

**MANAGEMENT'S DISCUSSION AND ANALYSIS
OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS
EXECUTIVE SUMMARY**

Our Business

To achieve our objective for long-term growth of the fair value of our net assets, we focus on three long-term business drivers — the profitability of new investment and guarantee business, growth in our investment and total credit guarantee portfolios and market share. Competition, other market factors, our housing mission under our charter and the HUD affordable housing goals and subgoals require that we make trade-offs in our business that affect each of these drivers. Our purchases of mortgage loans benefiting low- and moderate-income families and neighborhoods are an integral part of our mission and business, and we are committed to fulfilling the needs of these borrowers and markets.

Retained portfolio activities

Through our Retained portfolio investment activities, we seek to produce long-term growth of the fair value of our net assets primarily by opportunistically purchasing mortgage assets that offer attractive investment returns while meeting the requirements of our charter and supporting the affordable housing goals and subgoals set for us by HUD. We estimate our expected investment returns using an option-adjusted spread approach. We select our investments based on these expected returns and our market expertise, regardless of the timing of the recognition of these returns in net income.

During 2006, the unpaid principal balance of our Retained portfolio declined by 1 percent as relatively tight mortgage-to-debt option-adjusted spreads limited attractive investment opportunities and resulted in lower expected investment returns on new business. Also, as discussed in “BUSINESS — Business Activities — *Investment and Funding Activities*,” we began managing our Retained portfolio under a voluntary temporary growth limit effective July 1, 2006. We will keep this limit in place until we return to producing and publicly releasing quarterly financial statements prepared in conformity with GAAP. While operating under this limit, we continue to be selective about the new investments we make in order to achieve acceptable investment returns.

Over the last several years, there has been a particularly strong demand for mortgage assets by investors. This demand was driven in part by the steep yield curve evident up until the second half of 2005. When short-term interest rates are low relative to mortgage interest rates, initial returns on mortgage-related investments are relatively high. A significant portion of our current Retained portfolio was acquired at attractive spreads when the slope of the yield curve was steep compared to historical levels. As a result, the initial net interest yields on our fixed-rate mortgage-related investments were relatively high. However, over the last three years, the net interest yield on those assets declined as our initial medium-term funding matured and was replaced with higher-coupon funding as the yield curve flattened. In addition, throughout 2006 and 2005, new fixed-rate mortgage investments were acquired at lower initial net interest yields, which adversely affected the overall net interest yield of the Retained portfolio.

While the natural decline of net interest yields of our fixed-rate mortgage investments is a driver of the decline in our net interest yield over the last three years, other factors have also contributed to the decline. For example, the increase of our issuances of callable debt put downward pressure on net interest yield in the near term; however, we expect this funding to reduce future rebalancing requirements and related costs over time. In addition, during 2006 and the latter part of 2005, while the yield curve was flattening, we retired debt in order to take advantage of favorable funding spreads on our new debt issuances. While improving the spreads on our Retained portfolio had a positive impact on the fair value of our net assets, these debt retirements adversely impacted our net interest yields because retired lower-coupon debt was replaced at higher interest rates. During 2006, our average funding levels remained significantly below the London Interbank Offered Rate, or LIBOR, with spreads relative to LIBOR for our Reference Notes[®] securities improving by 2 to 5 basis points along the interest-rate curve. Also, in 2005 and 2004, we increased our purchases of variable-rate non-agency mortgage-related securities, taking advantage of attractive spreads. While the net interest yields on variable-rate securities are less sensitive to changes in the yield curve, they generally have lower initial net interest yields than fixed-rate investments.

Credit guarantee activities

We seek to generate fair value growth through our credit guarantee activities by issuing guarantees that offer attractive long-term returns relative to anticipated credit costs. The securitization market is increasingly competitive and we have reduced our guarantee fees on new business in an effort to maintain our market share. In addition, during 2006, the residential mortgage market weakened and the rate of home price appreciation slowed.

During 2006 and 2005, increases in the expected future credit costs associated with our credit guarantee activities increased the fair value of our Guarantee obligation, adversely impacting the fair value of our net assets. Also, as a result of the increase in expected future credit costs and competitive pressure on our guarantee fees, some of our new credit guarantee business was acquired below our normal expected return thresholds and we realized increased losses on certain

guarantees at their inception. These trends have also contributed to a decline in the overall expected returns on our credit guarantee activities.

During 2006, 2005 and 2004, the growth rates of our credit guarantee portfolio were 10.6 percent, 10.5 percent and 4.0 percent, respectively. For 2006, we estimate that our share of the total residential mortgage securitization market declined slightly due, in part, to lower purchase volumes of non-agency mortgage-related securities into our Retained portfolio. Also, our share of the GSE securitization market declined to approximately 43 percent in 2006 from approximately 45 percent in 2005 due to competitive pressures.

The credit quality of our guarantee portfolio remains strong, with a weighted average current loan-to-value ratio of approximately 57 percent as of the end of 2006 as compared with 56 percent at the end of 2005, and the portfolio remains geographically well diversified. In addition, our guarantee portfolio has benefited from several years of strong home price appreciation. However, as discussed in "BUSINESS," the mortgages added to our portfolio in recent years do not have the benefit of significant home price appreciation and, in some markets, recent values of the properties underlying the mortgages have declined. As recently acquired credit guarantee business matures and enters its peak default years, we anticipate that default rates and loss severities will trend higher.

As the residential mortgage market continues to grow, competition among loan originators and other market factors, such as relatively low interest rates and generally high home prices, have led to a higher proportion of variable-rate mortgage products and the proliferation of new mortgage products that offer borrowers a variety of payment options. We increased our purchases of these variable-rate and non-traditional mortgage products as they became more prevalent in the market. However, at December 31, 2006, long-term, fixed-rate mortgages comprised more than 80 percent of our credit guarantee portfolio. During 2006, interest-only mortgages comprised approximately 16 percent of our purchases and, at December 31, 2006, comprised approximately 5 percent of the total credit guarantee portfolio. Mortgages with optional payment terms, referred to as "option ARMs," comprised approximately 2 percent of purchases and approximately 1 percent of our total credit guarantee portfolio. We generally seek higher compensation for the additional credit risk inherent in these products; however, our ability to do so has been limited due to competition for this business.

Summary of 2006 Financial Results

GAAP Results

Net income was \$2.2 billion in 2006, up 4 percent compared to \$2.1 billion in 2005. In 2006, diluted earnings per common share increased by \$0.09 reflecting the increase in net income and the reduction in the diluted weighted average number of common shares outstanding, arising from our repurchase of approximately 32.7 million common shares during the year, partially offset by an increase in preferred dividends associated with our issuance of \$1.5 billion in new preferred stock. Pre-tax income declined by \$0.5 billion to \$2.1 billion in 2006 from \$2.6 billion in 2005.

Net interest income declined to \$4.2 billion in 2006 from \$5.4 billion in 2005. While our Retained portfolio declined slightly year-over-year, the average balance of our interest-earning assets increased, as did the related average yields. Notwithstanding this improvement, net interest income declined as we replaced, at higher contractual interest rates, approximately \$129 billion in long-term debt, which either matured or was repurchased during 2006.

Derivative gains (losses), a component of non-interest income, includes another component of our investment returns; interest received or paid on interest rate swaps. In 2006, we recognized \$92 million of interest income, as compared to \$337 million of interest expense in 2005, an improvement of \$429 million. This change primarily resulted from the impact of rising short-term interest rates, and partially offset the reduction in net interest income discussed above.

Management and guarantee income increased to \$1.7 billion in 2006 from \$1.5 billion in 2005; however, our contractual guarantee fee rate declined modestly as the average balance of outstanding PCs increased by approximately 15 percent during 2006.

Total non-interest expenses were unchanged year over year at \$3.0 billion. Administrative expenses increased slightly to \$1.6 billion in 2006 from \$1.5 billion in 2005, primarily due to higher professional services costs related to improving technology and our internal control over financial reporting. Our administrative expenses declined as a percent of the average total mortgage portfolio to 9.3 basis points from 9.7 basis points in 2005.

In 2006 and 2005, our provision for credit losses was \$215 million and \$251 million, respectively. The provision for credit losses in 2005 included \$128 million related to properties affected by Hurricane Katrina, of which we reversed \$82 million in 2006 because the related payment and delinquency experience on affected properties was better than expected. Absent the adjustments related to Hurricane Katrina in both years, from 2005 to 2006 our provision for credit losses increased by \$174 million due to credit deterioration in our single-family credit guarantee portfolio as more loans transitioned through delinquency to foreclosure and the expected severity of losses on a per-property basis increased, driven

in part by slower home price appreciation in certain areas. Consistent with this trend, our REO expenses increased to \$60 million in 2006 from \$40 million in 2005.

Net charge-offs for 2006 increased to \$147 million, representing approximately 1.0 basis point of our average credit guarantee portfolio, compared with \$109 million for 2005, representing approximately 0.8 basis points. The increase in net charge-offs primarily relates to a regional economic downturn affecting properties in the North Central region of the U.S.

We reported an income tax benefit for 2006 of \$108 million as compared with income tax expense of \$367 million in 2005. In 2006, we reduced our tax reserves by \$174 million as a result of a favorable U.S. Tax Court decision and a separate Internal Revenue Service settlement. Our negative effective tax rate in 2006, and the decrease in our effective tax rate over the past three years, also resulted from declines in pre-tax income, year-over-year increases in tax credits related to our investments in low-income housing tax credit partnerships and interest earned on tax-exempt housing related securities.

Capital Management

Our primary objective in managing capital is preserving our safety and soundness. We also seek to have sufficient capital to support our business and mission. As appropriate, we will consider opportunities to return excess capital to stockholders and to optimize our capital structure. At December 31, 2006, our estimated regulatory core capital was \$36.2 billion, with an estimated regulatory minimum capital surplus of \$10.3 billion, and an estimated \$2.6 billion in excess of the 30 percent mandatory target capital surplus.

During 2006, we repurchased \$2.0 billion of outstanding shares of common stock and issued \$1.5 billion of non-cumulative, perpetual preferred stock in connection with a plan to replace \$2.0 billion of common stock with an equal amount of preferred stock. During the first quarter of 2007, we issued \$1.1 billion of non-cumulative, perpetual preferred stock, including \$500 million to complete the planned issuance described above and \$600 million to replace higher-cost preferred stock that we redeemed in 2007. Also, during the first quarter of 2007 we received approval from OFHEO and our board of directors to repurchase up to an additional \$1 billion in common stock in conjunction with the issuance of up to \$1 billion in preferred stock.

Our board of directors approved a dividend per common share of \$0.50 for the fourth quarter of 2006, an increase of 6 percent over the \$0.47 per share common dividend paid for the first three quarters of 2006. On March 2, 2007, our board of directors declared a dividend per common share of \$0.50 for the first quarter of 2007.

Fair Value Results

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

In 2006, the fair value of net assets attributable to common stockholders, before capital transactions, increased by \$2.5 billion, resulting in a return on the average fair value of net assets attributable to common stockholders of approximately 9.5 percent, compared to a \$1.0 billion increase, or 3.7 percent return, in 2005. In addition, the payment of common dividends and the repurchase of common shares reduced total fair value by \$3.3 billion. The fair value of net assets attributable to common stockholders as of December 31, 2006 was \$26.0 billion, compared to \$26.8 billion as of December 31, 2005.

Our attribution of changes in the fair value of net assets relies on models, assumptions, and other measurement techniques that will evolve over time. The following attribution of changes in fair value is our current estimate of the items presented (on a pre-tax basis) and excludes the effect of returns on capital and administrative expenses.

Our investment activities contributed to the increase in fair value by an estimated \$1.3 billion in 2006. This estimate includes reductions in fair value of approximately \$0.9 billion attributable to the net widening of mortgage-to-debt option-adjusted spreads, or OAS. In 2006, asset-liability management returns and other market conditions did not meaningfully add to fair value results on the Retained portfolio, which remained generally consistent with 2005 levels.

Our investment activities increased fair value by an estimated \$0.5 billion in 2005. This estimate includes reductions in fair value of approximately \$2.7 billion attributable to the net widening of OAS. In 2005, asset-liability management returns and other market conditions added significantly to core spread results.

Our credit guarantee activities increased fair value by an estimated \$1.9 billion in 2006, including a \$0.3 billion increase attributable to reduced estimates of the impact of Hurricane Katrina. During 2005, our credit guarantee activities increased fair value by an estimated \$1.1 billion, which included a reduction in fair value of approximately \$1.2 billion related to the change in valuation methodology on our Guarantee asset and Guarantee obligation and a \$0.4 billion decrease attributable to 2005 estimates of the impact of Hurricane Katrina.

During 2006, we recognized a more significant mark-to-market decline in our existing credit guarantee portfolio due to the effect of credit deterioration and increased market risk premiums on our Guarantee obligation. In addition, we estimate that the fair value of new business entered into during 2006 was lower than the fair value of new business entered into during 2005.

We revised the method we previously used to report the impact that changes in OAS have on fair value results. This methodology change had no impact on the actual change in the fair value of net assets, only our attribution of that change. This change was made in order to more closely align the process we use to report the impact of changes in OAS with the interest-rate risk management framework of our investment activities. See “CONSOLIDATED FAIR VALUE BALANCE SHEETS ANALYSIS — Discussion of Fair Value Results — *How we estimate the impact of changes in mortgage-to-debt OAS on fair value results,*” for additional information about this change.

Business Outlook

Portfolio Growth and Credit

We expect that the amount of U.S. residential mortgage debt outstanding will continue to rise in 2007, at a rate more in line with an expected long-term growth projection of 7.0 to 9.5 percent. While our Total mortgage portfolio should benefit from continued growth in mortgage debt outstanding, we expect that our GSE and total securitization market shares will be under pressure in 2007 as our primary competitors bid for mortgages and there is continued consolidation in the mortgage lending business. We will manage the Retained portfolio in accordance with the voluntary temporary growth limit until we resume producing and publicly releasing quarterly financial statements prepared in conformity with GAAP.

We expect near-term credit losses to rise while still remaining below longer-term historical levels, as home price appreciation slows.

