirements with third-party custodians in connection with secured financings, interest-rate swap agreements, futures and daily trade activities with some counterparties. We pledge collateral to meet these requirements upon a demand by the respective counterparty. Based on agreements with our custodians, some collateral may be permitted by contract to be repledged by the custodian. Table 5.7 summarizes all securities pledged as collateral by us, including assets that the secured party may repledge and those that may not be repledged.

Table 5.7 — Collateral in the Form of Securities Pledged

	December 31,	
	2005	2004
	(in millions)	
Securities pledged with ability for secured party to repledge (parenthetically disclosed on our consolidated balance sheets)		
Available-for-sale	\$168	\$194
Securities pledged without ability for secured party to repledge		
Available-for-sale	<u>161</u>	<u>221</u>
Total assets pledged	<u>\$329</u>	<u>\$415</u>

NOTE 6: LOAN LOSS RESERVES

We maintain separate loan loss reserves for mortgage loans in the Retained portfolio that we classify as held-for-investment and for credit-related losses associated with certain mortgage loans that underlie guaranteed PCs and Structured Securities held by third parties.

Table 6.1 summarizes loan loss reserve activity during 2005, 2004 and 2003.

Table 6.1 — Detail of Loan Loss Reserves

	Year-Ended December 31,								
	2005			2004			2003		
	Reserves related to:			Reserves related to:			Reserves related to:		
	Retained Mortgages	PCs Outstanding	Total Loan Loss Reserves	Retained Mortgages	PCs Outstanding (in millions)	Total Loan Loss Reserves	Retained Mortgages	PCs Outstanding	Total Loan Loss Reserves
Beginning balance	\$ 114	\$150	\$ 264	\$ 174	\$125	\$ 299	\$ 177	\$ 88	\$ 265
Provision for credit losses	106	145	251	111	32	143	76	(81)	(5)
Charge-offs ⁽¹⁾	(294)	—	(294)	(300)	—	(300)	(224)	—	(224)
Recoveries ⁽¹⁾	185	—	185	160	—	160	145	—	145
Adjustment for change in accounting ⁽²⁾	—	—	—	—	—	—	—	110	110
Transfers-out ⁽³⁾	—	(11)	(11)	—	(20)	(20)	—	(11)	(11)
Other, net ⁽⁴⁾	8	11	19	(31)	13	(18)	—	19	19
Ending balance	<u>\$ 119</u>	<u>\$295</u>	<u>\$ 414</u>	<u>\$ 114</u>	<u>\$150</u>	<u>\$ 264</u>	<u>\$ 174</u>	<u>\$125</u>	<u>\$ 299</u>

- (1) It is our practice to purchase mortgage loans from the pools that underlie PCs principally at the point the mortgage loan is identified as being 120 days past due. Upon repurchase, that portion of amounts classified in Reserve for guarantee losses on Participation Certificates that relates to a purchased loan is reclassified to Reserve for losses on mortgage loans held-for-investment. Since all credit losses related to off-balance sheet PCs are preceded by the purchase of a delinquent mortgage loan from the PC pool, all charge-offs or recoveries are presented in the Retained Mortgages columns above.
- (2) On January 1, 2003, \$110 million of the recognized Guarantee obligation that was attributable to estimated incurred losses on outstanding PCs or Structured Securities was reclassified to Reserve for guarantee losses on Participation Certificates.
- (3) 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.
- (4) Represents the portion of the Guarantee obligation recognized upon the sale of PCs or Structured Securities that corresponds to incurred credit losses reclassified to Reserve for guarantee losses on Participation Certificates upon initial recognition of a Guarantee obligation. In addition, the 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.

Impaired Loans

Total loan loss reserves, as presented in “Table 6.1 — Detail of Loan Loss Reserves,” consists of a specific valuation allowance related to impaired loans, which are presented in Table 6.2, and an additional reserve for other probable incurred losses which equaled \$398 million, \$261 million and \$289 million at December 31, 2005, 2004 and 2003, respectively. Our recorded investment in impaired loans and the related valuation allowance are summarized in Table 6.2.

Table 6.2 — Impaired Loans⁽¹⁾

	December 31,								
	2005			2004			2003		
	Recorded Investment ⁽²⁾	Specific Reserve	Net Investment	Recorded Investment ⁽²⁾	Specific Reserve	Net Investment	Recorded Investment ⁽²⁾	Specific Reserve	Net Investment
	(in millions)								
Impaired loans having:									
Related-valuation allowance	\$ 54	\$(16)	\$ 38	\$ 46	\$ (3)	\$ 43	\$ 60	\$(10)	\$ 50
No related-valuation allowance ⁽³⁾	<u>2,536</u>	<u>—</u>	<u>2,536</u>	<u>2,261</u>	<u>—</u>	<u>2,261</u>	<u>2,309</u>	<u>—</u>	<u>2,309</u>
Total	<u>\$2,590</u>	<u>\$(16)</u>	<u>\$2,574</u>	<u>\$2,307</u>	<u>\$ (3)</u>	<u>\$2,304</u>	<u>\$2,369</u>	<u>\$(10)</u>	<u>\$2,359</u>

- (1) Single-family impaired loans include performing and non-performing troubled debt restructurings. Multifamily impaired loans are defined as performing and non-performing troubled debt restructurings, loans that are 60 days or more delinquent except for certain credit enhanced loans and certain mortgage loans with real estate collateral values less than the outstanding unpaid principal balances. For more details on multifamily impaired loans, see “NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES.”
- (2) Recorded Investment includes the unpaid principal balance of mortgage loans plus other amortized basis adjustments, which are modifications to their carrying value.
- (3) Impaired loans with no related valuation allowance primarily represent performing single-family troubled debt restructuring loans.

For the years ended December 31, 2005, 2004 and 2003, the average recorded investment in impaired loans was \$2,601 million, \$2,311 million and \$2,330 million, respectively. The increase in impaired loans in 2005 is primarily due to Hurricane Katrina.

Interest income on multifamily impaired loans is recognized on an accrual basis for loans performing under the original or restructured terms and on a cash basis for non-performing loans, which collectively totaled approximately \$24 million, \$13 million and \$16 million for the years ended December 31, 2005, 2004 and 2003, respectively. For single-family performing and non-performing loans, we recognize interest income on an accrual basis and establish reserves for estimated accrued but uncollectible interest for these loans at the consolidated balance sheet dates. Gross interest income on impaired single-family loans totaled \$149 million, \$157 million and \$160 million for the years ended December 31, 2005, 2004 and 2003, respectively.

Delinquency Rates

Table 6.3 summarizes the delinquency rates for our Total mortgage portfolio, excluding non-Freddie Mac mortgage-related securities and that portion of Structured Securities that is backed by Ginnie Mae Certificates, at December 31, 2005, 2004 and 2003.

Table 6.3 — Delinquency Performance⁽¹⁾

	December 31,		
	2005	2004	2003
Delinquencies, end of period:			
Single-family:⁽²⁾			
Non-credit-enhanced portfolio:			
Delinquency rate	0.30%	0.24%	0.27%
Total number of delinquent loans	26,037	19,691	21,063
Credit-enhanced portfolio:			
Delinquency rate	2.46%	2.75%	2.96%
Total number of delinquent loans	47,000	54,913	66,283
Total portfolio:			
Delinquency rate	0.69%	0.73%	0.86%
Total number of delinquent loans	73,037	74,604	87,346
Multifamily:⁽³⁾			
Total portfolio:			
Delinquency rate	—%	0.06%	0.05%
Net carrying value of delinquent loans (in millions)	\$ 2	\$ 35	\$ 24

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

(2) Based on the number of mortgage loans 90 days or more delinquent or in foreclosure.

(3) Based on net carrying value of mortgage loans 60 days or more delinquent.

NOTE 7: REAL ESTATE OWNED

We obtain REO properties when we are the highest bidder at foreclosure sales of properties that collateralize non-performing single-family and multifamily mortgage loans owned by us. Upon acquiring single-family properties, we establish a marketing plan to sell the property as soon as practicable by either listing it with a sales broker or by other means, such as arranging a real estate auction. Upon acquiring multifamily properties, we may operate them with third-party property-management firms for a period to stabilize value and then sell the properties through commercial real estate brokers. For each of the years ended December 31, 2005, 2004 and 2003, the weighted average holding period for our disposed REO properties was less than one year. Table 7.1 provides a summary of our REO activity.

Table 7.1 — Real Estate Owned

	REO, Gross	Valuation Allowance (in millions)	REO, Net
	Balance, December 31, 2002	\$ 670	\$ (76)
Additions	1,663	(93)	1,570
Dispositions and write-downs	(1,422)	53	(1,369)
Balance, December 31, 2003	911	(116)	795
Additions	1,641	(95)	1,546
Dispositions and write-downs	(1,685)	85	(1,600)
Balance, December 31, 2004	867	(126)	741
Additions	1,390	(78)	1,312
Dispositions and write-downs	(1,513)	89	(1,424)
Balance, December 31, 2005	<u>\$ 744</u>	<u>\$(115)</u>	<u>\$ 629</u>

We recognized losses of \$67 million, \$67 million and \$50 million on REO dispositions for the years ended December 31, 2005, 2004 and 2003, respectively, which are included in REO operations income (expense).

NOTE 8: DEBT SECURITIES AND SUBORDINATED BORROWINGS

Debt securities are classified as either due within one year or due after one year based on their remaining contractual maturity. Table 8.1 summarizes the balances and effective interest rates at December 31, 2005 and 2004 for debt securities, as well as subordinated borrowings.

Table 8.1 — Total Debt Securities, Net

	December 31,			
	2005		2004	
	Balance, Net ⁽¹⁾	Effective Rate ⁽²⁾	Balance, Net ⁽¹⁾	Effective Rate ⁽²⁾
	(dollars in millions)			
Senior debt, due within one year:				
Short-term debt securities	\$192,713	4.02%	\$196,639	2.05%
Current portion of long-term debt	<u>95,819</u>	3.42	<u>85,664</u>	3.33
Senior debt, due within one year	288,532	3.82	282,303	2.44
Senior debt, due after one year	454,627	4.64	443,772	4.36
Subordinated debt, due after one year	<u>5,633</u>	6.15	<u>5,622</u>	6.15
Senior and subordinated debt, due after one year	<u>460,260</u>	4.66	<u>449,394</u>	4.38
Total debt securities, net	<u>\$748,792</u>		<u>\$731,697</u>	

(1) Includes unamortized discounts and premiums, and foreign-currency-related and hedging-related basis adjustments.

(2) Represents the weighted average effective rate at the end of the period, which includes the amortization of discounts or premiums and issuance costs, but excludes the amortization of foreign-currency-related and hedging-related basis adjustments.

We finance the purchase of mortgage loans and mortgage-related securities primarily through the issuance of senior debt and subordinated debt.

Senior Debt, Due Within One Year

As indicated in Table 8.2, a majority of Senior debt, due within one year (excluding current portion of long-term debt) consisted of Reference Bills[®] securities and discount notes, paying only principal at maturity. Reference Bills[®] securities, discount notes and Medium-term Notes are unsecured general obligations. Certain Medium-term Notes that have original maturities of one year or less are classified as Short-term debt securities. Securities sold under agreements to repurchase are effectively collateralized borrowing transactions where we sell securities with an agreement to repurchase such securities. These agreements require the underlying securities to be delivered to the dealers who arranged the transactions. Federal funds purchased are unsecured borrowings from commercial banks that are members of the Federal Reserve System.

Table 8.2 provides additional information related to our debt securities due within one year.

Table 8.2 — Senior Debt, Due Within One Year

	December 31,					
	2005			2004		
	Par Value	Balance, Net ⁽¹⁾	Effective Rate ⁽²⁾	Par Value	Balance, Net ⁽¹⁾	Effective Rate ⁽²⁾
	(dollars in millions)					
Reference Bills [®] securities and discount notes	\$183,357	\$181,468	4.00%	\$181,071	\$180,198	2.04%
Medium-term Notes	2,035	2,032	4.17	162	162	2.51
Securities sold under agreements to repurchase and Federal funds purchased	450	450	4.26	—	—	—
Swap collateral obligations	8,736	8,768	4.30	16,279	16,279	2.24
Hedging-related basis adjustments	N/A	(5)	N/A	N/A	—	N/A
Short-term debt securities	<u>194,578</u>	<u>192,713</u>	4.02	<u>197,512</u>	<u>196,639</u>	2.05
Current portion of long-term debt	<u>95,596</u>	<u>95,819</u>	3.42	<u>83,625</u>	<u>85,664</u>	3.33
Senior debt, due within one year	<u>\$290,174</u>	<u>\$288,532</u>	3.82	<u>\$281,137</u>	<u>\$282,303</u>	2.44

(1) Represents par value, net of associated discounts or premiums. Swap collateral obligations include the related accrued interest payable.

(2) Represents the weighted average effective rate at the end of the period, which includes the amortization of discounts or premiums and issuance costs, but excludes the amortization of foreign-currency-related and hedging-related basis adjustments.

Senior and Subordinated Debt, Due After One Year

Table 8.3 summarizes our Senior and subordinated debt, due after one year at December 31, 2005 and 2004.

Table 8.3 — Senior and Subordinated Debt, Due After One Year

	Contractual Maturity ⁽¹⁾	December 31,					
		2005			2004		
		Par Value	Balance, Net ⁽²⁾	Interest Rates	Par Value	Balance, Net ⁽²⁾	Interest Rates
(dollars in millions)							
Senior debt, due after one year: ⁽³⁾							
Fixed-rate:							
Medium-term Notes — Callable ⁽⁴⁾	2007 - 2035	\$182,251	\$182,173	2.00% - 7.91%	\$181,094	\$180,957	1.63% - 8.05%
Medium-term Notes — Non-callable	2007 - 2028	19,927	19,936	1.00% - 7.69%	8,574	8,587	1.00% - 7.69%
U.S. dollar Reference Notes [®] securities — Non-callable	2007 - 2032	172,551	171,962	2.38% - 7.00%	167,836	167,622	1.88% - 7.00%
€Reference Notes [®] securities — Non-callable	2007 - 2014	25,528	25,478	3.50% - 5.75%	29,035	28,967	3.50% - 5.75%
Variable-rate:							
Medium-term Notes — Callable ⁽⁵⁾	2007 - 2030	28,709	28,709	Various	33,033	33,041	Various
Medium-term Notes — Non-callable ⁽⁶⁾	2007 - 2026	5,809	5,858	Various	1,183	1,207	Various
Zero-coupon:							
Medium-term Notes — Callable	2007 - 2035	39,939	7,675	—%	35,903	7,078	—%
Medium-term Notes — Non-callable	2007 - 2034	9,598	5,287	—%	5,528	1,968	—%
Foreign-currency-related and hedging-related basis adjustments		N/A	7,549		N/A	14,345	
Total senior debt, due after one year		484,312	454,627		462,186	443,772	
Subordinated debt, due after one year:							
Fixed-rate ⁽⁷⁾	2011 - 2016	5,564	5,550	5.25% - 8.25%	5,564	5,547	5.25% - 8.25%
Zero coupon	2019	332	83	—%	332	75	—%
Total subordinated debt, due after one year		5,896	5,633		5,896	5,622	
Total senior and subordinated debt, due after one year		\$490,208	\$460,260		\$468,082	\$449,394	

(1) Represents contractual maturities at December 31, 2005.

(2) Represents par value of long-term debt securities and subordinated borrowings, net of associated discounts or premiums.

(3) For debt denominated in a currency other than the U.S. dollar, the outstanding balance is based on the exchange rate at the date of the debt issuance. Subsequent changes in exchange rates are reflected in Foreign-currency-related and hedging-related basis adjustments.

(4) Includes callable Estate NotesSM securities and FreddieNotes[®] securities of \$11,805 million and \$11,850 million at December 31, 2005 and 2004, respectively. These debt instruments represent Medium-term Notes that permit persons acting on behalf of deceased beneficial owners to require us to repay principal prior to the contractual maturity date.

(5) Includes callable Estate NotesSM securities and FreddieNotes[®] securities of \$6,987 million and \$6,142 million at December 31, 2005 and 2004, respectively. See related footnote (4) above concerning the nature of these debt instruments.

(6) Includes Medium-term Notes of \$800 million at December 31, 2005 and 2004, which are repayable in whole or in part at the option of the beneficial owner, acting through the holder, on or after November 22, 2002 and prior to November 20, 2007 at 100 percent of the principal amount plus accrued interest.

(7) Balance, Net includes callable subordinated debt of \$3,493 million and \$3,491 million at December 31, 2005 and 2004, respectively.

A portion of our long-term debt is callable. Callable debt gives us the option to redeem the debt security on one or more specified call dates or at any time on or after a specified call date.

Table 8.4 summarizes the contractual maturities of long-term debt securities (including current portion of long-term debt) and subordinated borrowings outstanding at December 31, 2005, assuming callable debt is paid at contractual maturity.

Table 8.4 — Senior and Subordinated Debt, Due After One Year (including current portion of long-term debt)

Annual Maturities	Contractual Maturity ⁽¹⁾⁽²⁾ (in millions)
2006	\$ 95,596
2007	106,696
2008	72,125
2009	47,348
2010	52,249
Thereafter	211,790
Total ⁽¹⁾	585,804
Net discounts, premiums and foreign-currency-related and hedging-related basis adjustments ⁽²⁾	(29,725)
Senior and subordinated debt, due after one year, including current portion of long-term debt	\$556,079

(1) Represents par value of long-term debt securities and subordinated borrowings.

(2) For debt denominated in a currency other than the U.S. dollar, the par value is based on the exchange rate at the date of the debt issuance. Subsequent changes in exchange rates are reflected in Net discounts, premiums and foreign-currency-related and hedging-related basis adjustments.

We record gains and losses on debt repurchases that are accounted for as debt extinguishments based on the difference between the principal amount of the debt securities repurchased (adjusted for deferred premiums, discounts and hedging gains and losses) and proceeds paid and the write-off of related deferred debt issuance costs. We recognized a pre-tax gain of \$206 million and pre-tax losses of \$(327) million and \$(1,775) million on the repurchase of approximately \$11.7 billion, \$14.5 billion and \$27.3 billion in principal amount of debt outstanding in 2005, 2004 and 2003, respectively.

NOTE 9: STOCKHOLDERS' EQUITY

Preferred Stock

During 2005 and 2004, we completed no preferred stock offerings. All 17 classes of preferred stock outstanding at December 31, 2005 have a par value of \$1 per share. We have the option to redeem these shares, on specified dates, at their redemption price plus dividends accrued through the redemption date. In addition, all 17 classes of preferred stock are perpetual and non-cumulative, and carry no significant voting rights or rights to purchase additional Freddie Mac stock or securities. Costs incurred in connection with the issuance of preferred stock are charged to Additional paid-in capital.

Table 9.1 provides a summary of our preferred stock outstanding at December 31, 2005.

Table 9.1 — Preferred Stock

	Issue Date	Shares Authorized	Shares Outstanding	Total Par Value	Redemption Price per Share	Total Outstanding Balance ⁽¹⁾	Redeemable On or After ⁽²⁾	NYSE Symbol ⁽³⁾
(in millions, except redemption price per share)								
1996 Variable-rate ⁽⁴⁾ . . .	April 26, 1996	5.00	5.00	\$ 5.00	\$50.00	\$ 250	June 30, 2001	FRE.prB
6.14%	June 3, 1997	12.00	12.00	12.00	50.00	600	June 30, 2002	FRE.prD
5.81%	October 27, 1997	3.00	3.00	3.00	50.00	150	October 27, 1998	(5)
5%	March 23, 1998	8.00	8.00	8.00	50.00	400	March 31, 2003	FRE.prF
1998 Variable-rate ⁽⁶⁾ . . .	September 23 and 29, 1998	4.40	4.40	4.40	50.00	220	September 30, 2003	FRE.prG
5.1%	September 23, 1998	8.00	8.00	8.00	50.00	400	September 30, 2003	FRE.prH
5.3%	October 28, 1998	4.00	4.00	4.00	50.00	200	October 30, 2000	(5)
5.1%	March 19, 1999	3.00	3.00	3.00	50.00	150	March 31, 2004	(5)
5.79%	July 21, 1999	5.00	5.00	5.00	50.00	250	June 30, 2009	FRE.prK
1999 Variable-rate ⁽⁷⁾ . . .	November 5, 1999	5.75	5.75	5.75	50.00	287	December 31, 2004	FRE.prL
2001 Variable-rate ⁽⁸⁾ . . .	January 26, 2001	6.50	6.50	6.50	50.00	325	March 31, 2003	FRE.prM
2001 Variable-rate ⁽⁹⁾ . . .	March 23, 2001	4.60	4.60	4.60	50.00	230	March 31, 2003	FRE.prN
5.81%	March 23, 2001	3.45	3.45	3.45	50.00	173	March 31, 2011	FRE.prO
6%	May 30, 2001	3.45	3.45	3.45	50.00	173	June 30, 2006	FRE.prP
2001 Variable-rate ⁽¹⁰⁾ . . .	May 30, 2001	4.02	4.02	4.02	50.00	201	June 30, 2003	FRE.prQ
5.7%	October 30, 2001	6.00	6.00	6.00	50.00	300	December 31, 2006	FRE.prR
5.81%	January 29, 2002	6.00	6.00	6.00	50.00	300	March 31, 2007	(5)
Total		<u>92.17</u>	<u>92.17</u>	<u>\$92.17</u>		<u>\$4,609</u>		

- (1) Amounts stated at redemption value.
- (2) As long as the capital monitoring framework established by the Office of Federal Housing Enterprise Oversight, or OFHEO, in January 2004 remains in effect, any preferred stock redemption will require prior approval by OFHEO. See "NOTE 10: REGULATORY CAPITAL" for more information.
- (3) Preferred stock is listed on the New York Stock Exchange, or NYSE, unless otherwise noted.
- (4) Dividend rate resets quarterly and is equal to the sum of three-month LIBOR plus 1 percent divided by 1.377, and is capped at 9.00 percent.
- (5) Not listed on any exchange.
- (6) Dividend rate resets quarterly and is equal to the sum of three-month LIBOR plus 1 percent divided by 1.377, and is capped at 7.50 percent.
- (7) Dividend rate resets on January 1 every five years after January 1, 2005 based on a five-year Constant Maturity Treasury, or CMT, rate, and is capped at 11.00 percent. Optional redemption on December 31, 2004 and on December 31 every five years thereafter.
- (8) Dividend rate resets on April 1 every two years after April 1, 2003 based on the two-year CMT rate plus 0.10 percent, and is capped at 11.00 percent. Optional redemption on March 31, 2003 and on March 31 every two years thereafter.
- (9) Dividend rate resets on April 1 every year based on 12-month LIBOR minus 0.20 percent, and is capped at 11.00 percent. Optional redemption on March 31, 2003 and on March 31 every year thereafter.
- (10) Dividend rate resets on July 1 every two years after July 1, 2003 based on the two-year CMT rate plus 0.20 percent, and is capped at 11.00 percent. Optional redemption on June 30, 2003 and on June 30 every two years thereafter.

Stock Repurchase and Issuance Programs

On October 5, 2005, our board of directors authorized us to repurchase up to \$2 billion of outstanding shares of our common stock, all of which remained available for repurchase at December 31, 2005, and to issue up to \$2 billion of non-cumulative, perpetual preferred stock, in each case, from time to time depending on market conditions and other factors. Completion of the authorized capital transactions will have no material impact on our regulatory minimum capital surplus, including the 30 percent mandatory target set in January 2004 by OFHEO. In accordance with the existing capital monitoring framework established by OFHEO in January 2004, we obtained OFHEO's approval for this common stock repurchase. The repurchase authorization replaces all unused repurchase authority remaining under the common stock repurchase plan approved by our board of directors in September 1997.

NOTE 10: REGULATORY CAPITAL

Regulatory Capital Standards

The Federal Housing Enterprises Financial Safety and Soundness Act of 1992, or GSE Act, established minimum, critical and risk-based capital standards for us.

Those standards determine the amounts of Core capital and Total capital that we must maintain to meet regulatory capital requirements. Core capital consists of the par value of outstanding common stock (common stock issued less

common stock held in treasury), the par value of outstanding non-cumulative perpetual preferred stock, additional paid-in capital and retained earnings, as determined in accordance with GAAP. Total capital includes Core capital and general reserves for mortgage and foreclosure losses and any other amounts available to absorb losses that OFHEO includes by regulation.

Minimum Capital

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

Critical Capital

The critical capital standard requires us to hold an amount of Core capital that is generally equal to the sum of 1.25 percent of aggregate on-balance sheet assets and approximately 0.25 percent of the sum of outstanding mortgage-related securities we guaranteed and other aggregate off-balance sheet obligations.

Risk-Based Capital

The risk-based capital standard requires the application of a stress test to determine the amount of Total capital that we must hold to absorb projected losses resulting from adverse interest-rate and credit-risk conditions specified by the GSE Act and adds 30 percent additional capital to provide for management and operations risk. The adverse interest-rate conditions prescribed by the GSE Act include one scenario in which 10-year Treasury yields rise by as much as 75 percent (up-rate scenario) and one in which they fall by as much as 50 percent (down-rate scenario). The credit risk component of the stress tests simulates the performance of our mortgage portfolio based on loss rates for a benchmark region. The criteria for the benchmark region are established by the GSE Act and are intended to capture the credit-loss experience of the region that experienced the highest historical rates of default and severity of mortgage losses for two consecutive origination years.

Classification

OFHEO monitors our performance with respect to the three regulatory capital standards by classifying our capital adequacy not less than quarterly.

To be classified as “adequately capitalized,” we must meet both the risk-based and minimum capital standards. If we fail to meet the risk-based capital standard, we cannot be classified higher than “undercapitalized.” If we fail to meet the minimum capital requirement but exceed the critical capital requirement, we cannot be classified higher than “significantly undercapitalized.” If we fail to meet the critical capital standard, we must be classified as “critically undercapitalized.” In addition, OFHEO has discretion to reduce our capital classification by one level if OFHEO determines that we are engaging in conduct OFHEO did not approve that could result in a rapid depletion of Core capital or determines that the value of property subject to mortgage loans we hold or guarantee has decreased significantly.

When we are classified as adequately capitalized, we generally can pay a dividend on our common or preferred stock or make other capital distributions (which includes common stock repurchases and preferred stock redemptions) without prior OFHEO approval so long as the payment would not decrease Total capital to an amount less than our risk-based capital requirement and would not decrease our Core capital to an amount less than our minimum capital requirement.

If we were classified as undercapitalized, we would be prohibited from making a capital distribution that would decrease our Core capital to an amount less than our minimum capital requirement. We also would be required to submit a capital restoration plan for OFHEO approval, which could adversely affect our ability to make capital distributions.

If we were classified as significantly undercapitalized, we would be able to make a capital distribution only if OFHEO determined that the distribution satisfied certain statutory standards. Under these circumstances, we would be prohibited from making any capital distribution that would decrease our Core capital to less than the critical capital level, and OFHEO also could take action to limit our growth, require us to acquire new capital or restrict us from activities that create excessive risk. We also would be required to submit a capital restoration plan for OFHEO approval, which could adversely affect our ability to make capital distributions.

If we were classified as critically undercapitalized, OFHEO would be required to appoint a conservator for us unless OFHEO made a written finding that it should not do so and the Secretary of the Treasury concurred in that determination.

Performance Against Regulatory Capital Standards

OFHEO has never classified us as other than “adequately capitalized,” the highest possible classification, reflecting our consistent compliance with the minimum, critical and risk-based capital requirements.

Table 10.1 summarizes our regulatory capital requirements and surpluses.

Table 10.1 — Regulatory Capital Requirements⁽¹⁾

	December 31,	
	2005	2004
	(in millions)	
<i>Minimum capital requirement⁽²⁾</i>	\$25,010	\$24,131
Core capital ⁽²⁾	35,964	35,009
Minimum capital surplus ⁽²⁾	10,954	10,878
<i>Critical capital requirement⁽²⁾</i>	\$12,782	\$12,308
Core capital ⁽²⁾	35,964	35,009
Critical capital surplus ⁽²⁾	23,182	22,701
<i>Risk-based capital requirement⁽³⁾</i>	\$11,282	\$11,108
Total capital ⁽³⁾	36,781	34,691
Risk-based capital surplus ⁽³⁾	25,499	23,583

(1) OFHEO is the authoritative source of the capital calculations that underlie our capital classifications.

(2) Amounts for 2005 are based on amended reports we submitted to OFHEO on May 30, 2006.

(3) Amounts for 2005 and 2004 are those calculated by OFHEO prior to the issuance of our 2005 and 2004 financial results.

Factors that could adversely affect the adequacy of our regulatory capital for future periods include declines in GAAP income; increases in our risk profile; changes in the economic environment, such as large interest-rate or implied volatility moves or house-price declines; changes in option-adjusted spreads; legislative or regulatory action that could increase capital requirements or changes in or adoption of new accounting standards such as SFAS 155. See “NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — Recently Issued Accounting Standards, Not Yet Adopted” for more information regarding SFAS 155. In particular, interest-rate levels or implied volatility can affect the amount of our Core capital, even if we were economically well hedged against interest-rate changes, because certain gains or losses are recognized through GAAP earnings while other offsetting gains or losses may not be. Changes in option-adjusted spreads can also affect the amount of our Core capital, because option-adjusted spreads are a factor in the valuation of our guaranteed mortgage portfolio.

Subordinated Debt Commitment

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 those commitments and set forth a process for implementing them. Under the terms of this agreement, we committed to issue qualifying subordinated debt for public secondary market trading and rated by no less than two nationally recognized statistical rating organizations in a quantity such that the sum of Total capital plus the outstanding balance of qualifying subordinated debt will equal or exceed the sum of 0.45 percent of outstanding guaranteed PCs and Structured Securities and 4 percent of on-balance sheet assets at the end of each quarter. Qualifying subordinated debt is defined as subordinated debt that contains a deferral of interest payments for up to five years if our Core capital falls below 125 percent of our critical capital requirement or our Core capital falls below our minimum capital requirement and pursuant to our request, the Secretary of the Treasury exercises discretionary authority to purchase our obligations under Section 306(c) of our charter. Qualifying subordinated debt will be discounted for the purposes of this commitment as it approaches maturity with one-fifth of the outstanding amount excluded each year during the instrument’s last five years before maturity. When the remaining maturity is less than one year, the instrument is entirely excluded.

Table 10.2 summarizes our compliance with our subordinated debt commitment.

Table 10.2 — Subordinated Debt Commitment

	December 31, 2005
	(in millions)
Total on-balance sheet assets and guaranteed PCs and Structured Securities outstanding target ⁽¹⁾⁽²⁾	\$36,633
Total capital plus qualifying subordinated debt ⁽²⁾	41,831
Surplus ⁽²⁾	5,198

(1) Equals the sum of 0.45 percent of outstanding guaranteed PCs and Structured Securities and 4 percent of on-balance sheet assets.

(2) Amounts for 2005 are based on amended reports we submitted to OFHEO on May 30, 2006.