Fair Value Returns

We expect to achieve long-term returns, before capital transactions, on the average fair value of net assets attributable to common stockholders in the low-to mid-teens, although period-to-period returns may fluctuate substantially due to market conditions. These long-term expectations are based on assumptions regarding rates of growth in our business, spreads that we expect to earn and a return over a period of years to capital levels consistent with current statutory requirements, among other factors. Our assumptions do not contemplate that the challenging market conditions and competitive pressures we are currently experiencing will continue through the next several years. We have also made no assumptions regarding any potential impact of pending legislation or regulatory actions, discussed more extensively in “Legislative and Regulatory Matters.” Our actual results may differ materially from these expectations.

Capital Management

Management expects to initiate a common stock repurchase in conjunction with the issuance of preferred stock under the new \$1 billion authorization from time to time depending on market conditions.

Financial Reporting

An important milestone for our return to quarterly reporting will be the progress achieved in the remediation of internal controls and implementation of new accounting systems. Throughout 2007, we will evaluate our remediation progress each quarter to determine whether we have reduced the risk of a material misstatement. It is our objective to resume quarterly financial reporting in the second half of 2007. See “RISK MANAGEMENT — Operational Risks — *Internal Control Over Financial Reporting*” and “RISK FACTORS — Business and Operational Risks.”

Risk Management

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

Operational Risks — Internal Control Over Financial Reporting

In 2006, we continued working on initiatives to improve our financial reporting infrastructure and remediate material weaknesses and other deficiencies in our internal controls. Although we have made substantial progress on our plan, we

continue to have a significant number of material weaknesses and other internal control deficiencies that have not been fully remediated and considerable challenges remain.

Interest-Rate Risk

Our interest-rate risk remains low. For 2006, PMVS-L and duration gap averaged 1 percent and zero months, respectively.

Credit Risk

See “RISK MANAGEMENT — Credit Risks” for information about our credit risks and our strategies for managing them.

Legislative and Regulatory Matters

We face a highly uncertain regulatory environment in light of GSE regulatory oversight legislation currently under consideration in Congress. We generate a significant portion of our net income through our Retained portfolio. Currently, we have in place a voluntary temporary growth limit on our Retained portfolio. GSE regulatory oversight legislation under consideration in the House of Representatives would give our regulator substantial authority to regulate the amount and composition of our portfolio investments and to require substantial reductions in those investments. This legislation also includes provisions that would increase the regulator’s authority to require us to maintain higher minimum and risk-based capital levels and, for 2007 through 2011, require us to make an annual contribution to an affordable housing fund in an amount equal to 1.2 basis points of our average total mortgage portfolio. See “REGULATION AND SUPERVISION — GSE Regulatory Oversight Legislation” for more information regarding this bill. We cannot predict the prospects for the enactment, timing or content of any final legislation. The provisions of this legislation, individually and in certain combinations, could have a material adverse effect on our ability to fulfill our mission, future earnings, stock price and stockholder returns, the rate of growth in our fair value, and our ability to recruit qualified officers and directors.

CONSOLIDATED RESULTS OF OPERATIONS

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

Table 7 — Summary Consolidated Statements of Income

	Year Ended December 31,		
	2006	2005	2004
	(in millions)		
Net interest income	\$4,235	\$5,370	\$9,137
Non-interest income (loss):			
Management and guarantee income	1,672	1,450	1,382
Gains (losses) on Guarantee asset	(800)	(1,064)	(1,135)
Income on Guarantee obligation	867	920	732
Derivative gains (losses)	(1,164)	(1,357)	(4,475)
Hedge accounting gains (losses)	2	22	743
Gains (losses) on investment activity	(474)	(127)	(348)
Gains (losses) on debt retirement	466	206	(327)
Other	346	149	389
Non-interest income (loss)	<u>915</u>	<u>199</u>	<u>(3,039)</u>
Non-interest expense:			
Administrative expenses	(1,641)	(1,535)	(1,550)
Other	(1,406)	(1,478)	(821)
Non-interest expense	<u>(3,047)</u>	<u>(3,013)</u>	<u>(2,371)</u>
Income before income tax expense and cumulative effect of change in accounting principle	2,103	2,556	3,727
Income tax benefit (expense)	108	(367)	(790)
Net income before cumulative effect of change in accounting principle, net of taxes	2,211	2,189	2,937
Cumulative effect of change in accounting principle, net of tax	—	(59)	—
Net income	<u>\$2,211</u>	<u>\$2,130</u>	<u>\$2,937</u>

Net Interest Income

Table 8 summarizes our Net interest income and net interest yield and provides an attribution of changes in annual results to changes in interest rates or changes in volumes of our interest-earning assets and interest-bearing liabilities. Average balance sheet information is presented because we believe end-of-period balances are not representative of activity throughout the periods presented. For most components of the average balances, a daily weighted average balance was calculated for the period. When daily weighted average balance information was not available, a simple monthly average balance was calculated.

Table 8 — Average Balance, Net Interest Income and Rate/Volume Analysis

	Year Ended December 31,								
	2006			2005			2004		
	Average Balance ⁽¹⁾⁽²⁾	Interest Income (Expense) ⁽¹⁾	Average Rate	Average Balance ⁽¹⁾⁽²⁾	Interest Income (Expense) ⁽¹⁾	Average Rate	Average Balance ⁽¹⁾⁽²⁾	Interest Income (Expense) ⁽¹⁾	Average Rate
	(dollars in millions)								
Interest-earning assets:									
Mortgage loans ⁽³⁾⁽⁴⁾	\$ 63,870	\$ 4,152	6.50%	\$ 61,248	\$ 4,037	6.59%	\$ 61,576	\$ 4,007	6.51%
Mortgage-related securities	650,059	34,673	5.33	611,452	29,684	4.85	590,213	28,460	4.82
Total Retained portfolio	713,929	38,825	5.44	672,700	33,721	5.01	651,789	32,467	4.98
Investments ⁽⁵⁾	57,705	2,789	4.83	53,252	1,773	3.33	81,833	2,716	3.32
Securities purchased under agreements to resell and Federal funds sold	28,577	1,473	5.15	25,344	833	3.28	29,996	420	1.40
Total interest-earning assets	<u>\$800,211</u>	<u>\$ 43,087</u>	5.38	<u>\$751,296</u>	<u>\$ 36,327</u>	4.83	<u>\$763,618</u>	<u>\$ 35,603</u>	4.66
Interest-bearing liabilities:									
Short-term debt	\$179,882	\$ (8,665)	(4.82)	\$192,497	\$ (6,102)	(3.17)	\$205,072	\$ (2,908)	(1.42)
Long-term debt ⁽⁶⁾	587,978	(28,218)	(4.80)	524,270	(23,246)	(4.43)	530,816	(22,950)	(4.32)
Total debt securities	767,860	(36,883)	(4.80)	716,767	(29,348)	(4.09)	735,888	(25,858)	(3.51)
Due to Participation Certificate investors	7,475	(387)	(5.18)	10,399	(551)	(5.30)	12,401	(708)	(5.71)
Total interest-bearing liabilities	775,335	(37,270)	(4.81)	727,166	(29,899)	(4.11)	748,289	(26,566)	(3.55)
Income (expense) related to derivatives		(1,582)	(0.20)		(1,058)	(0.15)		100	0.01
Impact of net non-interest-bearing funding	24,876	—	0.16	24,130	—	0.14	15,329	—	0.07
Total funding of interest-earning assets	<u>\$800,211</u>	<u>\$(38,852)</u>	(4.85)	<u>\$751,296</u>	<u>\$(30,957)</u>	(4.12)	<u>\$763,618</u>	<u>\$(26,466)</u>	(3.47)
Net interest income/yield	\$ 4,235	0.53		\$ 5,370	0.71		\$ 9,137	1.20	
Fully taxable-equivalent adjustments ⁽⁷⁾	392	0.05		339	0.05		267	0.03	
Net interest income/yield (fully taxable-equivalent basis)	<u>\$ 4,627</u>	0.58%		<u>\$ 5,709</u>	0.76%		<u>\$ 9,404</u>	1.23%	
	2006 vs. 2005 Variance			2005 vs. 2004 Variance					
	Due to			Due to					
	Rate⁽⁸⁾	Volume⁽⁸⁾	Total Change	Rate⁽⁸⁾	Volume⁽⁸⁾	Total Change			
	(in millions)								
Interest-earning assets:									
Mortgage loans	\$ (56)	\$ 171	\$ 115	\$ 51	\$ (21)	\$ 30			
Mortgage-related securities	3,042	1,947	4,989	194	1,030	1,224			
Total Retained portfolio	2,986	2,118	5,104	245	1,009	1,254			
Investments	857	159	1,016	9	(952)	(943)			
Securities purchased under agreements to resell and Federal funds sold	523	117	640	487	(74)	413			
Total interest-earning assets	<u>\$ 4,366</u>	<u>\$ 2,394</u>	<u>\$ 6,760</u>	<u>\$ 741</u>	<u>\$ (17)</u>	<u>\$ 724</u>			
Interest-bearing liabilities:									
Short-term debt	\$(2,986)	\$ 423	\$(2,563)	\$(3,383)	\$ 189	\$(3,194)			
Long-term debt	(2,008)	(2,964)	(4,972)	(581)	285	(296)			
Total debt securities	(4,994)	(2,541)	(7,535)	(3,964)	474	(3,490)			
Due to Participation Certificate investors	12	152	164	48	109	157			
Total interest-bearing liabilities	(4,982)	(2,389)	(7,371)	(3,916)	583	(3,333)			
Income (expense) related to derivatives	(524)	—	(524)	(1,158)	—	(1,158)			
Total funding of interest-earning assets	<u>\$(5,506)</u>	<u>\$(2,389)</u>	<u>\$(7,895)</u>	<u>\$(5,074)</u>	<u>\$ 583</u>	<u>\$(4,491)</u>			
Net interest income	\$(1,140)	\$ 5	\$(1,135)	\$(4,333)	\$ 566	\$(3,767)			
Fully taxable-equivalent adjustments	30	23	53	76	(4)	72			
Net interest income (fully taxable-equivalent basis)	<u>\$(1,110)</u>	<u>\$ 28</u>	<u>\$(1,082)</u>	<u>\$(4,257)</u>	<u>\$ 562</u>	<u>\$(3,695)</u>			

- (1) Excludes mortgage loans and mortgage-related securities traded, but not yet settled.
- (2) For securities classified as available-for-sale, we calculated average balances based on their unpaid principal balance plus their associated deferred fees and costs (e.g., premiums and discounts), but excluded the effects of mark-to-fair-value changes. For securities in the Retained portfolio classified as trading, we calculated average balances excluding their mark-to-fair-value adjustments. For securities in the Cash and investments portfolio classified as trading during 2004, we calculated average balances based on their fair values.
- (3) Non-accrual loans are included in average balances.
- (4) Loan fees included in mortgage loan interest income were \$280 million, \$371 million and \$223 million for the years ended December 31, 2006, 2005 and 2004, respectively.
- (5) For 2006 and 2005, Investments consisted of Cash and cash equivalents and non-mortgage-related securities. For 2004, Investments also included Mortgage-related securities held in the Cash and investments portfolio.
- (6) Includes current portion of long-term debt. See "NOTE 8: DEBT SECURITIES AND SUBORDINATED BORROWINGS" to our consolidated financial statements for a reconciliation of Senior debt, due within one year on our consolidated balance sheets.
- (7) The determination of Net interest income/yield (fully taxable-equivalent basis), which reflects fully taxable-equivalent adjustments to interest income, involves the conversion of tax-exempt sources of interest income to the equivalent amounts of interest income that would be necessary to derive the same net return if the investments had been subject to income taxes using our statutory tax rate of 35 percent.
- (8) Rate and volume changes are calculated on the individual financial statement line item level. Combined rate/volume changes were allocated to the individual rate and volume change based on their relative size.

Table 9 summarizes components of our Net interest income.

Table 9 — Net Interest Income

	Year Ended December 31,		
	2006	2005 ⁽¹⁾ (in millions)	2004 ⁽¹⁾
Contractual amounts of Net interest income	\$ 8,059	\$ 8,897	\$11,735
Amortization expense, net: ⁽²⁾			
Asset-related amortization expense, net	(639)	(1,023)	(1,397)
Debt-related amortization expense, net	(1,603)	(1,446)	(1,301)
Total amortization expense, net	(2,242)	(2,469)	(2,698)
Income (expense) related to derivatives:			
Amortization of deferred balances in Accumulated other comprehensive income ⁽³⁾	(1,620)	(1,966)	(1,814)
Accrual of periodic settlements of derivatives: ⁽⁴⁾			
Pay-fixed swaps	—	—	(427)
Receive-fixed swaps ⁽⁵⁾	502	1,185	1,968
Foreign-currency swaps	(464)	(277)	376
Other	—	—	(3)
Total accrual of periodic settlements of derivatives	38	908	1,914
Total income (expense) related to derivatives	(1,582)	(1,058)	100
Net interest income	4,235	5,370	9,137
Fully taxable-equivalent adjustments	392	339	267
Net interest income (fully taxable-equivalent basis)	<u>\$ 4,627</u>	<u>\$ 5,709</u>	<u>\$ 9,404</u>

(1) Certain amounts for 2005 and 2004 have been revised to conform with the 2006 presentation.

(2) Represents amortization related to premiums, discounts, deferred fees and other adjustments to the carrying value of our financial instruments and the reclassification of previously deferred balances from Accumulated other comprehensive income, or AOCI, for certain derivatives in cash flow hedge relationships related to individual debt issuances and mortgage purchase transactions.

(3) Represents changes in fair value of derivatives in cash flow hedge relationships that were previously deferred in AOCI and have been reclassified to earnings as the associated hedged forecasted issuance of debt and mortgage purchase transactions affect earnings.

(4) Reflects the accrual of periodic cash settlements of all derivatives in qualifying hedge accounting relationships.

(5) The accrual of periodic settlements of Receive-fixed swaps includes imputed interest on zero-coupon swaps.