Regulatory Capital Monitoring Framework

In a letter dated January 28, 2004, OFHEO created a framework for monitoring our capital due to our higher operational risk, including our inability to produce timely financial statements in accordance with GAAP. The letter directed that we maintain a mandatory target capital surplus of 30 percent over our minimum capital requirement, subject to certain conditions and variations; that we submit weekly reports concerning our capital levels; and that we obtain prior approval of certain capital transactions.

Our failure to meet the mandatory target capital surplus would result in an OFHEO inquiry regarding the reason for such failure. If OFHEO were to determine that we had acted unreasonably regarding our compliance with the framework, as set forth in OFHEO's letter, OFHEO could seek to require us to submit a remedial plan or take other remedial steps.

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

This framework will remain in effect until the Director of OFHEO determines that it should be modified or expire. OFHEO's letter indicated that this determination would consider our resumption of timely financial and regulatory reporting that complies with GAAP, among other factors.

Table 10.3 summarizes our compliance with the mandatory target capital surplus portion of OFHEO's capital monitoring framework.

Table 10.3 — Mandatory Target Capital Surplus

	December 31,	
	2005	2004
	(in millions)	
Minimum capital requirement plus 30% add-on ⁽¹⁾	\$32,513	\$31,370
Core capital ⁽¹⁾	35,964	35,009
Surplus ⁽¹⁾	3,451	3,639

(1) Amounts for 2005 are based on amended reports we submitted to OFHEO on May 30, 2006.

NOTE 11: STOCK-BASED COMPENSATION

We have three stock-based compensation plans under which grants are currently being made: (i) the Employee Stock Purchase Plan, or ESPP, as amended and restated in 2004; (ii) the 2004 Stock Compensation Plan, or 2004 Employee Plan; and (iii) the 1995 Directors' Stock Compensation Plan, or Directors' Plan. Prior to the stockholder approval of the 2004 Employee Plan on November 4, 2004, employee stock-based compensation was awarded in accordance with the terms of the stockholder-approved 1995 Stock Compensation Plan, or 1995 Employee Plan. We collectively refer to the 2004 Employee Plan and 1995 Employee Plan as the Employee Plans.

Common stock delivered under these plans may be shares currently held by us as treasury stock, shares purchased by us in the open market or authorized but previously unissued shares. At December 31, 2005, our stock-based awards consisted of stock options, restricted stock units and restricted stock. Such awards, discussed below, are generally forfeitable for at least one year after the grant date, with vesting provisions contingent upon service requirements.

- Stock options granted allow for the purchase of our common stock at an exercise price equal to the fair market value of our common stock on the grant date. Options generally may be exercised for a period of 10 years from the grant date, subject to a vesting schedule commencing on the grant date. Stock options granted by us include dividend equivalent rights.

On November 30, 2005, the Compensation and Human Resources Committee of our board of directors approved a change in the manner in which dividend equivalents are paid out on certain stock option awards. This change affected all stock options outstanding at December 31, 2005 and unvested at December 31, 2004 (affected stock options) and was made to bring the awards into operational and documentary compliance with Internal Revenue Code Section 409A. In 2006, we made a lump sum payment for all previously accrued dividend equivalents to grantees holding affected stock options at December 31, 2005. With the change, dividend equivalents on affected stock options are paid when and as dividends on common stock are declared. In addition, dividend equivalent rights will no longer be granted in connection with awards of stock options to grantees. For options not affected by the change approved on November 30, 2005, the dividend equivalent right provides option holders with the right to receive, at the time stock options are exercised or upon expiration, an amount equal to the accumulated dividends declared on the stock from the grant date.

- A restricted stock unit entitles the grantee to receive one share of common stock at a specified future date. Restricted stock units do not have voting rights, but do have dividend equivalent rights, which are (a) paid to restricted stock

unit holders who are employees as and when dividends on common stock are declared or (b) which are accrued as additional restricted stock units for non-employee directors.

- Restricted stock entitles participants to all the rights of a stockholder, including dividends, except that the shares awarded are subject to a risk of forfeiture and may not be disposed of by the participant until the end of the restriction period established at the time of grant.

ESPP: We have established a stockholder-approved ESPP, which was amended and restated as of January 1, 2005, that is qualified under Internal Revenue Code Section 423. Under the ESPP, substantially all full-time and part-time employees that choose to participate in the ESPP have the option to purchase shares of common stock at specified dates, with an annual maximum market value of \$20,000 per employee as determined on the subscription (grant) date. The purchase price is equal to 85 percent of the lower of the average price (average of the daily high and low prices) of the stock on the subscription date or the average price of the stock on the purchase (exercise) date.

On November 4, 2004, stockholders approved the amendment and restatement of the ESPP effective as of January 1, 2005. The restated ESPP authorized granting 3.6 million shares in addition to the 3.2 million shares remaining under the former ESPP. At December 31, 2005, the maximum number of shares of common stock authorized for grant to employees, including those additional shares granted in accordance with the amended and restated ESPP, totaled 6.8 million shares, of which approximately 0.2 million shares had been issued and approximately 6.6 million shares remained available for grant. At December 31, 2005, 2004 and 2003, no options were exercisable under the ESPP, as the options outstanding at year-end become exercisable subsequent to year-end, and are exercised or forfeited during the subsequent year.

2004 Employee Plan: Under the stockholder-approved 2004 Employee Plan, we may grant employees stock-based awards, including stock options, restricted stock units and restricted stock. In addition, we have the right to impose performance conditions with respect to these awards. Under the 2004 Employee Plan, employees may also be granted stock appreciation rights; however, at December 31, 2005, no stock appreciation rights had been granted under the 2004 Employee Plan. At December 31, 2005, the maximum number of shares of common stock authorized for grant to employees in accordance with the 2004 Employee Plan totaled 13.8 million shares, of which approximately 1.8 million shares had been issued and approximately 12.0 million shares remained available for grant.

Directors' Plan: Under the stockholder-approved Directors' Plan, which was amended and restated in 1998, we are permitted to grant to non-employee directors stock options, restricted stock units and restricted stock. At December 31, 2005, the maximum number of shares of common stock authorized for grant to directors in accordance with the Directors' Plan totaled 2.4 million shares, of which approximately 0.8 million shares had been issued and approximately 1.6 million shares remained available for grant.

See "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES," for a description of the accounting treatment for employee stock-based compensation, including grants under the ESPP, Employee Plans and Directors' Plan.

Table 11.1 provides a summary of activity related to the option to purchase stock under the ESPP.

Table 11.1 — ESPP Activity

	Year Ended December 31,					
	2005		2004		2003	
	Options to Purchase Stock	Weighted Average Exercise Price	Options to Purchase Stock	Weighted Average Exercise Price	Options to Purchase Stock	Weighted Average Exercise Price
Outstanding, beginning of year	60,416	\$56.83	65,257	\$48.08	1,000,370	\$52.27
Granted	258,061	53.58	250,899	53.40	145,866	44.16
Exercised	(239,873)	52.78	(244,625)	50.53	(355,485)	41.76
Forfeited or expired	(17,020)	53.22	(11,115)	50.77	(725,494)	43.02
Outstanding, end of year	<u>61,584</u>	52.16	<u>60,416</u>	56.83	<u>65,257</u>	48.08
Weighted-average fair value of options granted during year	\$ 11.56		\$ 11.23		\$ 10.72	

Table 11.2 provides a summary of activity related to stock options under the Employee Plans and the Directors' Plan.

Table 11.2 — Employee Plans and Directors' Plan Stock Options Activity

	Year Ended December 31,					
	2005		2004		2003	
	Stock Options	Weighted Average Exercise Price	Stock Options	Weighted Average Exercise Price	Stock Options	Weighted Average Exercise Price
Outstanding, beginning of year	7,627,941	\$52.94	8,656,340	\$46.89	9,231,105	\$44.21
Granted	1,199,586	62.80	1,343,554	61.09	1,216,442	53.28
Exercised	(1,563,477)	43.55	(1,861,617)	29.06	(1,052,156)	23.12
Forfeited or expired	(570,366)	61.17	(510,336)	58.84	(739,051)	57.18
Outstanding, end of year	<u>6,693,684</u>	56.20	<u>7,627,941</u>	52.94	<u>8,656,340</u>	46.89
Options exercisable at year-end	<u>3,590,168</u>	52.14	<u>4,018,666</u>	47.46	<u>4,755,640</u>	38.23
Weighted-average fair value of options granted during year	\$ 26.84		\$ 25.04		\$ 21.84	

Table 11.3 provides a summary of activity related to restricted stock and restricted stock units under the Employee Plans and the Directors' Plan.

Table 11.3 — Employee Plans and Directors' Plan Restricted Stock and Restricted Stock Unit Activity

	Year Ended December 31,					
	2005		2004		2003	
	Restricted Stock	Restricted Stock Units	Restricted Stock	Restricted Stock Units	Restricted Stock	Restricted Stock Units
Outstanding, beginning of year	164,781	1,624,628	566,635	1,295,722	1,089,327	359,227
Granted ⁽¹⁾	—	838,576	—	698,587	—	1,146,164
Lapse of restrictions	(79,961)	(659,946)	(240,514)	(145,340)	(381,103)	(114,240)
Forfeited	(15,118)	(329,075)	(161,340)	(224,341)	(141,589)	(95,429)
Outstanding, end of year	<u>69,702</u>	<u>1,474,183</u>	<u>164,781</u>	<u>1,624,628</u>	<u>566,635</u>	<u>1,295,722</u>
Weighted-average fair value of awards granted during year		\$ 62.68		\$ 62.97		\$ 55.01

(1) Restricted stock units granted under the Employee Plans were 831,730, 673,720 and 1,143,810 in 2005, 2004 and 2003, respectively. Restricted stock units granted under the Directors' Plan were 6,846, 24,867 and 2,354 in 2005, 2004 and 2003, respectively.

Table 11.4 provides additional information for stock options outstanding under the Employee Plans and the Directors' Plan at December 31, 2005 by range of exercise prices.

Table 11.4 — Employee Plans and Directors' Plan Stock Options Outstanding

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Outstanding at December 31, 2005	Weighted Average Remaining Contract Life in Years	Weighted Average Exercise Price	Exercisable at December 31, 2005	Weighted Average Exercise Price
\$15.00 - 24.99	235,040	0.4	\$20.90	235,040	\$20.90
25.00 - 34.99	266,550	1.4	34.27	266,550	34.27
35.00 - 44.99	703,326	4.0	41.57	703,326	41.57
45.00 - 54.99	1,145,870	5.8	51.23	553,125	49.37
55.00 - 64.99	3,595,381	7.3	62.21	1,300,868	62.01
65.00 - 68.99	747,517	5.3	67.59	531,259	67.65
\$15.00 - 68.99	<u>6,693,684</u>	6.0	56.20	<u>3,590,168</u>	52.14

Table 11.5 summarizes the weighted-average assumptions used in determining the fair values of options granted under our stock-based compensation plans using a Black-Scholes option pricing model. Estimates used to determine the weighted-average assumptions noted in the table below are determined as follows: (i) the expected dividend yield is based on the most recent dividend announcement relative to the grant date and the stock price at the grant date, (ii) the expected

volatility is based on the historical volatility of the stock over a time period equal to the expected life and (iii) the expected life is based on historical option exercise trends.

Table 11.5 — Weighted Average Assumptions Used to Determine the Fair Value of Options

	Employee Stock Purchase Plan			Employee Plans and Directors' Plan		
	2005	2004	2003	2005	2004	2003
Expected dividend yield ⁽¹⁾	2.15%	1.85%	2.01%	—	—	—
Expected life	3 months	3 months	3 months	7.4 years	7.0 years	7.0 years
Expected volatility	19.7%	17.8%	35.0%	30.0%	31.5%	32.0%
Risk-free interest rate	3.20%	1.33%	0.95%	4.23%	3.55%	3.40%

(1) The value of the dividend equivalent feature of options for the Employee Plans and Directors' Plan was incorporated into the Black-Scholes model by using an expected dividend yield of zero percent. To account for a modification of stock options on November 30, 2005, the dividend equivalent feature of affected stock options for the Employee Plans and Directors' Plan was valued separately. Other assumptions used to value the affected stock options were as follows: (i) expected dividend yield of 2.96 percent, (ii) expected life of 5.1 years, (iii) expected volatility of 25.4 percent, and (iv) risk-free interest rate of 4.34 percent.

Compensation Expense: Compensation expense related to stock-based compensation plans recorded in Salaries and employee benefits was \$69 million, \$59 million and \$65 million for the years ended December 31, 2005, 2004 and 2003, respectively.

NOTE 12: DERIVATIVES

We use derivatives to conduct our risk management activities. We principally use the following types of derivatives:

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

Our derivative portfolio also includes certain forward purchase and sale commitments and other contractual agreements including (a) credit risk sharing agreements where we remit and receive payments based upon the default performance of certain mortgage loans; (b) swap guarantee derivatives where we guarantee the sponsor's or the borrower's performance as a counterparty on certain interest-rate swaps; and (c) a prepayment management agreement (which was terminated effective December 31, 2005) in which we were partially compensated for the adverse impacts caused by disproportionately higher mortgage prepayments on certain mortgage pools.

Hedging Activity

Derivative instruments are reported at their fair value, generally netted by counterparty (provided that a legally enforceable master netting agreement exists), as either Derivative assets, at fair value, or Derivative liabilities, at fair value, on the consolidated balance sheets. See "NOTE 17: CONCENTRATION OF CREDIT AND OTHER RISKS" for further information related to our derivative counterparties.

No Hedge Designation

At December 31, 2005 and 2004, most of our derivative portfolio was not designated in hedge accounting relationships. We report changes in the fair value of derivatives not in hedge accounting relationships as Derivative gains (losses) on the consolidated statements of income. For derivatives that are not designated in hedge accounting relationships, any associated interest received or paid is recognized on an accrual basis and recorded in Derivative gains (losses) on the consolidated statements of income.

Effective at the beginning of the second quarter of 2004, we determined that substantially all pay-fixed interest-rate swaps and other derivatives that previously had been in cash flow hedge accounting relationships no longer met the hedged item shared risk exposure requirement and hedge effectiveness assessment as required by SFAS 133. Consequently, we discontinued hedge accounting treatment for these relationships for financial reporting purposes at that time, resulting in pay-fixed swaps with a notional balance of approximately \$108 billion being moved from the cash flow hedge designation to no hedge designation. We also voluntarily discontinued hedge accounting treatment for a significant amount of our receive-fixed interest-rate swaps effective November 1, 2004, resulting in receive-fixed interest-rate swaps with a notional balance of approximately \$50 billion being moved from a fair value hedge designation to no hedge designation. 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.

Fair Value Hedges

Fair value hedges represent hedges of exposure to foreign-currency fluctuations and changes in the fair value of a recognized liability. We primarily use interest-rate swaps and foreign-currency swaps to hedge against the changes in fair value of fixed-rate debt due to changes in benchmark interest rates, either LIBOR or the Euro Interbank Offered Rate, or

Euribor, or foreign-currency fluctuations, or a combination of both. During 2005 and 2004, these derivatives in fair value hedge relationships were executed to manage interest-rate risk or foreign-currency risk at an individual debt instrument level. In 2004, these derivatives in fair value hedge relationships were also used to manage interest-rate risk at an aggregate portfolio level. Derivatives executed to manage interest-rate risk at an aggregate portfolio level were linked to specific debt positions for hedge accounting purposes. We frequently reset the amount of fixed-rate debt being hedged in order to maintain highly effective accounting hedges. To accomplish this, the accounting hedges were typically terminated at the time of reset and the derivatives were contemporaneously redesignated in new hedge accounting relationships of fixed-rate debt. Alternatively, when derivatives are executed for specific debt instruments, redesignation is not necessary to maintain highly effective accounting hedges. Derivatives used to manage interest-rate risk at an aggregate portfolio level were moved to no hedge designation effective November 1, 2004 as part of the voluntary discontinuance of hedge accounting treatment, as discussed above.

For a derivative in a fair value hedge relationship, we report changes in the fair value of the derivative as Hedge accounting gains (losses) on the consolidated statements of income along with the offsetting changes in the fair value of the hedged item attributable to the risk being hedged. Any differences arising from fair value changes that are not exactly offset result in hedge ineffectiveness. Hedge accounting gains (losses) will vary from period to period based on the notional amount of derivatives accounted for in hedge accounting relationships and the extent of hedge ineffectiveness.

Table 12.1 summarizes certain gains (losses) recognized related to our hedge accounting categories.

Table 12.1 — Hedge Accounting Categories Information

	Year Ended December 31,		
	2005	2004	2003
	(in millions)		
Fair value hedges			
Hedge ineffectiveness recognized in Hedge accounting gains (losses) — pre-tax ⁽¹⁾	\$ 22	\$742	\$697
Cash flow hedges			
Hedge ineffectiveness recognized in Hedge accounting gains (losses) — pre-tax ⁽¹⁾	—	1	(53)
Net pre-tax gains (losses) resulting from the determination that it was probable that forecasted transactions would not occur	(25)	2	29

(1) No amounts have been excluded from the assessment of effectiveness.

Cash Flow Hedges

Cash flow hedges represent hedges of exposure to the variability in the cash flows of a variable-rate or foreign-currency denominated instrument or relate to a forecasted transaction. We use interest-rate swaps, foreign-currency swaps and forward purchase and sale commitments to hedge the changes in cash flows associated with the forecasted issuances of debt, forecasted purchase or sale of mortgage-related assets, and foreign-currency fluctuations.

For a derivative qualifying as a cash flow hedge, changes in fair value are generally reported in AOCI, net of taxes, on the consolidated balance sheets to the extent the hedge is effective. The remaining ineffective portion of changes in fair value is reported as Hedge accounting gains (losses) on the consolidated statements of income. As shown in Table 12.2 below, the total AOCI, net of taxes, related to cash flow hedge relationships was a loss of \$(6,287) million at December 31, 2005, primarily composed of deferred net losses on closed cash flow hedges. Closed cash flow hedges involve derivatives that have been terminated or are no longer designated as cash flow hedges. Fluctuations in prevailing market interest rates have no impact on the deferred portion of AOCI relating to losses on closed cash flow hedges.

Over the next 12 months, we estimate that approximately \$1,280 million of deferred losses in AOCI, net of taxes, will be reclassified into earnings. The maximum remaining length of time over which we have hedged the exposure related to the variability in future cash flows on forecasted transactions, primarily forecasted debt issuances, is 28 years. However, over 90 percent of the AOCI, net of taxes, balance at December 31, 2005 relating to cash flow hedges is linked to forecasted transactions occurring in the next 10 years. The occurrence of forecasted transactions may be satisfied by either periodic issuances of short-term debt over the required time period or longer-term debt, such as Reference Notes® securities.

Table 12.2 presents the changes in AOCI, net of taxes, related to derivatives designated as cash flow hedges. Net change in fair value related to cash flow hedging activities, net of tax, represents the net change in the fair value of the derivatives that were designated as cash flow hedges, after the effects of our statutory tax rate of 35 percent, to the extent the hedges were effective. Net reclassifications of losses to earnings, net of tax, represent the AOCI amount, after the effects of our statutory tax rate of 35 percent, that was recognized in earnings as the originally hedged forecasted transactions affected earnings unless it was deemed probable that the forecasted transaction would not occur. If it is probable that the forecasted transaction will not occur, then the entire deferred gain or loss associated with the hedge related to the forecasted transaction is reclassified into earnings immediately.

Table 12.2 — AOCI, Net of Taxes, Related to Cash Flow Hedge Relationships

	Year Ended December 31,		
	2005	2004	2003
	(in millions)		
Beginning balance ⁽¹⁾	\$(7,924)	\$(7,837)	\$(9,877)
Net change in fair value related to cash flow hedging activities, net of tax (benefit) expense of \$27, \$(1,089) and \$(352), respectively ⁽²⁾	50	(2,021)	(653)
Net reclassifications of losses to earnings, net of tax benefit of \$855, \$1,042 and \$1,450, respectively ⁽²⁾	1,587	1,934	2,693
Ending balance ⁽¹⁾	<u>\$(6,287)</u>	<u>\$(7,924)</u>	<u>\$(7,837)</u>

(1) Represents the effective portion of the fair value of open derivative contracts (*i.e.*, net unrealized gains and losses) and net deferred gains and losses on closed (*i.e.*, terminated or redesignated) cash flow hedges.

(2) Includes the accrual of periodic cash settlements for derivatives designated in cash flow hedge relationships.

NOTE 13: LEGAL CONTINGENCIES

We are involved as a party to a variety of legal proceedings arising from time to time in the ordinary course of business including, among other things, contractual disputes, personal injury claims, employment-related litigation and other legal proceedings incidental to our business. We are frequently involved, directly or indirectly, in litigation involving mortgage foreclosures. From time to time, we are also involved in proceedings arising from our termination of a seller/servicer's eligibility to sell mortgages to, and service mortgages for, us. In these cases, the former seller/servicer sometimes seeks damages against us for wrongful termination under a variety of legal theories. In addition, we are sometimes sued in connection with the origination or servicing of mortgages. These suits typically involve claims alleging wrongful actions of seller/servicers. Our contracts with our seller/servicers generally provide for them to indemnify us against liability arising from their wrongful actions.

We are subject to various other legal proceedings, including regulatory investigations and administrative and civil litigation, arising from the restatement of our previously issued consolidated financial statements for the years 2000 and 2001 and the first three quarters of 2002 and the revision of fourth quarter and full-year consolidated financial statements for 2002 (collectively referred to as the "restatement"). We established a reserve in accordance with SFAS 5 of \$75 million in the second quarter of 2003 for this loss contingency. In the first quarter of 2005, we recorded a \$339 million expense related to our litigation reserves for legal settlements including our settlement of the securities class action lawsuits and the shareholder derivative lawsuits discussed below. We continue to believe that an additional loss is probable in connection with the remaining legal proceedings related to the restatement. Litigation and claims resolution are subject to many uncertainties and are not susceptible to accurate prediction. It is not possible for us to reasonably estimate the upper end of the range of any additional losses that might result from the adverse resolution of any of the remaining legal proceedings and such losses could be greater than our current reserves.

SEC Investigation. In June 2003, the SEC initiated a formal investigation of us in connection with the restatement. On August 18, 2004, we announced that we had received a "Wells Notice" from the staff of the SEC. The Wells Notice advised us that the SEC staff is considering recommending that the SEC initiate a civil injunctive action against us for possible violations of federal securities laws, including Section 10(b) of the Securities Exchange Act of 1934 and the SEC's Rule 10b-5, as well as Sections 17(a)(1), (2) and (3) of the Securities Act of 1933. The Wells Notice also indicated that the SEC staff may seek a permanent injunction and a civil money penalty in connection with the contemplated action. We continue to cooperate fully with the SEC's investigation as we evaluate our response to the Wells Notice.

Securities Class Action Lawsuits. In June 2003, and thereafter, securities class action lawsuits were brought in three separate federal district courts against us and certain former executive officers in connection with the restatement. While most of the cases were voluntarily dismissed by the plaintiffs, the two remaining ones were consolidated in the U.S. District Court for the Southern District of New York. In essence, the plaintiffs in the consolidated action claimed that the defendants improperly managed earnings to create a misleading impression of steady earnings by Freddie Mac. Plaintiffs further alleged that the defendants engaged in a number of improper transactions that violated GAAP and that they made false and misleading statements regarding our financial status. The complaint covered the period from June 15, 1999 through June 6, 2003.

On April 20, 2006, we announced an agreement in principle to settle the securities class action lawsuits, as well as the shareholder derivative actions described below. The settlement of these actions includes a cash payment of \$410 million, including the application of expected net insurance proceeds. The settlement does not include any admission of wrongdoing by the company. The parties have completed and filed with the court the necessary settlement documents and are awaiting preliminary court approval. However, no assurances can be made that the court will approve the settlement or its terms in the form and substance negotiated among the parties.

Shareholder Derivative Lawsuits. Two shareholder derivative lawsuits were filed during 2003 against us and certain former and current executives and, in one of the suits, members of our board of directors, alleging breach of fiduciary duty and seeking indemnification in connection with the restatement. Both cases were ultimately assigned to the same judge in New York who is handling the securities class action lawsuits described above. In July 2003, all of the then current Board members were dismissed from the lawsuits in which they were named with the consent of the plaintiff. On January 16, 2004, we moved to dismiss one of the lawsuits brought by the Ester Sadowsky Testamentary Trust because of the plaintiff's failure to make a pre-suit demand. The court dismissed the case without prejudice on July 19, 2004. Subsequently, the Sadowsky plaintiff sent a demand notice to us and on March 4, 2005, filed a new complaint in an action in the same court.

On May 13, 2005, the Sadowsky plaintiff filed an amended complaint that was purportedly brought on our behalf (as a nominal defendant) as a derivative action by a purported shareholder to recover damages we allegedly suffered in connection with certain events underlying the restatement. The defendants in the action included former officers, ten current Directors, ten former Directors, and five counterparties to transactions we executed. The plaintiff alleged claims for breach of fiduciary duties, indemnification, waste of corporate assets, unjust enrichment, and aiding and abetting breach of fiduciary duties.

As described above, we announced on April 20, 2006, an agreement in principle to settle both shareholder derivative actions. The settlement of these cases was based in part on corporate governance reforms we instituted under our current management. The parties have completed and filed with the court the necessary settlement documents and are awaiting preliminary court approval. However, no assurances can be made that the court will approve the settlement or its terms in the form and substance negotiated among the parties.

ERISA Lawsuits. Two class action lawsuits were filed in 2003 in the U.S. District Court for the Southern District of Ohio against us, certain individuals, and our Retirement Committee alleging violations of the Employee Retirement Income Security Act, or ERISA. Both actions were consolidated and transferred to the same judge in New York who is handling the securities and derivative lawsuits described above and are still pending.

Department of Labor Investigation. In July 2003, the Department of Labor, or DOL, began an investigation of our Thrift/401(k) Savings Plan in relation to the restatement. On December 28, 2005, we and five former members of our Retirement Committee entered into an agreement with the DOL that extended the period for DOL to commence an action until December 28, 2006. The investigation is still pending and we continue to cooperate fully with the DOL.

OFHEO Proceedings. In June 2003, OFHEO commenced a special investigation of the company in connection with the restatement. On December 9, 2003, Freddie Mac and OFHEO entered into a consent order and settlement that concluded OFHEO's investigation of the company. Under the terms of the consent order, we agreed to pay a civil money penalty of \$125 million, which was recorded in the second quarter of 2003 (the period in which OFHEO commenced its special investigation), as well as to undertake certain remedial actions relating to governance, corporate culture, internal controls, accounting practices, disclosure and oversight. In agreeing to the consent order, we made no admission regarding any wrongdoing or any asserted or implied findings.

In December 2003, OFHEO filed administrative notices of charges against us and Messrs. Brendsel and Clarke, two of our former executive officers. In its charge against us, OFHEO sought to have us take certain actions in connection with these individuals' salaries and compensation as well as their termination status with the company. On February 18, 2005, OFHEO filed an amended notice of charges against Messrs. Brendsel and Clarke, who opposed the amended notice on several grounds. On April 26, 2005, the Administrative Law Judge presiding over the OFHEO administrative proceeding ruled that the amended notice of charges against Messrs. Brendsel and Clarke did not clearly identify the factual and legal issues, and consequently ordered OFHEO to file a second amended notice of charges clearly setting forth the factual and legal bases for the charges and satisfying several other requirements identified by the judge. On June 24, 2005 OFHEO filed its second amended notice of charges against Messrs. Brendsel and Clarke. The parties are also engaged in the discovery phase of the case.

On September 9, 2005, we entered into a stipulated consent order with OFHEO to settle the administrative notice of charges against us. Under the terms of the consent order, we agreed to produce certain documents and make available any current employees that OFHEO requests to interview in connection with its ongoing administrative actions against Messrs. Brendsel and Clarke, and to take certain additional steps following the administrative actions against the former officers in accordance with any final order resulting in those actions. The text of this consent order and a related production agreement are available on OFHEO's website at www.ofheo.gov. In agreeing to the consent order, we made no admission regarding any wrongdoing or any asserted or implied findings. Based on the consent order, OFHEO has dismissed the administrative notice of charges against us.

U.S. Attorney’s Investigation. In June 2003, the U.S. Attorney’s Office in Alexandria, Virginia commenced an investigation of us surrounding the restatement. We will continue to cooperate with the U.S. Attorney’s Office if and as requested.

Antitrust Lawsuits. We and Fannie Mae were named in a consolidated lawsuit alleging that both companies conspired to establish and maintain artificially high guarantee fees. The complaint covers the period January 1, 2001 to the present and asserts a variety of claims under federal and state antitrust laws, as well as claims under consumer-protection and similar state laws. The plaintiffs seek injunctive relief, unspecified damages (including treble damages with respect to the antitrust claims and punitive damages with respect to some of the state claims) and other forms of relief. We filed a motion to dismiss the action and are awaiting a ruling from the court. At present, it is not possible for us to predict the probable outcome of the consolidated lawsuit or any potential impact on our business, financial condition or results of operations.

Other Inquiries. We receive inquiries from the Internal Revenue Service, or IRS, in connection with its regular audits of our tax returns for prior years, some of which relate to matters connected with the restatement. We continue to respond to these inquiries. See “NOTE 14: INCOME TAXES” for more information.

FEC Investigation. In March 2004, we provided certain information to the Federal Election Commission, or FEC, concerning compliance with federal election laws. The FEC conducted an investigation into this matter and, on April 18, 2006, we announced we had entered into a conciliation agreement with the FEC. Under the terms of the conciliation agreement, we agreed to pay a civil penalty of \$3.8 million and to cease and desist from engaging in activities that violate specified provisions of the Federal Election Campaign Act relating to prohibitions on the use of corporate resources for political fundraising. This amount was recorded in the 2005 consolidated statements of income as a component of Other expense.

NOTE 14: INCOME TAXES

We are exempt from state and local income taxes. Table 14.1 presents the components of our provision for income taxes.

Table 14.1 — Provision for Income Taxes

	Year Ended December 31,		
	2005	2004	2003
	(in millions)		
Current tax provision	\$1,819	\$1,136	\$1,465
Deferred tax provision	(1,452)	(346)	737
Total provision for income taxes	<u>\$ 367</u>	<u>\$ 790</u>	<u>\$2,202</u>

Table 14.2 summarizes our deferred tax assets and liabilities.