2006 versus 2005

Net interest income and net interest yield on a fully taxable-equivalent basis decreased in 2006 as spreads on fixed-rate investments continued to narrow, driven by increases in long- and medium-term interest rates. The increase in our long-term debt interest costs reflects the turnover of medium-term debt that we issued during the past few years to fund our investments in fixed-rate mortgage-related investments when the yield curve was steep (*i.e.* short- and medium-term interest rates were low as compared to long-term interest rates). As the yield curve flattened during 2005 and 2006, we experienced increased funding costs associated with replacing maturing lower-cost debt used to fund existing fixed-rate mortgage investments. During 2006, net interest margins declined as a result of changes in interest rates on variable-rate assets acquired in 2004 and 2005 impacted our results. Also, we adjusted our funding mix in 2006 by increasing the proportion of callable debt outstanding, which we use to manage prepayment risk associated with our mortgage-related investments, and which generally has a higher interest cost than non-callable debt. In 2006, we considered the issuance of callable debt to be more cost effective than alternative interest-rate risk management strategies, primarily the issuance of non-callable bullet debt combined with the use of derivatives. We also reduced the balance of our short-term debt securities to approximately 23 percent of total outstanding debt as of December 31, 2006, from approximately 26 percent at the beginning of the year, to take advantage of the attractive funding spreads relative to LIBOR on our long-term debt. The impact of rising short-term rates on our short-term debt was largely offset by the impact of rising rates on our variable-rate assets in our Retained portfolio and our Cash and investments portfolio.

Net interest income for 2006 also reflected lower net interest income on derivatives in qualifying hedge accounting relationships. Net interest income associated with the accrual of periodic settlements declined as the benchmark LIBOR and the Euro Interbank Offered Rate, or Euribor, interest rates increased during the year, adversely affecting net settlements on our receive-fixed swaps and foreign-currency swaps (primarily Euro-denominated). Net interest income was also affected by our decisions in March and December 2006 to discontinue hedge accounting treatment for a significant amount of our receive-fixed swaps and foreign-currency swaps, as discussed in “NOTE 12: DERIVATIVES” to our consolidated financial statements. The net interest expense related to these swaps is no longer a component of Net interest income, after hedge accounting was discontinued, but instead is recognized as a component of Derivative gains (losses). By the end of 2006, nearly all of our derivatives were not in hedge accounting relationships.

Effective January 1, 2006, we enhanced our process for forecasting interest rates and estimating prepayments used to amortize discounts, premiums and deferred fees for assets held in the Retained portfolio. This change in estimate resulted in a \$93 million pre-tax reduction in Net interest income on mortgage-related securities.

Enhancements to certain models used to estimate prepayment speeds on mortgage-related securities and our approach for estimating uncollectible interest on single-family mortgages greater than 90 days delinquent resulted in a net decrease in Retained portfolio interest income of \$166 million (pre-tax) during the first quarter of 2005.

2005 versus 2004

Net interest income and net interest yield on a fully taxable-equivalent basis decreased in 2005 due to narrowing spreads on fixed-rate assets as the yield curve flattened and the composition of our Retained portfolio changed toward a greater percentage of lower-yielding, variable-rate assets.

The decline in Net interest income for 2005 also reflected higher interest expense on derivatives in qualifying hedge accounting relationships. Net interest income associated with the accrual of periodic settlements related to our receive-fixed swaps and foreign-currency swaps declined as the benchmark LIBOR interest rate increased. Net interest income was also affected by our decision in 2004 to discontinue hedge accounting treatment for a significant amount of our pay-fixed swaps and receive-fixed swaps, as discussed in “NOTE 12: DERIVATIVES” to our consolidated financial statements. The net interest expense related to these swaps was no longer a component of Net interest income after hedge accounting was discontinued, but was recognized as a component of Non-interest income (loss) in Derivative gains (losses).

Another factor in the decline in Net interest income for 2005 was our decision to cease the PC market-making and support activities conducted through our Securities Sales and Trading Group, or SS&TG, business unit and our external Money Manager program during the fourth quarter of 2004. By the end of 2004, we divested the trading portfolios related to our SS&TG business unit and our external Money Manager program in the Investments portfolio. This divestiture reduced the interest expense for funding the Investments portfolio as well as the hedging costs associated with it, which were reflected in Gains (losses) on investment activity. Our investments in mortgage-related securities held by our SS&TG business unit and external Money Manager program were generally hedged by entering into forward sales of mortgage-related securities. For 2004, the valuation difference between the trading securities and the related forward sale commitments resulted in a loss of \$1,101 million in Gains (losses) on investment activity that was offset by Net interest income on the held position.

Non-Interest Income (Loss)

Management and Guarantee Income

Table 10 provides summary information about Management and guarantee income. Management and guarantee income consists of contractual amounts due to us related to our management and guarantee fee as well as amortization of certain pre-2003 deferred fees, including credit and buy-down fees. Other guarantee-related revenue is deferred and recognized over time as a component of Income on Guarantee obligation.

Table 10 — Management and Guarantee Income⁽¹⁾

	Year Ended December 31,					
	2006		2005		2004	
	Amount	Rate	Amount	Rate	Amount	Rate
	(dollars in millions, rate in basis points)					
Contractual management and guarantee fees	\$1,613	15.4	\$1,431	15.7	\$1,303	16.5
Amortization of credit and buy-down fees included in Other liabilities ⁽²⁾	59	0.6	19	0.2	79	1.0
Total management and guarantee income	<u>\$1,672</u>	<u>16.0</u>	<u>\$1,450</u>	<u>15.9</u>	<u>\$1,382</u>	<u>17.5</u>
Unamortized balance of credit and buy-down fees included in Other liabilities, at period end	\$ 136		\$ 186		\$ 323	

(1) Excludes amounts related to PCs we held in our Retained portfolio, which are reported in Net interest income.

(2) A change in estimate resulted in a net pre-tax increase (decrease) in the Amortization of credit and buy down fees of \$18 million and \$(17) million for 2006 and 2005, respectively. See “NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES” to our consolidated financial statements for further information.

Management and guarantee income increased in both 2006 and 2005, primarily reflecting increases in the average outstanding PC balances of 15 percent in each year. The average contractual management and guarantee fee rate decreased in both years from the prior years, reflecting lower guarantee fee rates on new business and the liquidation of existing business with relatively higher guarantee fee rates. The continued decline in guarantee fee rates on new business is the result of competitive pricing pressures. Management and guarantee income includes the amortization of pre-2003 deferred credit fees and buy-down fees on our outstanding PCs. However, similar fees received after January 1, 2003 are primarily deferred and recognized over time as a component of Income on Guarantee obligation.

Gains (Losses) on Guarantee Asset

Upon issuance of a guarantee of securitized assets, we may record a Guarantee asset on our consolidated balance sheets representing the fair value of the guarantee fees we expect to receive over the life of the related PCs and Structured

Securities. Subsequent changes in the fair value of the Guarantee asset are reported in current period income as Gains (losses) on Guarantee asset.

The change in fair value of the Guarantee asset reflects:

- reductions related to the contractual guarantee fees due that are considered a return of our recorded investment in the Guarantee asset; and
- changes in the fair value of expected future guarantee fees we expect to receive over the life of the related PC or Structured Security.

As shown on “Table 11 — Attribution of Change — Gains (Losses) on Guarantee Asset,” contractual guarantee fees due represent Management and guarantee income realized in the current period related to PCs and Structured Securities held by third parties with an established Guarantee asset. A portion of contractual guarantee fees due is attributed to imputed interest income on the Guarantee asset.

The fair value of expected future cash flows is driven by changes in the expected interest and related discount rates that affect the estimated life of the mortgages underlying the outstanding PCs and Structured Securities and other economic factors that influence the amount and timing of the future cash flows. Our valuation methodology for the Guarantee asset, first implemented for 2005, uses market-based information to determine the fair value of future cash flows associated with the Guarantee asset. Changes in the fair value of the Guarantee asset, which are recorded in current period earnings through Gains (losses) on Guarantee asset, reflect the volatility associated with the market-based inputs used in our valuation. Changes in the estimated lives of the underlying mortgages also affect the fair value of the Guarantee asset. See “CONSOLIDATED BALANCE SHEETS ANALYSIS — Table 25 — Changes in Guarantee Asset” for additional information about the Guarantee asset.

Table 11 — Attribution of Change — Gains (Losses) on Guarantee Asset

	Year Ended December 31,		
	2006	2005	2004
	(in millions)		
Contractual guarantee fees due	\$ (1,475)	\$ (1,270)	\$ (1,086)
Portion of contractual guarantee fees due related to imputed interest income	466	371	257
Return of investment on Guarantee asset	(1,009)	(899)	(829)
Change in fair value of future cash flows	169	(138)	(306)
Change in estimate ⁽¹⁾	40	(27)	—
Gains (losses) on Guarantee asset	<u>\$ (800)</u>	<u>\$ (1,064)</u>	<u>\$ (1,135)</u>

(1) Represents a change in estimate resulting from enhancing our approach for determining the fair value of the Guarantee asset. See “NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES” to our consolidated financial statements for further information.

The reduction in our Guarantee asset attributable to the Return of investment on Guarantee asset increased during 2006, 2005 and 2004. The Return of investment on Guarantee asset increased as the outstanding PCs and Structured Securities have grown each year.

Losses on the Guarantee asset decreased in 2006 as compared with 2005, due to increases in the fair value of the Guarantee asset consistent with the increase in mortgage interest rates during the year, which generally extends the life of the Guarantee asset. Losses on the Guarantee asset decreased in 2005 as compared with 2004, reflecting the increase in mortgage interest rates during the year offset by the effect of the change in our valuation method.

Income on Guarantee Obligation

Upon issuance of a guarantee of securitized assets, we record a Guarantee obligation on our consolidated balance sheets representing the fair value of our obligation to perform under the terms of the guarantee. The Guarantee obligation consists of the following:

- performance and other related costs, which consist of: estimated default costs, including the unrecoverable principal and interest that will be incurred over the expected life of the underlying mortgages; estimated foreclosure-related costs; and estimated administrative and other costs related to our guarantee; and
- deferred guarantee income on newly-issued Guarantor Swap transactions, which represents the excess of compensation received on issued guarantees and the fair value of the related Guarantee asset, as compared to the fair value of the corresponding Guarantee obligation. Compensation received includes cash, credit and buy-down fees received at the time of securitization. Credit fees vary with the relative credit quality of the underlying mortgages and buydown fees vary based on customer compensation payment preferences.

The Guarantee obligation is amortized into income in relation to the decline in the unpaid principal balance on the mortgage loans underlying the PCs and Structured Securities.

Table 12 provides information about the components of Income on Guarantee obligation.

Table 12 — Income on Guarantee Obligation

	Year Ended December 31,		
	2006	2005	2004
	(in millions)		
Amortization income related to:			
Performance and other related costs	\$ 584	\$ 616	\$ 537
Deferred guarantee income	283	304	195
Income on Guarantee obligation ⁽¹⁾	<u>\$ 867</u>	<u>\$ 920</u>	<u>\$ 732</u>
Components of the Guarantee obligation, at period end:			
Unamortized balance of performance and other related costs	\$4,869	\$3,743	\$2,738
Unamortized balance of deferred guarantee income	2,248	1,798	1,327
Ending Guarantee obligation ⁽²⁾	<u>\$7,117</u>	<u>\$5,541</u>	<u>\$4,065</u>
Liquidation rate for outstanding PCs and Structured Securities	17%	24%	29%

(1) Includes \$170 million, \$197 million and \$128 million of amortization related to deferred credit and buydown fees received from counterparties in Guarantor Swap and similar transactions, or “upfront fees,” at December 31, 2006, 2005 and 2004, respectively.

(2) Includes \$1,391 million, \$1,167 million and \$940 million of unamortized upfront fees at December 31, 2006, 2005 and 2004, respectively.

In 2006, Income on Guarantee obligation decreased as increasing mortgage interest rates resulted in lower liquidation rates on outstanding PCs and Structured Securities and lower rates of amortization. In 2005, Income on Guarantee obligation increased as compared with 2004 as the additions to the Guarantee obligation from new business more than offset the impact of lower PC and Structured Security liquidation rates caused by increases in mortgage interest rates. During 2006 and 2005, the growth in unamortized balances reflects the increase in our portfolio of outstanding PCs and Structured Securities and increased expected credit costs associated with newly-issued guarantees.

Derivative Overview

Table 13 presents the notional amount for each of our hedge accounting classifications and the corresponding impact of those positions on our consolidated financial statements.

Table 13 — Summary of the Effect of Derivatives on Selected Consolidated Financial Statement Captions

Description	Consolidated Balance Sheets					
	December 31, 2006			December 31, 2005		
	Notional Amount	Fair Value (Pre-Tax) ⁽¹⁾	AOCI (Net of Taxes) ⁽²⁾	Notional Amount	Fair Value (Pre-Tax) ⁽¹⁾	AOCI (Net of Taxes) ⁽²⁾
(in millions)						
Fair value hedges-open	\$ —	\$ —	\$ —	\$115,146	\$3,402	\$ —
Cash flow hedges-open	70	—	—	668	(26)	4
No hedge designation	757,127	7,729	—	567,558	3,131	—
Subtotal	757,197	7,729	—	683,372	6,507	4
Balance related to closed cash flow hedges	—	—	(5,033)	—	—	(6,291)
Total	<u>\$757,197</u>	<u>\$7,729</u>	<u>\$(5,033)</u>	<u>\$683,372</u>	<u>\$6,507</u>	<u>\$(6,287)</u>
Description	Consolidated Statements of Income					
	2006			2005		
	Derivative Gains (Losses)	Hedge Accounting Gains (Losses) ⁽³⁾	Derivative Gains (Losses)	Hedge Accounting Gains (Losses) ⁽³⁾	Derivative Gains (Losses)	Hedge Accounting Gains (Losses) ⁽³⁾
(in millions)						
Fair value hedges-open ⁽⁴⁾	\$ —	\$ 2	\$ —	\$22	\$ —	\$742
Cash flow hedges-open ⁽⁴⁾⁽⁵⁾	—	—	(25)	—	2	1
No hedge designation	(1,164)	—	(1,332)	—	(4,477)	—
Total	<u>\$(1,164)</u>	<u>\$ 2</u>	<u>\$(1,357)</u>	<u>\$22</u>	<u>\$(4,475)</u>	<u>\$743</u>

(1) The fair values of derivatives (netted by counterparty) are presented as Derivative assets, at fair value, and Derivative liabilities, at fair value, on our consolidated balance sheets.

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

(3) Hedge accounting gains (losses) arise when the fair value change of a derivative does not exactly offset the fair value change of the hedged item attributable to the hedged risk. For further information, see “Hedge Accounting Gains (Losses)” below and “NOTE 12: DERIVATIVES” to our consolidated financial statements.

(4) For all derivatives in qualifying hedge accounting relationships, the accrual of periodic cash settlements is recorded in Net interest income on our consolidated statements of income and those amounts are not included in the table. For derivatives not in qualifying hedge accounting relationships, the accrual of periodic cash settlements is recorded in Derivative gains (losses) on our consolidated statements of income.

(5) Derivative gains (losses) in each period include gains or losses reclassified from AOCI, net of taxes, as a result of the termination of cash flow hedge designations because we determined that the related forecasted transaction is probable of not occurring.

Over the course of 2006, 2005 and 2004, we discontinued nearly all of our cash flow hedge and fair value hedge accounting relationships. At December 31, 2006, the only derivatives in hedge accounting relationships were certain commitments to forward sell mortgage-related securities, which were designated in cash flow hedge relationships. See “NOTE 12: DERIVATIVES” to our consolidated financial statements for additional information on our discontinuation of hedge accounting treatment. Derivatives that are not in qualifying hedge accounting relationships generally increase the volatility of reported Non-interest income (loss) because the fair value gains and losses on the derivatives are recognized in earnings without the offsetting recognition in earnings of the change in value of the economically hedged exposures.

For derivatives designated in cash flow hedge accounting relationships during 2006 and in prior years, the effective portion of the change in fair value of the derivative asset or derivative liability is presented in the stockholders’ equity section of our consolidated balance sheets in AOCI, net of taxes.

At December 31, 2006 and 2005, the net cumulative change in the fair value of all derivatives designated in cash flow hedge relationships for which the forecasted transactions had not yet affected earnings (net of amounts previously reclassified to earnings through each year end) was a loss of approximately \$5.0 billion and \$6.3 billion, respectively, on an after-tax basis. These amounts relate almost entirely to net deferred losses on closed cash flow hedges. The majority of the closed cash flow hedges relate to hedging the variability of cash flows from forecasted issuances of debt. Fluctuations in prevailing market interest rates have no impact on the deferred portion of AOCI, net of taxes, relating to closed cash flow hedges. The deferred amounts related to closed cash flow hedges will be recognized into earnings as the hedged forecasted transactions affect earnings, unless it becomes probable that the forecasted transactions will not occur. If it is probable that the forecasted transactions will not occur, then the deferred amount associated with the forecasted transactions will be reclassified into earnings immediately.

At December 31, 2006, over 70 percent and 90 percent of the \$5.0 billion net deferred losses in AOCI, net of taxes, relating to cash flow hedges were linked to forecasted transactions occurring in the next 5 and 10 years, respectively. Over the next 10 years, the forecasted debt issuance needs associated with these hedges range from approximately \$21.5 billion to \$104.7 billion in any one quarter, with an average of \$66.2 billion per quarter.

Table 14 presents the scheduled amortization of the net deferred losses in AOCI at December 31, 2006, related to closed cash flow hedges. The scheduled amortization is based on a number of assumptions. Actual amortization will differ from the scheduled amortization, perhaps materially, as we make decisions on debt funding levels or as changes in market conditions occur that differ from these assumptions. For example, for the scheduled amortization for cash flow hedges related to future debt issuances, we assume that we will not repurchase the related debt and that no other factors affecting debt issuance probabilities will change.

Table 14 — Scheduled Amortization to Income of Net Deferred Losses in AOCI Related to Closed Cash Flow Hedge Relationships

<u>Period of Scheduled Amortization to Income</u>	<u>December 31, 2006</u>	
	<u>Amount (Pre-tax)</u>	<u>Amount (After-tax)</u>
	(in millions)	
2007	\$(1,466)	\$ (953)
2008	(1,334)	(867)
2009	(1,109)	(721)
2010	(914)	(594)
2011	(723)	(470)
2012 to 2016	(1,562)	(1,016)
Thereafter	(635)	(412)
Total net deferred losses in AOCI related to closed cash flow hedge relationships	<u>\$(7,743)</u>	<u>\$(5,033)</u>

Derivative Gains (Losses)

Table 15 provides a summary of the period-end notional amounts and the gains and losses related to derivatives that we used to manage interest-rate risk, but that were not accounted for in hedge accounting relationships.

Table 15 — Derivatives Not in Hedge Accounting Relationships

	Year Ended December 31,					
	2006		2005		2004	
	Notional or Contractual Amount	Derivative Gains (Losses)	Notional or Contractual Amount	Derivative Gains (Losses)	Notional or Contractual Amount	Derivative Gains (Losses)
	(in millions)					
Call swaptions	\$194,200	\$ (1,128)	\$146,615	\$ (402)	\$189,945	\$ 386
Put swaptions	29,725	(100)	34,675	202	25,175	(1,423)
Receive-fixed swaps	222,631	(290)	81,185	(1,535)	25,572	(396)
Pay-fixed swaps	217,565	649	181,562	612	95,043	(793)
Futures	22,400	(248)	86,252	63	129,110	(213)
Other ⁽¹⁾	70,606	(139)	37,269	40	157,618	(320)
Subtotal	757,127	(1,256)	567,558	(1,020)	622,463	(2,759)
Accrual of periodic settlements:						
Receive-fixed swaps ⁽²⁾		(418)		426		104
Pay-fixed swaps		541		(763)		(1,826)
Other		(31)		—		6
Total accrual of periodic settlements		92		(337)		(1,716)
Total	<u>\$757,127</u>	<u>\$ (1,164)</u>	<u>\$567,558</u>	<u>\$ (1,357)</u>	<u>\$622,463</u>	<u>\$ (4,475)</u>

(1) Consisted of basis swaps, certain option-based contracts, foreign-currency swaps, interest-rate caps, forward purchase and sale commitments, credit derivatives and swap guarantee derivatives not accounted for in hedge accounting relationships. 2004 and 2005 also included a prepayment management agreement which was terminated effective December 31, 2005.

(2) The accrual of periodic settlements of Receive-fixed swaps includes imputed interest on zero-coupon swaps.

Derivative gains (losses) reflect the change in the fair value of and the accrual of periodic settlements of all derivatives not in hedge accounting relationships. From 2004 through 2006, we experienced significant periodic income volatility due to changes in the fair values of our derivatives and changes in the composition of our portfolio of derivatives not in hedge accounting relationships.

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

During 2006, fair value losses on our swaptions increased as implied volatility declined and both long-term and short-term swap interest rates increased. During 2006 and 2005, fair value changes of our pay-fixed and receive-fixed swaps were primarily driven by increases in long-term swap interest rates. An increase in the notional balance of our receive-fixed swaps not in qualifying hedge accounting relationships as a result of our discontinuation of hedge accounting treatment, combined with fluctuations in swap interest rates throughout the year, reduced fair value losses recognized on our receive-fixed swaps during 2006. See "NOTE 12: DERIVATIVES" to our consolidated financial statements for additional information on our discontinuation of hedge accounting treatment.

During 2004, losses on our put swaptions resulted from changes in swap interest rates and a decline in implied volatility of interest rates. Additionally, in 2004, a large portion of our pay-fixed swaps that were not in hedge accounting relationships was scheduled to begin on a future date. The net loss on our pay-fixed swaps in 2004 resulted from the overall decline in forward swap interest rates.

The accrual of periodic settlements for derivatives not in qualifying hedge accounting relationships increased during 2006 compared to 2005 as short-term interest rates increased and the net income due to the receive variable-rate leg of our pay-fixed swaps was only partly offset by the net expense due to the pay variable-rate leg of our receive-fixed swaps.

The expense associated with accrual of periodic settlements for derivatives not in qualifying hedge accounting relationships declined during 2005 compared to 2004 because interest accruals related to our pay-fixed and receive-fixed swaps largely offset one another during 2005, but only did so for the later part of 2004, following the discontinuation of hedge accounting for certain receive-fixed swaps in November 2004.

Hedge Accounting Gains (Losses)

Hedge accounting gains (losses) represent the extent to which differences in the characteristics or terms of a derivative in a hedge accounting relationship and the hedged item result in fair value or cash flow changes that are not exactly offset. Our net hedge ineffectiveness gains in 2006 and 2005 were not significant. Net hedge ineffectiveness gains in 2004 related primarily to fair value hedge accounting relationships where the derivative was valued using forward rates while the hedged debt was valued using spot rates. As discussed in “NOTE 12: DERIVATIVES” to our consolidated financial statements, a substantial portion of our derivatives in fair value hedge accounting relationships was reclassified to no hedge designation during 2004 and 2006.

Gains (Losses) on Investment Activity

Table 16 summarizes the components of Gains (losses) on investment activity.

Table 16 — Gains (Losses) on Investment Activity

	Year Ended December 31,		
	2006	2005	2004
	(in millions)		
Gains (losses) on trading securities	\$ (3)	\$ (289)	\$ (1,071)
Gains (losses) on PC residuals, at fair value	(19)	(95)	58
Gains (losses) on sale of mortgage loans ⁽¹⁾	86	92	209
Gains (losses) on sale of available-for-sale securities	22	546	584
Security impairments:			
Interest-only security impairments	(147)	(71)	(66)
Other security impairments	(393)	(300)	(60)
Total security impairments	(540)	(371)	(126)
Lower-of-cost-or-market adjustments	(20)	(10)	(2)
Total gains (losses) on investment activity	<u>\$ (474)</u>	<u>\$ (127)</u>	<u>\$ (348)</u>

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

Gains (losses) on trading securities

In 2006 and 2005, the increases in long-term interest rates resulted in losses on mortgage-related securities classified as trading. However, these losses were significantly lower in 2006 than in 2005 as interest rates increased less in 2006 than in 2005. The losses in both years were partly offset by gains on interest-only mortgage-related securities classified as trading, which generally increased in fair value as interest rates rose.

Prior to 2005, our trading positions related primarily to our SS&TG business unit and external Money Manager program, both of which ceased operations in the fourth quarter of 2004. The trading activities of our SS&TG business unit resulted in valuation differences, recorded as trading losses, that totaled \$1,101 million in 2004, which were offset by net interest income on the trading securities held. Absent the SS&TG business unit, our trading gains (losses) netted to a \$30 million gain in 2004.

Gains (losses) on PC residuals, at fair value

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

The decrease in net losses on PC residuals in 2006 as compared to 2005 resulted from increasing interest rates in 2006 which increased the expected lives of related PCs and Structured Securities. In 2005, net losses on PC residuals included the effect of changes in the approach we used to estimate the fair values of our guarantee-related assets and liabilities, which resulted in net pre-tax losses of \$78 million in the first quarter of 2005. In 2004, expected default costs declined due to continued home price appreciation and generated gains, partially offset by declines in mortgage interest rates which reduced the estimated fair value of future contractual guarantee fees related to securities we hold.

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

In 2006, gains on sales of available-for-sale securities included net gains of \$188 million related to the sale of certain commercial mortgage-backed securities as discussed in “*Total security impairments.*” These gains were partly offset by net losses due primarily to the increase in interest rates during the year. In 2005, gains on sales of available-for-sale securities declined as the impact of rising interest rates was partly offset by an increase in the volume of securitization activity.

Total security impairments

Total security impairments in 2006, 2005 and 2004 included:

- \$147 million, \$71 million and \$66 million, respectively, related to mortgage-related interest-only securities, primarily due to periodic declines in mortgage interest rates experienced during those years;
- \$332 million, \$115 million and \$60 million, respectively, related to mortgage-related securities where we determined that a decline in fair value below amortized cost was other-than-temporary due to the deterioration of the credit quality of the underlying mortgage loans or because the impairment was interest-rate related and we did not have the intent to hold the security until the loss would be recovered; and
- \$61 million, \$185 million and \$— million, respectively, related to impairments of certain commercial mortgage-backed securities which involved cash flows from mixed pools of multifamily and non-residential commercial mortgages. In December 2005, HUD determined that these mixed-pool investments were not authorized under our charter and OFHEO subsequently directed us to divest these investments, which we did in 2006.

Gains (Losses) on Debt Retirement

We repurchase or call our outstanding debt securities from time to time to help support the liquidity and predictability of the market for our debt securities and to manage our mix of assets and liabilities. When we repurchase outstanding debt, we recognize a gain or loss related to the difference between its fair value and its carrying value, including any remaining unamortized deferred items (*e.g.*, premiums, discounts, issuance costs and hedging-related basis adjustments). When we exercise a call option on our callable debt, we recognize a gain or loss related to the difference between its call price and its carrying value, including any remaining unamortized deferred items.

In 2006 and 2005, we recognized net gains on debt retirements due primarily to the repurchases of outstanding debt trading at attractive prices to take advantage of favorable funding spreads relative to LIBOR on our new debt issuances. In 2004, we recognized net losses on debt retirements due primarily to the repurchase of outstanding debt to help preserve the liquidity and price performance of our debt securities as market interest rates declined, particularly in the early part of the year.

Other Income

Other income increased in 2006 as we recognized net foreign-currency gains on foreign-currency denominated debt as the U.S. dollar strengthened relative to the Euro during December 2006. We actively manage the foreign-currency risk associated with our foreign-currency denominated debt using derivatives, which were designated in fair value hedge accounting relationships until we voluntarily discontinued hedge accounting for those derivatives on December 1, 2006. After that date, we continued to manage our foreign-currency risk; however, translation gains and losses on our foreign-currency denominated debt were recorded in Other income and were substantially offset by net losses we recorded in Derivative gains (losses). In 2005, Other income included approximately \$80 million of expense, net, related to certain errors not material to our consolidated financial statements with respect to income in previously reported periods.

Non-Interest Expense

Table 17 summarizes the components of Non-interest expense.

Table 17 — Non-Interest Expense

	Year Ended December 31,		
	2006	2005	2004
	(in millions)		
Administrative Expenses:			
Salaries and employee benefits	\$ 830	\$ 805	\$ 758
Professional services	460	386	588
Occupancy expense	61	58	60
Other administrative expenses	290	286	144
Total administrative expenses	1,641	1,535	1,550
Provision for credit losses	215	251	143
REO operations (income) expense	60	40	(3)
Losses on certain credit guarantees	476	234	33
Housing tax credit partnerships	407	320	281
Minority interests in earnings of consolidated subsidiaries	58	96	129
Other expenses	190	537	238
Total Non-interest expense	<u>\$3,047</u>	<u>\$3,013</u>	<u>\$2,371</u>

Administrative Expenses

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

In 2006, professional services expense increased as we progressed with various initiatives to improve our financial accounting systems and continued our remediation activities. Professional services expense declined during 2005 in part because we were able to replace consultants with employees, increasing our Salaries and employee benefits expense as a consequence.