Table 14.2 — Deferred Tax Assets and (Liabilities)

	December 31,	
	2005	2004
	(in millions)	
Deferred tax assets:		
Deferred fees related to securitizations	\$ 1,779	\$ 1,612
Credit related items and reserve for loan losses	61	5
Employee compensation and benefit plans	168	166
Cash flow hedge deferrals and unrealized (gains) losses related to available-for-sale securities	4,724	1,930
Other items, net	39	—
Total deferred tax assets	<u>6,771</u>	<u>3,713</u>
Deferred tax liabilities:		
Premium and discount amortization	(1,679)	(1,961)
Basis differences related to assets held-for-investment	(307)	(502)
Basis differences related to derivative instruments	(1,779)	(2,478)
Other items, net	—	(43)
Total deferred tax liabilities	<u>(3,765)</u>	<u>(4,984)</u>
Net deferred tax assets and (liabilities)	<u>\$ 3,006</u>	<u>\$(1,271)</u>

Included in deferred taxes is the tax effect on the (a) net unrealized (gains) losses on available-for-sale securities and (b) net (gains) losses related to derivatives designated in cash flow hedge relationships, which are both reported in AOCI, net of taxes and (c) cumulative effect of change in accounting principles.

We have not established a valuation allowance against our deferred tax assets at December 31, 2005 or 2004, because we have determined that it is more likely than not that all such tax assets will be realized in the future.

Table 14.3 reconciles the statutory federal tax rate to the effective tax rate for 2005, 2004 and 2003.

Table 14.3 — Reconciliation of Statutory to Effective Tax Rate

	Year Ended December 31,		
	2005	2004	2003
Statutory corporate rate	35.0%	35.0%	35.0%
Tax-exempt interest	(8.7)	(4.7)	(2.1)
Tax credits	(14.3)	(7.3)	(3.0)
Provision related to tax contingencies	1.9	(2.0)	0.4
Penalties	0.1	—	1.0
Other	0.4	0.2	0.1
Effective rate	<u>14.4%</u>	<u>21.2%</u>	<u>31.4%</u>

Impact of tax issues. The IRS has a policy to examine the income tax returns of large corporate taxpayers, including us, generally every year. We believe that an adequate provision has been made for contingencies related to all income taxes and related interest and potential penalties in accordance with SFAS 5. However, the ultimate outcome of these tax contingencies could result in a tax benefit or tax provision that could be material to our quarterly or annual results of operations. We do not believe that liabilities arising from these matters, if any, will have a material adverse effect on our consolidated financial condition.

Tax Years 1985 through 1990. We are currently in litigation in the U.S. Tax Court, or Court, to contest income tax deficiencies asserted by the IRS for years 1985 through 1990. The principal matters in controversy in the case involve questions of tax law as applied to our transition from non-taxable to taxable status in 1985 and primarily involve the amortization of certain intangible assets, the two most significant of which are:

- *Favorable Financing.* A number of financing arrangements where the contract rates of interest were less than the market rates of interest as of January 1, 1985 due to an increase in interest rates since the date on which we had entered into the respective arrangements; and
- *Customer Relationships.* Our business relationships with a substantial number of mortgage originating institutions that sold mortgages to us on a regular basis.

Tax Court Rulings. On September 4, 2003 and September 29, 2003, the Court decided favorably for us on two preliminary motions involving questions of law in the case. On September 4, the Court ruled favorably for us on the question whether our intangibles are amortizable using, as the adjusted basis, the higher of (a) the regular adjusted cost basis or (b) the fair market value on January 1, 1985. On September 29, the Court ruled favorably for us on the question whether, as a matter of law, “favorable financing” (as defined above) was amortizable for tax purposes. As part of this case, we claimed, and the court agreed, that the economic benefit of this below-market financing as of January 1, 1985 is an intangible asset subject to amortization. In October 2003, the Court ruled unfavorably on two other less significant issues in the case. In November 2005, the Court ruled favorably on another less significant issue in the case.

While significant, the Court’s rulings do not dispose of all of the matters in controversy in the case, which, upon final resolution by the Court of all such matters, are subject to appeal by the parties. In addition, we still had to demonstrate that the intangible assets in question have an ascertainable value and have a limited useful life, the duration of which can be ascertained with reasonable accuracy. A trial on the value and useful life of Favorable Financing was completed in early June 2005. We are awaiting the Court’s decision.

In view of the favorable rulings in September 2003 described above, we recorded in 2002 a reduction in our tax reserves in the amount of \$155 million. If the IRS were to appeal the Court decisions and an adverse ruling resulted, we may reconsider our reserves related to this matter.

If our tax position on the customer relationship amortization issue described above is upheld through the legal process, we will be able to recognize tax benefits not previously recorded that could be material in the quarter during which they are recognized. However, we are unable to provide assurances that any such tax benefits will be realized.

Tax Years 1991 through 1993. The IRS examination of our federal income tax returns for the years 1991 through 1993 has been completed. In 2002, we filed a petition in the Court to contest the deficiencies asserted by the IRS in a Statutory Notice of deficiency. The principal matters in controversy in this case are the same questions at issue in the 1985 through 1990 case as applied to years 1991 to 1993, plus an additional question of tax law regarding the timing of taxation of our Management and guarantee income.

Tax Years 1994 through 1997. In 2002, the IRS completed its examination of our federal income tax returns for the years 1994 through 1997. In October 2005 we filed a Petition in the Court to contest tax deficiencies asserted by the IRS for these years. The principal matter in controversy, other than the same questions at issue in the 1985 through 1993 cases described above, involves the character of losses on dispositions of mortgage-related securities.

Tax Treatment of REITs. In February 1997, we formed two REIT subsidiaries that issued a total of \$4.0 billion in step-down preferred stock to investors. Under the IRS regulations in effect when the REITs were formed, we believed that the dividend payments by the REITs to holders of the REITs' step-down preferred stock were fully tax deductible. We entered into a closing agreement with the IRS that resolved issues related to the tax treatment of dividends paid on the step-down preferred stock. We and the IRS agreed that we will only be entitled to deductions attributable to the step-down preferred stock transactions as if we had borrowed directly from the REITs' preferred shareholders. As a result of this closing agreement, we recorded a reduction in tax reserves of \$94 million in 2004. See "NOTE 18: MINORITY INTERESTS" for more information concerning the REITs.

Tax Years 1998 through 2002. This examination cycle includes the years for which we have restated our financial statements. The IRS has completed its regular examination of our 1998 through 2002 tax returns, but could raise additional issues. As a result of the regular examination, the principal matter in controversy, other than the same questions at issue in the 1985 through 1997 cases described above, involves questions of timing and potential penalties regarding our tax accounting method for certain hedging transactions. We believe the risk of loss due to the assertion of penalties by the IRS related to our tax accounting methods is remote. As to the questions of timing, we believe that an adequate provision has been made for contingencies related to income taxes and related interest.

Tax Treatment of Paired Swap Transactions. In August and September of 2001, we entered into a series of nine sets of paired swap transactions. We reported and paid tax treating each pair of those swap transactions as a single integrated transaction for federal income tax purposes. Two additional swaps were executed in November 2001. Although the facts and circumstances surrounding these swaps were different from the earlier swaps, we also reported and paid tax treating these swaps as a single integrated transaction for federal income tax purposes. The IRS examination report did not assert a tax deficiency related to any of these paired swap transactions.

NOTE 15: EMPLOYEE BENEFITS

Defined Benefit Plans

We maintain a tax-qualified defined benefit pension plan, or Pension Plan, covering substantially all of our employees. Pension Plan benefits are based on an employee's years of service and highest average compensation, up to legal plan limits, over any consecutive 36 months of employment. Pension Plan assets are held in trust and the investments consist primarily of funds comprised of listed stocks and corporate bonds. In addition to our Pension Plan, we maintain a nonqualified, unfunded defined benefit pension plan for our officers, referred to as our non-qualified pension plan. The related retirement benefits for our nonqualified pension plan are paid from our general assets. These nonqualified and qualified defined benefit pension plans are collectively referred to as defined benefit pension plans.

We maintain a defined benefit postretirement health care plan, or Retiree Health Plan, that generally provides postretirement health care benefits on a contributory basis to retired employees age 55 or older who rendered at least 10 years of service (five years of service if retiree is eligible to retire prior to March 1, 2007) and who, upon separation or termination, immediately elected to commence benefits under the Pension Plan in the form of an annuity. Our Retiree Health Plan is currently unfunded and the benefits are paid from our general assets. This plan and our defined benefit pension plans are collectively referred to as defined benefit plans.

For financial reporting purposes, we use a September 30 valuation measurement date for all of our defined benefit plans. We are required to accrue the estimated cost of retiree benefits as employees render the services necessary to earn their pension and postretirement health benefits. Our pension and postretirement health care costs related to these defined benefit plans for 2005, 2004 and 2003 presented in the following tables were calculated using assumptions as of September 30, 2004, 2003 and 2002, respectively. The funded status of our defined benefit plans for 2005, 2004 and 2003 presented in the following tables was calculated using assumptions as of September 30, 2005, 2004 and 2003, respectively.

Table 15.1 below shows the changes in our projected benefit obligations and fair value of plan assets using a September 30 valuation measurement date for amounts recognized on our consolidated balance sheets at December 31, 2005 and 2004, respectively.

Table 15.1 — Defined Benefit Plan Obligation and Funded Status

	Pension Benefits		Postretirement Health Benefits	
	2005	2004	2005	2004
	(in millions)			
Change in Projected Benefit Obligation:				
Projected benefit obligation at October 1 (prior year)	\$ 385	\$ 339	\$ 102	\$ 102
Service cost	27	24	9	10
Interest cost	22	20	6	6
Net actuarial loss (gain)	28	6	(6)	(15)
Benefits paid	(5)	(4)	(1)	(1)
Projected benefit obligation at September 30	<u>457</u>	<u>385</u>	<u>110</u>	<u>102</u>
Change in Fair Value of Plan Assets:				
Fair value of plan assets at October 1 (prior year)	260	229		
Actual return on plan assets	29	22		
Employer contributions	49	13		
Benefits paid	(5)	(4)		
Fair value of plan assets at September 30	<u>333</u>	<u>260</u>		
Funded Status:				
Funded status at September 30	(124)	(125)	(110)	(102)
Unrecognized net actuarial loss	125	112	31	40
Unrecognized prior service cost	1	1	(5)	(6)
Initial unrecognized net transition asset	—	1	—	—
Net amount recognized	<u>\$ 2</u>	<u>\$ (11)</u>	<u>\$ (84)</u>	<u>\$ (68)</u>
Amounts Recognized on our Consolidated Balance Sheets:				
Other assets:				
Prepaid benefit cost	\$ 28	\$ —	\$ —	\$ —
Intangible and other assets	1	6	—	—
Other liabilities:				
Accrued benefit liability	(28)	(25)	(84)	(68)
AOCI:				
Minimum pension liability	1	8	—	—
Net amount recognized	<u>\$ 2</u>	<u>\$ (11)</u>	<u>\$ (84)</u>	<u>\$ (68)</u>

The change in the minimum pension liability recognized in AOCI, net of taxes, was a \$7 million decrease for the year ended December 31, 2005, and a \$2 million decrease for the year ended December 31, 2004. The accumulated benefit obligation for all defined benefit pension plans was \$316 million and \$282 million at September 30, 2005 and 2004, respectively. The accumulated benefit obligation represents the actuarial present value of future expected benefits, assuming current salary levels remain in effect.

Table 15.2 provides additional information for our defined benefit pension plans. The aggregate accumulated benefit obligation and fair value of plan assets are disclosed as of September 30, 2005, with the projected benefit obligation included for illustrative purposes.

Table 15.2 — Additional Information for Defined Benefit Pension Plans

	2005			2004		
	Pension Plan	Non-qualified Pension Plans	Total	Pension Plan	Non-qualified Pension Plans	Total
	(in millions)					
Projected benefit obligation	\$416	\$ 41	\$457	\$356	\$ 29	\$385
Fair value of plan assets	\$333	\$ —	\$333	\$260	\$ —	\$260
Accumulated benefit obligation	288	28	316	262	20	282
Fair value of plan assets over (under) accumulated benefit obligation ...	<u>\$ 45</u>	<u>\$ (28)</u>	<u>\$ 17</u>	<u>\$ (2)</u>	<u>\$ (20)</u>	<u>\$ (22)</u>

The measurement of our benefit obligations includes assumptions about the rate of future compensation increases included in Table 15.3 below.

Table 15.3 — Weighted Average Assumptions Used to Determine Projected and Accumulated Benefit Obligations

	Pension Benefits		Postretirement Health Benefits	
	September 30,		September 30,	
	2005	2004	2005	2004
Discount rate.....	5.75%	5.75%	5.75%	5.75%
Rate of future compensation increase ⁽¹⁾	5.10% to 6.50%	4.50	—	—

(1) For the 2005 plan year for our defined benefit pension plans, we refined our assumptions used to determine our benefit obligations to include the dispersion of compensation from a flat rate to an age-graded rate.

Table 15.4 presents the components of the net periodic benefit costs with respect to pensions and postretirement health benefits for the years ended December 31, 2005, 2004 and 2003. Net periodic benefit costs are included in Salaries and employee benefits on our consolidated statements of income.

Table 15.4 — Net Periodic Benefit Cost Detail

	Pension Benefits			Postretirement Health Benefits		
	Year Ended December 31,			Year Ended December 31,		
	2005	2004	2003	2005	2004	2003
	(in millions)					
Service cost of current period.....	\$ 27	\$ 24	\$ 16	\$ 9	\$ 10	\$ 6
Interest cost on projected benefit obligation.....	22	20	16	6	6	3
Expected return on plan assets.....	(18)	(16)	(12)	—	—	—
Recognized net actuarial loss.....	5	7	3	3	5	2
Recognized prior service cost.....	1	—	—	(1)	(1)	(1)
Net periodic benefit costs.....	<u>\$ 37</u>	<u>\$ 35</u>	<u>\$ 23</u>	<u>\$ 17</u>	<u>\$ 20</u>	<u>\$ 10</u>

Table 15.5 — Weighted Average Assumptions Used to Determine Net Periodic Benefit Cost

	Pension Benefits			Postretirement Health Benefits		
	Year Ended December 31,			Year Ended December 31,		
	2005	2004	2003	2005	2004	2003
Discount rate.....	5.75%	6.00%	7.00%	5.75%	6.00%	7.00%
Rate of future compensation increase.....	4.50	4.50	4.50	—	—	—
Expected long-term rate of return on plan assets.....	7.00	7.00	7.25	—	—	—

For the 2005 benefit obligations, we determined the discount rate using a yield curve consisting of spot interest rates at half-year increments for each of the next 30 years, developed with pricing and yield information from high-quality bonds. The future benefit plan cash flows were then matched to the appropriate spot rates and discounted back to the measurement date. Finally, a single equivalent discount rate was calculated that, when applied to the same cash flows, results in the same present value of the cash flows as of the measurement date. In 2004 and 2003, we used the Moody's Aa Corporate Bond Rate Index as a basis for selecting the discount rate shown in Table 15.5. The effect of the change in our estimate of the discount rate was not material.

The expected long-term rate of return on plan assets was estimated using a portfolio return calculator model. The model considered the historical returns and the future expectations for returns for each asset class in our defined benefit plans in conjunction with our target investment allocation to arrive at the expected rate of return.

The assumed health care cost trend rates used in measuring the accumulated postretirement benefit obligation as of September 30, 2005 are 11 percent in 2006, gradually declining to an ultimate rate of 5 percent in 2011 and remaining at that level thereafter.

Table 15.6 sets forth the effect on the accumulated postretirement benefit obligation for health care benefits as of September 30, 2005, and the sum of the service cost and interest cost components of the net periodic postretirement health benefit costs that would result from a one percent increase or decrease in the assumed health care cost trend rate.

Table 15.6 — Selected Data Regarding our Retiree Health Plan

	One Percent Increase	One Percent Decrease
	(in millions)	
Effect on the accumulated postretirement benefit obligation for health care benefits.....	\$25	\$(19)
Effect on the service and interest cost components of the net periodic postretirement health benefit costs.....	4	(3)

Plan Assets

Table 15.7 sets forth our Pension Plan weighted average asset allocations, based on fair value, at September 30, 2005 and 2004, and target allocation by asset category.