Other administrative expenses are presented net of certain expenses that we defer related to software development activities. The net effect of these capitalized software costs, including the write-off of previously capitalized amounts, was an increase (reduction) to Other administrative expenses totaling \$15 million, \$29 million and \$(94) million in 2006, 2005 and 2004, respectively. In addition, Other administrative expenses increased in 2006 and 2005 compared to 2004 as a result of higher OFHEO regulatory assessments associated with its oversight responsibilities and charitable contributions, particularly associated with Hurricane Katrina.

Provision for Credit Losses

The provision for credit losses declined in 2006 as compared with 2005, which included an additional provision of \$128 million for our estimate of incurred losses for loans affected by Hurricane Katrina. In 2006, we reversed \$82 million of the provision for credit losses recorded in 2005 associated with Hurricane Katrina because the related payment and delinquency experience on affected properties was more favorable than expected. Absent the adjustments related to Hurricane Katrina, the provision for credit losses would have been \$297 million, \$123 million and \$143 million in 2006, 2005 and 2004, respectively. We recorded additional reserves in 2006 related to our single-family portfolio reflecting:

- increased estimates of incurred losses with respect to delinquent loans that are expected to experience higher default rates based on their year of origination;
- an observed increase in the transition rates of loans through delinquency to foreclosure and corresponding increases in the number of properties that we acquired as real estate owned; and
- increases in the expected severity of losses on a per-property basis, driven in part by the expectation of low or slower home price appreciation in certain areas.

We expect that near-term credit losses, which include net charge-offs and REO expenses, will rise while still remaining below longer-term historical levels, as home price appreciation continues to slow significantly.

Losses on Certain Credit Guarantees

Losses on certain credit guarantees includes (a) losses recognized upon the issuance of PCs in Guarantor Swap transactions and (b) losses on non-performing loans repurchased from PC loan pools.

We negotiate contracts with our customers in Guarantor Swap transactions based upon our view of the overall economics of the transaction, considering the volume and types of mortgage loans to be delivered to us and our estimates of the net present value of related future guarantee fees, credit costs and other associated cash flows. However, the accounting for our guarantee-related assets and liabilities is not determined at the contract level, rather it is determined separately for each PC-related loan pool. We determine the initial fair value of the pool-level guarantee-related assets and liabilities using methodologies that employ direct market-based information that may differ from the estimates we use to negotiate the guarantee fee we charge customers. While our guarantee fees are subject to competitive pressure and we may enter into transactions for which our expectations of economic returns are below our normal return thresholds (*e.g.*, to achieve our affordable housing goals or maintain our market share), we expect the vast majority of our Guarantor Swap transactions will generate positive economic returns over the lives of the related PCs.

For each loan pool created, we compare the initial fair value of the related Guarantee obligation to the initial fair value of the related Guarantee asset and credit enhancement-related assets. If the Guarantee obligation is greater than the Guarantee asset, we immediately recognize a loss equal to the difference with respect to that pool. If the Guarantee obligation is less than the Guarantee asset, no initial gain is recorded; rather, guarantee income equal to the difference is deferred as an addition to the Guarantee obligation and is recognized as that liability is amortized. Accordingly, a Guarantor Swap transaction may result in some loan pools for which a loss is recognized immediately in earnings and other loan pools where guarantee income is deferred. We record these losses as Losses on certain credit guarantees.

In 2006 and 2005, we realized losses of \$350 million and \$234 million, respectively, on certain Guarantor Swap transactions entered into during those years. The increase in these losses was driven by a combination of higher expected future credit costs and competitive pressure on guarantee fees. In addition, our Guarantee asset associated with certain non-traditional mortgage products, including interest-only loans and option ARMs, is subject to a lower market valuation than traditional mortgage products due to the lower liquidity or corresponding lack of observable market prices for the associated cash flows.

Losses on non-performing loans repurchased from the mortgage loan pools underlying PCs and Structured Securities held by third parties occur when the carrying value of the repurchased loan, net of any allocated loan loss reserve, exceeds the estimated fair value of the loan. Increases in market interest rates and declining market values for delinquent loans led to the recognition of losses of \$126 million in 2006.

Losses on certain credit guarantees increased during 2005 when compared to 2004, as a result of the initial application of our approach for determining the fair values of our guarantee-related assets and liabilities at inception. This approach uses more market-based information and is discussed in “NOTE 2: TRANSFERS OF SECURITIZED INTERESTS IN MORTGAGE-RELATED ASSETS” to our consolidated financial statements. We also realized losses in 2005 and to a lesser extent in 2006, as a result of our efforts to acquire business at competitive prices in order to meet the affordable housing goals and subgoals established by HUD.

Housing Tax Credit Partnerships

Operating losses of our housing tax credit partnerships, which are recorded as a component of Non-interest expense, have increased over the last three years as our investments in these partnerships have increased. The increased investment in housing tax credit partnerships generated related tax benefits, which consisted of tax credits and tax deductible operating losses. Tax benefits associated with our investments in housing tax credit partnerships reduced Income tax expense by \$603 million, \$476 million and \$378 million for 2006, 2005 and 2004, respectively. See “Income Tax Expense (Benefit)” for additional information about the impact of these investments on our income tax expense.

Other Expenses

In April 2006, we reached an agreement in principle to settle the securities class action and shareholder derivative lawsuits relating to our restatement. The settlement became final in November 2006. In 2005, we recorded expenses of \$339 million to increase our reserves for legal settlements, including this settlement, net of expected insurance proceeds. See “NOTE 13: LEGAL CONTINGENCIES” to our consolidated financial statements for more information.

Income Tax Expense (Benefit)

For 2006, 2005 and 2004, our effective tax rates were (5.1) percent, 14.4 percent and 21.2 percent, respectively. The decrease in the effective tax rate over the past three years is primarily due to the decline in pre-tax income, the year-over-year increases in tax credits related to our investments in low-income housing tax credit partnerships and interest earned on tax-exempt housing-related securities. We expect tax credits resulting from our investments in housing tax credit partnerships to grow in the future. However, our ability to use all of the tax credits generated by existing or future investments in housing tax credit partnerships to reduce our federal income tax liability may be limited.

Our effective tax rate for 2006 and 2004 also benefited from reductions to our tax reserves of \$174 million and \$94 million, respectively, due predominantly to a favorable U.S. Tax Court decision in 2006 and separate settlements with the Internal Revenue Service in both years. For additional information, see “NOTE 14: INCOME TAXES” to our consolidated financial statements.

CONSOLIDATED BALANCE SHEETS ANALYSIS

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

Table 18 — Summary Consolidated Balance Sheets

	December 31,	
	2006	2005
	(in millions)	
Assets:		
Retained portfolio	\$700,543	\$709,384
Cash and investments	79,973	67,792
Derivative assets, at fair value	7,908	7,097
Guarantee asset, at fair value	6,070	5,083
Other	18,587	16,866
Total assets	<u>\$813,081</u>	<u>\$806,222</u>
Liabilities and stockholders' equity:		
Liabilities:		
Total debt securities, net	\$753,938	\$748,792
Guarantee obligation	7,117	5,541
Derivative liabilities, at fair value	179	590
Other	23,030	23,159
Total liabilities	<u>784,264</u>	<u>778,082</u>
Minority interests in consolidated subsidiaries	516	949
Stockholders' equity:		
Preferred stock, at redemption value	6,109	4,609
Common stock	152	152
Additional paid-in capital	962	924
Retained earnings	32,177	31,559
AOCI, net of taxes:		
Available-for-sale securities	(2,749)	(2,485)
Cash flow hedge relationships	(5,033)	(6,287)
Defined benefit plans	(87)	(1)
Total AOCI, net of taxes	<u>(7,869)</u>	<u>(8,773)</u>
Treasury stock, at cost	(3,230)	(1,280)
Total stockholders' equity	<u>28,301</u>	<u>27,191</u>
Total liabilities and stockholders' equity	<u>\$813,081</u>	<u>\$806,222</u>

Retained Portfolio

As discussed in “BUSINESS — Business Activities — *Investment and Funding Activities*,” beginning July 1, 2006, we voluntarily limited the annual growth of our Retained portfolio. At December 31, 2006, the carrying value of the Retained portfolio was \$700.5 billion, which was below the voluntary limit of \$717.4 billion.

Table 19 provides detail regarding the mortgage loans and mortgage-related securities in our Retained portfolio.

Table 19 — Characteristics of Mortgage Loans and Mortgage-Related Securities in the Retained Portfolio

	December 31,					
	2006			2005 ⁽¹⁾		
	Fixed Rate	Variable Rate ⁽²⁾	Total	Fixed Rate	Variable Rate ⁽²⁾	Total
	(in millions)					
Mortgage loans	\$ 61,273	\$ 4,574	\$ 65,847	\$ 56,458	\$ 5,023	\$ 61,481
Guaranteed PCs and Structured Securities: ⁽³⁾						
Single-family	282,052	71,828	353,880	299,167	61,766	360,933
Multifamily	241	141	382	247	144	391
Total Guaranteed PCs and Structured Securities	282,293	71,969	354,262	299,414	61,910	361,324
Non-Freddie Mac mortgage-related securities:						
Agency mortgage-related securities: ⁽⁴⁾						
Fannie Mae:						
Single-family	25,805	17,640	43,445	28,818	13,180	41,998
Multifamily	987	2	989	1,294	41	1,335
Ginnie Mae:						
Single-family	707	231	938	1,045	218	1,263
Multifamily	13	—	13	30	—	30
Total agency mortgage-related securities	27,512	17,873	45,385	31,187	13,439	44,626
Non-agency mortgage-related securities:						
Single-family	4,280	174,081	178,361	4,749	181,678	186,427
Commercial mortgage-backed securities	23,768	20,992	44,760	34,533	8,954	43,487
Mortgage revenue bonds ⁽⁵⁾	13,760	74	13,834	11,229	92	11,321
Manufactured housing ⁽⁶⁾	1,381	129	1,510	1,508	172	1,680
Total non-agency mortgage-related securities ⁽⁷⁾	43,189	195,276	238,465	52,019	190,896	242,915
Total unpaid principal balance of Retained portfolio	\$414,267	\$289,692	703,959	\$439,078	\$271,268	710,346
Premiums, discounts, deferred fees, impairments of unpaid principal balances and other basis adjustments			103			2,111
Net unrealized gains (losses) on mortgage-related securities, pre-tax			(4,046)			(3,551)
Participation Certificate residuals, at fair value			597			597
Reserve for losses on mortgage loans held-for-investment			(70)			(119)
Total Retained portfolio per consolidated balance sheets			\$700,543			\$709,384

(1) Certain amounts for 2005 have been revised to conform with the 2006 presentation.

(2) Variable-rate mortgage loans and mortgage-related securities include those with a contractual coupon rate that, prior to contractual maturity, is either scheduled to change or subject to change based on changes to the composition of the underlying collateral. Mortgage loans also include mortgages with balloon/reset provisions.

(3) For Guaranteed PCs and Structured Securities we issue, we are subject to the credit risk associated with the underlying mortgage loan collateral.

(4) Agency mortgage-related securities are generally not separately rated by nationally recognized statistical rating organizations, but are viewed as having a level of credit quality at least equivalent to non-agency mortgage-related securities rated AAA or equivalent.

(5) Consists of obligations of states and political subdivisions. Approximately 67 percent and 66 percent of these securities were AAA-rated at December 31, 2006 and 2005, respectively.

(6) At December 31, 2006 and 2005, 38 percent and 51 percent, respectively, of mortgage-related securities backed by manufactured housing were rated BBB— or above. For the same dates, 97 percent of these securities were supported by third-party credit enhancements (e.g., bond insurance) and other credit enhancements (e.g., deal structure through subordination). Approximately 30 percent and 33 percent of these securities were AAA-rated at December 31, 2006 and 2005, respectively.

(7) Credit ratings for most non-agency mortgage-related securities are designated by at least two nationally recognized statistical rating organizations. At December 31, 2006 and 2005, approximately 96 percent and 98 percent, respectively, of total non-agency mortgage-related securities were AAA-rated.

Table 20 provides additional detail regarding the fair value of mortgage-related securities in the Retained portfolio.

Table 20 — Fair Value of Available-For-Sale and Trading Mortgage-Related Securities in the Retained Portfolio

	December 31,		
	2006	2005	2004
	(in millions)		
Available-for-sale securities:			
Mortgage-related securities issued by:			
Freddie Mac	\$344,088	\$351,447	\$352,102
Fannie Mae	43,886	43,306	59,519
Ginnie Mae	733	1,115	1,762
Other	224,099	231,356	168,058
Obligations of states and political subdivisions	13,925	11,241	9,020
Total available-for-sale mortgage-related securities	<u>626,731</u>	<u>638,465</u>	<u>590,461</u>
Trading securities:			
Mortgage-related securities issued by:			
Freddie Mac	6,573	8,156	11,398
Fannie Mae	802	534	385
Ginnie Mae	222	204	59
Total trading mortgage-related securities	<u>7,597</u>	<u>8,894</u>	<u>11,842</u>
Total fair value of available-for-sale and trading mortgage-related securities	<u>\$634,328</u>	<u>\$647,359</u>	<u>\$602,303</u>

Issuers Greater than 10 Percent of Stockholders' Equity

We held Fannie Mae securities in our Retained portfolio with a fair value of \$44.7 billion, which represented 158 percent of Total stockholders' equity of \$28.3 billion at December 31, 2006. In addition, we held at the individual trust level in our Retained portfolio securities issued by Countrywide Home Equity Loan Trust with a fair value of \$3.3 billion, which represented 11.5 percent of Total stockholders' equity at December 31, 2006. No other individual issuer at the individual trust level exceeded 10 percent of Total stockholders' equity at December 31, 2006.

Cash and Investments

Table 21 provides additional detail regarding the non-mortgage-related securities in our Cash and investments portfolio.

Table 21 — Cash and Investments

	December 31,					
	2006		2005		2004	
	Fair Value	Average Maturity (Months)	Fair Value	Average Maturity (Months)	Fair Value	Average Maturity (Months)
	(dollars in millions)					
Cash and cash equivalents	\$11,359	<3	\$10,468	<3	\$35,253	<3
Investments:						
Available-for-sale securities:						
Non-mortgage-related securities:						
Asset-backed securities ⁽¹⁾	32,122	N/A	30,578	N/A	21,733	N/A
Obligations of state and political subdivisions ⁽¹⁾	2,273	363	5,823	282	8,097	303
Commercial paper	11,191	<3	5,764	<3	—	—
Total available-for-sale non-mortgage-related securities ⁽²⁾	<u>45,586</u>		<u>42,165</u>		<u>29,830</u>	
Federal funds sold and Eurodollars	19,778	<3	9,909	<3	18,647	<3
Securities purchased under agreements to resell	3,250	<3	5,250	<3	13,550	<3
Subtotal	<u>23,028</u>		<u>15,159</u>		<u>32,197</u>	
Total investments	<u>68,614</u>		<u>57,324</u>		<u>62,027</u>	
Total Cash and investments per consolidated balance sheets	<u>\$79,973</u>		<u>\$67,792</u>		<u>\$97,280</u>	

(1) Consists primarily of securities that can be prepaid prior to their contractual maturity without penalty.

(2) Credit ratings for most securities are designated by at least two nationally recognized statistical rating organizations. At December 31, 2006 and 2005, all of our available-for-sale non-mortgage-related securities were rated A or better. At December 31, 2004, 99.9% of these securities were rated A or better.

The increase in the Cash and investments portfolio during 2006 compared to 2005 was in part driven by our decision to maintain higher levels of liquid investments to ensure that we could appropriately service our outstanding debt and PCs and Structured Securities while operating under the Federal Reserve Board's intraday overdraft policy, which was revised effective July 2006. The revised policy restricts the GSEs, among others, from maintaining intraday overdraft positions at the Federal Reserve.

Derivative Assets and Liabilities, at Fair Value

Table 22 summarizes the notional or contractual amounts and related fair value of our total derivative portfolio by product type.

Table 22 — Total Derivative Portfolio

	December 31,			
	2006		2005	
	Notional or Contractual Amount ⁽¹⁾	Fair Value ⁽²⁾	Notional or Contractual Amount ⁽¹⁾	Fair Value ⁽²⁾
	(in millions)			
Interest-rate swaps:				
Receive-fixed	\$222,631	\$ (334)	\$159,212	\$ 756
Pay-fixed	217,565	(1,352)	181,562	(991)
Basis (floating to floating)	683	—	234	—
Total interest-rate swaps	<u>440,879</u>	<u>(1,686)</u>	<u>341,008</u>	<u>(235)</u>
Option-based:				
Call swaptions	194,200	4,034	146,615	3,453
Put swaptions	29,725	958	34,675	1,200
Other option-based derivatives ⁽³⁾	27,185	(15)	11,814	(7)
Total option-based	<u>251,110</u>	<u>4,977</u>	<u>193,104</u>	<u>4,646</u>
Futures	22,400	28	86,252	19
Foreign-currency swaps	29,234	4,399	37,850	2,124
Interest-rate caps	—	—	45	—
Subtotal	<u>743,623</u>	<u>7,718</u>	<u>658,259</u>	<u>6,554</u>
Forward purchase and sale commitments	10,012	15	21,961	(44)
Credit derivatives	2,605	(1)	2,414	(1)
Swap guarantee derivatives	957	(3)	738	(2)
Total derivative portfolio	<u>\$757,197</u>	<u>\$ 7,729</u>	<u>\$683,372</u>	<u>\$6,507</u>

- (1) Notional or contractual amounts are used to calculate the periodic amounts to be received and paid and generally do not represent actual amounts to be exchanged or directly reflect our exposure to institutional credit risk. Notional or contractual amounts are not recorded as assets or liabilities on our consolidated balance sheets.
- (2) The fair value by derivative type presented in this table is shown prior to netting by counterparty. The fair value of derivatives presented on our consolidated balance sheets, however, is netted by counterparty, and is reported in the Derivative assets, at fair value and Derivative liabilities, at fair value captions. The total fair value of the derivative portfolio presented in this table equals the difference between the fair value of the derivative assets and derivative liabilities presented on our consolidated balance sheets. The fair values for futures are directly derived from quoted market prices. Fair values of other derivatives are derived primarily from valuation models using market data inputs.
- (3) Primarily represents written options, including guarantees of stated final maturity of issued Structured Securities and written call options on PCs we issued.

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

The fair value of the total derivative portfolio increased in 2006 due primarily to the increase in the fair value of foreign-currency swaps we use to economically hedge Euro-denominated debt as the U.S. dollar weakened relative to the Euro.

Several factors contributed to the change in the composition of our derivative portfolio during 2006. We entered into additional pay-fixed swaps with relatively short maturities to offset our yield curve exposure in response to the continued flattening of the yield curve and generally higher interest rates in 2006. We entered into additional receive-fixed swaps as a result of economic hedging activities related to our callable debt securities outstanding, which increased as a proportion of our total debt portfolio during 2006. We employ receive-fixed swaps to protect against a decline in interest rates until the specified call date and between specified call dates of our callable debt. We increased the notional balance of our call swaptions to manage the risk of further declines in market interest rates following the declines observed in the second half of the year. The notional balance of our futures declined in 2006 primarily because we continued to reduce our position in Eurodollar future contracts held for risk management purposes in response to movements in short-term rates. The notional balance of our foreign-currency swaps declined due to maturities of such swaps throughout 2006 that were not replaced by new contracts as the balance of our Euro-denominated debt securities declined during the year.

Table 23 summarizes the changes in derivative fair values.

Table 23 — Changes in Derivative Fair Values

	2006	2005
	(in millions)	
Beginning balance, at January 1 — Net asset (liability)	\$ 6,507	\$15,031
Net change in:		
Forward purchase and sale commitments	59	(35)
Credit derivatives	—	1
Swap guarantee derivatives	(1)	(1)
Other derivatives: ⁽¹⁾		
Changes in fair value	2,008	(8,417)
Fair value of new contracts entered into during the period ⁽²⁾	2,577	2,522
Contracts realized or otherwise settled during the period	(3,421)	(2,594)
Ending balance, at December 31 — Net asset (liability)	<u>\$ 7,729</u>	<u>\$ 6,507</u>

(1) Includes fair value changes for interest-rate swaps, option-based derivatives, futures, foreign-currency swaps and interest-rate caps.

(2) Consists primarily of cash premiums paid or received on options and the initial value of interest-rate swaps after we have exercised related swaptions. Option premiums paid were \$2,784 million and \$2,248 million during 2006 and 2005, respectively.

Table 24 shows the fair value for each derivative type and the maturity profile of our derivative positions. A positive fair value in Table 24 for each derivative type is the estimated amount, prior to netting by counterparty, that we would be entitled to receive if we terminated the derivatives of that type. A negative fair value for a derivative type is the estimated amount, prior to netting by counterparty, that we would owe if we terminated the derivatives of that type. See “Table 36 — Derivative Counterparty Credit Exposure” under “RISK MANAGEMENT — Interest-Rate Risk and Other Market Risks” for additional information regarding derivative counterparty credit exposure. Table 24 also provides the weighted average fixed rate of our pay-fixed and receive-fixed swaps.

Table 24 — Derivative Fair Values and Maturities

	December 31, 2006				
	Total Fair Value	Fair Value ⁽¹⁾			
		Less than 1 Year	1 to 3 Years	Greater than 3 and up to 5 Years	In Excess of 5 Years
	(dollars in millions)				
Interest-rate swaps:					
Receive-fixed:					
Swaps	\$ (373)	\$ (149)	\$ (285)	\$ 106	\$ (45)
Weighted average fixed rate ⁽²⁾		4.64%	4.81%	5.01%	5.33%
Forward-starting swaps ⁽³⁾	39	—	—	—	39
Weighted average fixed rate		—	—	—	5.47%
Total receive-fixed	<u>(334)</u>	<u>(149)</u>	<u>(285)</u>	<u>106</u>	<u>(6)</u>
Pay-fixed:					
Swaps	419	93	90	3	233
Weighted average fixed rate ⁽²⁾		4.22%	5.07%	5.08%	5.09%
Forward-starting swaps ⁽³⁾	(1,771)	—	—	—	(1,771)
Weighted average fixed rate		—	—	—	5.77%
Total pay-fixed	<u>(1,352)</u>	<u>93</u>	<u>90</u>	<u>3</u>	<u>(1,538)</u>
Total interest-rate swaps	<u>(1,686)</u>	<u>(56)</u>	<u>(195)</u>	<u>109</u>	<u>(1,544)</u>
Option-based:					
Call swaptions	4,034	12	703	1,647	1,672
Put swaptions	958	—	—	219	739
Other option-based derivatives	(15)	(5)	—	(1)	(9)
Total option-based	<u>4,977</u>	<u>7</u>	<u>703</u>	<u>1,865</u>	<u>2,402</u>
Futures	28	28	—	—	—
Foreign-currency swaps	4,399	788	747	1,788	1,076
Forward purchase and sale commitments	15	15	—	—	—
Swap guarantee derivatives	(3)	—	—	—	(3)
Subtotal	<u>7,730</u>	<u>\$ 782</u>	<u>\$1,255</u>	<u>\$3,762</u>	<u>\$ 1,931</u>
Credit derivatives	(1)				
Total	<u>\$ 7,729</u>				

(1) Fair value is categorized based on the period from December 31, 2006 until the contractual maturity of the derivative.

(2) Represents the notional weighted average rate for the fixed leg of the swaps.

(3) Represents interest-rate swap agreements that are scheduled to begin on future dates which range from less than one year to ten years.

Guarantee Asset

See “CONSOLIDATED RESULTS OF OPERATIONS — Non-Interest Income (Loss) — Gains (Losses) on Guarantee Asset” for a description of the Guarantee asset. Table 25 summarizes changes in the Guarantee asset balance.

Table 25 — Changes in Guarantee Asset

	December 31,	
	2006	2005
	(in millions)	
Beginning balance	\$5,083	\$4,516
Additions, net of repurchases	1,787	1,631
Return of investment on Guarantee asset	(1,009)	(899)
Changes in fair value of future cash flows	209	(165)
Gains (losses) on Guarantee asset	(800)	(1,064)
Ending balance	<u>\$6,070</u>	<u>\$5,083</u>

In 2006 and 2005, the primary drivers affecting the net increase in our Guarantee asset balance were our business volumes and changes in mortgage interest rates. Additions, net of repurchases, increased in 2006 primarily because net repurchases of PCs and Structured Securities into the Retained portfolio declined. When a PC or Structured Security is repurchased into the Retained portfolio, any related Guarantee asset becomes a component of the associated PC residual, therefore such repurchases reduce the balance of the Guarantee asset. Losses on Guarantee asset decreased as mortgage interest rates increased during 2006, which extended the expected lives of the PCs and Structured Securities and increased the fair value of the Guarantee asset.

Total Debt Securities, Net

Table 26 reconciles the par value of our debt securities to the amounts shown on our consolidated balance sheets. See “LIQUIDITY AND CAPITAL RESOURCES” for further discussion of our debt management activities.

Table 26 — Reconciliation of the Par Value of Total Debt Securities to Our Consolidated Balance Sheets

	December 31,	
	2006	2005
	(in millions)	
Total debt securities:		
Par value ⁽¹⁾	\$787,970	\$780,382
Unamortized balance of discounts and premiums ⁽²⁾	(41,769)	(39,338)
Foreign-currency-related and hedging-related basis adjustments ⁽³⁾	7,737	7,748
Total debt securities, net	<u>\$753,938</u>	<u>\$748,792</u>

(1) Includes securities sold under agreements to repurchase and Federal funds purchased and swap collateral obligations.

(2) Primarily represents unamortized discounts on zero-coupon debt securities. Also, includes accrued interest payable on swap collateral obligations.

(3) Primarily represents deferrals related to the translation gain (loss) on foreign-currency denominated debt that was in hedge accounting relationships.

Table 27 summarizes our Senior debt, due within one year.

Table 27 — Senior Debt, Due Within One Year

	2006				
	December 31,		Average Outstanding During the Year		Maximum Balance, Net Outstanding at Any Month End
	Balance, Net ⁽¹⁾	Weighted Average Effective Rate ⁽²⁾	Balance, Net ⁽³⁾	Weighted Average Effective Rate ⁽⁴⁾	
			(dollars in millions)		
Reference Bills® securities and discount notes	\$157,553	5.14%	\$165,270	4.76%	\$182,946
Medium-term Notes	9,832	5.16	4,850	4.82	9,832
Securities sold under agreements to repurchase and Federal funds purchased	—	—	81	5.48	2,200
Swap collateral obligations	9,597	5.17	9,705	5.07	11,528
Hedging-related basis adjustments	—	N/A			
Short-term debt securities	176,982	5.14			
Current portion of long-term debt	117,879	4.10			
Senior debt, due within one year	<u>\$294,861</u>	4.73			
			2005		
	December 31,		Average Outstanding During the Year		Maximum Balance, Net Outstanding at Any Month End
	Balance, Net ⁽¹⁾	Weighted Average Effective Rate ⁽²⁾	Balance, Net ⁽³⁾	Weighted Average Effective Rate ⁽⁴⁾	
				(dollars in millions)	
Reference Bills® securities and discount notes	\$181,468	4.00%	\$181,878	3.11%	\$194,578
Medium-term Notes	2,032	4.17	850	3.35	2,032
Securities sold under agreements to repurchase and Federal funds purchased	450	4.25	267	3.08	1,000
Swap collateral obligations	8,768	4.09	10,374	3.14	13,533
Hedging-related basis adjustments	(5)	N/A			
Short-term debt securities	192,713	4.01			
Current portion of long-term debt	95,819	3.42			
Senior debt, due within one year	<u>\$288,532</u>	3.81			
			2004		
	December 31,		Average Outstanding During the Year		Maximum Balance, Net Outstanding at Any Month End
	Balance, Net ⁽¹⁾	Weighted Average Effective Rate ⁽²⁾	Balance, Net ⁽³⁾	Weighted Average Effective Rate ⁽⁴⁾	
				(dollars in millions)	
Reference Bills® securities and discount notes	\$180,198	2.04%	\$184,834	1.40%	\$212,715
Medium-term Notes	162	2.51	4,289	1.31	5,320
Securities sold under agreements to repurchase and Federal funds purchased	—	—	801	1.37	3,046
Swap collateral obligations	16,279	2.24	13,549	1.36	16,279
Short-term debt securities	196,639	2.05			
Current portion of long-term debt	85,664	3.33			
Senior debt, due within one year	<u>\$282,303</u>	2.44			

(1) Represents par value, net of associated discounts, premiums and foreign-currency-related and hedging-related basis adjustments. Swap collateral obligations include the related accrued interest payable.