Table 15.7 — Pension Plan Assets by Category

Asset Category	Target Allocation	Plan Assets at September 30,	
		2005	2004
Equity securities	65%	55.9%	61.2%
Debt securities	35	29.4	34.0
Other ⁽¹⁾	—	14.7	4.8
Total	<u>100%</u>	<u>100.0%</u>	<u>100.0%</u>

(1) Consists of cash contributions made on September 30, 2005 and 2004, respectively, which were not fully invested by September 30th of that year.

The Pension Plan's retirement committee had fiduciary responsibility for establishing and overseeing our Pension Plan's investment policies and objectives. The Pension Plan's retirement committee reviewed the appropriateness of our Pension Plan's investment strategy on an ongoing basis. Our Pension Plan employed a total return investment approach whereby a diversified blend of equities and fixed income investments is used to maximize the long-term return of plan assets for a prudent level of risk. Risk tolerance is established through careful consideration of plan characteristics, such as business and financial characteristics, demographics, and actuarial and company funding policies. Furthermore, equity investments are diversified across U.S. and non-U.S. listed companies with small and large capitalizations. Derivatives may be used to gain market exposure in an efficient and timely manner; however, derivatives may not be used to leverage the portfolio beyond the market value of the underlying investments. Investment risk is measured and monitored on an ongoing basis through quarterly investment portfolio reviews, annual liability measurements and periodic asset/liability studies.

The Pension Plan assets did not include any direct ownership of our securities at September 30, 2005 and 2004.

Defined Benefit Pension Plan Contributions

Our general practice is to contribute to our Pension Plan an amount equal to at least the minimum required contribution, if any, but no more than the maximum amount deductible for federal income tax purposes each year. On September 30, 2005, we made a tax-deductible contribution of \$48 million to our Pension Plan. We currently believe that under applicable law, no minimum contribution will be required for 2006. However, in 2006, we expect to contribute approximately \$20 million to our Pension Plan and an additional amount yet to be determined. Any contributions to our Retiree Health Plan and non-qualified pension plan will be in the form of benefit payments as these plans are required to be unfunded.

Estimated Future Benefit Payments

Table 15.8 sets forth estimated future benefit payments expected to be paid for our defined benefit plans. The expected benefits are based on the same assumptions used to measure our benefit obligation at September 30, 2005.

Table 15.8 — Estimated Future Benefit Payments

	Pension Benefits	Postretirement Health Benefits
	(in millions)	
2006	\$ 5	\$ 1
2007	6	2
2008	6	2
2009	8	2
2010	9	3
Years 2011-2015	84	22

Defined Contribution Plans

Our Thrift/401(k) Savings Plan, or Savings Plan, is a tax-qualified defined contribution pension plan offered to all eligible employees. Employees are permitted to contribute from 1 percent to 25 percent of their eligible compensation to the Savings Plan, subject to limits set by the Internal Revenue Code. We match employees' contributions up to 6 percent of their eligible compensation per pay period; the percentage matched depends upon the employee's length of service. Employee contributions and our matching contributions are immediately vested. In addition, we have discretionary authority to make additional contributions to our Savings Plan that are allocated uniformly on behalf of each eligible employee, based on the employee's eligible compensation. Employees become vested in our discretionary contributions after 5 years of service. We also maintain a non-qualified defined contribution plan for our officers, designed to make up for benefits lost due to limitations on eligible compensation imposed by the Internal Revenue Code and to make up for deferrals of eligible compensation under our Executive Deferred Compensation Plan. We incurred costs of \$31 million, \$29 million and

\$28 million for the years ended December 31, 2005, 2004 and 2003, respectively, related to these plans. These expenses were included in Salaries and employee benefits on our consolidated statements of income.

See “NOTE 13: LEGAL CONTINGENCIES” for more information regarding civil litigation and a Department of Labor investigation of our Savings Plan in relation to our restatement.

Executive Deferred Compensation Plan

Our Executive Deferred Compensation Plan is an unfunded, non-qualified plan that allows certain key employees to elect to defer substantially all or a portion of their annual salary and cash bonus, and certain key management employees to defer the settlement of restricted stock units received from us, as well as substantially all or a portion of their annual salary and cash bonus, for any number of years specified by the employee, but under no circumstances may the period elected exceed his or her life expectancy. During 2005, we amended the plan to modify certain provisions to comply with Internal Revenue Code Section 409A as a result of the issuance of proposed regulations and other guidance. Distributions are paid from our general assets. We record a liability equal to the accumulated deferred salary, cash bonus and accrued interest as set forth in the plan, net of any related distributions made to plan participants. We recognize expense equal to the interest accrued on deferred salary and bonus throughout the year. Expense associated with unvested deferred restricted stock units is recognized as part of stock-based compensation.

NOTE 16: FAIR VALUE DISCLOSURES

The supplemental consolidated fair value balance sheets in Table 16.1 present our estimates of the fair value of our recorded financial assets and liabilities and off-balance sheet financial instruments at December 31, 2005 and 2004. Our consolidated fair value balance sheets include the estimated fair values of financial instruments recorded in our consolidated balance sheets prepared in accordance with GAAP, as well as off-balance sheet financial instruments that represent our assets or liabilities that are not recorded in our GAAP consolidated balance sheets. These off-balance sheet items predominantly consist of: (a) the unrecognized Guarantee asset and Guarantee obligation associated with our PCs issued through our Guarantor Swap program prior to the implementation of FIN 45, (b) commitments to purchase multifamily and single-family mortgage loans that will be classified as held-for-investment in our GAAP consolidated financial statements and (c) certain credit enhancements on manufactured housing asset-backed securities. The valuations of financial instruments on our consolidated fair value balance sheets are in accordance with GAAP fair value guidelines prescribed by SFAS No. 107, “Disclosures about Fair Value of Financial Instruments,” or SFAS 107, and other relevant pronouncements.

Table 16.1 — Consolidated Fair Value Balance Sheets⁽¹⁾

	December 31,			
	2005		2004	
	Carrying Amount ⁽²⁾	Fair Value	Carrying Amount ⁽²⁾	Fair Value
	(in billions)			
Assets				
Mortgage loans	\$ 61.4	\$ 62.3	\$ 61.3	\$ 63.3
Mortgage-related securities ⁽³⁾	<u>648.0</u>	<u>648.0</u>	<u>603.2</u>	<u>603.4</u>
Retained portfolio	709.4	710.3	664.5	666.7
Cash and cash equivalents	10.5	10.5	35.3	35.3
Investments	42.2	42.2	29.8	29.8
Securities purchased under agreements to resell and Federal funds sold	15.2	15.2	32.2	32.2
Derivative assets	7.1	7.1	15.3	15.3
Guarantee asset ⁽⁴⁾	5.1	5.6	4.5	5.0
Other assets ⁽⁵⁾	<u>16.7</u>	<u>14.3</u>	<u>13.7</u>	<u>13.3</u>
Total assets	<u>\$806.2</u>	<u>\$805.2</u>	<u>\$795.3</u>	<u>\$797.6</u>
Liabilities and minority interests				
Total debt securities, net	\$748.8	\$747.0	\$731.7	\$737.0
Guarantee obligation	5.5	3.7	4.1	2.1
Derivative liabilities	0.6	0.6	0.2	0.2
Reserve for guarantee losses on Participation Certificates	0.3	—	0.2	—
Other liabilities ⁽⁵⁾	22.9	22.0	26.2	25.7
Minority interests in consolidated subsidiaries	<u>0.9</u>	<u>1.0</u>	<u>1.5</u>	<u>1.7</u>
Total liabilities and minority interests	<u>779.0</u>	<u>774.3</u>	<u>763.9</u>	<u>766.7</u>
Net assets attributable to stockholders				
Preferred stockholders	4.6	4.1	4.6	4.1
Common stockholders	<u>22.6</u>	<u>26.8</u>	<u>26.8</u>	<u>26.8</u>
Total net assets	<u>27.2</u>	<u>30.9</u>	<u>31.4</u>	<u>30.9</u>
Total liabilities and net assets	<u>\$806.2</u>	<u>\$805.2</u>	<u>\$795.3</u>	<u>\$797.6</u>

- (1) The consolidated fair value balance sheets do not purport to present our net realizable, liquidation or market value as a whole. Furthermore, amounts we ultimately realize from the disposition of assets or settlement of liabilities may vary significantly from the fair values presented.
- (2) Carrying amounts equal the amounts reported on our consolidated balance sheets prepared in accordance with GAAP.
- (3) The fair value of Mortgage-related securities reported exceeds the carrying value because the fair value includes PC residuals related to some PCs held in the Retained portfolio that are not recognized in accordance with GAAP because such PCs were issued prior to the implementation of FIN 45 in 2003. The difference at December 31, 2005, rounds to zero.
- (4) The fair value of the Guarantee asset reported exceeds the carrying value primarily because the fair value includes the Guarantee asset related to some PCs held by third parties that are not recognized in accordance with GAAP because such PCs were issued prior to the implementation of FIN 45 in 2003.
- (5) Fair values include estimated income taxes calculated using the 35 percent statutory rate on the difference between the consolidated fair value balance sheets net assets, including deferred taxes from the GAAP consolidated balance sheets, and the GAAP consolidated balance sheet equity attributable to common stockholders.

Limitations

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

We report certain assets and liabilities that are not financial instruments (such as property, plant and equipment and deferred taxes), as well as certain financial instruments that are not covered by the SFAS 107 disclosure requirements (such as pension liabilities) at their carrying amounts in accordance with GAAP in our consolidated fair value balance sheets. We believe these items do not have a significant impact on our overall fair value results. Other non-financial assets and liabilities in our GAAP consolidated balance sheets represent deferrals of costs and revenues that are amortized in accordance with GAAP, such as deferred debt issuance costs and deferred credit fees. Cash receipts and payments related to these items are generally recognized in the fair value of net assets when received or paid, with no basis reflected in the fair value balance sheets.

Valuation Methods and Assumptions

Fair value is generally based on independent price quotations obtained from third-party pricing services, dealer marks or direct market observations, where available. However, certain financial instruments are less actively traded and, therefore, are not always able to be valued based on prices obtained from third parties. If quoted prices or market data are not

available, fair value is based on internal valuation models using market data inputs or internally developed assumptions, where appropriate.

During 2005 and 2004, our fair value results were impacted by several improvements in our approach for estimating fair values of certain financial instruments. In the first quarter of 2005, we improved our approach for estimating the fair values of certain financial instruments resulting in (a) a decrease in the fair value of Total net assets of approximately \$0.8 billion (after-tax) related to our guarantee-related assets and liabilities and (b) an increase in the fair value of Total net assets of approximately \$0.3 billion (after-tax) related to our multifamily whole loans, the minority interests in our consolidated REIT subsidiaries and other financial instruments. Also, in the second quarter of 2005, we improved our approach for estimating the fair values of certain securities we hold, which increased the fair value of Total net assets by approximately \$0.1 billion. The changes in our approach for estimating the fair values of these financial instruments are described below. In the fourth quarter of 2004, we began using newly available market prices received from broker/dealers and third-party pricing providers for the valuation of a greater portion of our debt instruments resulting in an increase in the fair value of Total net assets of approximately \$0.6 billion (after-tax).

The following methods and assumptions were used to estimate the fair value of assets and liabilities at December 31, 2005 and 2004.

Mortgage loans

Mortgage loans represent single-family and multifamily whole loans held in our Retained portfolio. For GAAP purposes, we must determine the fair value of these mortgage loans to calculate lower-of-cost-or-market adjustments for mortgages classified as held-for-sale. We use this same approach when determining the fair value of whole loans, including those held-for-investment, for fair value balance sheet purposes.

We determine the fair value of mortgage loans, excluding delinquent single-family loans purchased out of pools, based on comparisons to actively traded mortgage-related securities with similar characteristics, with adjustments for yield, credit and liquidity differences. Specifically, we aggregate mortgage loans into pools by product type, coupon and maturity and then convert the pools into notional mortgage-related securities based on their specific characteristics. We then calculate fair values for these notional mortgage-related securities using the process that is described in “*Mortgage-related securities*.”

Part of the adjustments for yield, credit and liquidity differences represent an implied guarantee fee. To accomplish this, the fair value of the single-family whole loans, excluding delinquent single-family loans purchased out of pools, includes an adjustment representing the estimated present value of the additional cash flows on the mortgage coupon in excess of the coupon expected on the notional mortgage-related securities. For multifamily whole loans, the fair value adjustment is estimated by calculating the net present value of guarantee fees we expect to retain. This retained guarantee fee is estimated by subtracting the expected cost of funding and securitizing a multifamily whole loan of a comparable maturity and credit rating from the coupon on the whole loan at the time of purchase.

The implied guarantee fee for both single-family and multifamily whole loans is also net of the related credit and other components inherent in our Guarantee obligation. For single-family whole loans, the process for estimating the related credit and other Guarantee obligation components is described in the “*Guarantee obligation*” section. For multifamily whole loans, the process for estimating the related credit and other Guarantee obligation components employs a market-based approach to estimate the potential credit obligation. This obligation is estimated by extracting the credit risk premium that multifamily whole loan investors require from market prices on similar securities. This credit risk premium is net of expected funding, liquidity and other risk premiums that are embedded in the market price of the reference securities.

Beginning in 2005, we refined the fair value estimates of multifamily whole loans by incorporating additional information and guidance from active market participants into the pricing of notional mortgage-related securities. In addition, beginning in 2005, for single-family whole loans that are extremely delinquent and have been purchased out of pools, we obtained dealer indications on aggregated groups of similar loans that reflect their current performance status. These market price indications reflect the estimated present value of all cash flows related to the whole loans, including expected credit losses and recoveries.

Mortgage-related securities

Mortgage-related securities represent passthroughs and other mortgage-related securities classified as available-for-sale and trading, which are already reflected at fair value on our GAAP consolidated balance sheets. Mortgage-related securities consist of securities issued by us, Fannie Mae and Ginnie Mae as well as non-agency mortgage-related securities.

The fair value of securities with readily available third-party market prices is generally based on market prices obtained from broker/dealers or reliable third-party pricing service providers. Fair value may be estimated by using third-party quotes for similar instruments, adjusted for differences in contractual terms. For other securities, a market option-adjusted spread approach based on observable market parameters is used to estimate fair value. Option-adjusted spreads for certain securities

are estimated by deriving the option-adjusted spread for the most closely comparable security with an available market price, using proprietary interest-rate and prepayment models. If necessary, our judgment is applied to estimate the impact of differences in prepayment uncertainty or other unique cash flow characteristics related to that particular security. Fair values for these securities are then estimated by using the estimated option-adjusted spread as an input to the interest-rate and prepayment models, and estimating the net present value of the projected cash flows. The remaining instruments are priced using other modeling techniques or by using other securities as proxies.

Mortgage-related securities also include PC residuals related to PCs held by us and reported in the mortgage-related securities line item. PC residuals are reported at fair value on our consolidated balance sheets. Fair value for PC residuals is estimated in the same manner as described for the Guarantee asset and the Guarantee obligation for PCs below.

Cash and cash equivalents

Cash and cash equivalents largely consist of highly liquid investment securities with an original maturity of three months or less used for cash management purposes, as well as cash collateral posted by our derivative counterparties. Given that these assets are short-term in nature with limited market value volatility, the carrying amount on our GAAP consolidated balance sheets is deemed to be a reasonable approximation of fair value.