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

(3) Includes unamortized discounts or premiums and issuance costs. Issuance costs are reported in the Other assets caption on our consolidated balance sheets.

(4) Represents the approximate weighted average effective rate during the period, which includes the amortization of discounts or premiums and issuance costs, but excludes the amortization of hedging-related basis adjustments.

Guarantee Obligation

See “CONSOLIDATED RESULTS OF OPERATIONS — Non-Interest Income (Loss) — Income on Guarantee Obligation” for a description of the components of the Guarantee obligation. Table 28 summarizes the changes in the Guarantee obligation balance.

Table 28 — Changes in Guarantee Obligation

	December 31,	
	2006	2005
	(in millions)	
Beginning balance	\$5,541	\$4,065
Transfer-out to the loan loss reserve ⁽¹⁾	(9)	(10)
Additions, net of repurchases:		
Fair value of performance and other related costs of newly-issued guarantees	1,719	1,629
Deferred guarantee income of newly-issued guarantees	733	777
Amortization income related to:		
Performance and other related costs	(584)	(616)
Deferred guarantee income	(283)	(304)
Income on Guarantee obligation	(867)	(920)
Ending balance	<u>\$7,117</u>	<u>\$5,541</u>
Components of the Guarantee obligation, at period end:		
Unamortized balance of performance and other related costs	\$4,869	\$3,743
Unamortized balance of deferred guarantee income	2,248	1,798
Ending Guarantee obligation	<u>\$7,117</u>	<u>\$5,541</u>

(1) Represents portions of the Guarantee obligation recognized through Guarantor Swap transactions or upon the sale of PCs and Structured Securities that correspond to incurred credit losses reclassified to Reserve for guarantee losses on Participation Certificates at initial recognition of a Guarantee obligation.

The Guarantee obligation increased in 2006 due to business volume and a decline in the rate of amortization. Generally increasing mortgage interest rates resulted in lower liquidation rates on outstanding PCs and Structured Securities.

Total Stockholders' Equity

The balance of Total stockholders' equity increased in 2006 primarily as a result of Net income, partially offset by preferred and common stock dividends declared during 2006. During 2006, we repurchased \$2.0 billion of outstanding shares of common stock and issued \$1.5 billion of non-cumulative, perpetual preferred stock in connection with a plan to replace \$2.0 billion of common stock with an equal amount of preferred stock. The repurchase of outstanding shares of common stock and the issuance of non-cumulative, perpetual preferred stock during 2006 resulted in a net reduction of \$0.5 billion to the balance of Total stockholders' equity. During the first quarter of 2007, we issued \$1.1 billion of non-cumulative, perpetual preferred stock, including \$500 million to complete the planned issuance described above and \$600 million to replace higher-cost preferred stock that we redeemed in 2007. See “LIQUIDITY AND CAPITAL RESOURCES — Capital Resources — *Core Capital*” for additional information.

The balance of AOCI at December 31, 2006 was a net loss of approximately \$7.9 billion, net of taxes, compared to a net loss of \$8.8 billion, net of taxes, at December 31, 2005. The reduction in the net loss in AOCI was primarily the result of the amortization of deferred losses in Net interest income related to closed cash flow hedge relationships, partially offset by an increase in unrealized losses on available-for-sale securities primarily driven by the increase in interest rates during 2006.

CONSOLIDATED FAIR VALUE BALANCE SHEETS ANALYSIS

Our consolidated fair value balance sheets include the estimated fair values of financial instruments recorded on 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 on 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) certain commitments to purchase mortgage loans and (c) certain credit enhancements on manufactured housing asset-backed securities. The fair value balance sheets also include certain assets and liabilities that are not financial instruments (such as property and equipment and real estate owned, which are included in Other assets) at their carrying value in accordance with GAAP. During 2006 and 2005, our fair value results were impacted by several improvements in our approach for estimating the fair value of certain financial instruments. See “OFF-BALANCE SHEET ARRANGEMENTS” and “CRITICAL ACCOUNTING POLICIES AND ESTIMATES” as well as “NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES” and “NOTE 16: FAIR VALUE DISCLOSURES” to our consolidated financial statements for more information on fair values.

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

Table 29 — Summary Consolidated Fair Value Balance Sheets⁽¹⁾

	December 31,			
	2006		2005	
	Carrying Amount ⁽²⁾	Fair Value	Carrying Amount ⁽²⁾	Fair Value
	(in billions)			
Total assets	\$813.1	\$811.3	\$806.2	\$805.2
Total liabilities and minority interests	\$784.8	\$779.5	\$779.0	\$774.3
Net assets attributable to stockholders:				
Preferred stockholders	6.1	5.8	4.6	4.1
Common stockholders	22.2	26.0	22.6	26.8
Total net assets	28.3	31.8	27.2	30.9
Total liabilities and net assets	\$813.1	\$811.3	\$806.2	\$805.2

(1) The summary 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 GAAP consolidated balance sheets.

Key Components of Changes in Fair Value of Net Assets

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

Core spread income

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

Changes in mortgage-to-debt OAS

The fair value of our net assets can be significantly affected from period to period by changes in the net OAS between the mortgage and agency debt sectors. The fair value impact of changes in OAS for a given period represents an estimate of the net unrealized increase or decrease in fair value of net assets arising from net fluctuations in OAS during that period. We do not attempt to hedge or actively manage the basis risk represented by the impact of changes in mortgage-to-debt OAS because we generally hold a substantial portion of our mortgage assets for the long term and we do not believe that periodic increases or decreases in the fair value of net assets arising from fluctuations in OAS will significantly affect the long-term value of the Retained portfolio. Our estimate of the effect of changes in OAS excludes the impact of other market risk factors we actively manage, or economically hedge, to keep interest-rate risk exposure within prescribed limits.

Asset-liability management return

Asset-liability management return represents the estimated net increase or decrease in the fair value of net assets resulting from net exposures related to the market risks we actively manage. We do not hedge all of the interest-rate risk that exists at the time a mortgage is purchased or that arises over its life. The market risks to which we are exposed as a result of our Retained portfolio activities that we actively manage include duration and convexity risks, yield curve risk and volatility risk. We seek to manage these risk exposures within prescribed limits as part of our overall portfolio management strategy. Taking these risk positions and managing them within prudent limits is an integral part of our strategy to optimize the risk/reward profile of our investment activity and produce fair value growth. We expect that the residual risk positions we take and manage under our integrated risk management framework will produce fair value returns that contribute to meeting our fair value growth objectives, although those positions may result in a net increase or decrease in fair value for a given period. During 2006, our duration and convexity risk level as measured by our PMVS was below the risk limits set by management and the board of directors. See “RISK MANAGEMENT — Interest-Rate Risk and Other Market Risks” for more information.

Core guarantee fees, net

Core guarantee fees, net represents a fair value estimate of the annual income of the credit guarantee portfolio, based on current portfolio characteristics and market conditions. This estimate considers both contractual guarantee fees collected

over the life of the credit guarantee portfolio and credit-related delivery fees collected up-front when pools are formed, and associated costs and obligations, which include default costs.

Change in the fair value of the credit guarantee portfolio

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

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

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

Fee income

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

Discussion of Fair Value Results

In 2006, the fair value of net assets attributable to common stockholders, before capital transactions, increased by \$2.5 billion, resulting in a return on the average fair value of net assets attributable to common stockholders of approximately 9.5 percent, compared to a \$1.0 billion increase, or 3.7 percent return, in 2005. In addition, the payment of common dividends and the repurchase of common shares reduced total fair value by \$3.3 billion. The fair value of net assets attributable to common stockholders as of December 31, 2006 was \$26.0 billion, compared to \$26.8 billion as of December 31, 2005.

Estimated impact of changes in mortgage-to-debt OAS on fair value results

For the years ended December 31, 2006 and 2005, we estimate that on a pre-tax basis the increases in the fair value of net assets attributable to common stockholders, before capital transactions included decreases of approximately \$0.9 billion and \$2.7 billion, respectively, due to a net widening of mortgage-to-debt OAS.

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

Our estimate of the periodic increases or decreases in the fair value of net assets associated with fluctuations in option-adjusted spreads provides insight into a component of our fair value results that we do not believe will significantly affect the long-term fair value of the Retained portfolio. This belief is based on our expectation that differences between the prepayments forecasted by our models and the actual prepayments we will experience are not likely to be significant.

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

The impact of changes in OAS on fair value should be understood as an estimate rather than a precise measurement. To estimate the impact of OAS changes, we use models that involve the forecast of interest rates and prepayment behavior and other inputs. We also make assumptions about a variety of factors, including macroeconomic and security-specific data,

interest-rate paths, cash flows and prepayment rates. We use these models and assumptions in running our business, and we rely on many of the models in producing our financial statements and measuring, managing and reporting interest-rate and other market risks. The use of different estimation methods or the application of different assumptions could result in a materially different estimate of OAS impact.

We revised the method we previously used to report the impact that changes in OAS have on our fair value results. This methodology change had no impact on the actual change in the fair value of net assets, only our attribution of that change. This change was made in order to more closely align the process we use to report the impact of changes in OAS with the interest rate risk management framework of our investment activities.

An integral part this framework includes the attribution of fair value changes to assess the performance of our investment activities. On a daily basis, all interest rate sensitive assets, liabilities and derivatives are modeled using our proprietary prepayment and interest rate models. Management uses interest-rate risk statistics generated from this process, along with daily market movements, coupon accruals and price changes, to estimate and attribute returns into various risk factors commonly used in the fixed income industry to quantify and understand sources of fair value return. One important risk factor is the change in fair value due to changes in mortgage-to-debt OAS.

The method previously used to estimate the impact of mortgage-to-debt OAS changes on fair value was performed on a monthly basis and excluded certain portions of the investment portfolio. The new methodology estimates the impact of mortgage-to-debt OAS changes on fair value on a daily basis and includes all financial instruments.

On a pre-tax basis for 2006 and 2005, the reported OAS impacts using our new methodology were reductions in fair value of \$0.9 billion and \$2.7 billion, respectively. Using our previous methodology, the OAS impacts were pre-tax reductions in fair value of \$0.6 billion and \$2.0 billion, respectively.

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

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

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

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

LIQUIDITY AND CAPITAL RESOURCES

Liquidity

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

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

- receipts of principal and interest payments on securities we hold or mortgage loans we have securitized and sold;
- sales of securities we hold;

- borrowings against mortgage-related securities and other investment securities we hold;
- other cash flows from operating activities, including guarantee activities; and
- issuances of common and preferred stock.

We measure our cash position on a daily basis, netting uses of cash with sources of cash. We manage the net cash position over a rolling forecasted 120-day period, with the goal of providing the amount of debt funding needed to cover expected net cash outflows without adversely affecting our overall funding levels. We maintain alternative sources of liquidity to allow normal operations for 120 days without relying upon the issuance of unsecured debt consistent with industry practices of sound liquidity management. Our daily liquidity management activities are consistent with the liquidity component of our commitment with OFHEO to maintain alternative sources of liquidity to allow normal operations for 90 days without relying upon issuance of unsecured debt. See “RISK MANAGEMENT AND DISCLOSURE COMMITMENTS” for further information.

The Federal Reserve Board revised its payments system risk policy, effective in July 2006, to restrict or eliminate daylight overdrafts by GSEs in connection with their use of the Fedwire system. The revised policy also includes a requirement that the GSEs fully fund their accounts in the system to the extent necessary to cover payments on their debt and mortgage-related securities each day, before the Federal Reserve Bank of New York, acting as fiscal agent for the GSEs, will initiate such payments. We have taken actions to fully fund our account as necessary, such as opening lines of credit with third parties. Certain of these lines of credit require that we post collateral that, in certain limited circumstances, the secured party has the right to repledge to other third parties, including the Federal Reserve Bank. As of December 31, 2006, we pledged approximately \$20.2 billion of securities to these secured parties. These lines of credit, which provide additional intraday liquidity to fund our activities through the Fedwire system, are uncommitted intraday loan facilities. As a result, while we expect to continue to use these facilities, we may not be able to draw on them if and when needed. See “NOTE 5: RETAINED PORTFOLIO AND CASH AND INVESTMENTS PORTFOLIO” to our consolidated financial statements for further information. We believe that the revisions to the Federal Reserve Board’s policies will not have a material adverse effect on our liquidity.

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

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

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

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

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

Debt Securities

We fund our operating cash needs and finance our purchases of mortgage loans, mortgage-related securities and non-mortgage-related securities held in our Retained portfolio and Cash and investments portfolio primarily through the issuance of short-term and long-term debt. Table 30 summarizes the par value of the debt securities we issued, based on settlement dates, during 2006 and 2005. We seek to maintain a variety of consistent, active funding programs that promote high-quality coverage by market makers and reach a broad group of institutional and retail investors. By diversifying our investor base and the types of debt securities we offer, we believe we enhance our ability to maintain continuous access to the debt markets under a variety of market conditions.

Table 30 — Debt Security Issuances by Product, at Par Value⁽¹⁾

	Year Ended December 31,	
	2006	2005
(in millions)		
Short-term debt:		
Reference Bills® securities and discount notes	\$593,444	\$826,253
Medium-term Notes — Callable	8,532	1,745
Medium-term Notes — Non-callable	1,550	360
Total short-term debt	603,526	828,358
Long-term debt:		
Medium-term Notes — Callable ⁽²⁾	106,777	87,047
Medium-term Notes — Non-callable ⁽³⁾	17,721	33,624
U.S. dollar Reference Notes® securities — Non-callable ⁽⁴⁾	55,000	48,146
Freddie SUBS® securities ⁽⁵⁾	3,299	—
Total long-term debt	182,797	168,817
Total debt securities issued	<u>\$786,323</u>	<u>\$997,175</u>

- (1) Excludes securities sold under agreements to repurchase and Federal funds purchased, swap collateral obligations and securities sold but not yet purchased.
- (2) Includes \$100 million and \$— million of Medium-term Notes — Callable issued for the years ended December 31, 2006 and 2005, respectively, which were accounted for as debt exchanges.
- (3) Includes \$1,000 million and \$— million of Medium-term Notes — Non-callable issued for the years ended December 31, 2006 and 2005, respectively, which were accounted for as debt exchanges.
- (4) Includes \$— million and \$3,396 million of U.S. dollar Reference Notes® securities issued for the years ended December 31, 2006 and 2005, respectively, which were accounted for as debt exchanges.
- (5) Includes \$1,549 million of Freddie SUBS® securities issued for the year ended December 31, 2006, which were accounted for as debt exchanges.

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

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

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

Reference Notes® Securities. Through our Reference Notes® securities program, we sell large issues of long-term debt that provide investors worldwide with a high-quality, liquid investment vehicle. Reference Notes® securities are regularly issued, non-callable fixed-rate securities, which we currently issue with original maturities ranging from two through ten years. We primarily issue securities denominated in U.S. dollars. We have also issued €Reference Notes® securities denominated in Euros, but did not issue any such securities in 2006 or 2005. We hedge our exposure to changes in foreign-currency exchange rates by entering into swap transactions that convert foreign-currency denominated obligations to U.S. dollar-denominated obligations. See “RISK MANAGEMENT — Interest-Rate Risk and Other Market Risks — Sources of Interest-Rate Risk and Other Market Risks” for more information.

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

Subordinated Debt. In December 2006, we issued approximately \$2.0 billion of Freddie SUBS® securities, including approximately \$1.5 billion issued in exchange for previously issued Freddie SUBS® securities. In addition, we called approximately \$1.0 billion of previously issued Freddie SUBS® securities in August 2006 and issued approximately \$1.25 billion of Freddie SUBS® securities in June 2006. We did not issue, call or repurchase any Freddie SUBS® securities during 2005 and 2004. Our issuance of subordinated debt in the form of Freddie SUBS® securities supports our risk management and disclosure commitments with OFHEO (described in “RISK MANAGEMENT AND DISCLOSURE COMMITMENTS”).

Debt Retirement Activities. We repurchase or call our outstanding debt securities from time to time to help support the liquidity and predictability of the market for our debt securities and to manage interest rate risk associated with our assets and liabilities. When our debt securities become seasoned or European call options on our debt securities expire, they may become less liquid, which could cause their price to decline. By repurchasing debt securities, we help preserve the

liquidity of our debt securities and improve their price performance, which helps to reduce our funding costs over the long-term. Our repurchase activities also help us manage the funding mismatch, or duration gap, created by changes in interest rates. For example, when interest rates decline, the expected lives of the mortgage-related securities held in our Retained portfolio decrease, reducing the need for long-term debt. We use a number of different means to shorten the effective weighted average lives of our outstanding debt securities and thereby manage the duration gap, including retiring long-term debt through repurchases or calls; changing our debt funding mix between short- and long-term debt; or using derivative instruments, such as entering into receive-fixed swaps or terminating or assigning pay-fixed swaps. From time to time, we may also enter into transactions in which we exchange newly issued debt securities for similar outstanding debt securities held by investors. These transactions are accounted for as debt exchanges. See “CONSOLIDATED RESULTS OF OPERATIONS — Non-Interest Income (Loss) — Gains (Losses) on Debt Retirement” for more information.

Table 31 provides the par value, based on settlement dates, of debt securities we repurchased, called and exchanged during 2006 and 2005.

Table 31 — Debt Security Repurchases, Calls and Exchanges

	Year Ended December 31,	
	2006	2005
	(in millions)	
Repurchases of outstanding €Reference Notes® securities	\$ 5,210	\$ —
Repurchases of outstanding Medium-term Notes	28,560	11,663
Calls of callable Medium-term Notes	26,559	36,236
Calls of callable Freddie SUBS® securities	1,000	—
Exchanges of U.S. dollar Reference Notes® securities and Medium-term Notes	1,074	3,043
Exchanges of Freddie SUBS® securities	1,480	—

Credit Ratings. Our ability to access the capital markets and other sources of funding, as well as our cost of funds, are highly dependent upon our credit ratings. Table 32 indicates our credit ratings at March 1, 2007.

Table 32 — Freddie Mac Credit Ratings

	Nationally Recognized Statistical Rating Organization		
	Standard & Poor's	Moody's	Fitch
Senior long-term debt ⁽¹⁾	AAA	Aaa	AAA
Short-term debt ⁽²⁾	A-1+	P-1	F-1+
Subordinated debt	AA-	Aa2	AA-
Preferred stock	AA-	Aa3	AA-

(1) Includes Medium-term Notes, U.S. dollar Reference Notes® securities and €Reference Notes® securities.

(2) Includes Reference Bills® securities and discount notes.

In addition to the ratings described in Table 32, S&P provides a “Risk-To-The-Government” rating that measures our ability to meet our debt obligations and the value of our franchise in the absence of any implied government support. Our “Risk-To-The-Government” rating was AA- at March 1, 2007. Moody’s also provides a “Bank Financial Strength” rating that represents Moody’s opinion of our intrinsic safety and soundness and, as such, excludes certain external credit risks and credit support elements. Ratings under this measure range from A, the highest, to E. Our “Bank Financial Strength” rating was A- at March 1, 2007.

Equity Securities

See “Capital Resources — *Core Capital*” and “MARKET FOR THE COMPANY’S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES” for information about issuances and repurchases of our equity securities.

Cash and Investments Portfolio

We maintain a cash and investments portfolio that is important to our financial management and our ability to provide liquidity and stability to the mortgage market. At December 31, 2006, the investments in this portfolio consisted of liquid non-mortgage-related securities that we could sell or finance to provide us with an additional source of liquidity to fund our business operations. We also use the portfolio to help manage recurring cash flows and meet our other cash management needs. In addition, we use the portfolio to hold capital on a temporary basis until we can deploy it into Retained portfolio investments or credit guarantee opportunities. We may also sell or finance the securities in this portfolio to maintain capital reserves to meet mortgage funding needs, provide diverse sources of liquidity or help manage the interest-rate risk inherent in mortgage-related assets.

The non-mortgage-related securities in the Cash and investments portfolio consist principally of asset-backed securities and other marketable assets that can be readily converted to cash. For additional information on our Cash and investments portfolio, see “CONSOLIDATED BALANCE SHEETS ANALYSIS — Cash and Investments.” The non-mortgage-

related investments in this portfolio may expose us to institutional credit risk and the risk that the investments could decline in value due to market-driven events such as credit downgrades or changes in interest rates and other market conditions. See “RISK MANAGEMENT — Credit Risks — *Institutional Credit Risk*” for more information.

Contractual Obligations

Table 33 provides aggregated information about the listed categories of our contractual obligations. These contractual obligations affect our short- and long-term liquidity and capital resource needs. The table includes information about undiscounted future cash payments due under these contractual obligations, aggregated by type of contractual obligation, including the contractual maturity profile of our debt securities and other liabilities reported on our consolidated balance sheet and our operating leases at December 31, 2006. The timing of actual future payments may differ from those presented due to a number of factors, including discretionary debt repurchases. Our contractual obligations include other purchase obligations that are enforceable and legally binding. For purposes of this table, purchase obligations are included through the termination date specified in the respective agreements, even if the contract is renewable. Many of our purchase agreements for goods or services include clauses that would allow us to cancel the agreement prior to the expiration of the contract within a specified notice period; however, this table includes such obligations without regard to such termination clauses (unless we have provided the counterparty with actual notice of our intention to terminate the agreement).

In addition, in Table 33, the amounts of future interest payments on debt securities outstanding at December 31, 2006 are based on the contractual terms of our debt securities at that date. These amounts were determined using the key assumptions that (a) variable-rate debt continues to accrue interest at the contractual rates in effect at December 31, 2006 until maturity and (b) callable debt continues to accrue interest until its contractual maturity. The amounts of future interest payments on debt securities presented do not reflect certain factors that will change the amounts of interest payments on our debt securities after December 31, 2006, such as (a) changes in interest rates, (b) the call or retirement of any debt securities, (c) the issuance of new debt securities and (d) other factors. Accordingly, the amounts presented in the table do not represent a forecast of our future cash interest payments or interest expense.

Table 33 excludes the following items:

- future payments related to our Guarantee obligation, because the amount and timing of such payments are generally contingent upon the occurrence of future events and are therefore uncertain;
- future contributions to our Pension Plan, as we have not yet determined whether a contribution is required for 2007. See “NOTE 15: EMPLOYEE BENEFITS” to our consolidated financial statements for additional information about contributions to our Pension Plan;
- future cash settlements on derivative agreements not yet accrued, because the amount and timing of such payments are dependent upon changes in the underlying financial instruments and are therefore uncertain; and
- future dividends on the preferred stock we issued, because dividends on these securities are non-cumulative. In addition, the classes of preferred stock issued by our two consolidated real estate investment trust, or REIT, subsidiaries pay dividends and are cumulative. However, dividends on the REIT preferred stock are excluded because the timing of these payments is dependent upon declaration by the boards of the REITs.

Table 33 — Contractual Obligations by Year at December 31, 2006

	Total	2007	2008	2009	2010	2011	Thereafter
	(in millions)						
Long-term debt securities ⁽¹⁾	\$609,083	\$117,972	\$ 98,313	\$63,231	\$46,681	\$55,208	\$227,678
Short-term debt securities ⁽¹⁾	178,887	178,887	—	—	—	—	—
Interest payable ⁽²⁾	140,167	26,095	20,878	17,029	14,516	11,589	50,060
Other liabilities reflected on our consolidated balance sheet:							
Due to Participation Certificate investors	11,123	11,123	—	—	—	—	—
Other contractual liabilities ⁽³⁾⁽⁴⁾	2,704	1,711	556	178	78	41	140
Purchase obligations:							
Purchase commitments ⁽⁵⁾	9,856	9,856	—	—	—	—	—
Other purchase obligations	418	247	82	35	19	14	21
Operating lease obligations	114	18	16	13	12	7	48
Total specified contractual obligations	<u>\$952,352</u>	<u>\$345,909</u>	<u>\$119,845</u>	<u>\$80,486</u>	<u>\$61,306</u>	<u>\$66,859</u>	<u>\$277,947</u>

- (1) Represents par value. Callable debt is included in this table at its contractual maturity. For additional information about our debt securities, see “NOTE 8: DEBT SECURITIES AND SUBORDINATED BORROWINGS” to our consolidated financial statements.
- (2) Includes estimated future interest payments on our short-term and long-term debt securities. Also includes accrued interest payable recorded on our consolidated balance sheet, which consists primarily of the accrual of interest on short-term and long-term debt as well as the accrual of periodic cash settlements of derivatives, netted by counterparty.
- (3) Other contractual liabilities primarily represents future cash payments due under our contractual obligations to make delayed equity contributions to low-income housing tax credit partnerships that are unconditional and legally binding.
- (4) Accrued obligations related to our defined benefit plans, defined contribution plans and executive deferred compensation plan are included in the Total and 2007 columns. However, the timing of payments due under these obligations is uncertain. See “NOTE 15: EMPLOYEE BENEFITS” to our consolidated financial statements for additional information.
- (5) Purchase commitments represents our obligations to purchase mortgage loans and mortgage-related securities from third parties. The majority of purchase commitments included in this caption are accounted for as derivatives in accordance with SFAS No. 133, “Accounting for Derivative Instruments and Hedging Activities,” or SFAS 133.

Capital Resources

Capital Management

Our primary objective in managing capital is preserving our safety and soundness. We also seek to have sufficient capital to support our business and mission at attractive long-term returns. See “NOTE 10: REGULATORY CAPITAL” to our consolidated financial statements for more information regarding our regulatory capital requirements and OFHEO’s capital monitoring framework. As appropriate, we will consider opportunities to return excess capital to shareholders (through dividends and share repurchases) and optimize our capital structure to lower our cost of capital.

We assess and project our capital adequacy relative to our regulatory requirements as well as our economic risks. This includes targeting a level of additional capital above each of our capital requirements to help support ongoing compliance and to accommodate future uncertainties. We evaluate the adequacy of our targeted additional capital in light of changes in our business and risk exposures.

We develop an annual capital plan that is approved by our board of directors and updated periodically. This plan provides projections of capital adequacy, taking into consideration our business plans, forecasted earnings, economic risks and regulatory requirements.

Capital Adequacy

We estimate as of December 31, 2006 that we exceeded each of our regulatory capital requirements, including the 30 percent mandatory target capital surplus, based on our most recent submissions to OFHEO. See “NOTE 10: REGULATORY CAPITAL” to our consolidated financial statements for further information regarding our regulatory capital requirements and OFHEO’s capital monitoring framework.

Core Capital

During 2006 and 2005, we added approximately \$0.2 billion and \$1.0 billion, respectively, to Core capital primarily from Net income of \$2.2 billion and \$2.1 billion, respectively, partly offset by the payment of common and preferred stock dividends totaling \$1.6 billion and \$1.3 billion, respectively. In addition, during 2006, we repurchased \$2.0 billion of outstanding shares of common stock and issued \$1.5 billion of non-cumulative, perpetual preferred stock in connection with a plan to replace \$2.0 billion of common stock with an equal amount of preferred stock. During the first quarter of 2007, we issued \$1.1 billion of non-cumulative, perpetual preferred stock, including \$500 million to complete the planned issuance described above and \$600 million to replace higher-cost preferred stock that we redeemed in 2007. In accordance with OFHEO’s capital monitoring framework, we obtained OFHEO’s approval for both the common stock repurchases and preferred stock redemption described above. Also, during the first quarter of 2007, we received approval from OFHEO and our board of directors to repurchase up to an additional \$1 billion in common stock in conjunction with the issuance of up to \$1 billion in preferred stock.