Investments

At December 31, 2005 and 2004, Investments consists solely of non-mortgage-related securities, which are reported at fair value on our consolidated balance sheets. During 2004, Investments also included non-mortgage-related securities and mortgage-related securities held in connection with PC market making and support activities, which were reported at fair value on our consolidated balance sheets. We ceased our PC market making and support activities accomplished through our Securities Sales & Trading Group business unit and external Money Manager program during the fourth quarter of 2004. The fair values of those Investments were estimated using the methods described above in “*Mortgage-related securities.*”

Securities purchased under agreements to resell and Federal funds sold

Securities purchased under agreements to resell and Federal funds sold principally consists of short-term contractual agreements such as reverse repurchase agreements involving Treasury and agency securities, Federal funds sold and Eurodollar time deposits. Given that these assets are short-term in nature, the carrying amount on our GAAP consolidated balance sheets is deemed to be a reasonable approximation of fair value.

Guarantee asset

At December 31, 2005 and 2004, we had a Guarantee asset on our GAAP consolidated balance sheets for approximately 93 percent and 89 percent, respectively, of PCs and Structured Securities held by third parties. For more information regarding the accounting for the Guarantee asset related to PCs and Structured Securities, see “NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES.”

For fair value balance sheet purposes, the Guarantee asset is reflected for all PCs and Structured Securities held by third parties and is valued using the same method as used for GAAP fair value purposes. For a description of how we determine the fair value of our Guarantee asset, see “NOTE 2: TRANSFERS OF SECURITIZED INTERESTS IN MORTGAGE-RELATED ASSETS.”

Derivative assets

Derivative assets, at fair value largely consists of interest-rate swaps, option-based derivatives, futures, and forward purchase and sale commitments that we account for as derivatives, which are reflected at fair value on our GAAP consolidated balance sheets. The fair values of interest-rate swaps are determined by using the appropriate yield curves to calculate and discount the expected cash flows for both the fixed-rate and variable-rate components of the swap contracts. Option-based derivatives, which principally include call and put swaptions, are valued using an option-pricing model. This model uses market interest rates and market-implied option volatilities, where available, to calculate the option’s fair value. Market-implied option volatilities are based on information obtained from broker/dealers. The fair value of exchange-traded futures is based on end-of-day closing prices obtained from third-party pricing services. Derivative forward purchase and sale commitments are valued using the methods described for mortgage-related securities valuation above.

The fair value of derivative assets considers the impact of institutional credit risk in the event that the counterparty does not honor its payment obligation. Our fair value of derivatives is not adjusted for expected credit losses because we obtain collateral from most counterparties typically within one business day of the daily market value calculation and substantially all of our credit risk arises from counterparties with investment-grade credit ratings of A– or above.

Other assets

Other assets consists of accrued interest and other receivables, investments in qualified LIHTC partnerships that are eligible for federal tax credits, credit enhancement contracts related to PCs and Structured Securities (pool insurance and recourse and/or indemnification agreements), financial guarantee contracts for additional credit enhancements on certain manufactured housing asset-backed securities, REO, property, plant and equipment, and other miscellaneous assets.

The receivables are financial instruments and are required to be measured at fair value for disclosure purposes pursuant to SFAS 107. Because these receivables are short-term in nature, we believe the carrying amount on our GAAP consolidated balance sheets is a reasonable approximation of their fair values. Our investments in LIHTC partnerships, reported as consolidated entities or equity method investments in the GAAP financial statements, are not within the scope of SFAS 107 disclosure requirements. However, we present the fair value of these investments in Other assets. For the LIHTC partnerships, the fair value of expected tax benefits is estimated using expected cash flows discounted at a market-based yield.

For the credit enhancement contracts related to PCs and Structured Securities (pool insurance and recourse and/or indemnification agreements), fair value is estimated using an expected cash flow approach, and is intended to reflect the estimated amount that a third party would be willing to pay for the contracts. On our consolidated fair value balance sheets, these contracts are reported at fair value at each balance sheet date based on current market conditions; on our GAAP consolidated balance sheets, these contracts are initially recorded at fair value at inception, then amortized to expense.

For the credit enhancements on manufactured housing asset-backed securities, the fair value is based on the difference between the market price of non-credit impaired manufactured housing securities and credit-impaired manufactured housing securities that are likely to produce future credit losses, as adjusted for our estimate of a risk premium attributable to the financial guarantee contracts. The value of the contracts, over time, will be determined by the actual credit-related losses incurred and, therefore, may have a value that is higher or lower than our market-based estimate. On our GAAP consolidated financial statements, these contracts are recognized as realized.

The other categories of assets that comprise Other assets are not financial instruments required to be valued at fair value under SFAS 107, such as REO and property, plant and equipment. For the majority of these non-financial assets in Other assets, we use the carrying amounts from our GAAP consolidated balance sheets as the reported values on our consolidated fair value balance sheets, without any adjustment. These assets represent an insignificant portion of our GAAP consolidated balance sheets, and any change in their fair value would not be a meaningful part of our fair value of net assets business results. Certain non-financial assets in Other assets on our GAAP consolidated balance sheets are assigned a zero value on our consolidated fair value balance sheets. This treatment is applied to deferred items such as deferred debt issuance costs.

We adjust the GAAP-basis deferred taxes for consolidated fair value balance sheets purposes to include estimated income taxes on the difference between our consolidated fair value balance sheets net assets, including deferred taxes from the GAAP consolidated balance sheets, and our GAAP consolidated balance sheets equity attributable to common stockholders. To the extent the adjusted deferred taxes are a net asset, this amount is included in Other assets. If the adjusted deferred taxes are a net liability, this amount is included in Other liabilities.

Total debt securities, net

Total debt securities, net represents short-term and long-term debt used to finance our assets and, for GAAP presentation, is net of deferred items, including premiums, discounts and hedging-related basis adjustments. It includes both non-callable and callable debt as well as short-term zero coupon discount notes. The fair value of the short-term zero coupon discount notes is based on a discounted cash flow model with market inputs. The valuation of other debt securities is generally based on market prices obtained from broker/dealers, reliable third-party pricing service providers or direct market observations. In the fourth quarter of 2004, we began using newly available market prices received from broker/dealers and reliable third-party pricing services for the valuation of a greater portion of our debt instruments. Previously the calculation of the fair value of these instruments was based primarily on an internal model using available market inputs.

Guarantee obligation

We did not establish a Guarantee obligation for GAAP purposes for PCs and Structured Securities held by third parties that were issued through our Guarantor Swap program prior to adoption of FIN 45. In addition, after it is initially recorded at fair value the Guarantee obligation is not subsequently carried at fair value for GAAP purposes. For fair value balance sheet purposes, the Guarantee obligation reflects the fair value of our Guarantee obligation on all PCs held by third parties. Additionally, for fair value balance sheet purposes, the Guarantee obligation is valued using the same method as used for GAAP to determine its initial fair value. For information concerning our valuation approach and accounting policies related

to guarantee-related credit losses, see “NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES,” and “NOTE 2: TRANSFERS OF SECURITIZED INTERESTS IN MORTGAGE-RELATED ASSETS.”

Reserve for guarantee losses on Participation Certificates

The carrying amount of the Reserve for guarantee losses on Participation Certificates on our GAAP consolidated balance sheets represents loan loss reserves for off-balance sheet PCs in accordance with GAAP that are not already accounted for under SFAS 125/140. This line item has no basis in our consolidated fair value balance sheets, because the estimated fair value of all expected default losses is included in the Guarantee obligation reported on our consolidated fair value balance sheets, as discussed above.

Derivative liabilities

See discussion under “*Derivative assets*” above.

Other liabilities

Other liabilities principally consists of amounts due to PC investors (*i.e.*, principal and interest), funding liabilities associated with investments in LIHTC partnerships, accrued interest payable on debt securities and other miscellaneous obligations of less than one year. We believe the carrying amount of these liabilities is a reasonable approximation of their fair value, except for funding liabilities associated with investments in LIHTC partnerships, for which fair value is estimated using expected cash flows discounted at a market-based yield. Furthermore, certain deferred items reported as Other liabilities on our GAAP consolidated balance sheets are assigned zero value on our consolidated fair value balance sheets, such as deferred credit fees. Also, as discussed in “*Other assets*,” Other liabilities may include a deferred tax liability adjusted for fair value balance sheet purposes.

Minority interests in consolidated subsidiaries

Minority interests in consolidated subsidiaries primarily represent preferred stock interests that third parties hold in our two majority-owned REIT subsidiaries. In accordance with GAAP, we consolidated the REITs. The preferred stock interests are not within the scope of SFAS 107 disclosure requirements. However, we present the fair value of these interests in our fair value balance sheets. The fair value of the third-party minority interests in these REITs was based on the estimated value of the underlying REIT preferred stock we determined based on a valuation model. In 2005, we improved our fair value estimates to reflect observed market activity.

Net assets attributable to preferred stockholders

To determine the preferred stock fair value, we use a market-based approach incorporating quoted dealer prices.

Net assets attributable to common stockholders

Net assets attributable to common stockholders is equal to the difference between the fair value of total assets and the sum of total liabilities and minority interests reported on our consolidated fair value balance sheets, less the fair value of net assets attributable to preferred stockholders.

NOTE 17: CONCENTRATION OF CREDIT AND OTHER RISKS

Mortgages and Mortgage-Related Securities

Table 17.1 summarizes the geographical concentration of mortgages and mortgage-related securities that are held by us or that are collateral for PCs and Structured Securities, excluding:

- \$2,021 million and \$3,015 million of mortgage-related securities issued by Ginnie Mae that back Structured Securities at December 31, 2005 and 2004, respectively, because these securities do not expose us to meaningful amounts of credit risk;
- \$44,626 million and \$59,715 million of agency mortgage-related securities at December 31, 2005 and 2004, respectively, because these securities do not expose us to meaningful amounts of credit risk; and
- \$242,586 million and \$175,163 million of non-agency mortgage-related securities held in the Retained portfolio at December 31, 2005 and 2004, respectively, because geographic information regarding these securities is not available. With respect to these securities, we look to third party credit enhancements (*e.g.*, bond insurance) or other credit enhancements resulting from the securitization structure supporting such securities (*e.g.*, subordination levels) as a primary means of managing credit risk.

See “NOTE 5: RETAINED PORTFOLIO AND CASH AND INVESTMENTS PORTFOLIO” for more information about the securities we hold.

Table 17.1 — Concentration of Credit Risk

	December 31,			
	2005		2004	
	Amount ⁽¹⁾	Percentage	Amount ⁽¹⁾⁽²⁾	Percentage
	(dollars in millions)			
By Region⁽³⁾				
Northeast	\$ 340,960	24%	\$ 306,281	24%
West	326,952	23	296,390	23
North central	304,378	22	280,618	22
Southeast	247,494	18	223,921	18
Southwest	175,200	13	160,249	13
	<u>\$1,394,984</u>	<u>100%</u>	<u>\$1,267,459</u>	<u>100%</u>
By State				
California	\$ 182,178	13%	\$ 171,209	14%
Florida	86,988	6	75,879	6
Illinois	72,986	5	65,750	5
New York	71,998	5	65,344	5
All Others	980,834	71	889,277	70
	<u>\$1,394,984</u>	<u>100%</u>	<u>\$1,267,459</u>	<u>100%</u>

(1) Calculated as Total mortgage portfolio less Structured Securities backed by Ginnie Mae Certificates as well as agency and non-agency mortgage-related securities held in the Retained portfolio.

(2) Beginning in 2005, Puerto Rico and Virgin Islands were reclassified from Northeast to Southeast. The 2004 results were changed to conform with 2005 presentation.

(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).

Mortgage Lenders

A significant portion of our single-family mortgage purchase volume is generated from several key mortgage lenders that have entered into special business arrangements with us. These individually negotiated arrangements generally involve a lender's commitment to sell a high proportion of its conforming mortgage origination volume to us. During 2005, three mortgage lenders each accounted for 10 percent or more of our mortgage purchase volume and in the aggregate they accounted for approximately 47 percent of this volume. These three lenders are among the largest mortgage loan originators in the United States. We are exposed to the risk that we could lose purchase volume to the extent these arrangements are terminated or modified without replacement from other lenders.

Derivative Portfolio

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 derivatives exposes us to counterparty credit risk, which 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. Over-the-counter, or OTC, derivatives, however, expose us to counterparty credit risk because transactions are executed and settled between us and the counterparty. 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. Master netting agreements provide for the netting of amounts receivable and payable from an individual counterparty, which reduces our exposure to a single counterparty in the event of default. On a daily basis, the market value of each counterparty's derivatives outstanding is calculated to determine the amount of our net credit exposure, which is equal to derivatives in a net gain position by counterparty after giving consideration to collateral posted. Our collateral agreements require most counterparties to post collateral for the amount of our net exposure to them above the applicable threshold. Bilateral collateral agreements are in place for the majority of our counterparties. Collateral posting thresholds are tied to a counterparty's credit rating. Derivative exposures and collateral amounts are monitored on a daily basis using both internal pricing models and dealer price quotes. Collateral is typically transferred within one business day based on the

values of the related derivatives. This time lag in posting collateral can affect our net uncollateralized exposure to derivative counterparties.

Collateral posted by a derivative counterparty is typically in the form of cash, U.S. Treasury securities, our PCs and Structured Securities or our debt securities. In the event a counterparty defaults on its obligations under the derivatives agreement and the default is not remedied in the manner prescribed in the agreement, we have the right under the agreement to direct the custodian bank to transfer the collateral to us or, in the case of non-cash collateral, to sell the collateral and transfer the proceeds to us.

Our uncollateralized exposure to counterparties for OTC interest-rate swaps, option-based derivatives and foreign-currency swaps, after applying netting agreements and collateral, was \$190 million and \$601 million at December 31, 2005 and 2004, respectively. 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 exposure to counterparties for OTC forward purchase and sale commitments treated as derivatives was \$35 million and \$40 million at December 31, 2005 and 2004, respectively. Since the typical maturity for our OTC commitments is less than one year, we do not require master netting and collateral agreements for the counterparties of these commitments. Therefore, the exposure to our OTC commitments counterparties is uncollateralized. Similar to counterparties for our OTC interest-rate swaps, option-based derivatives and foreign-currency swaps, we monitor the credit fundamentals of our OTC commitments counterparties on an ongoing basis to ensure that they continue to meet our internal risk-management standards.

NOTE 18: MINORITY INTERESTS

The equity and net earnings attributable to the minority stockholder interests in consolidated subsidiaries are reported on our consolidated balance sheets as Minority interests in consolidated subsidiaries and on our consolidated statements of income as Minority interests in earnings of consolidated subsidiaries. The majority of the balances in these accounts relate to our two majority-owned REITs.

In February 1997, we formed two majority-owned REIT subsidiaries funded through the issuance of common stock (99.9 percent of which is held by us) and a total of \$4.0 billion of perpetual, step-down preferred stock issued to outside investors. The dividend rate on the step-down preferred stock is 13.3 percent from initial issuance through December 2006 (the initial term). Beginning in 2007, the dividend rate will step-down to 1.0 percent. Dividends on this preferred stock accrue in arrears. The balance of the two step-down preferred stock issuances as recorded within Minority interests in consolidated subsidiaries on our consolidated balance sheets totaled \$934 million and \$1,488 million at December 31, 2005 and 2004, respectively.

On November 10, 2005, we offered to purchase for cash any and all of the outstanding shares of the outstanding step-down preferred stock, of which \$142 million was purchased between the offer date and December 31, 2005. The preferred stock continues to be redeemable by the REITs under certain circumstances described in the preferred stock offering documents as a "tax event redemption." See "NOTE 14: INCOME TAXES" for more information concerning the REITs.

NOTE 19: EARNINGS PER COMMON SHARE

Basic earnings per common share are computed as Net income available to common stockholders divided by Weighted average common shares outstanding-basic for the period. Diluted earnings per common share are computed as Net income available to common stockholders divided by Weighted average common shares outstanding-diluted for the period, which consider the effect of dilutive common equivalent shares outstanding. The effect of dilutive common equivalent shares outstanding includes: (a) the weighted average shares related to stock options (including the ESPP) that have an exercise price lower than the average market price during the period; (b) the weighted average of non-vested restricted shares; and (c) all restricted stock units. Such items are excluded from Weighted average common shares outstanding — basic. See "NOTE 11: STOCK-BASED COMPENSATION" for additional information. Net income available to common stockholders is not affected by dilutive potential common shares for the years ended December 31, 2005, 2004 and 2003. For the years ended December 31, 2005, 2004 and 2003, there are approximately 1,929,000, 2,239,000 and 1,581,000 of dilutive common equivalent shares outstanding that could potentially dilute earnings per common share, based on the treasury stock method.

Options to purchase 2.3 million, 2.4 million and 3.4 million shares of common stock were excluded from the computation of Diluted earnings per common share at December 31, 2005, 2004 and 2003, respectively, because the options' exercise price exceeded the average market price of the common stock for the years ended December 31, 2005, 2004 and 2003, respectively.

**CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING
AND FINANCIAL DISCLOSURES**

None.

CONTROLS AND PROCEDURES

See “MD&A — RISK MANAGEMENT — Operational Risks — *Internal Control over Financial Reporting*” for a description of our material weaknesses and other deficiencies.

DIRECTORS AND EXECUTIVE OFFICERS

Information regarding our Directors and Executive Officers is set forth under “Proposal 1: Election of Directors — Nominees for Election” and “Executive Officers” of our Proxy Statement for our annual meeting of stockholders to be held on September 8, 2006, and is incorporated herein by reference. Additional information concerning our Audit Committee may be found under the caption “Corporate Governance — Audit Committee Financial Expert” in our Proxy Statement. We also provide information regarding our Section 16 compliance under “Section 16(a) Beneficial Ownership Reporting” in our Proxy Statement, incorporated by reference herein.

BOARD OF DIRECTORS (as of June 1, 2006)⁽¹⁾

Richard F. Syron

Chairman and Chief Executive Officer

Freddie Mac

McLean, Virginia

Barbara T. Alexander^{C, E}

Independent Consultant

Monarch Beach, California

Geoffrey T. Boisi^{B, D, E}

Chairman and Senior Partner

Roundtable Investment Partners LLC

A private investment management firm

New York, New York

Michelle Engler^{B, E}

Trustee

JNL Investor Series Trust and JNL Series Trust

and *Member of Board of Managers*

JNL/NY Variable Funds

Each an investment company

Lansing, Michigan

Richard Karl Goeltz^{A, C, D}

Retired Vice Chairman and Chief Financial Officer

American Express Company

A financial services company

New York, New York

Thomas S. Johnson^{A, B}

Retired Chairman and Chief Executive Officer

GreenPoint Financial Corp.

A financial services company

New York, New York

William M. Lewis, Jr.^{C, E}

*Managing Director and Co-Chairman
of Investment Banking*

Lazard Ltd.

An investment banking company

New York, New York

Eugene M. McQuade

President and Chief Operating Officer

Freddie Mac

McLean, Virginia

Shaun F. O'Malley (Lead Director)^{A, B, D}

Chairman Emeritus

Price Waterhouse LLP

An accounting and consulting firm

Philadelphia, Pennsylvania

Jeffrey M. Peek^{C, E}

Chairman and Chief Executive Officer

CIT Group, Inc.

A provider of commercial and consumer finance solutions

New York, New York

Ronald F. Poe^{B, D, E}

President

Ronald F. Poe & Associates

A private real estate investment firm

White Plains, New York

Stephen A. Ross^{A, C, D}

Professor

Massachusetts Institute of Technology

Cambridge, Massachusetts

William J. Turner^{A, C}

Manager

Signature Capital, Inc.

A venture capital investment firm

Portland, Maine

Committees	A Audit
	B Compensation and Human Resources
	C Finance and Capital Deployment
	D Governance, Nominating and Risk Oversight
	E Mission and Sourcing

(1) Our enabling legislation establishes the membership of the board of directors at 18 directors: 13 directors elected by the stockholders and 5 directors appointed by the President of the United States. Prior to our March 31, 2004 Annual Meeting, the Office of Counsel to the President informed us that the President did not intend to reappoint any of his then-current presidential appointees. Consequently, each of their terms as presidential appointees ended on the date of that annual meeting. No new appointees have been named by the President as of June 1, 2006.

EXECUTIVE COMPENSATION

Information regarding executive compensation is set forth under the section titled “Executive Compensation” of our Proxy Statement and is incorporated by reference into this Information Statement. Information regarding compensation of our board of directors is set forth under the section titled “Proposal 1: Election of Directors — Board Compensation” and information concerning members of the Compensation and Human Resources Committee is set forth under “Proposal 1: Election of Directors — Compensation Committee Interlocks and Insider Participation” of our Proxy Statement, incorporated by reference herein.

SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

Securities Authorized for Issuance under Equity Compensation Plans

Table 52 provides information about our common stock that may be issued upon the exercise of options, warrants and rights under our existing equity compensation plans at December 31, 2005. Our stockholders have approved the ESPP, the 2004 Employee Plan, the 1995 Employee Plan and the Directors’ Plan.

Table 52 — Equity Compensation Plan Information

Plan Category	(a) Number of securities to be issued upon exercise of outstanding options, warrants and rights	(b) Weighted-average exercise price of outstanding options, warrants and rights	(c) Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))
Equity compensation plans approved by stockholders	8,229,451 ⁽¹⁾	\$46.10 ⁽²⁾	20,159,506 ⁽³⁾
Equity compensation plans not approved by stockholders	None	N/A	None

- (1) Includes 1,474,183 restricted stock units issued under the Directors’ Plan and the Employee Plans and options to purchase up to 61,584 shares under the ESPP, which are issuable in connection with the offering period ended on January 31, 2006.
- (2) For the purpose of calculating this amount, the restricted stock units are assigned an exercise price of zero.
- (3) Consists of 12,005,314 shares, 6,597,276 shares and 1,556,916 shares available for issuance under the 2004 Employee Plan, the ESPP and Directors’ Plan, respectively.

Security Ownership of Management

Information regarding the beneficial ownership of our common stock by each of our directors, each director nominee, certain executive officers and by all directors and executive officers as a group is set forth under the section titled “Corporate Governance — Stock Ownership by Directors, Executive Officers and Greater than 5% Holders” of our Proxy Statement for our annual meeting of stockholders to be held on September 8, 2006 and is incorporated by reference into this Information Statement.

Security Ownership of Certain Beneficial Owners

Information regarding the beneficial ownership of our common stock by certain beneficial owners is set forth under the section titled “Corporate Governance — Stock Ownership by Directors, Executive Officers and Greater than 5% Holders” of our Proxy Statement for our annual meeting of stockholders to be held on September 8, 2006 and is incorporated by reference into this Information Statement.

CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

Information regarding certain relationships and related transactions is set forth under the section titled “Proposal 1: Election of Directors — Transactions with Institutions Related to Directors” of our Proxy Statement for our annual meeting of stockholders to be held on September 8, 2006 and is incorporated by reference into this Information Statement.

PRINCIPAL ACCOUNTING FEES AND SERVICES

Information regarding principal accountant fees and services is set forth under the section titled “Proposal 2: Ratification of Appointment of Independent Auditors” of our Proxy Statement for our annual meeting of stockholders to be held on September 8, 2006 and is incorporated by reference into this Information Statement.

CERTIFICATION*

I, Richard F. Syron, certify that:

1. I have reviewed this Information Statement of Freddie Mac;
2. Based on my knowledge, this Information Statement does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this Information Statement; and
3. Based on my knowledge, the consolidated financial statements, and other financial information included in this Information Statement, fairly present in all material respects the financial condition, results of operations and cash flows of Freddie Mac as of, and for, the periods presented in this Information Statement.

Date: June 28, 2006



Richard F. Syron
Chairman and Chief Executive Officer

CERTIFICATION*

I, Eugene M. McQuade, certify that:

1. I have reviewed this Information Statement of Freddie Mac;
2. Based on my knowledge, this Information Statement does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this Information Statement; and
3. Based on my knowledge, the consolidated financial statements, and other financial information included in this Information Statement, fairly present in all material respects the financial condition, results of operations and cash flows of Freddie Mac as of, and for, the periods presented in this Information Statement.

Date: June 28, 2006



Eugene M. McQuade
President and Chief Operating Officer

* For a detailed discussion of our progress with respect to our internal control over financial reporting and disclosure controls and procedures, see "RISK MANAGEMENT — Operational Risks — *Internal Control over Financial Reporting.*"

RATIO OF EARNINGS TO FIXED CHARGES

	Year Ended December 31,				
	2005	2004	2003	2002	2001
	(dollars in millions)				
Net income before cumulative effect of changes in accounting principles	\$ 2,189	\$ 2,937	\$ 4,816	\$10,090	\$ 3,115
Add:					
Income tax expense	367	790	2,202	4,713	1,339
Minority interests in earnings of consolidated subsidiaries	96	129	157	184	208
Total interest expense	29,899	26,566	26,509	26,876	27,577
Interest factor in rental expenses	6	6	5	5	5
Capitalized interest	—	1	—	1	1
Earnings, as adjusted	<u>\$32,557</u>	<u>\$30,429</u>	<u>\$33,689</u>	<u>\$41,869</u>	<u>\$32,245</u>
Fixed charges:					
Total interest expense	\$29,899	\$26,566	\$26,509	\$26,876	\$27,577
Interest factor in rental expenses	6	6	5	5	5
Capitalized interest	—	1	—	1	1
Total fixed charges	<u>\$29,905</u>	<u>\$26,573</u>	<u>\$26,514</u>	<u>\$26,882</u>	<u>\$27,583</u>
Ratio of earnings to fixed charges ⁽¹⁾	1.09	1.15	1.27	1.56	1.17

(1) Ratio of earnings to fixed charges is computed by dividing Earnings, as adjusted by Total fixed charges.

RATIO OF EARNINGS TO COMBINED FIXED CHARGES AND PREFERRED STOCK DIVIDENDS

	Year Ended December 31,				
	2005	2004	2003	2002	2001
	(dollars in millions)				
Net income before cumulative effect of changes in accounting principles	\$ 2,189	\$ 2,937	\$ 4,816	\$10,090	\$ 3,115
Add:					
Income tax expense	367	790	2,202	4,713	1,339
Minority interests in earnings of consolidated subsidiaries	96	129	157	184	208
Total interest expense	29,899	26,566	26,509	26,876	27,577
Interest factor in rental expenses	6	6	5	5	5
Capitalized interest	—	1	—	1	1
Earnings, as adjusted	<u>\$32,557</u>	<u>\$30,429</u>	<u>\$33,689</u>	<u>\$41,869</u>	<u>\$32,245</u>
Fixed charges:					
Total interest expense	\$29,899	\$26,566	\$26,509	\$26,876	\$27,577
Interest factor in rental expenses	6	6	5	5	5
Capitalized interest	—	1	—	1	1
Preferred stock dividends ⁽¹⁾	261	266	315	351	310
Total fixed charges including preferred stock dividends	<u>\$30,166</u>	<u>\$26,839</u>	<u>\$26,829</u>	<u>\$27,233</u>	<u>\$27,893</u>
Ratio of earnings to combined fixed charges and preferred stock dividends ⁽²⁾	1.08	1.13	1.26	1.54	1.16

(1) Preferred stock dividends represent pre-tax earnings required to cover any preferred stock dividend requirements using our effective tax rate for the relevant periods.

(2) Ratio of earnings to combined fixed charges and preferred stock dividends is computed by dividing Earnings, as adjusted by Total fixed charges including preferred stock dividends.

ADDITIONAL FINANCIAL INFORMATION

For more information about Freddie Mac stock contact:

Freddie Mac
Mailstop D40
1551 Park Run Drive
McLean, Virginia 22102-3110
Investor Relations: (571) 382-4732
Toll Free: (800) FREDDIE
On the Internet: <http://www.FreddieMac.com/investors>

ANNUAL MEETING

The annual meeting of Freddie Mac's stockholders will be held:

September 8, 2006
9:00 a.m. eastern time
8000 Jones Branch Drive
McLean, Virginia 22102

Proxy materials will be mailed to stockholders of record in accordance with Freddie Mac's bylaws and New York Stock Exchange requirements.

DIVIDEND PAYMENTS

Approved by Freddie Mac's board of directors, dividends on the company's common stock and non-cumulative preferred stock in 2005 and the first six months of 2006 were or are expected to be paid on:

March 31, 2005
June 30, 2005
September 29, 2005
December 29, 2005
March 31, 2006
June 30, 2006

Subject to approval by Freddie Mac's board of directors, dividends on the company's common stock and non-cumulative preferred stock in the last six months of 2006 are expected to be paid on or about:

September 30, 2006
December 31, 2006

CORPORATE HEADQUARTERS

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INDEX OF ACRONYMS

We are providing this index of acronyms used in this Information Statement for the convenience of the reader. All of the acronyms listed below are defined at their first use in this document.

AOCI	Accumulated other comprehensive income (loss), net of taxes
ARM	Adjustable-rate mortgage
CMBS	Commercial mortgage-backed securities
CMT	Constant Maturity Treasury
DOL	Department of Labor
EITF	Emerging Issues Task Force
ERISA	Employee Retirement Income Security Act
ESPP	Employee Stock Purchase Plan
Euribor	Euro Interbank Offered Rate
Fannie Mae	Federal National Mortgage Association
FASB	Financial Accounting Standards Board
FEC	Federal Election Commission
FHA	Federal Housing Administration
FICO	Credit scores initially developed by Fair, Issac and Co., Inc.
FIN	Financial Accounting Standards Board Interpretation
FSP	Financial Accounting Standards Board Staff Position
GAAP	U.S. generally accepted accounting principles
Ginnie Mae	Government National Mortgage Association
GSE	Government-sponsored enterprise
GSE Act	The Federal Housing Enterprises Financial Safety and Soundness Act of 1992
HUD	Department of Housing and Urban Development
IO	Interest only
IRR	Internal rates of return
IRS	Internal Revenue Service
LIBOR	London Interbank Offered Rate
LIHTC	Low-Income Housing Tax Credit
LTV	Loan-to-Value
MD&A	Management's Discussion and Analysis of Financial Condition and Results of Operations
NPV	Net present value
NYSE	New York Stock Exchange
OAS	Option-Adjusted Spread
OFHEO	Office of Federal Housing Enterprise Oversight
OTC	Over-the-Counter
PC	Mortgage Participation Certificate
PCAOB	Public Company Accounting Oversight Board
PMVS	Portfolio Market Value Sensitivity
PMVS-L	Portfolio Market Value Sensitivity-Level
PMVS-YC	Portfolio Market Value Sensitivity-Yield Curve
PwC	PricewaterhouseCoopers LLP
REIT	Real Estate Investment Trust
REMIC	Real Estate Mortgage Investment Conduit
REO	Real Estate Owned
RHS	Rural Housing Service
S&P	Standard & Poor's
SEC	Securities and Exchange Commission
SFAS	Statement of Financial Accounting Standards
SS&TG	Securities Sales and Trading Group
TBA	To Be Announced
VA	Department of Veterans Affairs
VIE	Variable interest entity



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